Corporate Governance

In 32 jurisdictions worldwide

Contributing editor
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SIDLEY AUSTIN LLP
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GETTING THE DEAL THROUGH

GETTING THE DEAL THROUGH

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United States

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Sources of corporate governance rules and practices

1 Primary sources of law, regulation and practice

What are the primary sources of law, regulation and practice relating to corporate governance?

In the United States there are two primary sources of law and regulation relating to corporate governance:

State corporate laws
State corporate law – both statutory and judicial – governs the formation of privately held and publicly traded corporations and the fiduciary duties of directors. Delaware is the most common state of incorporation. Since Delaware law and interpretation are influential in other states, the Delaware General Corporation Law (DGCL) is used in this article as the reference point for all state law discussion. Shareholder suits are the primary enforcement mechanism of state corporate law.

Federal securities laws
On the federal level, the primary sources are the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), each as amended. The Securities Act regulates all offerings and sales of securities, whether by public or private companies. The Exchange Act addresses many issues, including the organisation of the financial marketplace generally, the activities of brokers, dealers and other financial market participants and, as to corporate governance, specific requirements relating to the periodic disclosure of information by publicly held, or 'reporting', companies. A company becomes a reporting company under the Exchange Act when its securities are listed on a national securities exchange or when it has total assets exceeding US$10 million and a class of securities held of record by more than 2,000 persons or a maximum of 500 persons who are not sophisticated ('accredited') (with some exclusions). Both the Securities Act and the Exchange Act have addressed questions of corporate governance primarily by mandating disclosure, rather than through normative regulation.

The Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act) was enacted in July 2002 in response to the corporate failures of 2001 and 2002. The Sarbanes-Oxley Act, which applies to all reporting companies (whether organised in the US or elsewhere) with US-registered equity or debt securities, amends various provisions of the Exchange Act (and certain other federal statutes) to provide direct federal regulation of many matters that traditionally had been left to state corporate law or addressed by federal law through disclosure requirements. Under the Sarbanes-Oxley Act, many aspects of corporate governance that were previously addressed, if at all, through stock market listing requirements, best practice standards, or policy statements from the Securities and Exchange Commission (SEC) are now the subject of direct binding law. Since 2002, the SEC has promulgated a number of rules that implement provisions of the Sarbanes-Oxley Act.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) was enacted in July 2010 in response to the financial crisis in 2008 and 2009. The Dodd-Frank Act is intended to significantly restructure the regulatory framework for the US financial system and also extends federal regulation of corporate governance for all public companies. The SEC has promulgated several rules that implement provisions of the Dodd-Frank Act. Ongoing rulemaking by the SEC and national securities exchanges is required for full implementation.

The Jumpstart Our Business Startups Act of 2012 (JOBS Act) was enacted in April 2012 to, inter alia, facilitate private capital formation and ease reporting requirements that may apply to 'emerging growth companies' after the initial public offering. The JOBS Act requires the SEC to undertake various initiatives, including rulemaking and studies touching on capital formation, disclosure and registration requirements.

Listing rules provide an additional source of corporate governance requirements. To list a security on any of the three major listing bodies – the New York Stock Exchange (NYSE), NYSE MKT (formerly known as the American Stock Exchange) or the Nasdaq Stock Market (Nasdaq) – a company must agree to abide by specific corporate governance listing rules. In 2003, the SEC approved significant amendments to both the NYSE and Nasdaq corporate governance listing rules as described below. The Dodd-Frank Act requires amendments to corporate governance listing rules to be made by the NYSE and Nasdaq.

In addition, a number of corporate governance guidelines and codes of best practice recommend how public company boards should organise their structures and processes. The American Law Institute (ALI) Principles of Corporate Governance: Analysis and Recommendations present a thorough discussion of governance practices from a legal perspective. Other influential recommendations from the business community include:

- National Association of Corporate Directors (NACD), Key Agreed Principles (developed in collaboration with Business Roundtable and the Council of Institutional Investors);
- NACD, Report of the NACD Blue Ribbon Commission on Director Professionalism;
- Business Roundtable, Principles of Corporate Governance; and
- the Conference Board, Commission on Public Trust and Private Enterprise: Findings and Recommendations.

The investor community has also issued a number of corporate governance guidelines and codes of best practices that are increasingly influential among practitioners. These codes include:

- Council of Institutional Investors (CII), Corporate Governance Policies;
- Teachers Insurance and Annuity Association – College Retirement Equities Fund (TIAA-CREF), TIAA-CREF Policy Statement on Corporate Governance; and
- California Public Employees' Retirement System (CalPERS), Global Principles of Accountable Corporate Governance.

In addition, proxy advisory firms such as Institutional Shareholder Services and Glass Lewis have developed proxy voting guidelines that set forth the likely voting recommendations that such firms will make on particular issues to be voted on by shareholders. These guidelines are based on what such firms consider to be 'best practices' and have also become influential.

2 Responsible entities

What are the primary government agencies or other entities responsible for making such rules and enforcing them? Are there any well-known shareholder activist groups or proxy advisory firms whose views are often considered?

The primary means of enforcing state corporate law is through derivative suits initiated by shareholders. At the federal level, the SEC has the power to regulate, implement and enforce the Securities Act and the Exchange

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Act (including the Sarbanes-Oxley Act, the JOBS Act and relevant provisions of the Dodd-Frank Act). In addition, the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB) to regulate the services accounting firms provide to companies. The SEC oversees the PCAOB, appoints its members and must approve any rules adopted by the PCAOB.

The Council of Institutional Investors is an influential association of public and private pension funds that often pushes for governance reforms. Pension funds have been the most activist of the institutional investors, working both in concert and individually. Influential pension funds include TIAA-CREF and CalPERS – respectively, among the largest private and public pension funds in the world. In addition, Vanguard Group and BlackRock Inc, two of the United States' largest institutional investors, have recently become more assertive in pushing for corporate governance reforms and increased director-shareholder engagement at the companies in which they invest.

The views of proxy advisory firms Institutional Shareholder Services and Glass Lewis are also influential.

The rights and equitable treatment of shareholders

3 Shareholder powers

What powers do shareholders have to appoint or remove directors or require the board to pursue a particular course of action? What shareholder vote is required to elect directors?

Under state corporate law, shareholders generally have the right to elect directors (see DGCL, section 216).

For many years, it has been common practice for directors to be elected by a plurality of shareholders that can either vote in favour of, or withhold their votes from, the director candidates nominated by the board; 'withheld' votes are not counted. Accordingly, absent a contested election, the candidates nominated by the board are automatically elected whether or not a majority of shareholders vote for them. Relatively recently, shareholders have pressed companies for the ability to veto the election of a particular director nominee or nominees in the context of an uncontested election. This can be achieved through the adoption of charter or by-law provisions requiring that director nominees receive the approval of a 'majority of the votes cast' to be elected, or, in lieu of a charter or by-law provision, the adoption of corporate policies that effectively require a director who has not received a majority of the votes cast to resign. In 2006, the Delaware legislature adopted amendments to the DGCL that facilitate both of these options. Specifically, the amended DGCL, section 141(b) expressly permits a director to irrevocably tender a resignation that becomes effective if he or she fails to receive a majority vote in an election. The amended DGCL, section 216 provides that a by-law amendment adopted by shareholders specifying the vote required to elect directors may not be repealed or amended by the board alone (generally by-law provisions may be amended by the board).

The proportion of companies in the Standard & Poor's (S&P) 500 that have adopted some form of majority voting in uncontested director elections has increased dramatically from 16 per cent in 2006 to over 90 per cent in 2014.

Shareholders can also nominate their own director candidates either before or at the annual general meeting (AGM). To solicit the proxies needed to elect their candidates, however, a shareholder must mail to all other shareholders, at his or her own expense, an independent proxy solicitation statement that complies with the requirements of section 14 of the Exchange Act. Given these constraints, independent proxy solicitations are rare and usually undertaken only in connection with an attempt to seize corporate control (see also question 37).

In addition, shareholders generally have the right to remove directors with or without cause or, where the board is classified, only for cause (unless the certificate of incorporation provides otherwise) (see DGCL, section 141(k)). However, as many publicly held companies do not permit shareholders to call special meetings or act by written consent, this power can be difficult to exercise in practice.

Shareholders' liability for corporate actions is generally limited to the amount of their equity investment. In keeping with their limited liability, shareholders play a limited role in the control and management of the corporation. As discussed in question 4, a number of corporate decisions require shareholder approval. In addition, shareholders can typically enjoin ultra vires acts (see DGCL, section 124), and vote on certain issues of fundamental importance at the AGM, including the election of directors (see DGCL, section 216 and question 4).

4 Shareholder decisions

What decisions must be reserved to the shareholders? What matters are required to be subject to a non-binding shareholder vote?

Under state corporate law, shareholders typically have a right to participate in the following types of decisions:

- election of directors, held at least annually;
- approval or disapproval of major changes in the size of the corporation's board of directors that require amendment of the certificate of incorporation;
- approval or disapproval of amendments to the corporation's certificate of incorporation or by-laws, although the board is also typically authorised (in the certificate of incorporation) to amend the by-laws without shareholder approval (see DGCL, sections 109, 241 and 242);
- approval or disapproval of fundamental changes to the corporation not made in the regular course of business, including mergers, dissolution, compulsory share exchanges, or disposition of substantially all of the corporation's assets (see, for instance, DGCL, sections 251(c), 271 and 275); and
- authorisation of additional shares for future issuance by the corporation. Upon shareholder authorisation, the board has discretion to determine when and how many shares to issue at any time.

Commencing in 2011, the Dodd-Frank Act requires US public companies to conduct a separate shareholder advisory vote on:

- executive compensation – to be held at least once every three calendar years;
- whether the advisory vote on executive compensation should be held every year, every two years or every three years – to be held at least once every six calendar years; and
- certain 'golden parachute' compensation arrangements in connection with a merger or acquisition transaction that is being presented to shareholders for approval.

The rules of the NYSE and Nasdaq also require that shareholder approval be obtained prior to:

- any adoption of a stock option or purchase plan pursuant to which officers or directors may acquire stock, subject to limited exceptions;
- issuance of common stock to directors, officers, substantial security holders or their affiliates if the number of shares of common stock to be issued exceeds either 1 per cent of the number of shares of common stock or 1 per cent of the voting power outstanding before the issuance, with limited exceptions (NYSE), or could result in an increase in outstanding common shares or voting power of 5 per cent or more (Nasdaq);
- issuance of common stock that will have voting power equal to or greater than 20 per cent of the voting power prior to such issuance or that will result in the issuance of a number of shares of common stock that is equal to or greater than 20 per cent of the number of shares of common stock outstanding prior to such issuance, subject to certain exceptions; and
- issuance of securities that will result in a change of control of the company.

5 Disproportionate voting rights

To what extent are disproportionate voting rights or limits on the exercise of voting rights allowed?

Under state law, a corporation may issue classes of stock with different voting rights, limited voting rights and even no voting rights, if the rights are described in the corporation's certificate of incorporation (see DGCL, section 151). If, however, a corporation issues a class of non-voting common stock, it must have an outstanding class of common shares with full voting rights.

The NYSE and Nasdaq listing rules also permit classes of stock with different voting rights; however, the listing rules prohibit listed companies from disparately reducing or restricting the voting rights of existing shareholders unilaterally.

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6 Shareholders' meetings and voting

Are there any special requirements for shareholders to participate in general meetings of shareholders or to vote? Can shareholders act by written consent without a meeting?

Generally, all shareholders, at the record date set by the board, may participate in the corporation's AGM, and are entitled to vote (unless they hold non-voting shares) in person or by proxy (see DGCL, sections 212(b) and (c), and 213). The proxy appointment may be in writing (although there is no particular form) or provided by telephone or electronically.

In addition, section 14 of the Exchange Act and related SEC regulations set forth substantive and procedural rules with respect to the solicitation of shareholder proxies for the approval of corporate actions at AGMs and special shareholders' meetings. Foreign private issuers are exempt from the provisions of section 14 and related regulations insofar as they relate to shareholder proxy solicitations.

Shareholders may act by written consent without a meeting unless the certificate of incorporation provides otherwise. The majority of companies in the S&P 500 do not permit shareholder action by written consent.

7 Shareholders and the board

Are shareholders able to require meetings of shareholders to be convened, resolutions to be put to shareholders against the wishes of the board or the board to circulate statements by dissident shareholders?

Generally, state law provides that every shareholder has the right to petition the court to compel an AGM if the board has failed to hold the AGM within a specified period of time (see DGCL, section 211). Special shareholders' meetings may be called by anyone authorised to do so in the company's certificate of incorporation or by-laws. The majority of S&P 500 companies permit shareholders to call special meetings.

Any shareholder of a reporting company who is eligible to bring matters before a shareholders' meeting under state law and the company's certificate of incorporation and by-laws may, at the shareholder's own expense, solicit shareholder proxies in favour of any proposal. Such shareholder proxy solicitations must comply with section 14 of the Exchange Act and related SEC regulations, but need not be approved by the board.

Under circumstances detailed in rule 14a-8 under the Exchange Act, a reporting company must include a shareholder's proposal in the company's proxy materials and identify the proposal in its proxy form. The shareholder may also submit a 500-word supporting statement for inclusion in the company's proxy solicitation materials. This allows the proponent to avoid the costs associated with an independent solicitation. To qualify, a shareholder must have continuously held at least US$2,000 in market value or 1 per cent of the company's securities entitled to vote for at least one year by the date the shareholder submits the proposal. The shareholder must continue to hold those securities until the date of the meeting. Under specific circumstances, a company is permitted to exclude a shareholder proposal from its proxy solicitation, but only after demonstrating to the SEC that it is entitled to the exclusion (for example, if the proposal deals with a matter relating to the company's ordinary business operations).

Effective since September 2011, companies can no longer exclude from their proxy materials shareholder proposals (precatory or binding) relating to by-law amendments establishing procedures for shareholder nomination of director candidates and inclusion in the company's proxy materials, as long as the proposal is otherwise not excludable under rule 14a-8. This amendment to rule 14a-8 facilitates the development of 'proxy access' via private ordering at companies chartered in states where permissible, as shareholders are able to institute a shareholder nomination regime via binding by-law amendment or request, via precatory shareholder proposal, that such a by-law be adopted by the board.

The private ordering process has gained considerable momentum during the 2015 proxy season. More than 100 shareholder proposals requesting proxy access were submitted, 75 of which stemmed from a campaign by the New York City Comptroller. The most common formulation would give shareholders who hold 3 per cent of the company's common stock for at least three years the right to nominate up to 25 per cent of the company's directors using the company's proxy materials. Dozens of companies have adopted proxy access by-laws, most often in response to a shareholder proposal, or have negotiated withdrawal of shareholder proposals in exchange for agreeing to adopt proxy access or include a management proposal on proxy access on the ballot for the AGM. As a result of this private ordering, proxy access is likely to become the norm at large public companies in the US in the next few years.

As noted in question 6, shareholders may act by written consent without a meeting unless the certificate of incorporation provides otherwise. The majority of companies in the S&P 500 do not permit shareholder action by written consent.

8 Controlling shareholders' duties

Do controlling shareholders owe duties to the company or to non-controlling shareholders? If so, can an enforcement action against controlling shareholders for breach of these duties be brought?

Controlling shareholders owe a fiduciary duty of fair dealing to the corporation and minority shareholders when the controlling shareholder enters into a transaction with the corporation. When a controlling shareholder transfers control of the corporation to a third party, this obligation may be extended to creditors and holders of senior securities as well. A controlling shareholder who is found to have violated a duty to minority shareholders upon the sale of control may be liable for the entire amount of damages suffered, instead of only the purchase price paid or for the amount of the control premium. Minority shareholders can bring claims against a controlling shareholder for breach of fiduciary duty on either a derivative or direct basis, depending on the nature of the harm suffered.

9 Shareholder responsibility

Can shareholders ever be held responsible for the acts or omissions of the company?

Shareholders' liability for corporate actions is generally limited to the amount of their equity investment. In unusual circumstances, exceptions may apply.

Corporate control

10 Anti-takeover devices

Are anti-takeover devices permitted?

In general, anti-takeover devices are permitted. However, there are limits on what types of devices are allowed.

The shareholder rights plan or 'poison pill' is a device adopted by boards to grant existing shareholders the right to purchase large amounts of additional stock for a nominal price if and when an outsider acquires a certain amount of shares (for example, 15 per cent of the outstanding capital). This greatly dilutes the potential acquirer's holdings. Poison pills can usually be 'redeemed' or 'disarmed' by the board of directors before they are 'triggered'. Thus, a poison pill forces a potential acquirer to either negotiate with the existing board or incur the time and expense of initiating a proxy fight to replace the existing directors with directors friendly to the acquirer (who can then redeem the poison pill).

Variations on the traditional poison pill have been designed to make it even more difficult for potential hostile acquirers by restricting the ability of newly placed directors to redeem the poison pill. For example, a 'dead-hand' provision in a poison pill provides that only the specific directors who originally approved the adoption of the poison pill may redeem it. A 'no-hand' poison pill cannot be redeemed at all, and a 'chewable' poison pill gives the incumbent directors a specific period to negotiate before the pill becomes effective. Some states allow the use of dead-hand, no-hand and chewable poison pills (although Delaware does not permit the use of dead-hand or no-hand poison pills). Note that shareholder activists and proxy advisory firms tend to disfavour poison pills that have not been approved by shareholders.

State corporate law does not prescribe the disclosure of poison pills. However, the SEC requires reporting companies to disclose any by-law and charter provisions (such as a poison pill) that would delay, defer or prevent a change in control in the course of an extraordinary corporate transaction, such as a merger, sale transfer or reorganisation.

A variety of other anti-takeover devices and practices are also available. Courts have upheld the use of the following anti-takeover devices:

- acquisition of another business to increase the chances that the threatened takeover will raise antitrust considerations;

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- adoption of voting and other procedures (such as board classification, for example, into three classes of directors, pursuant to which one-third of the board is elected every year) that make it difficult for an acquirer of a majority of voting shares to replace the board of directors;
- imposition of restrictions on business combinations with significant shareholders without board approval (freeze-out – default position in Delaware, DGCL, section 203);
- institution of a suit to enjoin the offer for violations of antitrust laws, rules regulating tender offers or other legal grounds;
- issuance, or proposed issuance, of additional shares to persons who oppose the takeover (a lock-up);
- amendment of basic corporate documents to make a takeover more difficult;
- buyout of the aggressor;
- inclusion of supermajority voting requirements in the corporate charter;
- issuance of dual classes of common stock;
- greenmail (but subject to 50 per cent federal excise tax);
- provision of extremely large severance payments to key executives whose employment is terminated following a change in control (golden parachutes);
- undertaking of defensive acquisitions;
- purchase of the corporation's own shares to increase the market price of the stock; and
- imposition of restrictions in connection with the creation of debt that frustrate an attempted takeover.

Under NYSE and Nasdaq listing rules, listed companies are prohibited from using defensive tactics that discriminate among shareholders.

11 Issuance of new shares

May the board be permitted to issue new shares without shareholder approval? Do shareholders have pre-emptive rights to acquire newly issued shares?

Under Delaware law, the board is permitted to issue new shares without shareholder approval up to the amount of authorised capital as set forth in the company's certificate of incorporation. Authorisation of additional shares for issuance will require shareholder approval. In addition, the rules of the NYSE and Nasdaq require shareholder approval be obtained prior to:

- any adoption of a stock option or purchase plan pursuant to which officers or directors may acquire stock, subject to limited exceptions;
- issuance of common stock to directors, officers, substantial security holders or their affiliates if the number of shares of common stock to be issued exceeds either 1 per cent of the number of shares of common stock or 1 per cent of the voting power outstanding before the issuance, with limited exceptions (NYSE), or could result in an increase in outstanding common shares or voting power of 5 per cent or more (Nasdaq);
- issuance of common stock that will have voting power equal to or greater than 20 per cent of the voting power prior to such issuance or that will result in the issuance of a number of shares of common stock that is equal to or greater than 20 per cent of the number of shares of common stock outstanding prior to such issuance, subject to certain exceptions; and
- issuance of securities that will result in a change of control of the company.

Under Delaware law, shareholders do not have any pre-emptive rights to acquire newly issued shares unless pre-emptive rights are expressly granted to shareholders in the certificate of incorporation (DGCL, section 102(b)(3)) or are granted to shareholders on a contractual basis.

12 Restrictions on the transfer of fully paid shares

Are restrictions on the transfer of fully paid shares permitted, and if so what restrictions are commonly adopted?

Under Delaware law, DGCL, section 202, restrictions on the transfer and ownership of fully paid securities are permitted. A corporation may impose these restrictions in its certificate of incorporation or by-laws, or through an agreement among shareholders. However, any restrictions imposed after the issuance of securities are not binding on those securities, unless the shareholders of the securities are parties to an agreement or voted in favour of the restriction. All permitted restrictions must be noted conspicuously on the certificate representing the restricted security, or, in the case of uncertificated shares, contained in the notice sent to the registered owner. Regardless of any such restrictions, all sales or transfers of securities by public (or private) corporations must be made pursuant to (or subject to an exemption under) the Securities Act.

13 Compulsory repurchase rules

Are compulsory share repurchases allowed? Can they be made mandatory in certain circumstances?

Under DGCL, section 253, a corporation owning at least 90 per cent of the outstanding shares of each class of the stock of a corporation may merge that other corporation into itself without requiring shareholder approval (known as a 'freeze-out' or 'short-form' merger). Minority shareholders who object to the merger are entitled to appraisal rights (see question 14, below).

In addition, corporations may issue shares of stock subject to redemption by the corporation at its option or at the option of the holders of the stock upon the occurrence of certain events.

If a corporation chooses to issue shares subject to redemption, then it must state the time, place and rate at which the stock will be redeemed in the certificate of incorporation or in a board resolution on the issue.

There are two restrictions on a corporation's ability to redeem its own shares. First, state laws, such as DGCL, section 151, require that immediately following the redemption the corporation must have at least one class or series of stock with full voting powers that is not subject to redemption. The second restriction only applies to listed corporations. Under listing rules, such companies must promptly notify, and provide specified information to, the NYSE or Nasdaq, as applicable, before they take any action that would result in the full or partial redemption of a listed security.

14 Dissenters' rights

Do shareholders have appraisal rights?

Under DGCL, section 262, shareholders who do not vote in favour of a merger or consolidation are entitled to an appraisal by the Delaware Court of Chancery of the fair value of their shares unless:

- the shares were listed on a national securities exchange (for example, the NYSE or Nasdaq);
- the shares were held of record by more than 2,000 holders; or
- the merger or consolidation did not require a shareholder vote.

Notwithstanding the applicability of the above points, appraisal rights will be available if shareholders are required to accept anything other than:

(i) shares of the surviving or resulting company;
(ii) shares listed on a national securities exchange;
(iii) cash in lieu of fractional shares; or
(iv) any combination of (i) to (iii).

For example, a shareholder will retain his or her appraisal rights if he or she is required to accept cash, debt or shares of a private company in exchange for his or her shares in the company to be merged or consolidated.

The responsibilities of the board (supervisory)

15 Board structure

Is the predominant board structure for listed companies best categorised as one-tier or two-tier?

The predominant board structure for listed companies in the US is one-tier. DGCL, section 141 states that 'the business and affairs of every corporation organised under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.' The board of directors delegates managerial responsibility for day-to-day operations to the CEO and other senior executives. Members of senior management may serve on the board, but they are not organised as a separate management board.

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16 Board's legal responsibilities

What are the board's primary legal responsibilities?

The primary legal responsibility of the board is to direct the business and affairs of the corporation (see DGCL, section 141). While the functions of a board are not specified by statute, it is generally understood, as noted in the ALI's Principles of Corporate Governance and other codes of best practice, that board functions typically include:

- selecting, evaluating, fixing the compensation of and, where appropriate, replacing the CEO and other members of senior management;
- developing, approving and implementing succession plans for the CEO and senior executives;
- overseeing management to ensure that the corporation's business is being run properly;
- reviewing and, where appropriate, approving the corporation's financial objectives and major corporate plans, strategies and actions;
- understanding the corporation's risk profile and reviewing and overseeing the corporation's management of risks;
- reviewing and approving major changes in the auditing and accounting principles and practices to be used in preparing the corporation's financial statements;
- establishing and monitoring effective systems for receiving and reporting information about the corporation's compliance with its legal and ethical obligations, and articulating expectations and standards related to corporate culture and the 'tone at the top';
- understanding the corporation's financial statements and monitoring the adequacy of its financial and other internal controls, as well as its disclosure controls and procedures;
- evaluating and approving major transactions such as mergers, acquisitions, significant expenditures and the disposition of major assets;
- providing advice and counsel to senior management;
- reviewing the process for providing adequate and timely financial and operational information to management, directors and shareholders;
- establishing the composition of the board and its committees and determining governance practices;
- retaining independent advisers in performance of committee duties and decision-making;
- assessing the effectiveness of the board and its committees; and
- performing such other functions as are necessary.

17 Board obligees

Whom does the board represent and to whom does it owe legal duties?

Directors are elected by shareholders. They are fiduciaries of the corporation and its shareholders. Directors represent the shareholding body as a whole, and not any particular set of shareholding constituents. If a corporation becomes insolvent, directors continue to owe their fiduciary duties to the corporation, not directly to creditors; however, creditors will have standing to assert derivative claims. See *North American Catholic Educational Programming Foundation Inc v Gheewalla* (Del 2007).

18 Enforcement action against directors

Can an enforcement action against directors be brought by, or on behalf, of those to whom duties are owed?

Shareholders can bring suit against the directors on their own behalf or on behalf of the corporation (a derivative suit), depending on the nature of the allegation. To institute a derivative suit, a shareholder must first make a demand to the board of directors that the corporation initiate the proposed legal action on its own behalf. However, if the shareholder can show that bringing such a demand would be futile, it is not required.

Directors will not be held liable for their decisions, even if such decisions harm the corporation or its shareholders, if the decisions fall within the judicially created safe harbour known as the 'business judgment rule'. The rule states a judicial presumption that disinterested and independent directors make business decisions on an informed basis and with the good faith belief that the decisions will serve the best interests of the corporation. If a board's decision is challenged in a lawsuit, the court will examine whether the plaintiff has presented evidence to overcome this presumption. If the presumption is not overcome, the court will not investigate the merits of the underlying business decision.

This helps courts avoid second-guessing board decisions, and protects directors from liability when they act on an informed and diligent basis and are not otherwise tainted by a personal interest in the outcome. This is true even if the decision turns out badly from the standpoint of the corporation and its shareholders.

19 Care and prudence

Do the board's duties include a care or prudence element?

Directors owe duties encompassing both a duty of care and a duty of loyalty to the corporation and to the corporation's shareholders.

Although grounded in common law, the duty of care has been codified in more than 40 states. Most state statutes require that directors discharge their responsibilities in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner the director reasonably believes to be in the corporation's best interests. Conduct that violates the duty of care may also – in certain circumstances – violate the good faith obligation which is a component of the duty of loyalty. For example, a failure to ensure that reliable information and reporting systems are in place to detect misconduct could give rise to a claim for breach of the duty of care and the obligation of good faith. See *In Re Caremark International Inc Derivative Litigation* (Del Ch 1996) and *Stone v Ritter* (Del 2006).

The duty of loyalty prohibits self-dealing and misappropriation of assets or opportunities by board members. Directors are not allowed to use their position to make a personal profit or achieve personal gain or other advantage. The duty of loyalty includes a duty of candour that requires a director to disclose to the corporation any conflicts of interest. Transactions that violate the duty of loyalty can be set aside and directors can be found liable for breach. Thus, whenever a board is considering a transaction in which a director has a personal interest, the material facts about the director's relationship or interest in the transaction should be disclosed to the board and a majority of the disinterested directors should authorise the transaction. Alternatively, the material facts should be disclosed to shareholders, for a vote to approve the transaction.

In 2003, the Delaware Court of Chancery rendered an important opinion concerning the 'duty of good faith' of corporate directors (*In Re The Walt Disney Co* (Del Ch 2003)). In this opinion, the court held that directors who take an 'ostrich-like approach' to corporate governance and 'consciously and intentionally disregard their responsibilities', adopting a 'we don't care about the risks' attitude may be held liable for breaching their duty to act in good faith. The opinion was rendered on a motion to dismiss for failure to state a claim. The opinion is notable for its sharp focus on the importance of good faith, in addition to due care and loyalty, when considering director conduct. By characterising the alleged lack of attention by directors as a breach of the duty of good faith rather than a breach of the duty of care, the court effectively stripped the directors of the protection afforded by the Delaware Director Protection Statute (which is described in greater detail in question 32).

In 2005, the Delaware Court of Chancery rendered another opinion in connection with the same Disney litigation that further defines the contours of the duty of good faith (*In Re The Walt Disney Co* (Del Ch 2005)). In this opinion, the court focused on the element of intent in identifying whether a breach of the duty of good faith has occurred. Generally, the court determined, the duty of good faith is not satisfied where a director 'intentionally acts with a purpose other than [...] the best interests of the corporation'; where a director 'intend[s] to violate applicable [...] law'; or where a director 'intentionally fails to act in the face of a known duty to act'. With respect to the specific case at hand, however, the court ruled that the Disney directors did not, in fact, breach their duty of good faith because they did make some business judgements and, therefore, their conduct did not meet the intent elements enumerated by the court as necessary to constitute a breach of the duty of good faith.

In 2006, the Delaware Supreme Court upheld the Delaware Court of Chancery's ruling that the Disney directors were not liable.

The Supreme Court also provided guidance with respect to the contours of the duty of good faith, describing the following two categories of fiduciary behaviour as conduct in breach of the duty of good faith: conduct motivated by subjective bad faith (that is, actual intent to do harm); and conduct involving 'intentional dereliction of duty, a conscious disregard for one's responsibilities'. The Supreme Court further held that gross negligence on the part of directors 'clearly' does not constitute a breach of the duty of good faith.

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In late 2006, the Delaware Supreme Court held in *Stone v Ritter* (Del 2006) that 'good faith' is not a separate fiduciary duty. The Supreme Court stated that 'the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty' and the fiduciary duty of loyalty 'encompasses cases where the fiduciary fails to act in good faith'.

20 Board member duties

To what extent do the duties of individual members of the board differ?

Generally, all board members owe the same fiduciary duties regardless of their individual skills. However, case law suggests that when applying the standard of due care (namely, that a director acted with such care as an ordinarily prudent person in a like position would exercise under similar circumstances) subjective considerations, including a director's background, skills and duties, may be taken into account. For example, 'inside' directors – usually officers or senior executives – are often held to a higher standard because they more actively participate in and have greater knowledge of the corporation's activities.

Additionally, in 2004, the Delaware Court of Chancery rendered an important opinion concerning the fiduciary duties of directors with special expertise (*Emerging Communications Shareholders' Litigation* (Del Ch 2004)). In *Emerging Communications*, the court held a director in breach of his duty of good faith for approving a transaction 'even though he knew, or at the very least had strong reason to believe' that the per share consideration was unfair. The court, in part, premised the culpability of the director (described in the opinion as a 'principal and general partner of an investment advisory firm') on his 'specialised financial expertise, and [...] ability to understand [the company's] intrinsic value, that was unique to [the company's] board members'. As the court also found that the director in question was not 'independent' of management, the *Emerging Communications* decision should not necessarily be interpreted as a pronouncement holding directors with 'specialised expertise' to a higher standard of care in general.

21 Delegation of board responsibilities

To what extent can the board delegate responsibilities to management, a board committee or board members, or other persons?

State corporate law generally provides that the business and affairs of the corporation shall be managed by or under the direction of the board of directors. The board has wide-ranging authority to delegate day-to-day management and other aspects of its responsibilities both to non-board members and to board committees and even individual directors. Typically, the board delegates wide powers to the corporation's senior managers. State laws generally make a distinction between those matters a board must address directly and those it may delegate to officers or other agents of the corporation, or to board committees. For example, under DGCL, section 141(c), the board of a company incorporated prior to 1 July 1996 cannot delegate the power to:

- adopt, amend or repeal any by-law of the corporation, unless the resolution, by-laws or certificate of incorporation expressly provides this power;
- amend the corporation's certificate of incorporation (except that a board committee may make certain specified decisions relating to the rights, preferences or issuance of authorised stock, to the extent specifically delegated by the board);
- adopt an agreement of merger or consolidation;
- recommend to shareholders the sale, lease or exchange of all or substantially all of the corporation's property and assets;
- recommend to shareholders a dissolution of the corporation or a revocation of a dissolution;
- approve, adopt or recommend to shareholders any action or matter that is required to be submitted to shareholders for approval;
- declare a dividend, unless that power is expressly provided for in the certificate of incorporation, resolution or by-laws; and
- authorise the issuance of stock or adopt a certificate of ownership and merger, unless that power is expressly provided for in the certificate of incorporation, resolution or by-laws.

The Sarbanes-Oxley Act and the NYSE and Nasdaq listing rules also require that each listed company have an audit committee comprising independent directors who have responsibility for certain audit and financial reporting matters. As required by the Dodd-Frank Act, NYSE and Nasdaq listing rules also require that each listed company have a compensation committee comprising independent directors who are responsible for certain matters relating to executive compensation. NYSE listing standards require that each listed company have a nominating or corporate governance committee comprising independent directors who are responsible for director nominations and corporate governance. Nasdaq listing rules require independent directors (or a committee of independent directors) to have responsibility for certain decisions relating to director nominations. (See questions 25 and 27.) These committees are permitted to delegate their responsibilities to subcommittees solely comprising one or more members of the relevant committee.

Directors may also reasonably rely on information, reports and recommendations provided by officers, other agents and committees on matters delegated to them (see DGCL, section 141(e)). Nevertheless, the board retains the obligation to provide oversight of its delegates, to act in good faith and to become reasonably familiar with their services or advice before relying on such advice.

22 Non-executive and independent directors

Is there a minimum number of 'non-executive' or 'independent' directors required by law, regulation or listing requirement? If so, what is the definition of 'non-executive' and 'independent' directors and how do their responsibilities differ from executive directors?

NYSE and Nasdaq listing rules require that independent directors comprise a majority of the board. Controlled companies (ie, companies in which more than 50 per cent of the voting power is held by an individual, group or another company) and foreign private issuers are exempt from this requirement.

Under the NYSE rules, for a director to be deemed 'independent', the board must affirmatively determine that he or she has no material relationship with the company. A material relationship can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. Under the NYSE rules, directors having any of the following relationships may not be considered independent:

- a person who is an employee of the listed company or is an immediate family member of an executive officer of the listed company;
- a person who receives, or is an immediate family member of a person who receives, compensation directly from the listed company, other than director compensation or pension or deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), of more than US$120,000 per year;
- a person who is a partner of, or employed by, or is an immediate family member of a person who is a partner of, or employed (and works on the listed company's audit) by a present or former internal or external auditor of the company;
- a person, or an immediate family member of a person, who has been part of an interlocking compensation committee arrangement; or
- a person who is an employee or is an immediate family member of a person who is an executive officer, of a company that makes payments to or receives payments from the listed company for property or services in an amount that in a single fiscal year exceeds the greater of 2 per cent of such other company's consolidated gross revenues or US$1 million.

In applying the independence criteria, no individual who has had a relationship as described above within the past three years can be considered independent (except in relation to the test set forth in the final bullet point above, which is concerned with current employment relationships only). The Nasdaq listing rules take a different but similar approach to defining independence.

For NYSE and Nasdaq companies, only independent directors are allowed to serve on audit, compensation and nominating or governance committees. Note that the Sarbanes-Oxley Act, section 301, defines an independent director for audit committee purposes as one who has not accepted any compensation from the company other than directors' fees

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and is not an 'affiliated person' of the company or any subsidiary. NYSE listing standards require NYSE companies to have an audit committee that satisfies the requirements of Rule 10A-3 under the Exchange Act. That rule, which embodies the independence requirements of the Sarbanes-Oxley Act, section 301, provides that an executive officer of an 'affiliate' would not be considered independent for audit committee purposes. As required by the Dodd-Frank Act, the NYSE and Nasdaq developed heightened independence standards for compensation committee members that became effective during 2014. Under these standards, in affirmatively determining the independence of a director for compensation committee purposes, the board of directors must consider all factors specifically relevant to determining whether a director has a relationship to the listed company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member, including the source of compensation received by the director and whether the director is affiliated with the company or any subsidiary.

23 Board composition

Are there criteria that individual directors or the board as a whole must fulfil? Are there any disclosure requirements relating to board composition? Are there minimum and maximum numbers of seats on the board? How is the size of the board determined? Who is authorised to make appointments to fill vacancies on the board?

Delaware law requires that the board of directors comprises one or more members, each of whom must be a natural person (DGCL, section 141(b)). Beyond the requirement for at least one director, corporate law does not set a minimum or a maximum. As a practical matter, a board should be of a size sufficient to accommodate an appropriate amount of experience, independence and diversity for the full board and its committees. The number of directors is fixed by or in the manner provided in the by-laws or certificate of incorporation; typically the by-laws will specify a range and the board will fix the exact number of directors by resolution. Directors need not be shareholders of the corporation. The certificate of incorporation or the by-laws may provide for director qualifications and address who is authorised to fill vacancies on the board.

The NYSE and Nasdaq require that listed companies have an audit committee comprising at least three members. Nasdaq requires listed companies to have a compensation committee comprising at least two members; the NYSE does not require a minimum number of members of the compensation committee.

Institutional Shareholder Services has stated that a company should have no less than six nor more than fifteen directors, with a board size of between nine and twelve directors 'considered ideal'.

The SEC requires companies to provide the following proxy statement disclosures relating to board composition:

- which directors qualify as 'independent' under applicable independence standards; and
- for each director and nominee:
  - name, age and positions and offices held with the company;
  - term of office as a director;
  - any arrangements or understandings between the director or nominee and any other person pursuant to which the director or nominee was or is to be selected as a director or nominee;
  - family relationships with any director, nominee or executive officer;
  - business experience and other public company directorships over the past five years;
  - the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director of the company; and
  - whether the director or nominee has been involved in certain kinds of legal proceedings during the past 10 years.

There is increasing concern in the institutional investor community about the lack of gender and racial diversity on public company boards of directors.

24 Board leadership

Do law, regulation, listing rules or practice require separation of the functions of board chairman and CEO? If flexibility on board leadership is allowed, what is generally recognised as best practice and what is the common practice?

There is no legal requirement or listing rule that mandates that the positions of board chairman and CEO be held separately or jointly. Corporate boards are generally free to decide for themselves the leadership structure of the board and company (although the corporate charter or by-laws could provide otherwise). Shareholder proposals calling for a separation of the board chairman and CEO roles have become increasingly common in recent years.

The NYSE and Nasdaq listing rules, however, require that the non-management directors meet without management present on a regular basis. Under the NYSE rules, companies are required to either choose and disclose the name of a director to preside during executive sessions or disclose the method it uses to choose someone to preside (for example, a rotation among committee chairs). Although the NYSE rules do not set forth other specific duties for the presiding director, some companies have a 'lead independent director' perform the presiding function while also having a role in agenda-setting and determining the information needs of the outside directors. The Nasdaq listing rules also require that boards convene executive sessions of independent directors, but do not include a presiding director disclosure requirement.

In late 2009, the SEC adopted rules requiring each reporting company to disclose the board's leadership structure and why the company believes it is the best structure for the company. Each company has to disclose whether and why they have chosen to combine or separate the CEO and board chairman roles. Where these positions are combined, the company must disclose whether and why the company has a lead independent director and the specific role the lead independent director plays in the leadership of the company.

Several best practice codes recommend a clear division of responsibilities between a board chairman and CEO to ensure that the board maintains its ability to provide objective judgement concerning management. They suggest that the board should either separate the roles of board chairman and CEO or designate a lead outside or independent director for certain functions. For example, the NACD's Report on Director Professionalism recommends appointing an independent board leader to:

- organise the board's evaluation of the CEO and provide feedback;
- chair sessions of the non-executive directors;
- set the agenda (with the CEO or chairman/CEO); and
- lead the board in anticipating and responding to a crisis.

Furthermore, under its proxy voting guidelines, Institutional Shareholder Services will generally vote for shareholder proposals requiring that the board chairman position be filled by an independent director, taking into consideration the following:

- the scope of the proposal, such as whether it is precatory or binding;
- the company's current board leadership structure, including recent transitions in board leadership and the designation of an independent lead director;
- the company's governance structure and practices to assess whether more independent oversight at the company may be advisable; and
- the company's financial performance compared to its peers and the market as a whole.

Common practice is to combine the roles of CEO and chairman, however, separation of the roles has become increasingly prevalent at S&P 500 companies over the past 10 years – the roles were separated at 47 per cent of S&P 500 companies in 2014 up from 27 per cent in 2004. Chairmen who qualified as independent were in place at 28 per cent of S&P 500 companies in 2014 compared to 9 per cent in 2004. The vast majority of companies that do not have an independent chairman have appointed a lead or presiding director.

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25 Board committees

What board committees are mandatory? What board committees are allowed? Are there mandatory requirements for committee composition?

The Sarbanes-Oxley Act requires that all boards of companies with listed securities have audit committees composed entirely of directors who receive no compensation from the company other than directors' fees and are not affiliated with the company. In addition, companies are required to disclose the name of at least one audit committee member who is an 'audit committee financial expert' as defined by the SEC, or explain why they do not have one. Generally, audit committees are to:

- retain, compensate and when necessary terminate the independent auditors;
- pre-approve all audit and non-audit services provided by the independent auditor;
- ensure that the independent auditor lacks relationships with the company and its management that might impair its independence;
- review and discuss with the independent auditor its report of the firm's internal quality control procedures, the financial reports and policies with respect to risk assessment and risk management;
- generally assist board oversight of the integrity of the company's financial statements and compliance with legal and regulatory requirements; and
- establish whistle-blowing policies and procedures for handling complaints or concerns regarding accounting, internal accounting controls or auditing matters.

Since 1999, the NYSE and Nasdaq listing rules have required that listed companies have audit committees consisting entirely of independent directors (prior to that time, a majority of independent directors had been a long-standing audit committee requirement for companies listed on the NYSE). In 2003, the NYSE and Nasdaq adopted listing rules that also require companies to have compensation and nominating or governance committees (or committees that perform those functions) consisting entirely of independent directors, although Nasdaq permits nomination decisions to be made by a majority of independent directors (definitions of independence are provided in question 22). The NYSE and Nasdaq rules also require that the audit committee comprises at least three members and impose requirements with respect to the financial literacy of audit committee members. Effective beginning in 2014, each Nasdaq listed company must have, and certify that it has and will continue to have, a compensation committee of at least two members, each of whom must be an independent director; the NYSE does not require a minimum number of members of the compensation committee. As required by the Dodd-Frank Act, the NYSE and Nasdaq each adopted heightened independence standards for compensation committee members that became effective in 2014 and take into account the source of compensation received by the director and whether the director is affiliated with the company or any subsidiary.

26 Board meetings

Is a minimum or set number of board meetings per year required by law, regulation or listing requirement?

Under state law, the corporation's by-laws or certificate of incorporation prescribe the requirements for board meetings and may or may not prescribe a set number of meetings. Generally, it is believed that a board should meet at least once per financial reporting quarter. However, most boards of large publicly traded corporations meet more frequently. For example, companies represented on the S&P 500 held 8.1 board meetings on average in 2014. SEC rules require companies to disclose the total number of board and committee meetings held during the past year and provide details regarding director attendance at such meetings.

27 Board practices

Is disclosure of board practices required by law, regulation or listing requirement?

As discussed in response to question 35, the SEC requires disclosure of certain board practices, including disclosures about the identity and compensation of directors and the composition and activities of the audit, compensation and nominating committees.

Under the NYSE listing rules, listed companies are required to adopt and disclose 'corporate governance guidelines' that address:

- qualification standards for directors;
- responsibilities of directors;
- director access to management and, as necessary, independent advisers;
- compensation of directors;
- continuing education and orientation of directors;
- management succession; and
- an annual performance evaluation of the board.

Nasdaq-listed companies are not required to adopt corporate governance guidelines but many have done so as a best practice.

The NYSE rules also require listed companies to adopt and disclose charters for their compensation, nominating or governance and audit committees.

The compensation committee's charter must detail the committee's purpose and responsibilities, which include reviewing and approving corporate goals and objectives relevant to CEO compensation, evaluating the CEO's performance in light of those goals and objectives, setting his or her compensation level based on this evaluation, making recommendations to the board with respect to non-CEO executive officer compensation, incentive-based compensation plans and equity-based plans and producing a compensation committee report on executive compensation required by SEC rules to be included in the company's proxy statement. The charter must also provide that the committee will perform an annual self-evaluation. In addition, pursuant to the Dodd-Frank Act, the NYSE and Nasdaq recently adopted listing standards requiring compensation committees to consider specified independence factors prior to engaging consultants and other advisers and to have the authority and discretion to retain or obtain the advice of consultants and other advisers at the company's expense.

The nominating or governance committee's charter must detail the committee's purpose and responsibilities. These include:

- identifying the board's criteria for selecting new directors;
- identifying individuals who are qualified to become board members;
- selecting or recommending that the board select nominees for election at the next AGM;
- developing and recommending to the board a set of corporate governance principles for the corporation; and
- overseeing the evaluation of the board and management.

In addition, the charter must include a provision for an annual performance evaluation of the committee. Unlike the NYSE, the Nasdaq does not include a requirement with respect to the charter for the nominating or governance committee, although companies are required to certify that they have adopted a formal written charter or board resolution, as applicable, addressing the nominations process.

The audit committee charter must specify the committee's purpose, which must include: assisting board oversight of the integrity of the company's financial statements, the company's compliance with legal and regulatory requirements, the independent auditor's qualifications and independence and the performance of the company's internal audit function and independent auditors; and preparing the report that SEC rules require to be included in the company's annual proxy statement. The charter must also detail the duties and responsibilities of the audit committee, including:

- the ability to hire and fire the company's independent auditor and other registered public accounting firms;
- establishing whistle-blowing policies and procedures for handling complaints or concerns regarding accounting, internal accounting controls or auditing matters;
- at least annually, obtaining and reviewing a report by the independent auditor describing the independent auditor's internal quality control procedures; reviewing any material issues raised by the auditor's most recent internal quality control review of themselves or peer review, or any inquiry or investigation by governmental or professional authorities within the preceding five years; and assessing the auditor's independence;
- discussing the annual audited financial statements and quarterly financial statements with management and the independent auditor;
- discussing earnings press releases, as well as financial information and earnings guidance that is given to analysts and rating agencies;

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- obtaining the advice and assistance of outside legal, accounting or other advisers, as necessary, with funding to be provided by the company;
- discussing policies with respect to risk assessment and risk management;
- meeting separately, from time to time, with management, with the internal auditors and with the independent auditor;
- reviewing with the independent auditor any audit problems or difficulties and management's response to such issues;
- setting clear hiring policies for employees or former employees of the independent auditor;
- reporting regularly to the board of directors; and
- evaluating the audit committee on an annual basis.

The Nasdaq rules also require an audit committee to have a charter addressing all of its duties and responsibilities under the Sarbanes-Oxley Act, including: having the sole power to hire, determine funding for and oversee the outside auditors; having the authority to consult with and determine funding for independent counsel and other advisers; and having the responsibility to establish procedures for receipt of complaints.

In addition, both the NYSE and Nasdaq rules require that companies adopt and disclose a code of conduct that addresses conflicts of interest and legal compliance. The NYSE rules also require that the code address corporate opportunities, confidentiality, fair dealing and protection of company assets.

Public companies post their corporate governance guidelines, board committee charters, codes of conduct and other governance documents on their corporate websites, typically under a heading such as 'Corporate Governance' or 'Investor Relations'.

28 Remuneration of directors

How is remuneration of directors determined? Is there any law, regulation, listing requirement or practice that affects the remuneration of directors, the length of directors' service contracts, loans to directors or other transactions between the company and any director?

The remuneration of directors is generally a matter for the board of directors, or a committee of the board (usually, the compensation committee or the nominating or governance committee), to determine.

In determining the appropriate amount of compensation to be paid to directors, many boards and compensation or nominating or governance committees rely on the advice of independent compensation consultants, whose expertise lies in analysing compensation trends in industry or other market segments. As discussed in question 35, the SEC recently amended its regulations to require enhanced disclosure with respect to a company's use of compensation consultants.

Boards should exercise caution when approving equity compensation plans that permit equity awards to be made to non-employee directors. Such plans should include meaningful limits on the amount of equity that directors can award themselves, to ensure that awards made under the plan are entitled to business judgement rule protection (*Seinfeld v Slager* (Del Ch 2012)).

Compensation given to all directors must be disclosed by reporting companies. Under the Sarbanes-Oxley Act, audit committee members can only receive director's fees (including fees for committee work) from the companies they serve. In addition, as discussed in questions 22 and 25, the board must consider the source of compensation of a director when considering his or her suitability for compensation committee service. As discussed in question 27, the NYSE requires listed companies to adopt and disclose corporate governance guidelines, which are required to address, among other things, the compensation of directors.

There is no law, regulation or listing requirement that affects the length of directors' service contracts. Rather, directors are elected for a term by the shareholders and it is up to each company to determine whether to place any limits on the number or length of such terms, although NYSE listing rules provide that directors' terms of office should not exceed three years.

Term limits are very rare among large public companies but retirement age policies are common. The average tenure of directors at S&P 500 companies is 8.4 years. 18 per cent of S&P 500 boards have an average director tenure of five years or less, 66 per cent have an average director tenure between six and ten years, and 16 per cent have an average tenure of eleven or more years. Institutional Shareholder Services recently announced that it considers a term of longer than nine years 'excessive' in that it may potentially compromise a director's independence.

Section 402 of the Sarbanes-Oxley Act prohibits companies from extending or maintaining personal loans to their directors, other than certain consumer credit arrangements (such as home improvement or credit card loans) made in the ordinary course of business of a type generally made available by the company to the public and on market terms or terms no more favourable than offered by the company to the general public.

The duty of loyalty restricts directors from competing with the corporation. Thus, while directors are not precluded from engaging in other businesses, they may not:

- use their position as directors to prevent the corporation from competing with their other businesses;
- divert corporate assets to their own uses or the uses of their other businesses;
- disclose the corporation's trade secrets or confidential information to others;
- lure corporate opportunities, business or personnel away from the corporation; or
- receive, unbeknown to the corporation, a commission on a corporate transaction.

Under the corporate opportunity doctrine, directors cannot divert to themselves an opportunity that belongs to the corporation. An opportunity belongs to the corporation if the corporation has a right to it, a property interest in it, an expectancy interest in it or if by 'justice' it should belong to the corporation. The corporation may renounce any interest or expectancy in an opportunity in its certificate of incorporation or by action of its board of directors (see DGCL, section 122(17)). At times, a director's interest may still conflict with the interests of the corporation. Conflicts that cannot be avoided must be fully disclosed by the interested director and any action that needs to be taken should be taken by vote of the disinterested directors.

29 Remuneration of senior management

How is the remuneration of the most senior management determined? Is there any law, regulation, listing requirement or practice that affects the remuneration of senior managers, loans to senior managers or other transactions between the company and senior managers?

The remuneration of a corporation's CEO and senior management is generally a matter for the board of directors, or a committee of the board (usually, the compensation committee), to determine.

NYSE listing rules require that a compensation committee comprising independent directors determine the amount of compensation paid to the CEO, and make recommendations to the board with respect to non-CEO executive officer compensation. These provisions are interpreted broadly, such that a compensation committee or group of independent directors, as the case may be, must approve each specific element of CEO compensation at all listed companies. Effective beginning in 2014, Nasdaq listing rules require that CEO and executive officer compensation be determined by a compensation committee comprising at least two independent directors.

In addition, applicable tax and securities rules require the approval of independent directors to grant equity-based awards (such as, stock option and restricted stock awards) to senior management and best practice would have the board or compensation committee approve the compensation paid to key members of senior management. For example, under Internal Revenue Code section 162(m), the tax code provides tax incentives for certain performance-based compensation decisions when made by a committee of outside directors. As a result, the responsibility between the board (or compensation committee) and the CEO in determining the elements and amount of compensation paid to senior managers (other than the CEO) differs from company to company and, even within a company, from element of compensation to element of compensation.

In determining the appropriate amount of compensation to be paid to the CEO and other senior managers, many boards and compensation committees rely on the advice of independent compensation consultants, whose expertise lies in analysing compensation trends in industry or other market segments. As discussed in question 35, the SEC recently amended

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its regulations to require enhanced disclosure with respect to a company's use of compensation consultants.

Section 402 of the Sarbanes-Oxley Act prohibits companies from extending or maintaining personal loans to their executive officers, other than certain consumer credit arrangements (such as home improvement or credit card loans) made in the ordinary course of business of a type generally made available by the company to the public and on market terms or terms no more favourable than offered by the company to the general public.

30 D&O liability insurance

Is directors' and officers' liability insurance permitted or common practice? Can the company pay the premiums?

Companies may purchase and typically do maintain directors' and officers' liability insurance to protect directors and officers against the risk of personal liability (see DGCL, section 145(g)). Although such coverage has become substantially more expensive, it is usually available and has not been limited by legislative and regulatory actions. Companies are allowed to pay the premiums for directors' and officers' liability insurance.

31 Indemnification of directors and officers

Are there any constraints on the company indemnifying directors and officers in respect of liabilities incurred in their professional capacity? If not, are such indemnities common?

A company may indemnify a director for liability incurred if that director: acted in good faith; acted in a manner that he or she reasonably believed was in the best interests of the company; and in the case of a criminal proceeding, had no reasonable cause to believe his or her conduct was unlawful (see DGCL, section 145). Many companies employ such indemnities (see also the discussion of the duty of good faith in question 19).

32 Exculpation of directors and officers

To what extent may companies or shareholders preclude or limit the liability of directors and officers?

The Delaware Director Protection Statute allows the shareholders of a corporation to provide additional protection to corporate directors through the adoption of a provision in the certificate of incorporation 'eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of a fiduciary duty as a director' (DGCL, section 102(b)(7)). Such a provision, however, may not shield directors from liability for: breaches of the duty of loyalty; 'acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law'; unlawful payments of dividends or unlawful stock purchases or redemptions; or 'any transaction from which the director derived an improper personal benefit' (see also the discussion of fiduciary duties in question 19).

33 Employees

What role do employees play in corporate governance?

Employees play no formal role in corporate governance. However, it is not uncommon for employees to own shares of the corporation's stock directly or through employee stock option or retirement plans. Stock ownership enables employees to participate in corporate governance as shareholders.

Disclosure and transparency

34 Corporate charter and by-laws

Are the corporate charter and by-laws of companies publicly available? If so, where?

Corporate certificates of incorporation are publicly available for a small fee from the office of the secretary of state in the state of incorporation. By-laws of private companies are generally not publicly available because they are not required to be filed with the secretary of state. If the corporation is a reporting company, its by-laws and certificate of incorporation are also available as exhibits to various forms filed with the SEC, which can be accessed over the internet free of charge from EDGAR, the SEC database, which is accessible via the SEC's website (www.sec.gov).

35 Company information

What information must companies publicly disclose? How often must disclosure be made?

Federal securities laws and SEC rules require reporting companies (or companies making public offerings) to disclose a wide variety of information in annual and quarterly reports, as well as in proxy statements and public offering prospectuses. In general, a company must disclose all information that would be material to investors. This includes:

- a business description;
- a description of material legal proceedings;
- detailed disclosure of the risks associated with the business and market risk;
- related person transaction disclosure;
- the number of shareholders of each class of common equity;
- management's discussion and analysis of the company's financial condition and results of operations (MD&A);
- a statement as to whether the company has had any disagreements with its accountants;
- disclosure regarding the effectiveness of disclosure controls and procedures, and changes in internal control over financial reporting;
- financial information;
- executive and director compensation; and
- a signed opinion of the company's auditors with respect to the accuracy of the financial information.

Corporations are expected to keep all of this public information current by filing 'current' reports whenever certain specified events occur, as well as issuing press releases and providing website disclosure.

Since the passage of the Sarbanes-Oxley Act and its accompanying SEC implementing rules, reporting companies are also required to disclose all material off-balance-sheet transactions, arrangements, obligations (including contingent obligations) and certain other relationships of the company with unconsolidated entities or other persons. In addition, the Sarbanes-Oxley Act requires that a reporting company's financial reports reflect 'all material correcting adjustments' identified by outside auditors.

Section 404 of the Sarbanes-Oxley Act requires that a reporting company's annual report include an internal control report from management containing a statement of the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and an assessment at the end of the company's most recent fiscal year of the effectiveness of the company's internal control structure and procedures for financial reporting. The company's registered public accounting firm must also attest to, and report on, the effectiveness of the company's internal control over financial reporting.

Reporting companies are also required to disclose the 'total compensation' received by the corporation's CEO, its CFO, and its three most highly compensated executives other than the CEO and CFO (together, the named executive officers) and directors. The information is required to be presented in the form of a summary compensation table listing the name of the employee, the year, salary, bonus, other annual compensation, stock and option awards, changes in pension value and non-qualified deferred compensation earnings, all other forms of compensation and total compensation, as well as several other tables relating to grants of plan-based awards, outstanding equity awards, option exercises and vested stock, pension benefits, non-qualified deferred compensation and director compensation. In addition, reporting companies are required to include a 'compensation discussion and analysis' section in their disclosure documents that explains all material elements of the company's compensation of the named executive officers, and includes a description of the company's compensation philosophy and objectives.

The JOBS Act affords 'emerging growth companies' (companies that have conducted an IPO after 8 December 2011 and have total annual revenues of less than US$1 billion) the flexibility to provide reduced disclosures relating to financials, MD&A and compensation for a maximum period of five years.

SEC regulations also require the disclosure of certain information concerning any beneficial owner known to the company to possess more than 5 per cent of any class of the corporation's voting securities, including the amount of ownership and percentage and title of the class of stock owned. Note that any person acquiring more than 5 per cent of the equity of a reporting company also must publicly disclose its intentions with respect to such acquisition. In addition, the Exchange Act requires that officers,

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Update and trends

The SEC is continuing to work to implement the remaining mandates of the Dodd-Frank Act in the area of corporate governance. These include the adoption of rules regarding disclosure of 'pay versus performance', pay ratios and corporate policies on hedging of company stock by employees and directors and the proposal and adoption of rules regarding recovery of executive compensation. In April 2015, the Chair of the SEC indicated that the SEC will be advancing the remaining rule-makings in 2015.

During the past year, the SEC has engaged in a 'disclosure effectiveness project'. The goal of the project is to review existing disclosure requirements to determine whether modifications should be made to reduce the costs and burdens on public companies while also promoting the disclosure of material information to investors and eliminating duplicative disclosures. The SEC has not made any specific recommendations and has not provided a timetable for when it will do so.

The boards of directors of US public companies are under ever-growing pressure as shareholder efforts to intervene in and influence corporate decisions increase. The elimination of takeover defences in the name of 'good governance' has shifted power to shareholders and made boards and companies more vulnerable to intervention. The emergence of and reliance on proxy advisory firms and greater shareholder voting rights have also played a role in increasing the power and coordination of shareholders.

In recent years the focus of shareholder proposals has shifted from highly successful campaigns to remove antitakeover protections (ie, classified boards, plurality voting in uncontested director elections) to proxy access and other efforts to influence board composition. Proxy access has gained considerable momentum in the past year through private ordering. More than 100 shareholder proposals requesting proxy access were submitted for the 2015 proxy season. In response to such proposals and increasing pressure from institutional investors and proxy advisory firms, dozens of companies have adopted (or have agreed to adopt) proxy access or have committed to include management proxy access proposals in their proxy ballots. Proxy access is likely to become the norm at large public companies in the US in the next few years. While market practice is still developing, future proxy access by-laws will most likely require ownership of either 3 or 5 per cent of a company's common stock held for at least three years with the ability to nominate up to 20 or 25 per cent of the directors on the board.

Companies are also more vulnerable to shareholder intervention due to a recent shift in SEC policy regarding the ability of companies to exclude shareholder proposals from proxy ballots. In the past, the SEC has frequently granted no-action relief to companies under Exchange Act rule 14a-8(i)(9), which allows a company to exclude a shareholder proposal when management puts forth its own directly conflicting proposal. The Chair of the SEC directed review of the rule and the SEC Staff announced in January 2015 that it will not grant no-action relief under rule 14a-8(i)(9) for the 2015 proxy season pending that review. The SEC took this unusual step in response to investor concerns raised by a company's attempt to exclude a shareholder's proxy access proposal based on management's intent to include a proxy access proposal at much higher threshold; however, the SEC's decision also impacts other types of shareholder proposals. In addition, the SEC historically has permitted companies to exclude shareholder proposals if they deal with the company's ordinary business operations, but recent denials of no-action requests suggest that the SEC's interpretation of the ordinary business exclusion is becoming more narrow. In those cases, the SEC invoked a rarely-used 'fundamental business strategy' carve-out from the ordinary business exclusion to prevent exclusion of the proposals relating to pricing policies for the company's products.

Shareholders are also seeking to engage with companies outside of the shareholder proposal mechanism. For example, it is becoming more common for large institutional investors to send letters on specific issues of concern to portfolio companies. In the past year, public campaigns of this sort have urged the adoption of proxy access and more direct engagement between directors and shareholders.

Institutional Shareholder Services and Glass Lewis recently adopted policies in effect for the 2015 proxy season whereby they will recommend votes against directors if boards unilaterally adopt by-law and charter amendments that they view as limiting shareholder rights.

In light of these developments, shareholder influence is more potent than ever and continued attention to the quality of shareholder relations has become paramount. Companies are engaging with their key large institutional investors more directly and more frequently to hear their interests and concerns, including from a governance perspective. Companies are also increasingly providing disclosure regarding their shareholder engagement efforts in their annual meeting proxy statements.

directors and beneficial owners of 10 per cent or more of a company's equity securities file a statement of ownership each time there has been a change in that person's beneficial ownership of the company's securities.

In addition, special attention is given to corporate governance. Reporting companies must include a copy of the audit committee report in their annual proxy statements. This report must disclose, inter alia, whether the committee has reviewed the audited financial statements with management, recommended that the audited statements be included in the corporation's annual report to the board, and discussed certain matters with independent auditors to assess their views on the auditors' independence, the quality of the corporation's financial reporting and the name of the committee member with financial expertise (if any). Under section 406 of the Sarbanes-Oxley Act, companies are required to disclose whether they have adopted a code of ethics for their senior financial officers. If a company has not adopted such a code it must explain why it has not done so. Certain changes to or waivers of any provision of the code must also be disclosed.

Under the Sarbanes-Oxley Act, the reliability and accuracy of the financial and non-financial information disclosed in a company's periodic reports has to be certified by the company's CEO and CFO. In each quarterly report both officers must certify, among other things, that:

- they reviewed the report;
- to their knowledge the report does not contain a material misstatement or omission and that the financial statements and other financial information in the report fairly present, in all material respects, the financial condition of the company, its results of operations and cash flows for the periods covered in the report;
- they are primarily responsible for the company's controls and procedures governing the preparation of all SEC filings and submissions, not just the periodic reports subject to certification; and
- they evaluated the 'effectiveness' of these controls and procedures and reported to the audit committee any significant deficiencies or material weaknesses in the company's financial reporting controls, together with any corrective actions taken or to be taken. Their conclusions must be disclosed in the certified report.

NYSE-listed companies are required to disclose their corporate governance guidelines. Committee charters (if any) must be disclosed as described in detail in question 27.

In 2003, the SEC adopted rules that require reporting companies to disclose in their proxy statements or annual reports certain information regarding the director nomination process, including:

- whether the company has a nominating committee and, if not, how director nominees are chosen;
- whether the members of the nominating committee are independent;
- the process by which director nominees are identified and evaluated;
- whether third parties are retained to assist in the identification and evaluation of director nominees;
- minimum qualifications and standards used in identifying potential nominees;
- whether nominees suggested by shareholders are considered; and
- whether nominees suggested by large, long-term shareholders have been rejected.

These rules also require reporting companies to disclose certain information regarding shareholder communications with directors, including:

- the process by which shareholders can communicate with directors (and, if the company does not have an established process, why it does not);
- whether communications are screened and, if so, how;

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- any policies regarding the attendance of directors at AGMs; and
- the number of directors that attended the preceding year's AGM.

In 2006, the SEC adopted rules that require reporting companies to disclose in their proxy statements or annual reports certain information regarding the corporate governance structure that is in place for considering and determining executive and director compensation, including:

- the scope of authority of the compensation committee;
- the extent to which the compensation committee may delegate any authority to other persons, specifying what authority may be so delegated and to whom;
- any role of executive officers in determining or recommending the amount or form of executive and director compensation; and
- any role of compensation consultants in determining or recommending the amount or form of executive and director compensation, identifying such consultants, stating whether such consultants are engaged directly by the compensation committee or any other person, describing the nature and scope of their assignment and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement.

Moreover, in late 2009, the SEC adopted rules requiring companies to provide the following enhanced proxy statement disclosures:

- for each director and nominee, the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director of the company;
- other directorships held by each director or nominee at any public company during the previous five years (rather than only current directorships);
- expanded legal proceedings disclosure relating to the past ten years (rather than five years);
- whether and, if so, how the nominating committee considers diversity in identifying nominees for director; if the nominating committee has a policy with regard to the consideration of diversity in identifying director nominees, how this policy is implemented and how the nominating committee or the board assesses the effectiveness of its policy;
- the board's leadership structure and why the company believes it is the best structure for the company; whether and why the board has chosen to combine or separate the CEO and board chairman positions; where these positions are combined, whether and why the company has a lead independent director and the specific role the lead independent director plays in the leadership of the company;
- the board's role in the oversight of risk management and the effect, if any, that this has on the company's leadership structure;
- the company's overall compensation policies or practices for all employees generally, not just executive officers, 'if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company'; and
- fees paid to and services provided by compensation consultants and their affiliates if the consultants provide consulting services related to director or executive compensation and also provide other services to the company in an amount valued in excess of US$120,000 during the company's last fiscal year.

In early 2010, the SEC also issued an interpretive release on disclosure relating to climate change, which is intended to provide guidance to reporting companies on the application of existing disclosure requirements to climate change and other matters. In addition, in September 2010, the SEC issued an interpretive release relating to disclosure of liquidity and funding risks posed by short-term borrowing practices.

The SEC issued disclosure guidance relating to cyber-security (October 2011) and European sovereign debt exposure (January 2012), among other matters.

In 2011, the SEC approved final rules relating to advisory votes on executive compensation (say-on-pay) pursuant to the Dodd-Frank Act, which also require companies to include a discussion in the proxy statement as to whether and, if so, how the company has considered the results of the most recent say-on-pay vote in determining compensation policies and decisions and, if so, how that consideration has affected the company's executive compensation decisions and policies.

In 2012, the SEC approved final rules mandated by the Dodd-Frank Act requiring proxy statement disclosure regarding compensation consultant conflicts of interest. Such disclosure became required to be included in proxy statements for annual meetings occurring on or after 1 January 2013.

In August 2012, the Exchange Act was amended by the Iran Threat Reduction and Syria Human Rights Act of 2012 to require public companies to provide disclosure if the company or any of its affiliates has knowingly engaged in certain enumerated activities subject to US trade sanctions involving Iran or specified Iranian entities or nationals as well as certain other non-Iranian persons or entities deemed to promote terrorist activities or the proliferation of weapons of mass destruction. Such disclosure became required to be included in quarterly and annual reports beginning in February 2013.

The Dodd-Frank Act amended the Exchange Act to require disclosure relating to 'conflict minerals' (gold, tantalum, tin and tungsten) originating from the Democratic Republic of Congo or an adjoining country. Beginning in May 2014, public companies were required to make various disclosures where conflict minerals are necessary to the functionality or production of a product that is either manufactured by the company or by a third party with which the company contracts for such manufacture. A group of business groups filed litigation challenging the conflict minerals rule on several grounds, including that the required disclosure would violate the First Amendment to the US Constitution. In April 2014, the US Court of Appeals for the District of Columbia Circuit found that one disclosure provision of the conflict minerals rule violated the First Amendment but upheld the remainder of the rule. The SEC filed an appeal of that decision and in November 2014 the court granted a petition to rehear the case. The decision remained on appeal as of May 2015.

In addition, the Dodd-Frank Act amended the Exchange Act to require 'resource extraction issuers' to disclose specified information regarding payments made to a foreign government or the US federal government for the purpose of commercial development of oil, natural gas or minerals. The SEC adopted a resource extraction disclosure rule in August 2012 that was vacated by the US District Court for the District of Columbia in July 2013. In September 2013, the SEC announced that it would redraft the resource extraction rule rather than appeal the ruling. In a March 2015 court filing, the SEC indicated that it may not repropose the resource extraction rule until spring 2016.

The Dodd-Frank Act requires several new disclosures that require SEC rulemaking, including in relation to 'pay versus performance', 'internal pay equity' (requiring disclosure of the median of the annual total compensation of all company employees except the CEO, the CEO's total annual compensation and the ratio of the former to the latter), 'clawback' policies requiring the recovery of excess compensation paid to executives and corporate policies on hedging of company stock by directors and employees. The SEC has proposed rules relating to the 'pay versus performance' and 'internal pay equity' disclosure requirements and corporate hedging policies and intends to adopt the rules in final form in 2015. The SEC has not yet proposed rules with respect to recovery of executive compensation.

Hot topics

36 Say-on-pay

Do shareholders have an advisory or other vote regarding executive remuneration? How frequently may they vote?

Commencing in 2011, the Dodd-Frank Act requires US public companies to conduct a separate shareholder advisory vote on:

- executive compensation – to be held at least once every three calendar years;
- whether the advisory vote on executive compensation should be held every year, every two years or every three years – to be held at least once every six calendar years; and
- certain 'golden parachute' compensation arrangements in connection with a merger or acquisition transaction that is being presented to shareholders for approval.

See question 29 for further details about the remuneration of executives.

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37 Proxy solicitation

Do shareholders have the ability to nominate directors without incurring the expense of proxy solicitation?

Since September 2011, companies can no longer exclude from their proxy materials shareholder proposals (precatory or binding) relating to by-law amendments establishing procedures for shareholder nomination of director candidates and inclusion in the company's proxy materials, as long as the proposal is otherwise not excludable under rule 14a-8. This amendment to rule 14a-8 facilitates the development of 'proxy access' via private ordering at companies chartered in states where permissible, as shareholders are able to institute a shareholder nomination regime via binding by-law amendment or request, via precatory shareholder proposal, that such a by-law be adopted by the board.

The private ordering process has gained considerable momentum during the 2015 proxy season. More than 100 shareholder proposals requesting proxy access were submitted, 75 of which stemmed from a campaign by the New York City Comptroller. The most common formulation would give shareholders who hold three per cent of the company's common stock for at least three years the right to nominate up to 25 per cent of the company's directors using the company's proxy materials. Dozens of companies have adopted proxy access by-laws, most often in response to a shareholder proposal, or have negotiated withdrawal of shareholder proposals in exchange for agreeing to adopt proxy access or include a management proposal on proxy access on the ballot for the AGM. As a result of this private ordering, proxy access is likely to become the norm at large public companies in the US in the next few years.

Furthermore, the SEC is exploring whether changes should be made to the federal proxy rules to facilitate the use of universal proxy cards, which would allow shareholders to vote for a mix of management and dissident nominees in a contested director election.

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