

TABLE OF CONTENTS

Foreword	i
Preface to the First Edition.....	vii
1. The Role of the Director.....	1
1.1 The Duties and Legal Responsibilities of the Director	1
ON A CLEAR DAY	1
1.1.1 Duty of Care.....	1
1.1.2 Duty of Loyalty	2
1.1.3 Business Judgment Rule	3
1.1.4 Duties to Debtholders	3
ON A CLOUDY OR RAINY DAY	3
1.1.5 Delaware Corporations: The Duty of Proportionality.....	5
1.1.6 Delaware Corporations: Neutral Planning.....	7
1.1.7 Delaware Corporations: Price Maximization	9
1.2 The Delegation of Powers and Oversight	9
1.3 Relations with Members of Senior Management	10
1.4 Retaining and Interacting with Advisors.....	10
1.5 Corporate Opportunities and Conflicts of Interest	11
1.5.1 Doing Business with the Company	11
1.5.2 Corporate Opportunity	12
1.5.2.1 Subsidiary Insolvency	16
1.5.2.2 Management Buyouts.....	17
1.6 Managing Corporate Conflicts of Interest	18
1.6.1 Bad News	19
1.6.2 Good News	23
1.7 Managing Corporate Disclosures: Financial Reporting, Forecasts, Guidance, Safe Harbors and Market Rumors	25
1.7.1 Duty	26
1.7.2 Materiality	27
1.7.3 Content	27

The Directors' Handbook

1.7.4	Scope	31
1.7.4.1	Guidance: The Perilous Practice.....	32
1.7.4.2	Quarterly Forecasting, Mid-Quarter Reviews and Hockey-Stick Sales.....	35
1.7.4.3	The Disclosure Protections of the Litigation Reform Act.....	39
1.7.4.3.1	Safe Harbor for Forward-Looking Statements.....	39
1.7.4.3.2	Oral Forward-Looking Statements.....	42
1.7.4.4	Investor Relations over the Internet.....	44
1.7.4.5	Confidential Sharing of Forecasts with Potential Merger Partners — A Special Disclosure Question	45
1.8	Investing in Your Public Company.....	45
1.8.1	Options and Short-Swing Profits.....	45
1.8.2	Trading Windows	46
1.8.2.1	Strict Time Periods	47
1.8.2.2	General Counsel's Office Permission Required	47
1.8.2.3	The Hybrid.....	48
1.8.2.4	Awareness and Periodic Reaffirmance	49
1.8.2.5	Foreign Enforcement.....	49
1.8.2.6	Self-Imposed Duty?.....	49
1.8.2.7	Audit Committee Role	50
1.8.2.8	10b5-1 Plans.....	50
1.8.2.9	SOX	51
2.	Corporate Governance.....	53
2.1	The Sarbanes-Oxley Act of 2002	53
2.2	SOX Overview	54
2.3	Summary and Comment on SOX, NYSE and NASDAQ Listing Requirements, and GM Board Guidelines Concerning Significant Corporate Governance Issues	55
2.3.1-2	Require a Majority of Independent Directors (NYSE/NASDAQ Heightened Independence Standards).....	55
2.3.3	Empower Non-Management Directors (NYSE/NASDAQ).....	56

Contents

2.3.4	Nominating/Corporate Governance Committee (NYSE).....	56
2.3.5	Require a Compensation Committee of Independent Directors (NYSE).....	57
2.3.6-7	Audit Committee Strengthening.....	57
2.3.8	Increase Shareholder Control over Equity Compensation Plans (NYSE).....	57
2.3.9	Corporate Governance Guideline Disclosure (NYSE).....	57
2.3.10	Codes of Business Conduct and Ethics (SOX, NYSE)	57
2.3.11	Selection of Chairman and CEO (GM).....	58
2.3.12	Board Materials Distributed in Advance (GM).....	58
2.3.13	Presentations (GM).....	58
2.3.14	Regular Attendance of Non-Directors at Board Meetings (GM)....	58
2.3.15	Board Access to Senior Management (NYSE/NASDAQ Implicitly) (GM).....	59
2.4	Board Responses to SOX.....	59
3.	Director Due Diligence	61
3.1	Financial and Operational Analysis.....	61
3.1.1	Current and Upcoming Quarterly Results	63
3.1.2	Characterizations	64
3.1.3	Comparisons	64
3.1.4	Revenue Recognition and Customer Contracts.....	63
3.1.5	Backlog	65
3.1.6	New Product Introductions	65
3.1.7	Accounting Policies and Internal Controls	65
3.1.8	Patents, etc.	67
3.1.9	The “Bring-Down”	67
3.2	The Role of the Audit Committee	68
3.2.1	Punctuated Equilibrium: Darwinian Evolution and SOX.....	68
3.2.2	Audit Committee Charter.....	68
3.2.3	Internal Audit	69
3.2.4	External Audit.....	70
3.2.4.1	The Engagement Letter	70
3.2.4.2	Timely Quarterly Reviews	71

The Directors' Handbook

3.2.4.3	The Audit.....	71
3.2.4.4	The Management Letter	72
3.2.5	NYSE-NASD-SEC Audit Committee Reforms.....	72
3.2.5.1	Revised Definition of an Independent Director.....	73
3.2.5.2	Required Empowered, Independent Audit Committee	74
3.2.5.3	Mandated Minimum Audit Committee Size and Increased Financial Literacy	74
3.2.5.4	Mandated Written Charter Detailing Responsibilities and Duties.....	75
3.2.5.5	Mandated Annual Public Disclosure of Audit Committee Activities	76
3.2.5.6	Clarified Oversight Responsibility for Outside Auditor's Engagement.....	76
3.2.5.7	Mandated Discussion with Outside Auditor Regarding Independence	76
3.2.5.8	Outside Auditor Required to Discuss Quality of Financial Reporting	77
3.2.5.9	Required Audit Committee Report.....	78
3.2.5.10	Mandated Interim Review of Quarterly Financial Reporting.....	78
3.2.5.11	Complaint Process	78
3.2.6	The SEC's Current "Hit List"	79
3.2.7	Audit Committee Best Practices and Important Auditing Standards	80
3.2.7.1	Best Practice Checklist.....	81
3.2.7.1(1)	Audit Committee Charter	81
3.2.7.1(2)	Audit Experience and Independence	81
3.2.7.1(3)	Audit Plan	82
3.2.7.1(4)	Audit Review	82
3.2.7.1(5)	Auditor's Management Letter and Follow-Up.....	83
3.2.7.1(6)	Review of Internal Audit Staff Work	83

Contents

3.2.7.1(7) Audit Committee High Risk Factor Checklist	84
3.2.7.1(8) Important Auditing Standards.....	85
3.2.8 Glossary of Terms and Applications	86
3.2.8.1 Sales and Profitability Analyses.....	86
3.2.8.2 Liquidity, Leverage and Receivables Ratios.....	89
3.2.8.3 Selected Productivity Ratios	90
3.2.8.4 Workforce Analysis	91
3.2.8.5 Inventory Analysis	91
3.2.8.6 Unique Company Relationships	92
4. Crisis Management.....	93
4.1 Responsibility of the Board.....	93
4.1.1 Documentation of Methodological Choices: Contemporaneous Record of Independent Business Judgment Applied to Accounting Paths Chosen	98
4.1.2 Pro-Active Response to Regulatory Inquiry and to Media Attention.....	99
4.1.3 Takeovers and other Significant Transactions	100
4.1.3.1 Takeover Readiness and the Project Team.....	100
4.1.3.2 Takeover Readiness Checklist	102
4.1.3.2.1 Stockholder Base Analysis	102
4.1.3.2.2 Is It Easy for an Insurgent to Call a Special Stockholders Meeting?	105
4.1.3.2.3 Removal of Directors	105
4.1.3.2.4 Special/Annual/“Control Share” Stockholder Meetings	106
4.1.3.2.5 Is Your Board A Staggered Board?	107
4.1.3.2.6 What Stockholder Votes Are Required?	107
4.1.3.2.7 Authorized/Outstanding Shares.....	107
4.1.3.2.8 Blank Check Preferred Stock	107
4.1.3.2.9 Hart Scott Rodino Threshold.....	108
4.1.3.2.10 Williams Act Threshold (13D)	108
4.1.3.2.11 Rights Plan Thresholds	108

The Directors' Handbook

4.1.3.2.12	Share Issuance Limit.....	109
4.1.3.2.13	Business Combination Threshold	110
4.1.3.2.14	Strategic and Financial Analysis	110
4.1.3.3	Takeover Dynamics	111
4.1.3.3.1	Unsolicited Offers and Board Responses	111
4.1.3.3.2	White Knights/White Squires.....	119
4.1.3.3.3	Auctions and Market Checks	121
4.1.3.3.4	Planned Mergers.....	122
4.1.3.3.5	Buying Out Minority Stockholders.....	124
4.1.3.3.6	MBO Special Committee Practice and Procedure under Delaware Law	125
4.1.4	Special Committee Directors' Requisite Care and Loyalty	126
4.1.4.1	Fair Price	126
4.1.4.2	Fair Process	127
4.1.4.3	Proxy Contests and Stockholder Proposals.....	130
4.1.4.4	Standstill Agreements	132
4.1.4.5	Other Corporate Crises	133
4.1.5	Board Oversight of Corporate Compliance Programs.....	137
5.	Compensation	139
5.1	Executive Compensation Sensitivity Check.....	139
5.1.1	Existing Compensation Arrangements.....	139
5.1.2	Shareholder Relations Issues	140
5.1.3	Decision-Making Process	141
5.1.4	Other Special Issues	142
5.2	The SEC's Proposed Substantial Changes to Executive Compensation and Related Disclosures	142
5.2.1	Executive Summary	143
5.2.2	Action Items.....	144
5.2.3	Executive Compensation Disclosure	145
5.2.3.1	Compensation Discussion and Analysis	146
5.2.3.2	Summary Compensation Table.....	148
5.2.3.2.1	Total Compensation	148
5.2.3.2.2	Salary and Bonus.....	149

Contents

5.2.3.2.3	Stock Awards and Option Awards	149
5.2.3.2.4	Non-Stock Incentive Plan Compensation ...	150
5.2.3.2.5	All Other Compensation	150
5.2.3.2.6	Perquisites	151
5.2.3.3	Transition Rule	152
5.2.3.4	Supplemental Annual Compensation Tables	152
5.2.3.5	Narrative Disclosure	152
5.2.3.6	Exercises and Holdings of Previously Awarded Equity	153
5.2.3.7	Post-Employment Compensation	153
5.2.3.8	Named Executive Officers	155
5.2.3.9	Narrative Disclosure Regarding Additional Employees	155
5.2.4	Director Compensation	156
5.2.5	Certain Relationships and Related Transactions Disclosure	157
5.2.6	Director Independence and Other Corporate Governance Disclosure	158
5.2.7	Management and Director Pledges of Stock	159
5.3	Employee Benefit Arrangements and Takeover Dynamics	159
5.3.1	Overview	159
5.3.2	Severance Agreements and Golden Parachutes	161
5.3.3	Other Severance Agreements: Tin Parachutes	161
5.3.4	Pension Parachutes	162
5.3.5	Employee Stock Ownership Plans	162
5.4	The Role of Parent Corporation Directors in Monitoring Compensation Determinations by Important Healthy Subsidiaries	164
6.	Litigation	167
6.1	Shareholder Class and Derivative Litigation	167
	Sugarcoating Bad News	168
6.2	Worldcom And Enron Settlement Implications for Directors	169
6.2.1	Likely Impact of Proposed Settlements	170
6.2.2	Countering the Potential Impact	172
6.2.3	Review of Personal Liability Protections	174

The Directors' Handbook

6.3	Privileges, Record Keeping, Document Retention.....	175
6.4	Internal Investigations	176
6.5	Joint Venture and Strategic Alliance Disputes	178
6.6	Executive Moves	179
7.	Director and Officer Insurance and Indemnification	181
8.	The Political Economy of Corporations: Varying Approaches to Corporate Governance around the World	185
8.1	Corporate Governance Abroad	185
8.1.1	The U.K.: “Comply or Explain”	187
8.1.2	The European Community and the OECD	188
8.1.3	East Asia	190
8.1.4	Mexico	191
8.2	Transparency International	191
8.3	From Governance to Political Economy	191
9.	Board Minutes and Directors’ Notes.....	199
9.1	Board Minutes.....	199
9.1.1	Purpose	199
9.1.2	Issues	199
9.1.3	Guidelines	200
9.2	Directors’ Notes	202
10.	Recent Developments: Mickey Mouse and the Cats around the Fishbowl.....	203
10.1	Some Added Judicial Clarity in Delaware	203
10.2	The Disney Decision: The Delaware Court Vindicates Disney’s Board in Connection with the High-Profile Hiring and Firing of Michael Ovitz	204
10.3	The Statutory Business Judgment Rule.....	208
10.3.1	Why this Matters to You	208

Contents

APPENDIX A	211
Sample Audit Committee Charter	211
Annotated Audit Committee Charter Elements	215
APPENDIX B	227
Disclosure in a Time of Uncertainty; Regulation FD Realities Today	227
Introduction	227
Spooked Executives and Confused Counsel	227
Forecasts	231
Good for the Day? Or Good until Cancelled?	231
Different Forward Looks.....	235
Curtailing Any Duty to Update: Best Practices and Not-So-Hot Practices	235
Bespeaking Caution and the PSLRA Safe Harbor Caveats	236
Examples: Point-in-Time vs. Good-until-Cancelled Forecasts	239
SAB 99 “Market Moving” Dilemmas	239
SUBJECT INDEX	243
CASE INDEX	263
STATUTES INDEX.....	265
TABLE OF RULES AND STANDARDS	267

THE DIRECTORS’ HANDBOOK COMPANION CD-ROM

The Directors’ Handbook, 2006 Edition

Case Law

In re The Walt Disney Company Derivative Litigation, Consol. C.A.
No. 15452, 2005 Del. Ch. LEXIS 113 (Del. Ch. Aug. 9, 2005).
Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173,
1986 Del. LEXIS 1053 (Del. 1986)
Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 1985 Del. LEXIS
482 (Del. 1985)
Unitrin, Inc. v. American Gen. Corp. (In re Unitrin, Inc.), 651 A.2d
1361, 1995 Del. LEXIS 13 (Del. 1995)
Weinberger v. UOP, Inc., 457 A.2d 701, 1983 Del. LEXIS 371 (Del.
1983)

The Directors' Handbook

Smith v. Van Gorkom, 488 A.2d 858, 1985 Del. LEXIS 421, Fed. Sec.
L. Rep. (CCH) P91921, 46 A.L.R.4th 821 (Del. 1985)
Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651, 1988 Del. Ch.
LEXIS 103 (Del. Ch. 1988)

Other Reference Materials

Sarbanes Oxley Act of 2002
The Combined Code from the UK
The NYSE Requirements for Corporate Governance
Sources for Corporate Governance Abroad
International Corporate Governance Codes
Sources for Board Minutes and Directors' Notes