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NEWSLETTER

SOLUTIONS FOR EXECUTIVES AND DIRECTORS



Overview of Corporate Governance and Fiduciary Responsibilities For Board of Directors and Compensation Committee Members

By Mike Melbinger, Winston & Strawn LLP

Boards of directors, the courts and judiciary, plaintiffs' class action lawyers, the IRS, the SEC, institutional investors, the press, and the U.S. Congress are all focusing on corporate governance as applied to executive compensation. The Congress and the IRS have affected some minor changes. However, the major developments — the ones that have most significantly changed the responsibility and potential liability for directors — have come from the SEC, the judiciary and the plaintiffs' lawyers.

It is important for directors and companies to understand the duties and responsibilities (and potential liabilities) that courts are imposing on board members.

Potential Liability: The Courts and the Class Action Lawyers

Historically, judges were reluctant to intrude on a board of director's business judgment in setting compensation because these decisions were so subjective. Accordingly, for decades, the courts had broadly interpreted the corporate waste standard and plaintiffs had been discouraged from bringing lawsuits that alleged excessive compensation. However, based on recent case law developments and surprisingly candid statements from the Delaware judiciary, it appears that judges now may be willing – even eager - to wade in these waters. The Walt Disney and Cendant case, among others, indicate that the plaintiffs' bar is emboldened to bring excessive compensation cases.

If a court were to find that directors permitted a CEO to receive several million dollars in excessive compensation by failing to meet minimal standards of due care or not considering all material information, the court might find that the board abrogated its duties to the company and failed to act in good faith. This could mean that each director would have to pay out of his or her own pocket — without being reimbursed by the company or the D&O insurance carrier — several million dollars each.

Delaware law requires that its corporations indemnify current or former officers and directors who are “successful on the merits or otherwise” in defense of legal actions against them for service on the board. However, Delaware law prohibits a corporation from indemnifying an officer or director if he acted in bad faith or in a manner that the director did not reasonably believe was in the best interests of the corporation.

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Overview of Corporate Governance and Fiduciary Responsibilities for Board of Directors and Compensation Committee Members

The federal securities laws do not apply to private companies but the actions of the SEC and its requirements can point out traps and help illustrate best practices. The fact that a company is private does not mean that the Delaware courts will hold the directors to a lower threshold. Recent decisions in the Delaware courts have applied to the boards of directors, individual directors and management of any Delaware corporation with shareholders. Because courts are finding that private company directors have duties similar to those of public companies, it is important for private companies to understand the duties and responsibilities (and potential liabilities) that courts are imposing on public company boards of directors.

Under the widely reported settlement with the former WorldCom directors, the individual directors agreed to pay \$18 million of their own money to settle claims that they were negligent in discharging their fiduciary duties. There was a lot more going on at WorldCom than careless compensation practices, but the undisclosed loans to the CEO were among the focal points. On the heels of the announcement of the WorldCom directors' settlement, came the announcement that Enron directors had agreed to pay \$13 million personally as part of a settlement. Directors at Cendant, Disney and other companies have faced similar claims.

Now that some courts are questioning the absolute shield of the business judgment rule, the Compensation Committee process, like other board of directors' functions, is becoming more important. If the Committee members carefully and thoroughly reviewed and understood all the elements of CEO compensation, and documented (in the minutes) the process and deliberations they undertook, a court will be very unlikely to overturn their judgment. Recent cases challenging compensation decisions have focused on situations where (i) there was no review process and understanding of the potential compensation, and/or (ii) the directors were not independent.

The Compensation Committee and the board of directors should evaluate the terms, cost and likely outcomes of the CEO's and other officers' compensation arrangements to protect themselves from potential liability, and for the good of: (i) the stockholders, (ii) the company's public image, and (iii) the CEO himself. The CEO, too, has fiduciary obligation to review his compensation. (See Disney Derivative Litigation and Integrated Health Systems (Elkins)). Additionally, by participating in the process of setting reasonable compensation, the CEO will gain a greater assurance that he will actually receive the compensation he expects.

CONTINUED ON NEXT PAGE



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... CONTINUED

Overview of Corporate Governance and Fiduciary Responsibilities for Board of Directors and Compensation Committee Members

In re The Walt Disney Company Derivative Litigation

In August 2005, the Delaware Chancery Court released its long-awaited *In re The Walt Disney Company Derivative Litigation* decision. In the Disney case, the Court absolved The Walt Disney board of directors from potential personal liability for their decision to pay Michael Ovitz \$140 million in severance after one year of undistinguished service. This decision, which is the leading case on directors' liability in Delaware, contains a few critical lessons for directors.

First, the business judgment rule still protects directors' decisions. The Disney board took a risk by approving this outsized (even by Hollywood standards) contract. The court held that corporate law does not to punish directors for taking a risk that does not pay off. Although the Disney board's practices and procedures could have been better ("should have been better" according to the court), the evidence showed that the board understood what it was doing and knowingly approved the contract.

The second important lesson, however, is that process counts. Directors should work to eliminate the liability risk created by inadequate practices and procedures; a risk they can control. Although the court found the directors not liable, the financial costs of this litigation may be approaching the limits of the directors and officers liability insurance coverage. In addition, the cost of this matter in time and bad publicity is incalculable.

Some commentators have characterized the Disney decision as a setback for those pushing for better corporate governance practices in the area of executive compensation. This is not accurate, except in the limited sense that a board (or compensation committee) that is really bent on ignoring good governance and best practices might be able to look to the Disney decision for some cover.

Instead, directors should be alert to the possibility that the Disney case, the attention surrounding it, and the best practices that have developed since the Disney board's actions in 1996, have already created higher standards for corporate governance. As we have seen in the development of case law in many other areas over the years, yesterday's "ordinary negligence" can develop into tomorrow's "bad faith." As the judge himself intimated:

Recognizing the protean nature of ideal corporate governance practices, particularly over an era that has included the Enron and WorldCom debacles, and the resulting legislative focus on corporate governance, it is perhaps worth pointing out that the actions (and the failures to act) of the Disney board that gave rise to this lawsuit took place ten years

CONTINUED ON NEXT PAGE



... CONTINUED

Overview of Corporate Governance and Fiduciary Responsibilities for Board of Directors and Compensation Committee Members

ago, and that applying 21st century notions of best practices in analyzing whether those decisions were actionable would be misplaced.

The court seemed to be saying that applying “21st century notions of best practices” to the facts of this case might have produced a different result, e.g., a decision of liability against the directors.

The Process

A critical component of corporate governance, including the adoption and implementation of executive compensation plans, programs and agreements, is simply following good procedures. The “business judgment rule” mandates that the courts will not second-guess the merits of a decision of disinterested and independent directors — who after reasonable investigation — adopt a course of action that they, in good faith, honestly and reasonably believe will benefit the corporation.

Under the business judgment rule, the courts will uphold almost any decision

- Made by an independent board of directors acting disinterestedly
- After careful and informed deliberation
- As reflected in the meeting minutes

Within the ambit of power granted to the board of directors is the authority and wide discretion to make decisions on executive compensation. There is, however, an outer limit to this discretion; a point at which a compensation package is so disproportionate to services rendered as to be unconscionable and constitute waste. A shareholder who believes that the board has crossed this line may bring a derivative action against the board of directors alleging breach of fiduciary duty and/or corporate waste.

The Business Judgment Rule

An executive compensation decision, like most business decisions, is protected from claims of breach of fiduciary duty by the business judgment rule. The business judgment rule “is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”

The business judgment rule is a director’s best protection against liability. Unless, the board or the relevant committee that awarded the compensation lacked independence (e.g., was dominated or controlled by the individual receiving the compensation), or



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Overview of Corporate Governance and Fiduciary Responsibilities for Board of Directors and Compensation Committee Members

lacked good faith (i.e., lacked an actual intention to advance corporate welfare) in making the award, the business judgment rule will protect the board's decisions on executive compensation issues.

Director Independence

The use of independent and disinterested persons to evaluate a compensation plan enhances the likelihood that a court will uphold the plan. For this reason, corporations create compensation committees composed of independent and disinterested directors and retain independent compensation consultants and counsel to advise them.

Director independence is a mechanism to ensure that a board acts in the best interests of the company and its shareholders. Courts give great deference to the business judgment of an independent board of directors. Whether a director is disinterested and independent depends on the facts and circumstances of each situation.

A director with a direct interest in a transaction would not be disinterested, and should recuse himself from consideration of that transaction. For example, if a director would receive a fee upon completion of a transaction, or the director has an ownership interest in the party "across the table" in the transaction, the director should recuse himself. An executive whose compensation and/or employment agreement the board is considering is not independent and disinterested.

Use of Experts

Delaware Corporate Law expressly enables the board of directors to rely on outside experts when making business decisions and provides them shelter from liability when they do so.

- A member of the board of directors . . . shall in the performance of such member's duties be fully protected in relying in good faith upon . . . information, opinions, reports or statements presented to the corporation by . . . any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation. 8 Del.C. § 141(e)

Courts have held that when a corporation has been advised by an expert, a derivative action challenging the transaction is ripe for summary judgment unless the complaint alleges particularized facts (not conclusions) that:

- The directors did not in fact rely on the expert;

CONTINUED ON NEXT PAGE





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... CONTINUED

Overview of Corporate Governance and Fiduciary Responsibilities for Board of Directors and Compensation Committee Members

- Their reliance was not in good faith;
- They did not reasonably believe that the expert's advice was within the expert's professional competence;
- The expert was not selected with reasonable care by or on behalf of the corporation, and the fault selection process was attributable to the directors;
- The subject matter that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice; or
- That the decision of the board was so unconscionable as to constitute waste or fraud.

IRS Executive Compensation Audit Program

The IRS has gone "live" with its Executive Compensation Audit Program. The IRS is now deadly serious about this program. All upcoming corporate income tax audits will include a review of executive compensation by employment tax specialists.

Executives and companies need to understand that this is a problem for both of them. The IRS's first step in the Audit process is to review the corporate executives' individual Form 1040 tax returns, compare them to the company's 1120 return, and determine if the compensation deductions taken by the company have been reported on the individual executives' Forms W-2 and 1099. The IRS calls this the "matching principle." This "matching" is the first step in the audit program.

In a teleconference on the Executive Compensation Audit Program organized by the ABA and the American College of Employee Benefit Counsel, IRS representatives said they would review the individual tax returns of the top five — 50 executives, depending on the size of the company. Thus, the corporate audit can quickly morph into an audit of all of the top executives. IRS does not ever have to ask the company or its executives for the forms and information to conduct this review/audit; it already has it!

The risks to the Company under the executive compensation audit program's matching principle are primarily for improper reporting or incorrect timing of deductions. For example:

- If IRS determined that the Company reported earnings to an executive on a Form 1099 instead of a Form W-2, it might cite the Company for under reporting and under-withholding employment tax income.
- Alternatively, the IRS could find that the Company incorrectly took a deduction in one

CONTINUED ON NEXT PAGE





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NEWSLETTER

SOLUTIONS FOR EXECUTIVES AND DIRECTORS



... CONTINUED

Overview of Corporate Governance and Fiduciary Responsibilities for Board of Directors and Compensation Committee Members

year for annual bonus payments to executives in the following year (or took its deduction for stock option awards, etc. too early).

- Finally, the IRS could find that the Company took deductions for certain fringe benefits and perquisites it provided to executives, but did not report the full value of the benefits and perks to the executives.

However, the greater risk under the “matching principle” might be for the executives. Many aspects of the new executive compensation audit program target the Company but may have an impact on the executives.

First, the matching principle will quickly ferret out any “non-filers” among your executives. The IRS stated that it was shocked by the number of non-filing executives it discovered in the “pilot” executive compensation audit program. We all assume that our executives are filing their tax returns, but might be a good time to warn all executives, just in case.

Second, the IRS review will find any mismatches between the income an executive reported to IRS and the income the Company thinks he or she should have reported.

Finally, the IRS has stated that, when reviewing the executives’ tax returns, its agents will be alert to any other items that raise red flags. If the reviewing agent finds such an item, it likely will trigger a full-blown audit of the executive.

Proxy Statements

Public companies should seek the assistance of experienced counsel in drafting annual proxy statements, including executive compensation disclosures updated for best practices. Critical issues in the executive compensation area include:

- Code Section 162(m),
- New FAS 123R,
- Compensation Committee reports,
- The trend toward much more fulsome disclosure of executives’ total compensation, and
- The impact of ISS and its policies on the foregoing.

So let’s be careful out there. ■

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