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A Dozen Tips on How to Resolve Post-Closing M&A Disputes Outside the Courthouse

By **James C. Freund,** Of Counsel, Skadden, Arps, Slate, Meagher & Flom LLP

I was an M&A lawyer back in the halcyon days, but I've been retired for almost seven years now.

I haven't done any deals recently, but what I have been doing is acting as a mediator—helping the parties find their way in the messy aftermath of star-crossed M&A deals, where someone (usually the buyer) is suing or about to sue someone else (usually the seller) for indemnification under the acquisition agreement.

So, I'm in the somewhat unique position for a transactional lawyer of seeing rational negotiated deals rendered grotesquely through a litigator's spin, while being called upon to assess the merits of the litigation arguments from the vantage point of a knowledgeable neutral observer.

Now, you may think that once you get the deal done, your job is over, and that any problem down the road belongs to the litigators, but I'm here to tell you—that's not the case.

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How Not to Snatch Defeat From the Jaws of Victory in M&A Litigation: *Minding Your Record*

By **Justice Jack B. Jacobs,** Supreme Court of Delaware

I deeply appreciate, and feel quite honored, at being asked to speak to you this afternoon. I must confess, however, that it is humbling for me to be talking about M&A to you, a highly sophisticated audience that has far more experience in this area than do I. In case you were wondering, I have never negotiated a public company M&A agreement. All I have done, in my years as a lawyer, and in my later life as a judge, is litigate and then preside over disputes over such agreements. So, you would not be out of line to ask: what does a judge with a non-transactional background, bring to a conference that is about negotiating those highly complex agreements?

In all candor, my answer would be: very little, were it not for the fact that negotiated agreements, or defensive arrangements that corporate boards put into place to protect those agreements—are sometimes challenged in litigation. The litigation risk becomes more than occasional if the challenger is a third party bidder that wants to upset your deal with your acquiror to win the target company for itself. And, the likelihood of a court challenge rises exponentially if your

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Jack B. Jacobs is a Justice of the Supreme Court of Delaware. These remarks were delivered at the *27th Annual Forum on Negotiating Corporate Acquisitions*, sponsored by Glasser LegalWorks.

Third, be flexible. M&A deals often evolve in ways that are unpredictable, and if that happens, you must roll with the punches, and sometimes rewrite the script and rethink the record that would support that script. Fourth, and finally, there will be occasions where, despite your best efforts, the nature of the deal and your client's bargaining position will result in the record being (to put it euphemistically) less than optimal. If that happens, do not try to run away from that record, or make arguments that pretend that it does not exist. Instead, make the best argument that you can based on the cards you were dealt. Your client may not win but at least it—and you—will not lose credibility with the court.

Notes

1 *Mentor Graphics Corporation v. Quickturn Design Systems, Inc.*, 728 A.2d 25 (Del. Ch. 1998), *aff'd on other gds. sub nom, Quichturn Design Systems v. Shapiro*, 721 A.2d 1281 (Del. 1998).
2 771 A.2d 293 (Del. Ch. 2000).
3 789 A.2d 14 (Del. Ch. 2001).
4 *Blasius Indus. v. Atlas Corp.* 564 A.2d 651 (Del. Ch. 1988).
5 *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).
6 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).
7 771 A.2d at 331.
8 Mentor Graphics was an "Interested Person" for which the Rights Plan precluded the target board from redeeming the pill for six months.
9 789 A.2d at 49.
10 789 A.2d at 77.

The New NYSE and Nasdaq Corporate Governance Listing Standards

By **David B. H. Martin, David H. Engvall, Brian D. Wyatt** and **G. Paul Rose**

On November 4, 2003, the Securities and Exchange Commission approved long-awaited changes to the listing standards of the New York Stock Exchange and the Nasdaq Stock Market.[1] The new listing standards impose a broad array of requirements aimed at enhancing corporate governance at public companies.[2]

Despite the marked convergence of the NYSE and Nasdaq approaches since they were originally proposed, some differences remain. For example, the three-year look-back periods in the Nasdaq independence standards have no phase-in period, whereas the NYSE requires only a one-year look-back during the first year of the new standards. As another example, under certain circumstances, Nasdaq permits a non-independent director to serve on a listed company's audit, nominating, or compensation committee, while the NYSE does not allow non-independent directors to serve on these committees.

Clearly the new listing standards add a significant level of detail to the practices and procedures of boards of listed companies. These enhanced listing standards reflect a general regulatory trend toward improved governance processes. Moreover, the new listing standards signal another incremental expansion of federally derived law into the realm of regulation of corporate governance.

Background

In 2002, prior to the adoption of the Sarbanes-Oxley Act, the NYSE proposed amendments to its listing standards to enhance corporate governance provisions. This followed a request by the then-chairman of the SEC, Harvey Pitt, to review the adequacy of such standards. Later in 2002, the Sarbanes-Oxley Act mandated that all members of a listed company's audit committee be independent. In April 2003, the SEC implemented that mandate by directing national securities exchanges and national securities associations to prohibit the listing of securities of issuers that do not comply with specified audit committee standards.

In response to these developments, the NYSE and Nasdaq proposed a number of listing standard changes in the area of corporate governance, both to meet the minimum standards for audit committees imposed by the new SEC rules and to add other corporate governance requirements not specifically mandated by the SEC rules. Although the NYSE changes cover more subjects than Nasdaq's, the core topics of director

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independence and audit committee responsibility have been treated in generally similar fashion by both organizations.

In consultation with the SEC, the NYSE and Nasdaq worked to make the content of their respective standards more consistent with each other. Although some differences remain, the standards have converged significantly since the proposals were initially released. The approved listing standards for both the NYSE and Nasdaq now include:

- a requirement that a majority of each company's directors be independent;
- heightened independence standards for directors, generally, as well as for membership on audit committees;
- expanded duties for audit committees;
- increased responsibilities for independent directors serving on nomination or compensation committees; and
- a requirement that listed companies adopt a code of conduct.

New NYSE Listing Standards

The new NYSE listing standards modify a number of existing requirements and add a number of new requirements.

Independent Directors

In general, all NYSE-listed companies will be required to have a majority of independent directors on their boards. For a director to be deemed independent, the board must affirmatively determine that the director has no material relationship with the company.[3] In conducting its analysis, the board must consider materiality from the director's perspective *and* the perspective of any persons or organizations with which the director is affiliated. Material relationships may include commercial, industrial, banking, consulting, legal, accounting, charitable or familial relationships. They can also be indirect, so serving as a partner or officer, or holding shares, of an organization that has a relationship with the company may cause the director not to be independent. However, merely owning a significant amount of stock in the company will not, by itself, compel a determination that the director lacks independence.

Required Disclosures. The new standards require public disclosures about the process of determining independence. Whenever a board decides that a director's relationship with the company is not material, the company must disclose the basis for this determination in its annual proxy statement or, if no proxy statement is filed, in its annual report on Form 10-K.[4] If a board adopts categorical standards to assist it in making independence determinations, it must disclose those standards and may make a general disclosure if a director satisfies them. Specific explanation is required whenever the board determines that a director is independent even though he or she did not satisfy the company's disclosed standards.

Per Se Non-Independence. A director may not be deemed independent if:

- the director is an employee, or an immediate family member (as defined below) of the director is an executive officer, of the company, until three years after such employment ends;[5]
- the director receives, or an immediate family member of the director receives, more than $100,000 per year in direct compensation from the company, until three years after he or she stops receiving such amount;[6]
- the director is affiliated with or employed by, or an immediate family member of the director is affiliated with or employed in a professional capacity by, a current or past internal or external auditor of the company, until three years after the affiliation, employment relationship or auditing relationship ends;
- the director, or an immediate family member of the director, is employed as an executive officer of another company on whose compensation committee any of the listed company's current executives serve, until three years after the service or the employment ends; or
- the director is an executive officer of or is employed by, or an immediate family member of the director 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 which, in any single fiscal year, exceeds $1 million or 2% of such other company's consolidated gross revenues, whichever is greater, until three years after the applicable threshold is last crossed.[7]

Definition of Immediate Family Member. The new listing standards define "immediate family member" expansively to include a director's spouse, parents, children, siblings, mothers- and fathers-in-law, sonsand daughters-in-law, brothers- and sisters-in-law, and anyone (other than domestic employees) who shares the director's home. A person ceases to be an immediate family member upon legal separation or divorce, death, or incapacity. This definition is broader than the corresponding definition in the SEC's rule setting minimum standards for audit committees, which limits a director's immediate family to his or her spouse, minor children or stepchildren, or children or stepchildren sharing the director's house.

Contributions to Charitable Organizations. In applying the test described above for payments made to or received from a company that exceed the greater of $1 million or 2% of such company's revenues, contributions to charitable organizations receive special treatment. Under the new listing standards, a charitable organization is not considered a company for purposes of this test. Accordingly, a director serving as an executive officer of a charitable organization may be considered independent even if the listed company makes contributions to such charity exceeding the greater of $1 million or 2% of such charity's consolidated gross revenues. However, the listed company must disclose any such contributions. In addition, the new listing standards emphasize that the board should consider donations to a charitable organization for which a director serves as an executive officer in evaluating the director's independence generally.

Transition Period for Look-Backs. The three-year look-backs described above in the provisions defining relationships that constitute *per se* non-independence do not take effect until November 4, 2004. Until then, a one-year look-back applies. This represents a significant change from the earlier version of the listing standard changes proposed by the NYSE, apparently in response to the SEC's desire to accelerate the effective date for the enhanced standards. In the form originally proposed by the NYSE, although the look-back periods were five years instead of three years, they would have been applied only prospectively, meaning that any disqualifying relationships or transactions in prior periods would not be considered.

One of the quirks resulting from the transition period in the form adopted by the NYSE is that a director party to a disqualifying transaction that occurred from one to two years prior to adoption of the new standards will be able to serve as an independent director for the first year following such adoption, but would be disqualified thereafter until the third anniversary of the disqualifying transaction.

Board Committees

The new standards require all listed companies to have an audit committee, a nominating/corporate governance committee and a compensation committee. Each committee must be composed of directors who meet the definition of independence described above, and audit committee members must meet a separate, more stringent definition of independence. Each committee must have a charter setting forth the committee's specific purposes, goals and responsibilities. Each charter must require an annual performance evaluation of the committee.

Audit Committee

The new listing standards provide that the audit committee must satisfy the requirements with respect to audit committees set forth in Rule 10A-3 under the Exchange Act. That rule requires, among other things, that each member of the audit committee be independent according to specified criteria (described below), that the audit committee directly appoint, retain, compensate, evaluate and terminate the company's independent auditors, oversee the independent auditor, resolve all disagreements between management and the independent auditor, and pre-approve any non-audit services.

Further, the committee must establish procedures for handling complaints from listed company employees on accounting, internal accounting controls or auditing matters, as well as for confidential, anonymous submissions by listed company employees of concerns regarding questionable accounting matters. The listed company's board must grant unfettered power to the audit committee to retain and compensate such outside legal, accounting or other advisors as it deems necessary. The audit committee's responsibilities may not be delegated to a different committee. The new listing standards also provide that the NYSE will apply the requirements of such rule in a manner consistent with the guidance provided by the SEC in the adopting release for such rule.[8]

Independence. Under the new listing standards, the audit committee must have at least three members, all of whom must be independent. Members of the audit committee must satisfy the general definition of independence described above, as well as the criteria set forth in Rule 10A-3(b)(1) under the Exchange Act. That rule includes two threshold requirements for a finding of independence. First, a director may not accept, directly or indirectly, any consulting, advisory or other compensatory fee from the company or any subsidiary, other than director fees and fixed compensation under a retirement plan for prior service with the company, as long as the compensation is not contingent on continued service.

This extends to indirect payments, including payments to spouses, minor children and stepchildren, or children or stepchildren sharing a home with the director, as well as entities in which the director is a partner, member, managing director or executive officer or occupies a similar position and which provide accounting, consulting, legal, investment banking or financial advisory services to the company or any subsidiary. Second, a director may not be an "affiliated person" of the company or any subsidiary, apart from serving as a director on the board.[9]

Financial Literacy. Except in the case of foreign private issuers, each member of the committee must be financially literate or become financially literate within a reasonable time following his or her appointment. At least one member must also have accounting or related financial management expertise. A person who satisfies the definition of audit committee financial expert in Item 401(h) of Regulation S-K may be presumed to have such expertise.

Service on Multiple Audit Committees. When a listed company's audit committee member serves simultaneously on the audit committees of more than three public companies (including the listed company), and the listed company does not limit the number of audit committees on which its audit committee members may serve, its board must determine that the service will not impair the ability of such member to effectively serve on its committee. Such determination must be disclosed in the company's annual proxy statement or annual report on Form 10-K.

Audit Committee Responsibilities. The audit committee must be empowered by its charter to:

- assist board oversight of (1) the integrity of the company's financial statements, (2) the company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the company's internal audit function and its independent auditors;
- prepare the audit committee report that SEC proxy rules require to be included in the company's annual proxy statement; and
- carry out the duties set out in Rule 10A-3 under the Exchange Act (described above).

In addition, the new listing standards impose other responsibilities on the audit committee, including to:

- obtain and review at least annually a report from the independent auditor describing the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and all relationships between the independent auditor and the company;
- evaluate, based on the foregoing report and the independent auditor's work throughout the year, the auditor's qualifications, performance and independence (such evaluation should include the review and evaluation of the lead partner of the independent auditor and take into account the opinions of management and the company's personnel responsible for the internal audit function);
- assure the regular rotation of the lead audit partner, as required by law (the committee should also consider whether there should be a regular rotation of the audit firm itself);
- discuss the annual audited and quarterly financial statements with management and the independent auditor (including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations");
- discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and ratings agencies (earnings releases, financial information and earnings guidance may be discussed generally; it is not necessary to have the discussion in advance of an earnings release or the provision of particular guidance);
- discuss policies by which the company handles risk assessment and management (whenever companies manage and assess risk through mechanisms other than the audit committee, the audit committee should review in a general manner the processes that are in place for that purpose);
- meet separately and periodically with each of management, personnel responsible for the internal audit function and independent auditors;

- review with the independent auditor any audit problems or difficulties and management's response, including any restrictions on the scope of the independent auditor's activities and any significant disagreements with management (the review should include discussion of the responsibilities, budget and staffing of the company's internal audit function);
- set hiring policies for employees or former employees of the company's independent auditors; and
- report regularly to the board of directors (the committee should review with the full board any issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's auditors, or the performance of the company's internal audit function).[10]

Nominating/Corporate Governance Committee

Under the new listing standards, the nominating/corporate governance committee must be empowered by its charter to:

- identify individuals qualified to become board members (consistent with the criteria approved by the board);
- select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders;
- develop and recommend to the board a set of corporate governance principles; and
- oversee the evaluation of the board and management.

A listed company's board may delegate the foregoing responsibilities to other committees, as long as they are populated by independent directors and have a published charter. If the company is contractually or otherwise obligated to give third parties the right to nominate one or more directors, the selection and nomination process described above need not apply. This is an important concession to companies who, for example, have granted nomination rights to preferred shareholders.

Compensation Committee

The compensation committee must, at a minimum, be empowered by its charter to have direct responsibility to:

- review and approve corporate goals and objectives relevant to CEO compensation;
- evaluate the CEO's performance in light of those goals and objectives;
- determine and approve, either as a committee or together with the other independent directors (as directed by the board), the CEO's compensation level based on this evaluation;
- make recommendations to the board with respect to non-CEO compensation, incentive-compensation plans and equity plans; and
- produce, as the SEC requires, an annual report on executive compensation to be disclosed in the company's annual proxy statement or annual report on Form 10-K filed with the SEC.

The new listing standards recommend criteria for determining the long-term component of a CEO's compensation and note that, notwithstanding anything to the contrary in the standards, the committee may take account of applicable tax laws in making compensation awards. The board may delegate the committee's responsibilities to other committees, subject to the same conditions that apply to delegations of the nominating/corporate governance committee's obligations.

Internal Audit Function

Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company's risk management processes and system of internal control. A company may elect to outsource this function to a firm other than its independent auditor.

Regular Executive Sessions of, and Procedures for Contacting, Non-Management Directors

Under the new listing standards, non-management directors must meet regularly in executive session, without management present. For this purpose, non-management directors are those who are not company officers, as defined in Rule 16a-1(f) under the Exchange Act. If the group of non-management directors includes directors who are not independent under the new listing standards, the company should schedule an executive session with only the independent directors at least once per year. The same person may preside at each executive session, or the position may be rotated.

In addition, the new listing standards require companies to publicize procedures for interested parties to communicate directly with the presiding director or with the non-management directors as a group. For this purpose, companies may use the same procedures established to comply with the requirement under SEC rules that audit committees adopt procedures for receiving and addressing employee complaints regarding accounting and auditing matters.

Corporate Governance Guidelines

Each listed company must adopt and disclose corporate governance guidelines. The guidelines should be posted on the company's website, and its annual report must indicate that the information is available on its website and in print for any shareholder who requests it.

Eschewing a one-size-fits-all policy, the new listing standards provide that a company's guidelines must address certain "key areas of universal importance," which include director qualifications and responsibilities, the responsibilities of key board committees, and director compensation.

The corporate governance guidelines must address the following subjects:

- director qualification standards (at a minimum, the guidelines should reflect the independence requirements described above; companies may address other qualification requirements, including limits on the number of boards on which a director may sit, and director tenure, retirement and succession);
- director responsibilities;
- director access to management and, as necessary and appropriate, independent advisors;
- director compensation (the guidelines should include general principles for determining the form and amount of director compensation; the board should be aware that extra-customary compensation, substantial contributions to director-affiliated charities, entering into consultancy agreements with directors, and other forms of indirect compensation all raise questions as to a director's independence; and the board should evaluate critically each of the foregoing matters when determining compensation and/or independence of a director);
- director orientation and continuing education;
- management succession (this should cover CEO selection, performance review, and succession); and
- annual performance evaluation of the board (and its committees).

Code of Business Conduct and Ethics

Each listed company must adopt and disclose a code of business conduct and ethics for directors, officers and employees. This requirement goes well beyond the code of ethics for senior officers required to be disclosed under Item 406 of Regulation S-K. The code required by the NYSE should be posted on the company's website, and its annual report must indicate that the information is available on its website and in print for any shareholder who requests it.

The standards require that each listed company's code of business conduct and ethics contain compliance standards and procedures "that will facilitate the effective operation of the code." Violations of the code should be promptly and consistently addressed. Each code must require that only the board or a board committee may waive the code for executive officers or directors. Any such waiver must be disclosed promptly to shareholders.

Although the standards do not specify which policies the code should contain, they do suggest that the following topics be addressed:

- conflicts of interest, as defined in the standards (the company should have a policy for preventing conflicts and a means for employees, officers and directors to communicate potential conflicts to the company);
- corporate opportunities (directors have a duty to advance the legitimate interests of their company whenever the opportunity to do so arises);
- confidentiality (confidential information is defined as all non-public information that, if disclosed, might be useful to competitors or harmful to the company or its customers);
- fair dealing (the company may write its code in a manner that does not alter existing legal rights and obligations of the company and its employees, such as "at will" employment arrangements);
- protection and proper use of company assets (the targets here are inefficiency, waste, carelessness and illegitimate uses of assets);
- compliance with laws, rules and regulations, including insider trading laws; and
- encouraging the reporting of any illegal or unethical behavior (each listed company *must* ensure that all of its employees know that the company will not permit retaliation for reports made in good faith).

CEO Certification and Notification

CEOs of listed companies must certify to the NYSE each year that they are not aware of any violation by the company of NYSE corporate governance listing standards. This certification, together with any CEO/CFO certifications that must be filed with or provided to the SEC regarding the quality of the company's public disclosure, must be disclosed in the company's annual report to shareholders, or if the company does not prepare such a report, in the company's annual report on Form 10-K.

Each CEO of a listed company must also promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any material non-compliance with any applicable provisions of the corporate governance listing standards.

Exceptions

The new listing standards apply to all companies with common equity securities[11] listed on the NYSE, with the following exceptions:

Foreign Private Issuers. A foreign private issuer is permitted to follow its home country practice instead of the NYSE's corporate governance listing standards, provided that it has an audit committee that complies with the requirements of Exchange Act Rule 10A-3, and that its CEO promptly notifies the NYSE in writing upon any executive officer becoming aware of any material non-compliance with such rule. In addition, foreign private issuers must disclose the significant ways in which their home-country corporate governance practices differ from those followed by domestic companies under the new NYSE listing standards.

Controlled Companies, Limited Partnerships, and Companies in Bankruptcy. Due to their unique circumstances, companies of which more than 50% of the voting power is held by an individual, group or other company (a "controlled company"), as well as limited partnerships and companies in bankruptcy proceedings, need not comply with the requirement to have a majority of independent directors, nor the nominating/corporate governance committee and compensation committee requirements. A controlled company that chooses to take advantage of one or more of these exemptions must disclose that choice, that it is a controlled company, and the basis for the determination in its annual proxy statement or, if it does not file an annual proxy statement, in its annual report on Form 10-K. These companies must comply with the new audit committee requirements.[12]

Investment Companies. In general, closed-end and open-end management investment companies that are registered under the Investment Company Act of 1940 need only comply with the audit committee requirements described above and the requirement that such companies' CEOs notify the NYSE in writing upon discovery by any executive officer of any material non-compliance with such standards. Due to the common practice of having directors serve on multiple boards in the same fund complex, however, closed-end funds are not required to disclose board determinations with respect to simultaneous service of directors on more than three public company audit committees.

The new NYSE listing standards mandate that the audit committees of listed closed-end and open-end funds establish procedures for the confidential, anonymous submission by employees of the investment advisor, administrator, principal underwriter, or any other provider of accounting related services for the management company, as well as employees of the management company. These procedures are in addition to those required under the SEC's rule concerning submissions by employees of the listed company with respect to questionable accounting or auditing matters. The responsibility for establishing the foregoing procedures must be addressed in the audit committee charter.

Other Companies. There are also special provisions applicable to business development companies, asset-backed issuers and other passive business organizations, derivatives and special purpose securities.

Effective Dates

In general, listed companies must comply with the new corporate governance listing standards by the earlier of their first annual meeting after January 15, 2004, or October 31, 2004. A company with a classified board that would be required to change a director who would not otherwise stand for election at that annual meeting is permitted to keep such director in office until the second annual meeting after January 15, 2004, but no later than December 31, 2005. Foreign private issuers have until July 31, 2005 to meet the new audit committee standards.

There are also special transition rules available to companies listing for the first time after an initial public offering, or IPO. Such companies must have at least one independent member on their audit, nominating, and compensation committees upon listing, a majority of independent members on such committees within 90 days of listing, and fully independent committees within one year after listing. Such companies will also have 12 months after the IPO to satisfy the majority independent board requirement.

Companies emerging from bankruptcy or ceasing to be controlled companies, as defined in the standards, will be permitted to phase in independent nominating and compensation committees and majority independent boards on the same schedule as companies listing for the first time after an IPO.

When a company transfers from another market, it will have 12 months from the date of transfer to comply with the listing standards, to the extent that the former market does not also have the same requirements. If the former market has a substantially similar requirement and the company is subject to an unexpired transition period for that requirement, the transferor may rely on the former market's transition period.

New Nasdaq Listing Standards

Although Nasdaq's new listing standards generally have the same thrust as the new NYSE standards and address many of the same subjects, Nasdaq's approach does not reach as far as the NYSE's approach.

Independent Directors

Majority-Independent Requirement. The new listing standards require that a majority of the board members be independent. To comply with this requirement, each listed company's board must make an affirmative determination that those individuals serving as independent directors have no relationships that would impair their independence. The company must disclose in its annual proxy statement those directors whom the board has determined to be independent. The new Nasdaq standards give less guidance than the new NYSE standards regarding factors the board may wish to consider in making this determination. However, the new standards provide that ownership of the listed company's stock would not, by itself, preclude a finding of independence.

Per-se Non-Independence. A director may not be deemed independent if:

- the director is, or during the past three years was, employed by the company or by any parent or subsidiary of the company;[13]
- the director, or a family member (as defined below) of the director, accepts any payments from the company or any parent or subsidiary of the company in excess of $60,000 during the current fiscal year or any of the past three fiscal years, other than compensation for board service, payments arising solely from investments in the company's securities, compensation paid to a family member of the director who is a non-executive employee of the company or a parent or subsidiary of the company, benefits under a tax-qualified retirement plan, or non-discretionary compensation, and loans permitted under Section 13(k) of the Exchange Act;
- the director has a family member who is, or in the past three years was, employed as an executive officer[14] by the company or any parent or subsidiary of the company;
- the director, or a family member of the director, is a partner in, or a controlling shareholder or executive officer of, any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more, other than payments arising solely from investments in the company's securities or payments under non-discretionary charitable contribution matching programs;
- the director, or a family member of the director, is employed as an executive officer of another entity where any of the executive officers of the listed company serve on the compensation committee of the other entity, or if such relationship existed during the past three years;
- the director, or a family member of the director, is a partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit during the past three years; and
- in the case of an investment company (and in lieu of the foregoing exclusions), the director is an "interested person" of the company as defined in section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee.

Definition of Family Member. The new listing standards define "family member" as a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home. Like the definition of "immediate family member" under the new NYSE listing standards, the definition of family member is broader than the corresponding definition in the SEC's rule setting forth the minimum requirements for audit committee membership.

Contributions to Charitable Organizations. A director who is (or who has a family member who is) an executive officer of a charitable organization is not considered independent if the company makes payments to the charity exceeding the greater of 5% of the charity's revenues or $200,000. However, the listing standards state that Nasdaq encourages companies to consider other situations where a director or his or her family member and the company each have a relationship with the same charitable organization when addressing director independence.

Look-Back Periods in Definition of Per Se Non-Independence. The three-year look-back periods described above commence on the date the relationship ceases. Unlike the NYSE's new listing standards, these three-year look-backs will be in effect when the new listing standards become effective generally. There is no phase-in period for the look-backs.

Cure Period and Notice Requirement. If a listed company fails to comply with the majority-independent requirements due to one vacancy, or because a director ceases to be independent for reasons outside the director's control, the company must become compliant by the earlier of the next annual shareholders meeting or one year from the occurrence of the event which caused the non-compliance. The company must provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

Board Committees

The new Nasdaq listing standards require companies to have an audit committee. However, in contrast with the new NYSE listing standards, neither a compensation committee nor a nominating committee is mandated, as Nasdaq allows the functions of such committees to be performed, in the alternative, by a majority of independent directors.

Audit Committee

Membership Requirements. The audit committee must have at least three members, all of whom must be independent within the meaning of the new standards described above, as well as under Exchange Act Rule 10A-3(b)(1). In addition, audit committee members must not have participated in the preparation of the company's financial statements during the past three years, and they must have the ability to read and understand fundamental financial statements, including the company's balance sheet, income statement, and cash flow statement.

Each company must also certify that it has, and will continue to have, at least one audit committee member who has past employment experience in finance or accounting, requisite professional certification in accounting, or comparable experience or background which evidences financial sophistication. A person who served as a CEO, CFO or other senior officer with financial oversight responsibilities will satisfy this requirement, and a director who qualifies as an audit committee financial expert under Item 401(h) of Regulation S-K is presumed to qualify as a financially sophisticated audit committee member.

A director who does not meet the criteria of independence under Nasdaq's new listing standards but who does satisfy the criteria set forth in Exchange Act Rule 10A-3 may be appointed to the audit committee on two conditions. First, such person must not be a current officer or employee, or a family member of an officer or employee. Second, the board must determine that the appointment of such person is in the best interests of the company and its shareholders. In these exceptional and limited circumstances, the board must disclose, in the next annual proxy statement, the nature of the relationship and the reasons for the board's determination. Such director may not serve for more than two years and may not chair the audit committee.

Audit Committee Responsibilities. Each Nasdaq listed company must certify that it has adopted a formal written charter for the audit committee and that the audit committee has reviewed and reassessed the adequacy of the formal written charter on an annual basis. The charter must specify the scope of the audit committee's responsibilities and the means by which it carries out those responsibilities, the outside auditor's accountability to the audit committee, and the audit committee's responsibility to ensure the independence of the outside auditor.

The new Nasdaq listing standards require that the audit committee's charter include the following:

- the committee's purpose of overseeing the accounting and financial reporting processes of the company and the audits of the company's financial statements;
- responsibilities relating to registered public accounting firms (such as retention, compensation and oversight of auditors);
- the responsibility to establish procedures for complaints relating to accounting, internal accounting controls, and auditing matters;

- the authority to engage advisors; and
- the provision of appropriate funding for payment of such accounting firms and outside advisors, as well as other expenses incurred by the audit committee in carrying out its duties.

Approval of Related Party Transactions. Nasdaq rules currently require listed companies to conduct an appropriate review of all related party transactions. The amendments approved by the SEC now also mandate that all such related party transactions be approved by the audit committee or by another independent body of the directors. In addition, the new rules define related party transactions by reference to transactions required to be disclosed under Item 404 of Regulation S-K.

Cure Period and Notice Requirement. If a listed company fails to comply with the audit committee composition requirement due to one vacancy, or because an audit committee member ceases to be independent for reasons outside the member's control, the company must become compliant by the earlier of the next annual shareholders meeting or one year from the occurrence of the event which caused the non-compliance. The company must provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

Oversight of Executive Compensation

The new standards require that compensation of the CEO be determined, or recommended to the full board for determination, by a majority of a listed company's independent directors or a compensation committee comprised solely of its independent directors. The CEO may not be present during voting or deliberations. In addition, a majority of independent directors or a compensation committee comprised solely of independent directors must determine, or recommend to the full board for determination, the compensation for all other executive officers.

Under certain exceptional and limited circumstances, which must be disclosed in the next annual proxy statement, a non-independent director may serve on the compensation committee, if there is one, for a maximum of two years. For a non-independent director to serve, the compensation committee must be comprised of at least three members. The non-independent director cannot be a current officer or employee, or a family member of such person, and the board must determine that such service is required in the best interests of the company and its shareholders.

Oversight of Director Nominations

Director nominees must be selected, or recommended for the board's selection, by a majority of independent directors or a nominating committee comprised solely of independent directors. Each company must also certify that it has adopted a formal written charter or board resolution, as applicable, addressing the nominations process (and such related matters as may be required under federal securities law). As with the compensation committee, under certain exceptional and limited circumstances, which must be disclosed in the next annual proxy statement, a non-independent director may serve on the nominations committee, if there is one, for a maximum of two years. For a non-independent director to serve, the nominations committee must be comprised of at least three members. The non-independent director cannot be a current officer or employee, or a family member of such person, and the board must determine that such service is required in the best interests of the company and its shareholders.

The rule requiring oversight of director nominations by independent directors does not apply where the right to nominate a director legally belongs to a third party (e.g., holders of preferred stock). The rule is also not applicable where the company is subject to a binding obligation that requires a director nomination structure inconsistent with the aforementioned rules, and where such obligation pre-dates the approval of the new listing standards.

Regular Executive Sessions of Independent Directors

Independent directors must convene regularly in executive sessions at which only independent directors are present. The Nasdaq commentary interpreting the new rules suggest that executive sessions should occur at least twice a year in conjunction with regularly scheduled board meetings, and, perhaps, at other times.

Code of Conduct

Under the new rules, Nasdaq requires each listed company to adopt a code of conduct applicable to all directors, officers and employees. The code of conduct must satisfy the requirements of Section 406(c) of the Sarbanes-Oxley Act and Item 406 of Regulation S-K.

In addition, the code must be publicly available and must provide for an enforcement mechanism that "ensures prompt and consistent enforcement of the code, protection for persons reporting questionable behavior, clear and objective standards for compliance, and a fair process by which to determine violations."

Any waivers of the code for directors or executive officers must be disclosed in a Form 8-K filed within five days. Unlike the NYSE's standards, Nasdaq's standards do not suggest specific topics to include in a code of conduct.

Notice of Noncompliance

The new listing standards require a listed company to provide Nasdaq with prompt notice after an executive officer of the company becomes aware of any material noncompliance with the corporate governance and Nasdaq's other qualitative listing standards.

Exceptions

The new listing standards apply to all Nasdaq-listed companies, with the following exceptions:

Controlled Companies. A controlled company (as defined below) need not comply with the requirement that a majority of its board members be independent, nor with the requirements pertaining to independent director oversight of executive compensation and director nominations. A controlled company is a company in which more than 50% of the voting power is held by a single entity, or by a group of shareholders that has publicly filed notice (*e.g.*, a Schedule 13D) that they are acting as a group. A company relying on the exemption for controlled companies must disclose its reliance, and its basis for that reliance, in its annual proxy statement. Controlled companies must comply with the audit committee requirements and are also subject to the requirement that independent directors have regularly scheduled meetings without management present.

Foreign Private Issuers. Under existing rules, Nasdaq is authorized to grant exemptions from its listing standards to foreign private issuers where the Nasdaq requirement conflicts with a law, rule or regulation of any public authority exercising jurisdiction over such company or where the requirement is contrary to generally accepted business practices in the company's home country. The amendments approved by the SEC limit this exemptive authority. Under the new rules, an exemption may not be granted to the extent such exemption would be contrary to the requirements of U.S. federal securities laws, including, without limitation, Rule 10A-3 under the Exchange Act. A foreign private issuer that receives an exemption must disclose in its next annual report each requirement from which it is exempted and the home country practice, if any, followed by the issuer in lieu of the Nasdaq listing standards.

Investment Companies. Management investment companies registered under the Investment Company Act of 1940 are exempt from the requirement that a majority of board members be independent, and from the requirements pertaining to independent director oversight of executive compensation and director nominations. Such companies are also exempt from the code of conduct requirement.

Other Companies. There are also special provisions applicable to asset-backed issuers and other passive business organizations, as well as cooperative entities.

New Requirement to Disclose "Going Concern" Qualifications

Nasdaq's listing rules now require listed companies receiving a "going concern" qualification in an audit opinion to make a public announcement of such fact through the news media. The public announcement must be provided to Nasdaq and released to the media within seven days following disclosure of the audit opinion in a public filing with the SEC.[15]

Effective Dates

Except for foreign private issuers and small business issuers, listed companies generally must comply with the bulk of the new corporate governance listing standards (i.e., those pertaining to director independence, independent director oversight of executive compensation and director nominations, audit committee requirements, and notice of material noncompliance) by the earlier of their first annual meeting after January 15, 2004, or October 31, 2004. Foreign private issuers and small business issuers have until July 31, 2005 to comply.

A company with a staggered board that would be required to change a director who would not otherwise stand for election at the first annual meeting after January 15, 2004 will have until the second annual meeting after January 15, 2004 (but no later than December 31, 2005) to implement all new corporate governance requirements other than the audit committee requirements, which must be implemented by the earlier of the company's first annual meeting after January 15, 2004, or October 31, 2004.

Special transition rules are available to companies listing for the first time after an IPO. Such companies must have, upon listing, at least one independent member on any committee established by the board. Thereafter, each company must have a majority of independent members on such committees within 90 days of listing and fully independent committees within one year after listing. Companies who choose not to establish a compensation or nominating committee will be required to meet the majority independent board requirement within ~~24~~ 12 months of listing.

When a company transfers from another market, it will have 12 months from the date of transfer to comply with the listing standards, to the extent that the former market does not have substantially similar requirements. If the former market has substantially similar requirements and the company is subject to an unexpired transition period for that requirement, the transferor may rely on the former market's transition period.

The new code of conduct requirement must be implemented by May 4, 2004, and the new requirements with respect to approval of related party transactions become effective on January 15, 2004. The requirement to publicly announce the receipt of a "going concern" qualification became effective on November 4, 2003.

The new limitations on Nasdaq's authority to grant exemptions from its corporate governance listing standards to foreign private issuers go into effect on July 31, 2005. However, the requirement that a foreign private issuer disclose the receipt of a corporate governance exemption applies to new listings and filings made after January 1, 2004. M&A

Notes

1 See Release No. 34-48745, available at http://www.sec.gov/rules/sro/34-48745.htm. The American Stock Exchange ("AMEX") has also submitted proposed rule changes to the SEC that are substantially similar to the enhanced corporate governance standards adopted by the NYSE and Nasdaq. The proposed AMEX rules may be found at http://www.amex.com/atamex/news/enh_corp_governance2.pdf, with amendment at http://www.amex.com/atamex/news/enh_corp_governance_amendment.pdf. This advisory does not address the proposed AMEX rule changes, which still await SEC approval.

2 The NYSE standards will be codified in Section 303A of the NYSE's Listed Company Manual, and the Nasdaq standards will be codified in NASD Rules 4200 and 4350.

3 This includes a relationship with any parent or subsidiary in a consolidated group with the company.

4 If a listed company is not required to file a Form 10-K, disclosures required under the new standards must be made in whatever annual periodic disclosure form the company files with the SEC.

5 However, employment as an interim Chairman or CEO will not disqualify a director from being considered independent following such employment.

6 Director and committee fees and pension or other forms of deferred compensation for prior service (as long as it is not contingent on continued service) do not count toward the $100,000 limit, nor does compensation received by an immediate family member for services as a non-executive employee of the listed company or compensation given to a director for previous service as an interim Chairman or CEO.

7 The payments and the consolidated gross revenues to be measured are to be those reported in the last fiscal year. The three-year look-back does not require consideration of any previous employer of the director or immediate family member.

8 The NYSE also gives listed companies the opportunity to cure defects that would otherwise cause the company not to satisfy the requirements of such rule.

9 An "affiliated person" of the company is someone who directly, or indirectly through intermediaries, controls, or is controlled by, or is under common control with, the company. The rule includes a safe harbor providing that a person who is not an executive officer and who does not beneficially own (directly or indirectly) more than 10% of the voting stock of the company (and has no other control indicia) is not deemed to "control" the company.

10 Although the commentary to the new listing standards makes clear that the fundamental responsibility for the company's financial statements and disclosures lies with management and the independent auditor, the audit committee must review (i) major issues regarding accounting principles and financial statement presentations; (ii) major issues as to the adequacy of the company's internal controls and any special audit steps adopted in light of material control deficiencies; (iii) management and independent auditor analyses describing significant financial reporting issues and judgments made in connection with the preparation of the financial statements; (iv) how regulatory accounting initiatives and off-balance sheet structures effect the company's financial statements; and (v) the type and presentation of information to be included in earnings press releases (paying particular attention to any use of "pro forma" or "adjusted" non-GAAP information), as well as any financial information and earnings guidance provided to analysts and ratings agencies.

11 If a company lists only preferred or debt securities, the company's audit committee must comply with all applicable requirements of Exchange Act Rule 10A-3 (unless such rule offers an available exemption), and its CEO must promptly notify the NYSE in writing of any material non-compliance with such rule.

12 However, pursuant to Rule 10A-3(c)(2) under the Exchange Act, controlled companies that do not have equity securities listed on the NYSE (other than non-voting, non-participating preferred and similar securities) need not comply with the audit committee requirements, as long as their parent company is a public company that has listed equity securities and is itself subject to Rule 10A-3 under the Exchange Act.

13 In referring to "parent and subsidiary," the standards should be read to cover entities that are consolidated with the issuer's financial statements.

14 Executive officer means those officers covered in Rule 16a-1(f) under the Exchange Act.

15 Prior to the release of the announcement, the issuer must provide the text of the announcement to the StockWatch section of Nasdaq's MarketWatch Department.