

# Corporate governance and directors' duties in the United States: overview

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## CORPORATE GOVERNANCE TRENDS

### 1. What are the main recent corporate governance trends and reform proposals in your jurisdiction?

The main recent corporate governance trends and reform proposals are summarised below:

- Investor, director and management views on corporate governance "best practices" have converged with respect to several key issues in recent years. The "Commonsense Principles of Corporate Governance" (issued in July 2016 by a coalition of 13 executives of large public companies and institutional investors) and the Investor Stewardship Group's Corporate Governance Principles for US Listed Companies and Stewardship Principles (issued in January 2017 by a group of US-based institutional investors and global asset managers representing more than US\$20 trillion in assets under management) include converging views regarding key board governance, investor stewardship and shareholder engagement issues. Despite their common themes, the principles reflect general consensus that corporate governance practices and structures must be tailored to the company.
- Key institutional investors are prioritising environmental and social issues, such as board diversity and gender pay equity, for example:
  - climate change proposals are receiving stronger support and three passed at large energy companies in 2017: BlackRock and State Street identified environmental issues as key investment stewardship priorities in 2017, and Fidelity and Vanguard revised their voting guidelines to provide that they may now support (rather than abstain from voting on) environmental shareholder proposals; and
  - beginning in 2018, State Street stated it may vote against nominating committee chairs at companies that fail to take action to increase the number of female directors (see *Question 7, Gender*).
- Boards and key investors are increasingly scrutinising board composition (for example, experience/skill-sets, tenure, and diversity), refreshment and director succession planning.
- Proxy access is now a majority practice at large US public companies. As of October 2017, more than 450 companies have adopted proxy access, including more than 60% of Standard and Poor's (S&P) 500 companies (up from less than 1% in 2014). Several companies that adopted proxy access have since received shareholder proposals requesting the board amend the proxy access bye-law (for example, to increase the 20-person limit on shareholders that could aggregate to form a nominating group). The Securities and Exchange Commission (SEC) staff have granted no-action relief to permit companies to exclude many of these "fix-it" proposals.

- The Trump administration has indicated that it intends to reduce the perceived regulatory burden on US companies, by potentially rolling back certain corporate governance requirements imposed by federal law, but the nature and timing of these changes are unclear.

## CORPORATE ENTITIES

### 2. What are the main forms of corporate entity used in your jurisdiction?

The main forms of corporate entity used in the US are corporations and limited liability companies. The majority of large US businesses are corporations with equity and/or debt that trade on either the New York Stock Exchange (NYSE) or the Nasdaq Stock Market (Nasdaq).

## LEGAL FRAMEWORK

### 3. Outline the main corporate governance legislation and authorities that enforce it. How influential are institutional investors and other shareholder groups in monitoring and enforcing good corporate governance? List any such groups with significant influence in this area.

#### State corporate laws

State corporate law (statutory and case law) governs:

- The formation of privately held and publicly traded corporations.
- The rights of shareholders and directors in managing the corporation.
- Fiduciary duties of directors and officers.
- Director and officer protections.

The majority of US public companies are incorporated in the state of Delaware. Many other states base their legislation and interpretation on Delaware law (accordingly, the Delaware General Corporation Law (DGCL) is used in this guide as the reference point for all state law discussion). States are also influenced by the Model Business Corporation Act 1950, a model set of law prepared by the American Bar Association. Shareholder suits are the primary enforcement mechanism of state corporate law.

#### Federal securities laws

At the federal level, the primary sources are as follows (each as amended and including the regulations promulgated by the Securities and Exchange Commission (SEC) thereunder):

- The Securities Act of 1933 (Securities Act 1933). The Securities Act 1933 regulates all offerings and sales of securities by public or private companies.



- The Securities Exchange Act of 1934 (Exchange Act 1934). The Exchange Act 1934 addresses specific requirements relating to the periodic disclosure of information by public companies.

Most US federal securities regulation of public company corporate governance is disclosure-driven rather than substantive requirements.

The Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act 2002) provides direct federal regulation of matters that had been left to state corporate law or addressed by federal law through disclosure requirements.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act 2010) extends federal regulation of corporate governance applicable to public companies.

The SEC has promulgated several rules that implement provisions of the Sarbanes-Oxley Act 2002 and the Dodd-Frank Act 2010.

#### **Stock exchange listing rules and influential sources of best practice recommendations**

To list a security on the New York Stock Exchange (NYSE) or the Nasdaq Stock Market (Nasdaq), a company must agree to abide by the corporate governance requirements provided in the relevant exchange's listing rules.

Corporate governance guidelines and codes of "best practice" recommend how public company boards should organise their structures and processes. Influential recommendations from the business and investor community include:

- American Law Institute (ALI) Principles of Corporate Governance: Analysis and Recommendations.
- National Association of Corporate Directors (NACD) Key Agreed Principles (developed in collaboration with Business Roundtable and the Council of Institutional Investors (CII)) and annual Blue Ribbon Commission reports.
- Business Roundtable, Principles of Corporate Governance.
- Commonsense Principles of Corporate Governance.
- Investor Stewardship Group, Corporate Governance Principles for US Listed Companies and Stewardship Principles.
- CII, Corporate Governance Policies.
- California Public Employees' Retirement System, Governance and Sustainability Principles.
- Proxy voting policies of large institutional investors such as BlackRock, State Street, Vanguard and Fidelity.

Proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis, have developed influential proxy voting policies based on what they consider to be "best practices."

#### **4. Has your jurisdiction adopted a corporate governance code?**

The US has not adopted a corporate governance code for US companies. Corporate governance matters are provided in state and federal laws, regulations and listing rules.

An influential body of "best practices" literature around corporate governance also exists. It includes recommendations issued by groups such as the NACD, Business Roundtable and CII, as well as proxy voting policies of key institutional investors and proxy advisory firms (see *Question 3*).

### **CORPORATE SOCIAL RESPONSIBILITY AND REPORTING**

#### **5. Is it common for companies to report on social, environmental and ethical issues? Highlight, where**

#### **relevant, any legal requirements or non-binding guidance/best practice on corporate social responsibility.**

It is common for companies to report on social, environmental and ethical issues (often referred to as corporate social responsibility (CSR) issues).

The following SEC disclosure requirements tend to trigger disclosure of CSR matters, typically in annual and/or quarterly reports:

- **Regulation S-K Item 101:** Business description disclosure.
- **Regulation S-K Item 103:** Legal proceedings disclosure.
- **Regulation S-K Item 303:** Material known events and uncertainties disclosure included in Management's Discussion and Analysis of Financial Condition and Results of Operations.
- **Regulation S-K Item 503(c):** Risk factor disclosure.
- **Securities and Exchange Commission (SEC) Release Nos. 33-9106; 34-61469; FR-82 (8 February 2010):** Guidance regarding climate change disclosure.
- **Exchange Act Rule 13p-1:** Conflict minerals disclosure.

Many companies also report on CSR matters voluntarily (for example, by publishing a sustainability report).

Companies can be subject to additional disclosure requirements under state law (for example, certain companies doing business in California are required to disclose measures they take to eliminate slavery and human trafficking in their supply chains).

Large institutional investors have recently urged companies to disclose how long-term strategy incorporates corporate sustainability considerations.

Many companies consider two influential guides when determining if and what to disclose regarding CSR issues:

- The Global Reporting Initiative Sustainability Reporting Standards.
- The Sustainability Accounting Standards Board Implementation Guide.

### **BOARD COMPOSITION AND RESTRICTIONS**

#### **6. What is the management/board structure of a company?**

##### **Structure**

US public companies predominantly have a unitary board structure (that is, one tier).

##### **Management**

Section 141 of the Delaware General Corporation Law (DGCL) states that "the business and affairs of every corporation...shall be managed by or under the direction of a board of directors, except as may be otherwise provided ... in its certificate of incorporation." The board generally delegates the day-to-day operation of the business to the chief executive officer (CEO) and other senior executives. The board provides oversight of management.

##### **Board members**

Shareholders elect natural persons to serve as directors. The New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq) listing rules require that a majority of directors be independent.

##### **Employees' representation**

Employees are not entitled to board representation.

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### Number of directors or members

Section 141(b) of the DGCL requires that the board consist of one or more members. The number of directors is set by the corporation's certificate of incorporation or bye-laws. Typically, the bye-laws will specify a range and the board will fix the exact number of directors by resolution.

ISS considers a board size of between nine and 12 directors "ideal" and has stated that a company must have no less than six and no more than 15 directors.

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## 7. Are there any general restrictions or requirements on the identity of directors?

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### General restrictions

There are no relevant general restrictions.

### Age

Delaware law does not impose an age requirement on directors. However, some company bye-laws require that directors be at least 18 years of age. Further, 73% of S&P 500 boards disclosed a mandatory retirement age for directors in 2016, with the age of 72 being the most common limit (*Source: 2016 Spencer Stuart Board Index*).

### Nationality

State corporate law does not impose nationality or residency requirements on directors. In certain regulated industries, all or a minimum number of directors could be required to be US citizens and/or residents of the US or the state in which the corporation is incorporated.

### Gender

While boards of US public companies are not subject to gender quotas, key investors strive to have gender and racial diversity on boards. Securities and Exchange Commission (SEC) rules require companies to disclose whether and, if so, how the nominating committee considers diversity in identifying director nominees and if a diversity policy exists.

As part of a new initiative to promote greater gender diversity on boards, beginning in 2018, State Street stated it could vote against nominating committee chairs at companies that fail to take action to increase the number of female directors (*see Question 1*).

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## 8. Are non-executive, supervisory or independent directors recognised or required?

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### Recognition

Securities and Exchange Commission (SEC) rules require public companies to disclose the names of independent directors.

### Board composition

The New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq) listing rules require that independent directors comprise a majority of the board and serve on the audit, compensation and nominating/corporate governance committees (with some exemptions, including transition periods for newly public companies and cure periods during which companies can regain compliance).

### Independence

Under NYSE listing rules, for a director to qualify as "independent," the board must affirmatively determine that the director has no material relationship with the company including relationships that are (among others):

- Commercial.

- Industrial.
- Banking.
- Consulting.
- Legal.
- Accounting.
- Charitable.
- Familial.

A director cannot be considered independent if he or she:

- Is an employee of the listed company or is an immediate family member of an executive officer of the listed company.
- 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 the compensation is not contingent in any way on continued service), of more than US\$120,000 per year.
- Is a partner or employee of, 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 listed company.
- Is or has been, or is an immediate family member of a person who has been, part of an interlocking compensation committee arrangement.
- Is an employee or is an immediate family member of 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 any of the last three fiscal years exceeds the greater of 2% of the other company's consolidated gross revenues or US\$1 million.

In applying the independence criteria, an individual who has had a relationship as described above within the past three years cannot be considered independent (except for the test in the final bullet point which covers only current employment relationships). Nasdaq listing rules take a similar approach to defining independence.

Audit committee members of NYSE and Nasdaq companies must satisfy additional, heightened standards of independence.

Companies can also impose their own standards of independence, which must be disclosed.

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## 9. Are the roles of individual board members restricted?

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Individual board members of listed companies who serve on key committees must be independent (*see Question 8*).

The board determines its own leadership structure in accordance with the charter and bye-laws. Board leadership structure can take various forms, for example:

- Combined chair/CEO.
- Separate chair (who can be executive or non-executive, non-independent or independent) and CEO.
- Lead independent director, with responsibilities determined by the board.

SEC rules require disclosure of whether and why the board has chosen to combine or separate the board chair and CEO roles. Where the 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.

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## 10. How are directors appointed and removed? Is shareholder approval required?

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### Appointment of directors

**Election.** Under state corporate law, shareholders generally have the right to elect directors at the annual shareholder meeting (*sections 211 and 216, Delaware General Corporation Law (DGCL)*). Companies also adopt bye-laws authorising the board to elect directors to fill board vacancies and newly created directorships.

The statutory default is for plurality voting in uncontested director elections. Most large companies, however, have adopted some form of majority voting in uncontested director elections (over 95% of S&P companies in 2016, up from 16% in 2006).

**Nomination.** The board generally nominates director candidates, which is required to be done by an independent nominating committee for the New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq)-listed companies. Nasdaq, however, permits director nominations by independent directors without a formal committee.

Shareholders can also nominate director candidates either before or at a shareholder meeting if certain conditions are met, including, without limitation, compliance with advance notice and proxy access bye-laws.

### Removal of directors

Shareholders generally have the right to remove directors with or without cause. However, where the board is classified, shareholders can only remove directors with cause (unless the certificate of incorporation provides otherwise).

The holders of a majority of the shares that are entitled to vote at an election of directors can remove a director (subject to limited exceptions, such as where the company has cumulative voting) (*section 141(k), DGCL*). However, this power can be difficult to exercise in practice as many companies do not permit shareholders to call special meetings or act by written consent.

Directors can also be removed via judicial proceedings. Generally a board is highly constrained in its ability to remove a director.

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## 11. Are there any restrictions on a director's term of appointment?

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Directors are typically elected annually. Directors of companies with a classified board can be elected every three years (*section 141(d), Delaware General Corporation Law (DGCL) and the New York Stock Exchange (NYSE) listing rules*).

A small number of large US public companies have imposed director term limits (for example, 4% of S&P 500 companies disclosed a term limit in 2016 (*Source: Spencer Stuart Board Index 2016*)). While most institutional investors do not support director term and age limits, some are of the view that long-tenured directors are not independent.

## DIRECTORS' REMUNERATION

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## 12. Do directors have to be employees of the company? Can shareholders inspect directors' service contracts?

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### Directors employed by the company

Directors are not required to be employees of the company. Generally, the CEO is the only employee who serves on the board. As discussed in *Question 8*, according to the New York Stock Exchange (NYSE) or the Nasdaq Stock Market (Nasdaq) listing

rules, to be considered independent, the director cannot be, nor have been within the last three years, an employee of the corporation.

### Shareholders' inspection

US public companies do not normally enter into service contracts with their directors. Companies must file with the Securities and Exchange Commission (SEC) any agreements with a director (for example, indemnification agreements which are publicly available on the SEC website). Shareholders can also find information about directors' responsibilities, compensation and transactions with the company in the company's governance policies and SEC filings.

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## 13. Are directors allowed or required to own shares in the company?

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Directors are not required by law to own shares in the corporation (*section 141(b), Delaware General Corporation Law (DGCL)*). Many companies grant equity to directors (in addition to cash retainers and other benefits) to compensate them for director service.

Share and stock option ownership by directors is often required by companies' corporate governance guidelines (or bye-laws). These guidelines require directors to own a specified amount of the company's shares (or other equity) within a certain amount of time after joining the board.

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## 14. How is directors' remuneration determined? Is its disclosure necessary? Is shareholder approval required?

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### Determination of directors' remuneration

Generally, the board determines the amount and type of director compensation (usually upon the recommendation of the compensation or nominating/governance committee).

In determining the appropriate amount and type of director compensation, many boards (and/or committees) take into account advice provided by independent compensation consultants.

### Disclosure

Public companies must annually disclose director compensation for the prior fiscal year (including fees, stock and option awards and other benefits) in a tabular format, along with a narrative description of the information in the table. The New York Stock Exchange (NYSE) requires listed companies to adopt and disclose corporate governance guidelines which address director compensation. Since 2016, the Nasdaq Stock Market (Nasdaq) listed companies must disclose compensatory arrangements between directors or nominees and third parties in connection with that person's candidacy or service as a director (known as "golden leashes").

### Shareholder approval

NYSE and Nasdaq listing rules require companies to obtain shareholder approval of equity plans applicable to directors. Companies are not required to seek shareholder approval of cash compensation for directors.

### General issues and trends

Boards must exercise caution when approving equity compensation plans that permit equity awards to be made to non-employee directors. In light of recent Delaware litigation, these plans should include "meaningful limits" on the amount of equity that directors can award themselves to ensure that awards made under the plan are protected by the business judgement rule (*see Question 18*).

Proxy advisory firms do not scrutinise director compensation to the same extent as executive compensation. However, ISS' QualityScore governance rating for each company reports the



average outside directors' total compensation for the prior year as a multiple of the median pay of the company's ISS-determined comparison group for the same period.

## MANAGEMENT RULES AND AUTHORITY

### 15. How is a company's internal management regulated? For example, what is the length of notice and quorum for board meetings, and the voting requirements to pass resolutions at them?

The certificate of incorporation and bye-laws generally regulate a company's internal affairs. If the governing documents are silent, default rules under the relevant state law apply.

The Delaware General Corporation Law (DGCL) is silent with respect to notice for board meetings. Consequently, any applicable requirements will be as provided in the company's bye-laws and/or corporate governance guidelines.

DGCL section 141(b) provides that a majority of the total number of directors will constitute a quorum, unless the certificate of incorporation or bye-laws specify a greater or lesser quorum requirement (but not less than one third of the board). The vote of a majority of directors present at a meeting at which a quorum is present will be the act of the board (unless the certificate of incorporation, the bye-laws or the DGCL provide otherwise).

DGCL section 141(f) permits the board or any board committee to act without a meeting (so long as all members consent in writing or by electronic transmission), unless such action is restricted by the certificate of incorporation or bye-laws.

### 16. Can directors exercise all the powers of the company or are some powers reserved to the supervisory board (if any) or a general meeting? Can the powers of directors be restricted and are such restrictions enforceable against third parties?

#### Directors' powers

The board is responsible for managing and directing the business and affairs of the company except as may be provided in the certificate of incorporation (*section 141(a), Delaware General Corporation Law (DGCL)*). Generally, state law and the certificate of incorporation provide that directors can exercise all of the powers of the company. Boards typically delegate day-to-day responsibility for managing the company to management. The most critical powers of directors include selecting the CEO and overseeing senior management's performance in executing the company's strategy and managing risk.

Shareholders of US public companies have decision-making rights with respect to certain key matters:

- Director elections and removal of directors.
- Amendments to the certificate of incorporation.
- Amendments to the bye-laws (the board also typically has the right to amend bye-laws).
- Significant corporate transactions (such as mergers, sale of all or substantially all of the corporation's assets and dissolution).
- Advisory votes on executive compensation.
- Advisory or binding votes on shareholder proposals.
- Equity compensation plans and certain share issuances that exceed specified thresholds or would result in a change of control of the company (where listed on the New York Stock Exchange (NYSE) or the Nasdaq Stock Market (Nasdaq)).
- Auditor ratification (common but not required by law).

#### Restrictions

The certificate of incorporation and bye-laws can restrict the powers of directors.

### 17. Can the board delegate responsibility for specific issues to individual directors or a committee of directors? Is the board required to delegate some responsibilities, for example for audit, appointment or directors' remuneration?

Boards can delegate certain responsibilities to board committees. A board can, by resolution passed by a majority of the whole board, designate one or more committees, each consisting of at least one director. To the extent provided in the board resolution or the bye-laws, any of these committees can exercise all the powers and authority of the board. However, the board cannot delegate the power to (*section 141(c), Delaware General Corporation Law (DGCL)*):

- Adopt, amend or repeal any bye-law.
- Amend the certificate of incorporation (however, a board committee can 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 company's property and assets.
- Recommend to shareholders dissolution of the company or a revocation of 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 bye-laws).
- 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 bye-laws).

Boards of US public companies delegate responsibilities for audit, appointment of directors and compensation to board committees. The Sarbanes-Oxley Act 2002 and the New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq) listing rules require each company to have an audit committee comprised of independent directors that is responsible for certain audit and financial reporting matters. NYSE and Nasdaq listing rules require audit committee members to be financially literate and at least one member to be financially sophisticated.

As required by the Dodd-Frank Act, NYSE and Nasdaq listing rules provide that each company must have a compensation committee comprised of independent directors that is responsible for certain matters relating to executive compensation.

NYSE listing rules require that each company have a nominating/governance committee comprised of 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.

These committees are generally permitted to delegate their responsibilities to subcommittees solely comprised of one or more members of the relevant committee.

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## DIRECTOR'S DUTIES AND LIABILITIES

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### 18. What is the scope of a director's general duties and liability to the company, shareholders and third parties?

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#### Fiduciary duties

Directors owe fiduciary duties of care and loyalty to the company and its shareholders:

- **Duty of care.** The duty of care requires directors to act with the degree of care that an ordinarily prudent person in a like position would use under similar circumstances. The duty of care requires directors to act on an informed basis, after reasonable inquiry and deliberation. Directors are permitted to rely on management and experts where it is reasonable to do so.
- **Duty of loyalty.** The duty of loyalty requires directors to act in good faith and in a manner the director reasonably believes to be in the best interests of the company and its shareholders. The duty of loyalty prohibits self-dealing and misappropriation of assets or opportunities and requires directors to keep information confidential.

#### Directors' liability

Directors are subject to liability for their actions and inactions, but broad protections from liability typically apply. Courts will generally apply the business judgement rule which presumes that the directors and officers acted on an informed basis, in good faith and in the best interest of the company. If the plaintiff does not overcome the presumption, the court will not investigate the merits of the underlying board decision.

In certain contexts (such as sale of the company) a different standard of judicial review can apply. Directors are normally protected by governing document provisions that require exculpation from liability, indemnification and advancement of expenses, as well as directors and officers insurance.

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### 19. Briefly outline the regulatory framework for theft, fraud, and bribery that can apply to directors.

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Directors can be criminally liable under state and federal laws for actions that constitute theft, fraud or bribery. For example, a director can face sanctions for violating the Foreign Corrupt Practices Act (FCPA) which prohibits bribes to foreign officials for purposes of influencing a decision or securing an improper advantage to assist the company in obtaining or retaining business.

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### 20. Briefly outline the potential liability for directors under securities laws.

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Directors can face civil and criminal liability for violations of state and federal securities laws. For example, a director can be liable for (rule 10b-5, Exchange Act 1934 and section 11, Securities Act 1933):

- Material misrepresentations and material omissions in security offering documents.
- Insider trading and market manipulation.

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### 21. What is the scope of a director's duties and liability under insolvency laws?

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If a company becomes insolvent, directors continue to owe fiduciary duties to the company, but not directly to creditors. However, creditors of an insolvent company have standing to assert derivative (but not direct) claims against directors for breach of fiduciary duties (*North American Catholic Educational Programming Foundation Inc. v Gheewalla*, 930 A.2d (Del 18 May, 2007)).

When operating in the zone of insolvency, directors must continue to discharge their fiduciary duties to the company and its shareholders by exercising their business judgement in the best interests of the company and for the benefit of its shareholders. Directors can, as a matter of business judgement, favour certain non-insider creditors over others of similar priority without breaching their fiduciary duties.

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### 22. Briefly outline the potential liability for directors under environment and health and safety laws.

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Under certain circumstances, directors can be held personally liable for violations of environmental and health and safety laws, including:

- The Comprehensive Environmental Response.
- Compensation and Liability Act.
- Occupational Safety and Health Act.
- Clean Air Act and Clean Water Act.

Liability will vary depending on a director's knowledge or intent.

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### 23. Briefly outline the potential liability for directors under anti-trust laws.

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The primary federal anti-trust laws in the US include:

- The Sherman Act.
- The Federal Trade Commission Act.
- The Clayton Act.
- The Hart Scott Rodino Act.

In addition, most states have anti-trust laws that are enforced by state attorneys general or private plaintiffs.

Directors can be subject to significant liability for anti-trust law violations including:

- Criminal prosecution (typically limited to intentional and clear violations).
- Civil suits by the US or private citizens for an injunction or damages.
- Derivative actions by shareholders.

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### 24. Briefly outline any other liability that directors can incur under other specific laws.

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In some states, directors can be held personally liable for unpaid employee wages and other violations of wage and hour laws (for example, *California's A Fair Day's Pay Act 2016*).

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**25. Can a director's liability be restricted or limited? Is it possible for the company to indemnify a director against liabilities?**

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Companies normally include a provision in the certificate of incorporation eliminating or limiting the personal liability of directors to the company or shareholders for monetary damages for breach of fiduciary duty as a director (*section 102(b)(7), Delaware General Corporation Law (DGCL)*). This provision cannot eliminate or limit director liability for:

- Any breach 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.
- Any transaction from which the director derived an improper personal benefit.

Companies typically indemnify directors for liability incurred so long as the director (*section 145, DGCL*):

- Acted in good faith.
- Acted in a manner that he or she reasonably believed was in the best interests of the company.
- In the case of a criminal proceeding, had no reasonable cause to believe his or her conduct was unlawful.

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**26. Can a director obtain insurance against personal liability? If so, can the company pay the insurance premium?**

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Companies typically purchase and maintain directors' and officers' liability insurance to protect directors against the risk of personal liability (*section 145(g), Delaware General Corporation Law (DGCL)*). Companies can, and usually do, pay the insurance premiums on behalf of directors.

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**27. Can a third party (such as a parent company or controlling shareholder) be liable as a de facto director (even though such person has not been formally appointed as a director)?**

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A shareholder's liability for corporate actions is generally limited to the amount of its equity investment in the company. However, courts can "pierce the corporate veil" to impose personal liability on the shareholders in exceptional circumstances, such as where the corporate form is being used as a sham to perpetrate a fraud or to avoid liability.

Controlling shareholders can also owe fiduciary duties of fair dealing to the company and minority shareholders.

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**TRANSACTIONS WITH DIRECTORS AND CONFLICTS**

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**28. Are there general rules relating to conflicts of interest between a director and the company?**

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Directors owe a duty of loyalty to the company and its shareholders. This duty prohibits self-dealing and misappropriation of assets or opportunities. Directors cannot use their position to make a personal profit or achieve personal gain. The duty of loyalty requires directors to disclose any conflicts of interest. The board must recuse conflicted directors from board discussions and decision-making relating to the conflict. A self-

dealing transaction is not voidable if (*section 144, Delaware General Corporation Law (DGCL)*):

- It is approved by informed and disinterested directors or shareholders.
- The transaction is fair to the company.

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**29. Are there restrictions on particular transactions between a company and its directors?**

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Section 402 of the Sarbanes-Oxley Act 2002 prohibits companies from extending or maintaining personal loans to directors, with certain exceptions (for example, loans made by FDIC-insured institutions and ordinary course of business loans made by consumer lenders). Transactions with the company can also impact a director's independence (*see Question 7*).

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**30. Are there restrictions on the purchase or sale by a director of the shares and other securities of the company he is a director of?**

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In general, directors are not restricted from purchasing or selling shares and other securities of the company. However:

A director is prohibited from trading in a company's securities when in possession of material, non-public information about the company (*rule 10b-5, Exchange Act 1934*).

- Companies generally have policies that impose black-out periods and otherwise regulate trading in the company's stock by directors and officers.
- The public resale of directors' shares is not permitted unless certain conditions are met, such as specified holding periods and volume limitations (*Part 144, Securities Act 1933*).
- Directors must disclose their shareholdings and any transactions that result in a change in their share ownership (*section 16, Exchange Act 1934*).
- Directors must disgorge to the company any profits realised on the purchase and sale of the company's securities within a period of less than six months ("short-swing" profits) (*section 16, Exchange Act 1934*).
- Many companies prohibit directors from pledging and/or hedging company stock.

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**DISCLOSURE OF INFORMATION**

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**31. Do directors have to disclose information about the company to shareholders, the public or regulatory bodies?**

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Directors are required to sign certain disclosure documents the company files with the Securities and Exchange Commission (SEC) (for example, the annual report on Form 10-K).

Directors are increasingly involved in communicating with shareholders (for example, via shareholder engagement and/or letters from the board that are included in the proxy statement).

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## SHAREHOLDER RIGHTS

### Company meetings

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#### 32. Does a company have to hold an annual shareholders' meeting? If so, when? What issues must be discussed and approved?

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Most states require companies to hold an annual shareholders' meeting, (for example, for the election of directors), to be held at a date, time, and place prescribed or determined in accordance with the company's certificate of incorporation or bye-laws (*section 211(b), Delaware General Corporation Law (DGCL)*). Typically, the board determines when and where to hold the meeting, including whether a meeting should be held at a physical location, virtually or both.

The New York Stock Exchange (NYSE) requires companies to hold an annual shareholders' meeting during each fiscal year. The Nasdaq Stock Market (Nasdaq) requires each company to hold an annual shareholders' meeting no later than one year after the end of the company's prior fiscal year.

In addition to director elections, "any other proper business may be transacted at the annual meeting" under the DGCL. Common agenda items include:

- Ratification of the appointment of the independent auditor.
  - Approval of equity compensation plans.
  - Approval of proposed amendments to the certificate of incorporation.
  - Shareholder proposals (advisory or binding).
  - An advisory vote on executive compensation (say-on-pay).
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#### 33. What are the notice, quorum and voting requirements for holding meetings and passing resolutions?

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Companies must notify shareholders of shareholder meetings within a fixed number of days before the meeting date; the number varies according to state law. In Delaware, companies must provide notice to shareholders, in a maximum of 60 and a minimum of ten days, before the date of the annual meeting (*section 222, Delaware General Corporation Law (DGCL)*). Shareholders can waive notice under certain circumstances, such as by signing a written waiver or attending the meeting.

Notice must generally be in writing, although many states permit electronic transmission. A notice of an annual meeting need not specify the meeting's purposes except when fundamental corporate actions (for example, merger or dissolution) are to be voted on. A notice of special meeting must specify the purpose for which the meeting is being called.

State law generally allows companies to establish a record date to determine who is eligible to receive notice and vote at a shareholder meeting. The record date for Delaware companies must be a maximum of 60 and a minimum of ten days before the meeting date (*section 213, DGCL*).

The bye-laws prescribe the quorum necessary for valid shareholder action to be taken at a meeting, which in Delaware must be at least one-third of the shares entitled to vote at the meeting. If the governing documents are silent, state law typically provides that a majority of shares entitled to vote, present or represented by proxy, constitutes a quorum at a meeting of shareholders (*section 216, DGCL*). Director elections are by plurality voting under the statutory default. However, most large companies have adopted some form of majority voting in uncontested director elections.

Shareholders can also act by written consent in lieu of a meeting at some companies. The threshold for written consent may be unanimous or the same number of shareholders necessary to take action at a meeting. If shareholders act by less than unanimous written consent, the company must provide notice of the action taken to all shareholders.

#### 34. Are specific voting majorities required by statute for certain corporate actions?

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The shareholder vote required to approve a corporate action is typically provided in the certificate of incorporation or bye-laws, in accordance with state law. The Delaware General Corporation Law (DGCL) requires a majority shareholder vote to:

- Amend the certificate of incorporation (*section 242, DGCL*).
- Approve a merger or sale of assets (*sections 271 and 251, DGCL*).
- Effect a dissolution of the company (*section 275, DGCL*).

Companies can set a higher percentage than the default statutory standards.

#### 35. Can shareholders call a meeting or propose a specific resolution for a meeting? If so, what level of shareholding is required to do this?

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State law generally permits shareholders to petition the court to compel an annual shareholder meeting if the board failed to hold one (*section 211, Delaware General Corporation Law (DGCL)*). Shareholders can also call special meetings in accordance with, and subject to, the certificate of incorporation or bye-laws.

A shareholder eligible to bring matters before a shareholder meeting (including advance notice requirements) can also, at his or her own expense, solicit shareholder proxies in favour of any proposal, subject to the federal proxy rules.

Public companies must include proposals submitted by qualified shareholders in their proxy materials (*rule 14a-8, Exchange Act 1934*). To be eligible, a shareholder must have continuously held at least US\$2,000 in market value or 1% of the company's securities that are entitled to vote for at least one year by the date he or she submits the proposal, and hold those securities until the meeting date.

The majority of S&P 500 companies also permit shareholders or a group of shareholders with beneficial ownership of typically 3% for three years and meeting certain conditions, to include a limited number of director candidates in the company's proxy materials.

#### Minority shareholder action

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#### 36. What action, if any, can a minority shareholder take if it believes the company is being mismanaged and what level of shareholding is required to do this?

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A minority shareholder can take the following actions if it believes the company is being mismanaged:

- Inspect the books and records of the company (*section 220, Delaware General Corporation Law (DGCL)*).
- Engage in activism, for example, by:
  - waging a proxy contest (to nominate a director or replace members of the board or the corporation's management);



- filing a shareholder proposal (*rule 14a-8, Exchange Act 1934*); and/or
- engaging with management and/or the board.
- File a derivative action (that is, in the name of the company) alleging director misconduct.
- File a direct action.

## INTERNAL CONTROLS, ACCOUNTS AND AUDIT

### 37. Are there any formal requirements or guidelines relating to the internal control of business risks?

Public companies must include in annual reports on Form 10-K, an internal control report that includes (*section 404, Sarbanes-Oxley Act 2002*):

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company.
- Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the most recent fiscal year.
- A statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting (for example, Internal Control – Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission).
- A statement that the independent auditor has issued an attestation report on management's assessment of the company's internal control over financial reporting.

In addition, the CEO and the chief financial officer must provide quarterly certifications in relation to internal control over financial reporting.

The FCPA requires companies to have a system of internal accounting controls sufficient to provide reasonable assurances that:

- Transactions are properly authorised and recorded.
- Access to assets is properly authorised.

### 38. What are the responsibilities and potential liabilities of directors in relation to the company's accounts?

Directors can face civil and criminal liability based on violations of state and federal securities laws for fraudulent misrepresentation or material omissions in documents that are filed with the Securities and Exchange Commission (SEC).

Any director who makes or causes the making of a false or misleading statement in a document filed with the SEC (including those in relation to the company's accounts), has personal liability for the misrepresentation. This excludes directors who can prove that they acted in good faith and with lack of knowledge.

Directors can also face liability under rule 13b2-2 of the Exchange Act 1934 if they:

- Make a materially false statement to an accountant in connection with an audit or the preparation of an SEC filing.
- Fraudulently influence, coerce, manipulate or mislead an accounting firm during an audit, with the intention of rendering the financial statements materially misleading.

### 39. Do a company's accounts have to be audited?

A public company's annual financial statements must be audited by a registered independent accounting firm. Interim financial statements are not audited (they are reviewed).

### 40. How are the company's auditors appointed? Is there a limit on the length of their appointment?

A public company's audit committee must be directly responsible for the appointment, compensation and oversight of the independent auditors (*section 301, Sarbanes-Oxley Act 2002*). The audit committee has authority to approve all audit engagement terms and fees, as well as the authority to terminate the engagement. Companies typically seek shareholder ratification of independent auditor appointments.

Lead audit partners must rotate every five years (*section 203, Sarbanes-Oxley Act 2002*). Audit firm rotation is not required.

### 41. Are there restrictions on who can be the company's auditors?

Any firm auditing a public company's financial statements must be registered with the Public Company Accounting Oversight Board (PCAOB). They must also meet independence requirements provided in the federal securities laws (such as *rule 10A-2, Exchange Act 1934*) and PCAOB rules (PCAOB *rule 3520*).

### 42. Are there restrictions on non-audit work that auditors can do for the company that they audit accounts for?

Rule 2-01 of regulation S-X prohibits auditors from providing certain non-audit services to their clients and their client's affiliates, including:

- Bookkeeping and other services related to the accounting records or financial statements of the client.
- Financial information systems design and implementation.
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.
- Actuarial services.
- Internal audit outsourcing services.
- Management functions or human resources.
- Broker-dealer, investment adviser, or investment banking services.
- Legal services.
- Expert services unrelated to the audit.

The audit committee must also determine whether any service provided by the auditors can impair the firm's independence.

### 43. What is the potential liability of auditors to the company, its shareholders and third parties if the audited accounts are inaccurate? Can their liability be limited or excluded?

An auditor can be liable to the company for breach of contract, negligence or fraud, if the audited accounts are inaccurate.

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Shareholders and other third parties can also have claims against the auditor for negligence or fraud.

The Securities and Exchange Commission (SEC) can also bring proceedings to censure or temporarily or permanently bar auditors from appearing or practicing before the SEC if they are found to have engaged in improper professional conduct.

Auditor engagement letters can include a provision purporting to limit the auditor's liability **and/or** provide for indemnification under certain circumstances.

- Organise and keep minutes of board, committee and shareholder meetings.
- Maintain corporate books and records.
- Manage company filings.

The corporate secretary is also a key advisor to the board and management on corporate governance matters. The corporate secretary can also be involved in engagement with shareholders and proxy advisory firms.

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#### 44. What is the role of the company secretary (or equivalent) in corporate governance?

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Companies typically appoint a corporate secretary to:

### ONLINE RESOURCES

#### Delaware Code Online

**W** [www.delcode.delaware.gov/title8/c001/](http://www.delcode.delaware.gov/title8/c001/)

**Description.** The official website of the State of Delaware with an up-to-date version of the Delaware General Corporation Law maintained by the State's Division of Corporations.

#### Delaware Courts

**W** <http://courts.delaware.gov/opinions/list.aspx?ag=supreme%20court>

**Description.** The official website of the Delaware court system with access to opinions and orders of the Delaware Supreme Court and Delaware Court of Chancery.

#### Model Business Corporation Act 1950

**W** [www.americanbar.org/content/dam/aba/administrative/business\\_law/corplaws/2016\\_mbca.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/administrative/business_law/corplaws/2016_mbca.authcheckdam.pdf)

**Description.** The 2016 revision of the Model Business Corporation Act maintained by the Corporate Laws Committee of the Business Law Section of the American Bar Association.

#### Securities and Exchange Commission (SEC) Regulation S-K

**W** [www.ecfr.gov/cgi-bin/text-idx?tpl=/ecfrbrowse/Title17/17cfr229\\_main\\_02.tpl](http://www.ecfr.gov/cgi-bin/text-idx?tpl=/ecfrbrowse/Title17/17cfr229_main_02.tpl)

**Description.** The electronic Code of Federal Regulations maintained by the US Government Publishing Office including an up-to-date version of regulation S-K under the Securities and Exchange Act of 1934 (as amended).

#### The New York Stock Exchange (NYSE) Listed Company Manual

**W** [http://wallstreet.cch.com/LCMTTools/PlatformViewer.asp?selectednode=chp\\_1\\_4&manual=%2Fbcm%2Fsections%2Fbcm-sections%2F](http://wallstreet.cch.com/LCMTTools/PlatformViewer.asp?selectednode=chp_1_4&manual=%2Fbcm%2Fsections%2Fbcm-sections%2F)

**Description.** The listing rules applicable to companies listed on the NYSE, including Corporate Governance Standards in section 303A.

#### Nasdaq Stock Market Rules

**W**

[http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?ssearched=1&selectednode=chp\\_1\\_1\\_4\\_3\\_8&CiRestriction=5600&manual=%2Fnasdaq%2FMain%2Fnasdaq-equityrules%2F](http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?ssearched=1&selectednode=chp_1_1_4_3_8&CiRestriction=5600&manual=%2Fnasdaq%2FMain%2Fnasdaq-equityrules%2F)

**Description.** The listing rules applicable to companies listed on the Nasdaq Stock Market, including Corporate Governance Requirements in section 5600.

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