DIRECTOR INDEPENDENCE AND CORPORATE CHARITABLE GIVING

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The effective service of independent directors has long been regarded as an important component of good corporate governance for public companies. Consistent with this vision and in light of well-publicized corporate governance failures over the past several years, government regulators and self-regulatory entities such as the New York Stock Exchange and Nasdaq Stock Market are pursuing new initiatives to ensure the true independence of outside directors. In response to the requirements of the Sarbanes-Oxley Act, the Securities and Exchange Commission has adopted rules setting minimum independence standards for directors who serve on audit committees of listed companies, and the New York Stock Exchange and the Nasdaq Stock Market have each proposed a set of corporate governance listing standards that include criteria that directors must meet in order to be considered independent. In addition, within the past several weeks, the Delaware Chancery Court issued an opinion that could potentially re-cast how courts in Delaware and elsewhere assess director independence in a state-law context.

As a result of recent developments regarding director independence, boards of directors of public companies should re-evaluate the independence of their members. In particular, charitable contributions made, directly or indirectly, by a corporation[1] may be found to impair or impeach the independence of an outside director who is employed by, or otherwise has a material relationship with, the non-profit organization receiving the contribution.

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[1] Charitable contributions, including contributions of services or of goods in kind, from a variety of sources may present issues bearing upon a director's independence. In this memorandum, references to charitable contributions include, as appropriate: (a) charitable contributions made directly by a corporation to a non-profit organization; (b) charitable giving by a foundation sponsored by or associated with a corporation; (c) charitable contributions made directly or indirectly by directors or executive officers of a corporation; and (d) charitable contributions made by an "independent foundation" where the directors or executive officers of a corporation comprise a majority or significant minority of the foundation's board.

This memorandum summarizes the independence standards adopted pursuant to the Sarbanes-Oxley Act and the proposed standards of the NYSE and Nasdaq, focusing particular attention to the impact that charitable contributions could have on an analysis of a director's independence. In addition, this memorandum discusses the recent decision of the Delaware Chancery Court in *In re Oracle Corp.*[2], a case which found that directors who were university professors could be found to lack the necessary independence to dismiss claims against other defendant directors based upon the significant relationships of the other defendant directors with the same university at which the professor directors taught.

While the requirements in this area are continuing to evolve, with the NYSE and Nasdaq rules still being subject to SEC approval, the analysis required under any of the standards is clearly a highly fact-intensive exercise that must be conducted with care. As discussed at the conclusion of this memorandum, companies listed on the NYSE may wish to consider adopting categorical standards in order to facilitate compliance with its director independence requirements.

IMPACT OF CHARITABLE CONTRIBUTIONS UNDER FINAL SEC INDEPENDENCE STANDARDS AND PROPOSED NYSE AND NASDAQ INDEPENDENCE STANDARDS

SEC's Section 301 Rules

On April 9, 2003, the SEC published final rules under Section 301 of the Sarbanes-Oxley Act that will prohibit any national securities exchange from listing any security of an issuer that, among other things, does not have an audit committee comprised entirely of independent directors.[3] Under the Section 301 Rules, for a director to be considered independent, the director must satisfy the following two-prong test:

- ***No compensation***: the director may not receive, directly or indirectly, any consulting, advisory or other compensatory fee from the issuer or any of its subsidiaries (other than ordinary course director's fees); and

[2] *In re Oracle Corp.*, 2003 WL 21396449 (Del. Ch. June 17, 2003).

[3] Listed companies (other than foreign private issuers and small business issuers) must comply with the new standards by the earlier of (a) the first annual shareholders meeting after January 15, 2004 or (b) October 31, 2004.

- ***No affiliation***: the director may not be an "affiliated person" of the issuer.

The Section 301 Rules contain certain limited exceptions to the above test, as well as some clarifications. The Section 301 Rules define the "indirect" acceptance of fees to include the receipt of the following payments:

- Payments to a director's spouse, minor child or minor stepchild (or child or stepchild sharing a home with the committee member); and

- Payments to an entity in which the director is a partner, member, an officer such as a managing director occupying a comparable position or executive officer (or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who have no active role in providing services to the

- entity)) and which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any of its subsidiaries.[4]

Under a strict reading of the Section 301 Rules, it would seem unlikely that charitable contributions made directly or indirectly by a company would impair the independence of any of its directors. The principal thrust of the rule is scrutiny of compensatory arrangements that benefit, directly or indirectly, a director or the director's immediate family. The prohibition of "indirect" compensatory fees focuses on a director being affiliated with an entity that provides accounting, consulting, legal, investment banking or financial advisory services to the company on whose board the director sits, in each case a circumstance where the director's compensation may be indirectly affected by fees payable by the company. Accordingly, the rule would not appear to disqualify as independent a director who associated with a non-profit organization, particularly where the director serves the non-profit organization in a purely non-executive capacity.

Notwithstanding a strict interpretation of the Section 301 Rules, however, the recent emphasis placed by the SEC on the "spirit" of its regulations should be taken into account in examining the independence directors who have relationships with non-profit organizations that receive, directly or indirectly, contributions from the listed company. For example, the SEC release setting forth the Section 301 Rules stresses the importance of independent directors not being beholden to management, regardless of whether there are compensatory arrangements that impeach the independence of a director. Thus, a listed company providing 100% of the funding for a non-profit organization on which one of its "independent" directors serves as the sole executive officer and chief fundraiser may well be challenged on its characterization of such director as being independent.

Proposed NYSE and Nasdaq Listing Standards

In recent months, the NYSE and Nasdaq have both proposed new corporate governance listing standards.[5] The proposed standards would require in each case that listed companies have boards of directors comprised of a majority of independent directors (within 18 months following adoption of the final rules, in the case of NYSE-listed companies, and by the first annual meeting occurring after January 14, 2004, in the case of Nasdaq-listed companies). In addition, both sets of rules include proposed general standards for determining director

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[4] The SEC further clarified that the Section 301 Rules would not preclude independence based on payments made pursuant to an ordinary course business transaction between the issuer and an entity with which the director has a relationship.

[5] The NYSE filed its amended corporate governance listing standards with the SEC on April 4, 2003, and the Nasdaq filed its amended corporate governance listing standards with the SEC on March 11, 2003.

independence as well as specified categories that would be *per se* independence disqualifications.

Proposed NYSE Listing Standards. Summarized below is the base-line independence test under the proposed NYSE listing standards as well as one of the types of relationship that would be a *per se* independence disqualification.

- **Base-Line Test**. The proposed standards provide that no director qualifies as "independent" unless the board of directors "affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)."
- ***Per Se* Independence Disqualification**. The proposed standards consider the following relationship to be an absolute bar on a director being considered independent:[6]

> A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of another *company*: (i) that accounts for at least 2% or $1 million, whichever is greater, of the listed company's consolidated gross revenues; or (ii) for which the listed company accounts for at least 2% or $1 million, whichever is greater, of such other company's consolidated gross revenues. (emphasis added)

The applicability of this *per se* independence disqualification to non-profit organizations is ambiguous, particularly as non-profit organizations may not be regarded as being "companies" in a conventional sense. In this regard, we note that a spokesman for the NYSE has been quoted as indicating that the NYSE standard would leave to the listed company whether to apply the per se disqualification to non-profit executives. Assuming this *per se* disqualification is ultimately adopted as currently proposed and in the absence of other guidance, we believe that listed companies should assume that the references to "company" in the standard include non-profit organizations. Until this matter is clarified, we believe that prudence would dictate interpreting the prohibited relationships broadly. In addition, while the disqualification specifically addresses a director who is "an executive officer or an employee … of another company", consideration should also be given as to whether service on the board of directors or board of advisors of a non-profit entity presents questions bearing on a director's independence.

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[6] The proposed NYSE listing standards also include other *per se* independence disqualifications that are not discussed in this memorandum. These other disqualifications are notdiscussed in this memorandum because they are less relevant to the independence issues arising in the context of charitable contributions.

Even in the event that a company determines not to apply the *per* se disqualification to directors serving on the board of directors of non-profit organizations, the base-line independence determination may require consideration of such relationships. The NYSE's proposed standards do not expressly define what constitutes a "material relationship," but instead indicate that a board of directors would make that determination "broadly considering all relevant facts and circumstances." The proposed standards further provide that in making determinations as to a director's independence, the board of directors should consider the relationship both from the viewpoint of the director and also from the viewpoint of the persons or organizations with which the director is associated. Moreover, the proposed standards note that material relationships can include, among others, "commercial, industrial, banking, consulting, legal, accounting, *charitable* and familial relationships" (emphasis added). At a minimum, therefore, a listed company's board of directors will need to assess the materiality of any relationship between the listed company and one of its directors who has a relationship with a beneficiary of the listed company's charitable contributions. For example, a director of a listed company who is also the chairman of the board of a non-profit organization that solicits material contributions from the management of such listed company may compromise his or her independence even if the director is not an executive officer or employee of the non-profit organization.

Under the proposed standards, the basis for any board determination that a relationship is not material must be disclosed in the listed company's annual proxy statement. Alternatively, the proposed standards allow a board of directors to adopt and publicly disclose categorical standards to assist it in determining director independence. For example, a board may disclose its determination that direct and indirect contributions of less than a specified dollar and/or percentage threshold to a non-profit organization for which the director serves as an executive officer is, as a category, immaterial for purposes of determining independence. When disclosing the categorical standards, a listed company may then, if applicable, make the general statement that the independent directors meet the standards set by the board without detailing the particular aspects of the immaterial relationships between individual directors and the company. Any independence determinations for a director who does not meet the categorical standards must be specifically explained in the disclosure.

Proposed Nasdaq Listing Standards. Summarized below is the base-line independence test under the proposed Nasdaq listing standards as well as one type of relationship that is a *per se* independence disqualification relevant to assessing the impact of charitable contributions on the independence determination.

- **Base-Line Test**. The proposed standards define an independent director as "a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director."

- ***Per Se* Independence Disqualification.** The proposed standards specify that the following person shall not be considered independent: [7]

> "a director who is a partner in, or a controlling shareholder or an executive officer of, *any organization* to which the company made, or from which the company received, payments … that exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more…" (emphasis added).

Unlike the NYSE *per se* disqualification which refers to "companies", the Nasdaq *per se* disqualification is expressly more expansive applying to any "organization," an expression which would clearly include non-profit organizations. Indeed this standard updates an existing Nasdaq standard with the word "organization" being inserted in substitution for the phrase "for-profit business organization." Consequently, the Nasdaq standard-setters clearly intended to include non-profit affiliations within the scope of the potential *per se* disqualification. As with the proposed NYSE standard, the Nasdaq *per se* disqualification specifically addresses only directors who serve as a partner, a controlling shareholder or an executive officer of the non-profit organization. As with the NYSE's proposed standards, Nasdaq companies may conclude that the *per se* disqualification may not apply to persons who serve only as directors of non-profit organizations although such companies would be well advised to consider separately the impact of such service under the base-line test.

The proposed NYSE and proposed Nasdaq standards remain subject to SEC approval and may be revised prior to final approval. In this regard, we note that the SEC indicated several months ago that it intends to work towards harmonizing the proposed NYSE and Nasdaq standards.

IMPACT OF CHARITABLE CONTRIBUTIONS FOLLOWING DELAWARE CHANCERY COURT'S *ORACLE* DECISION

The question of director independence recently arose in a much different context involving the service of two non-executive directors on a special board committee established to consider shareholder derivative actions brought in the name of Oracle Corporation against certain Oracle directors and officers. On June 17, 2003, the Delaware Chancery Court issued an opinion that speaks to the Delaware state-law standard of independence in this context.

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[7] The proposed Nasdaq listing standards include other *per se* independence disqualifications that are not discussed in this memorandum because they are less relevant to the independence issues arising in the context of charitable contributions.

Factual Background

Four members of Oracle's board of directors (Lawrence Ellison, Oracle's chief executive officer and largest shareholder, Jeffrey Henley, Oracle's chief financial officer and two outside directors, Michael Boskin and Donald Lucas) sold shares of Oracle stock during January 2001. Following a negative earnings announcement on March 1, 2001, the price of Oracle's stock dropped markedly and thereafter the plaintiffs initiated derivative actions against each of Ellison, Henley, Lucas and Boskin alleging insider trading.

On February 1, 2002, in response to the derivative suits, Oracle formed a special litigation committee, or an "SLC," to investigate the claims and to determine whether Oracle should press the plaintiffs' claims, seek to settle the case or terminate it. Two non-executive members of the Oracle board were named to the SLC, both of whom were tenured professors at Stanford University—Professor Hector Garcia-Molina and Professor Joseph Grundfest. The SLC then embarked on what the Chancery Court characterized as an investigation that was "by any objective standard, extensive."[8]

In the end, the SLC produced a 1,100 page report and concluded that Oracle should not pursue the plaintiffs' claims against the director-defendants or any of the other Oracle directors serving during the third quarter of Oracle's 2001 fiscal year. Consistent with its report, the SLC then moved to terminate the derivative action, following which the plaintiffs were granted discovery. The central issue addressed in the *Oracle* decision is the plaintiffs' contention that the members of the SLC were not independent. Under Delaware law, the burden of proof resided with the SLC to establish, among other things, the independence of its members in order for its motion to terminate the derivative action to prevail.

Opinion of Delaware Chancery Court

In *Oracle*, the Delaware Chancery Court denied the SCL's motion to terminate the derivative action on the basis that the SLC had not met its burden to show an absence of a material factual question about the independence of its members. At the heart of the Court's decision were the multi-faceted relationships and ties between the two Stanford professors who comprised the SLC and the four director-defendants, some of whom had made significant charitable contributions to Stanford University. After devoting a substantial portion of its opinion to outlining these relationships, the Court concluded that "the ties among the SLC, the director defendants, and Stanford are so substantial that they cause reasonable doubt about the SLC's ability to impartially consider whether the director defendants should face suit."

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8 Simpson Thacher & Bartlett LLP has acted as counsel to the Oracle SLC on this matter. The description of the *Oracle* case contained in this memorandum is derived solely from the Chancery Court's publicly available opinion.

Although the Court focused on several types of relationships between the SLC members and the director-defendants (*e.g.*, Boskin, Garcia-Molina and Grundfest were all professors at Stanford, Boskin had taught Grundfest and Boskin and Grundfest both were named as members of the steering committee of the Stanford Institute for Economic Policy Research), a substantial number of the relationships that the Court examined centered on charitable contributions and activities directed by the director-defendants toward Stanford. For example, a foundation of which Lucas was the chairperson had donated $11.7 million to Stanford since its 1981 founding and from his own personal funds, Lucas had contributed $4.1 million to Stanford. In addition, during Ellison's tenure as CEO of Oracle, the company had made over $300,000 in donations to Stanford and Ellison and Stanford had discussed the possible creation of an "Ellison Scholars Program" with a budget (proposed by Stanford) of $170 million.

In response to the plaintiffs' argument that these relationships impaired the SLC's independence, the SLC pointed out that both of its members were well-respected, tenured faculty members with no fundraising obligations. The SLC also cited Delaware precedent holding that the focus of a bias inquiry in such a context should be on whether a director is dominated or controlled or there are economically material ties between the interested party and the director whose impartiality is questioned. Further, the SLC asserted that under Delaware law, generalized notions of "structural bias" and "other unseen socialization processes cutting against independent discussion and decision-making" are insufficient to establish a lack of independence[9] (*e.g.*, personal friends are not, solely by virtue of such ties, non-independent).

The Court, however, opined that the question of independence turns on "whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind." The Court then noted that a director may be compromised if he or she is beholden to an interested person and "[b]eholden in this sense does not mean just owing in the financial sense, it can also flow out of 'personal or other relationships' to the interested party." The Court ultimately embraced a "contextual approach" to the independence determination that took into account the "thickness of the social and institutional connections among Oracle, the director defendants, Stanford, and the SLC Members." Figuring prominently among the many connections between the SLC Members and the director defendants were the charitable contributions made (or considered) by the director-defendants in favor of Stanford.

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[9] *Aronson v. Lewis*, 473 A.2d 805 (Del.1984), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

IMPLICATIONS AND PRACTICAL CONSIDERATIONS

State of Regulation Remains in Flux. Despite the emphasis placed on director independence in newly promulgated or proposed regulations and the attention that the interplay of director independence and corporate charitable giving has recently received by the courts as well as in the press, there is currently little clarity in the applicable rules. The NYSE and Nasdaq listing standards are still in proposed form only, and the possibility exists that the SEC will ask these organizations to revise their standards before approving them. Furthermore, as regards the *Oracle* decision, the judge felt compelled to acknowledge that "it would be less than candid if I did not admit that Delaware courts have applied these general standards in a manner that has been less than wholly consistent"[10] and that there is a possibility that the defendants in the case will seek to appeal the decision. In assessing independence, the court also acknowledged the highly contextual nature of any independence decision by noting that saying no to a friend or colleague who seeks assent to a transaction is easier than causing a corporation to sue such person.

The confusion regarding these issues is further compounded by the many organizations that have published their views of what "independence" should mean. As early as 1998, a report by CalPERS entitled "*U.S. Corporate Governance Core Principles and Guidelines*" included an appendix in which it summarized eleven definitions of an independent director promulgated by various governmental agencies and corporate governance groups. Several of these organizations continue to press for a definition that takes into account relationships between a company and non-profit organizations affiliated with the company's directors. For example, the Council of Institutional Investors published a recent report stating that: "corporations should disclose all financial or business relationships with and payments to directors and their families and all significant payments to companies, non-profits, foundations and other organizations where company directors serve as employees, officers and directors." Other organizations decline to prescribe specifics, apparently preferring to confer greater discretion upon a company's board (*e.g.*, the Business Roundtable's May 2002 *Principles of Corporate Governance* states that "[b]oard independence depends not only on directors' individual relationships—personal, employment or business—but also on the board's overall attitude toward management … A substantial majority of directors of the board of a publicly owned corporation should be independent of management, both in fact and appearance.").

Fact-Intensive Analysis. Although the applicable regulatory standards are still evolving, any analysis of a director's independence in the context of direct or indirect corporate charitable contributions will clearly be highly fact-intensive. This will be true in the context of

10 *In re Oracle Corp Derivative Litigation*, 2003 WL 21396449 (Del. Ch.) at p. 20.

regulatory compliance as well as analysis under Delaware law. In addition, in light of the scrutiny these matters are currently receiving, companies and their boards need to take into consideration not only the precise requirements of adopted rules and standards but also the spirit of the regulation and matters that may give rise to the appearance of conflicts of interest. Initiatives in this area appear to be uniform in the conclusion that a director may not be considered independent if he or she is beholden to the company or its management. Assessing whether a director is "beholden," however, will require a careful examination of all the facts and circumstances in the relationship between the company and the director.

Begin Evaluations Now. Since the standards that are eventually adopted will likely necessitate a fact-intensive inquiry, companies and their boards would be well advised to begin evaluating the independence of their directors as soon as possible. Many companies could find that one or more of the directors they had previously considered independent have an affiliation with a non-profit organization that calls into question his or her independence given the changing climate. Our advice here is consistent with a recommendation by The Conference Board in its January 9, 2003 report: "[e]ach director should disclose to the board or to a designated committee all relationships between and among that director, the company, and senior management of the company, including any potential conflict of interest, whether or not required for public disclosure, in order to allow for a comprehensive determination of a director's independence." Director and officer questionnaires, for example, should expressly inquire about a director's direct and indirect affiliations with non-profit organizations so that the company can fully evaluate the impact of charitable contributions that may impair independence.

Because of the contextual nature of the analysis, boards of directors will need to proceed with care in assessing the independence of their members. In this regard, boards should examine relationships its members have with non-profit organizations even if those directors only serve on the board or other governing body of a non-profit organization. As detailed above, the focus of the current and proposed standards appears to be directors who serve as executives at the non-profit beneficiaries of corporate largesse. Nonetheless, with both the public and regulatory agencies, not to mention the courts in the state-law context, prepared to take a critical view of director's independence, it would be prudent for boards to take note of and consider those relationships in which one of its members serves as an officer *or* a director of a non-profit organization. Any analysis of a director's independence also needs to take into account the context in which such director's independence is being considered.

Consider Adopting Categorical Standards. For NYSE-listed companies (assuming the ability to adopt categorical standards survives in the final form of the listing standards), a board should consider adopting categorical standards of independence with regard to direct and indirect charitable contributions. Although to date there is little practical experience in this area, we believe that adopting categorical independence standards may be very useful in providing guidelines to avoid actions that might compromise directors' independence.

Categorical standards would also reduce the time that might otherwise be required to consider on a case-by-case basis the interplay between directors' independence and corporate charitable contributions and those of the company. In that connection, we note that several prominent companies already have put in place guidelines to assist their boards in making independence determinations as they relate to charitable contributions. General Electric, for example, had the following categorical standard published on its website:

> The following … charitable relationships will not be considered to be material relationships that would impair a director's independence … if a GE director serves as an officer, director or trustee of a charitable organization, and GE's discretionary charitable contributions to the organization are less than one percent of that organization's total annual charitable receipts. … The board will annually review all commercial and charitable relationships of directors. Whether directors meet these categorical independence tests will be reviewed and will be made public annually prior to their standing for re-election to the board.

We understand that a number of other companies including Automatic Data Processing Inc., Aetna Inc., Dell Computer Corp., Electronic Data Systems Corp. and Prudential Financial Inc have adopted policies relating to the relationships of directors with non-profit organizations and/or charitable giving. It should be noted, however, that while categorical standards may be useful in addressing compliance with the NYSE listing standards, categorical standards may not be respected by state courts addressing matters of director independence.

CONCLUSION

As companies and their boards continue to adapt to the recent and pending changes in law and regulation, they should expect increased attention on the impact of direct and indirect charitable contributions on director independence. With matters bearing on director independence likely to continue to receive considerable attention, we believe that public companies should evaluate carefully any and all links between charitable contributions and their directors. Although the law and regulation in this area remain unsettled, companies and directors alike should anticipate the application of increasingly rigorous standards to determinations of director independence.

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This memorandum is for general informational purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as

additional memoranda regarding recent corporate governance developments, can be obtained from our website, www.simpsonthacher.com.

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