

Representing Independent Directors After Sarbanes-Oxley

The Growing Role of Independent Counsel

By James M. Lyons

Seven years have passed since Congress enacted the Sarbanes-Oxley Act (SOX). SOX was the result of highly publicized hearings conducted by both houses of Congress in the aftermath of the scandals involving fraud and mismanagement at such major U.S. companies as Enron, Tyco, Adelphia, and WorldCom. Hailed as a landmark and comprehensive legislative scheme, SOX was intended to reform corporate governance and behavior, increase the standards of accountability for the accounting profession, and ensure the reliability of financial statements of public companies. An independent accounting oversight board was created, auditor independence mandated, corporate governance and responsibility standards strengthened, and financial accuracy obligations imposed on senior management of public companies. In 11 titles, Congress addressed what it perceived to be the corporate governance and auditing shortcomings that had contributed to the scandals culminating in the bankruptcy of Enron.

Title III put specific obligations on

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public companies for financial reports and set standards for audit committee independence and responsibilities. The audit committee was required to appoint, set compensation for, and oversee the company's auditors, and the auditors were required to report to the audit committee. Audit committee members were required to be members of the board of directors and be independent (i.e., have no direct or indirect affiliation with the company other than serving on the board of directors and the board's committees). Finally, the audit committee was required to establish procedures to handle accounting complaints including complaints from confidential, anonymous employee sources.

Section 301 of Title III also empowered the audit committee to engage counsel and other outside experts at the company's expense and in its sole discretion. This appeared to herald a new function for outside counsel in advising and assisting directors of public companies to meet their responsibilities to shareholders, regulators, and the public. In fact, section 301 and this newly created statutory authority largely recognized and codified existing best practices and procedures. Outside experts, particularly lawyers,

have been employed for many years by the boards and the audit committees of boards of public companies in a variety of settings.

Functions of Independent Counsel

Corporate independent counsel have served four distinct functions. First, they have been counsel or special committees empowered by statute or corporate bylaws to investigate and determine the merit of derivative claims asserted by shareholders in the company's name. Second, independent counsel have been engaged by public companies, their boards, or committees to conduct internal investigations in a wide variety of circumstances where corporate misconduct has been alleged and independent investigation is warranted, either in connection with regulatory or other inquiries, or where criminal violations or civil claims have been or may be asserted. These investigations often present complex questions of attorney-client privilege, attorney work product, and confidentiality.

Third, outside counsel have been regularly employed to represent independent directors of public companies where transactions involving management (e.g., leveraged buyouts) are contemplated or in merger and acquisition

transactions where management's interest may be different from that of the corporation. Typically, an independent committee of the board is formed consisting of members with no ongoing interest in the transaction. These independent committees are formed on an

practicing" before the SEC to report evidence of material violations of securities law or breach of fiduciary duty or similar violations by the company or its agents to the chief legal counsel or chief executive officer of the company. If the response of the chief legal coun-

committee for the payment of compensation to any advisors employed by the audit committee under paragraph (5).

Before SOX, the duties of an audit committee were both broad and specific. The audit committee was charged with reviewing the company's financial

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ad hoc basis, are represented by independent counsel, and rely on advice as to the fairness of the transaction from a financial point of view from a disinterested investment banking firm or other financial expert. They not only are established for acquisitions but also can act to consider corporate decisions to sell assets or businesses or otherwise restructure the company. Again, key decisions can be made by members of the board who are disinterested in the transaction and therefore require independent financial and legal advice.

Finally, outside counsel have been routinely engaged to deal with legal issues for the corporation or its board when the office of the general counsel may be conflicted by relationships to, or involvement in, corporate activities that have been called into question. For example, corporate general counsel increasingly take on nonlegal duties in management or corporate administration. Wearing these multiple hats can create a need or preference for advice to the board from outside counsel who is independent and without other entanglements that might affect or appear to affect independent judgment. Independent counsel also should be considered when a merger or acquisition triggers a change in control. Under these circumstances, senior management, including the general counsel, may have accelerated financial benefits (e.g., stock options) that create a substantial financial interest in the outcome of the transaction.

SOX and In-house Counsel

SOX imposed new responsibilities that directly affect in-house counsel. For example, section 307 requires those attorneys "appearing and

sel or CEO is not "appropriate to the evidence," the lawyer is then required to report the matter to the audit committee of the board of directors, to another committee of independent directors, or directly to the board of directors.

The SEC rules implementing section 307 specifically allow, but do not require, the attorney to reveal confidential information to the commission without the company's consent if the attorney reasonably believes it is necessary to prevent the commission of a material violation, perjury, or a false statement proscribed by 18 U.S.C. § 1001. Disclosure to the commission also can be done to rectify the consequences of a material violation by the company that caused or may cause substantial injury to the financial interests of the company or its investors. In a preemption-like maneuver, the SEC rules specifically provide that, where the standards of a state or other U.S. jurisdiction where an attorney is admitted or practices conflict with these rules, SEC rules govern.

Independent Counsel and Corporate Governance

While Congress increased the responsibilities of in-house counsel, it also established a specific place for outside counsel in audit committee functions, responsibilities, and outcomes. Section 301(5) contains a simple but empowering sentence: "Each audit committee shall have the authority to engage independent counsel and other advisors as it determines necessary to carry out its duties."

The law also directs each public company to provide appropriate funding as determined by the audit

performance, public financial reports, budgets, and internal controls. In section 404, SOX took those responsibilities a big step further by mandating that an annual report contain a yearly assessment of the effectiveness of the internal control structure and procedures of the company for financial reporting. Audit committees, working with the company's internal auditors and the company's outside auditing firms, are thus required to develop a thorough and comprehensive process to review internal controls of the company in order to make a meaningful and credible annual internal control report. Independent counsel can be of value here in advising the audit committee on the institution of section 404 testing, monitoring, and correcting procedures for internal controls and improvements in such chronically difficult areas as cash accounts and wire transfers.

About nine months after SOX was enacted, the ABA Task Force on Corporate Governance issued its report recommending corporate governance policies. This followed an earlier report by the Task Force on Corporate Responsibility that had recommended that both the audit committee and the compensation committee should be authorized to retain independent counsel.

Post-SOX commentary has been instructive but not uniform. Professors Hazard and Rock addressed the issue of outside directors retaining independent counsel in their article "A New Player in the Board Room: The Emergence of the Independent Directors Counsel," 59 *BUS. LAW.* 1389 (2004). The professors not only endorsed the notion of independent

board counsel for the retention and termination of a CEO but predicted that the requirements of SOX would “lead to the emergence of counsel for the independent directors” and “a new player in the board room.” In the same publication, however, former Chief Justice Norman Veasey of the Delaware Supreme Court opined that independent directors’ counsel should be limited to those situations where a “real need to assist and counsel independent directors” existed and that use of independent counsel on a “generalized or continuing basis” might not provide a cost benefit, would not advance constructive board skepticism (of management), and could lead to “unnecessarily contentious board rooms.”

For those of us who have dealt with the situations in real boardrooms and committees, the answer lies somewhere in the middle and is, of course, situation driven. For example, it is common for general counsel to recognize the discomfort, if not conflict, in dealing with CEO hiring or termination and welcome, if not insist on, outside counsel being retained to advise the compensation committee as well as the board. On other matters of corporate governance and good practice, such as annual board and committee peer evaluations and reviews, outside counsel can be an independent facilitator and honest broker who is not bound to the company or senior management. This does not seem to create undue boardroom contention but actually may serve to avoid it. Think, for example, of a situation where board members are privately critical of the members of the compensation committee for being unduly generous and not sufficiently demanding of management performance. Or consider where an entire compensation committee or board is prone to lax performance metrics for pay of its senior officers. Is a general counsel really going to feel comfortable in challenging the person or persons who set his or her salary and bonus for the coming year? Isn’t this a better position for independent outsiders to give advice to the board? And can’t shareholder and public confidence be

enhanced at a reasonable cost?

Another example in this area is the so-called shareholder say-on-pay movement of recent years. Here, shareholders of major public companies demand the right to either ratify or vote on severance packages for senior executives that exceed multiples (e.g., three times) of base executive pay and benefits. (Congress in the new economic stimulus package is currently suggesting a similar concept for companies that take TARP funds.) Generally speaking, general counsel and other senior management have employment contracts that contain severance packages that could fall within this range and might well be the subject of a shareholder proposal in the proxy statement and a stormy session at the annual meeting. Are the compensation committee and the board better served on these matters by in-house counsel with an obvious interest in the outcome or experienced public company compensation consultants and independent counsel retained for this purpose? And, in the end, can one truly question if the modest cost was worth the benefit?

Uses of Independent Counsel

Since SOX, practices have also developed and evolved within the corporate world to use independent counsel for traditional roles as well as expanded SOX roles. Independent counsel can be useful in several areas. First, they can review company-prepared draft minutes for the board and its committees to ensure completeness and accuracy and, where appropriate, make sure questions and concerns raised by members of the board with management are recorded. I do not suggest transcript-like minutes, recording everything said by everyone for page upon page. (Can you imagine the depositions of the directors as they are tediously taken line by line through minutes of meetings years ago and their individual and conflicting recollections compared?) Nor do I recommend minutes that simply state that “discussion was held” and then record the vote; there is little of defensive

value here. Again, a middle ground will serve the purpose of recording the significant issues raised and the directions given by the board to senior management. For example, assume the audit committee is presented with a finding of material weakness or substantial deficiency in an internal control by the outside auditors. A statement in the minutes that identifies the specific problem area, articulates an understanding of the issues presented, and records the direction of the audit committee to address and resolve them will establish diligence, good faith, and business prudence in what are often arcane and complicated accounting matters. A simple review of the minutes at the next meeting provides a checklist for follow-up by the committee or board and an opportunity to discharge its duties in this regard. And, of course, these statements can be particularly useful in future litigation where board members are called upon to demonstrate their diligence and business judgment in complicated discussions that occurred years earlier.

Second, independent counsel can prepare and maintain minutes or notes of executive sessions of the board. Privilege questions are raised here, too, but an argument can be made that legal advice sought or given in these sessions is to the independent members of the board as a group and not as individuals. This would allow a further argument that the group, not the entire board (or company), is the client. Bear in mind that these notes may well be discoverable and not protected by the work product doctrine unless litigation is either pending or reasonably contemplated at the time.

Third, independent counsel can review annually the company’s code of conduct and committee and board charters to ensure continuing compliance with corporate governance best practices and ongoing improvement in board governance performance. Fourth, they can review the company’s quarterly earnings reports and annual reports, especially for Legal Proceedings and Management Discussion and Analysis. The purpose

here is not to duplicate the work of the general counsel or outside disclosure counsel but to ensure that two often potentially troublesome areas (other than the accounting footnotes) are reviewed by another pair of eyes representing only the interests of the board and not the company.

Yet another value of independent counsel to the audit committee is to serve as a kind of lifeguard to observe the meetings of the committee and its interactions with management, internal auditors, outside auditing firms, and the company's compliance and ethics officers. A savvy audit committee regularly questions internal and external auditors to assure themselves that the auditing plan is reasonable and thorough, that the key areas of the company's business are in fact being reviewed and tested, and that the internal auditors have adequate resources and staff to do the job. Most critically, the audit committee must be attentive that senior management has set the right tone at the top. This is to ensure proper audit cooperation and scrutiny and that the highest ethical standards consistent with the company's code of conduct are maintained. Too often in the past, companies have fallen victim to the pressure to make the numbers, particularly in down economic times. Corners can get cut and

important safeguards overlooked or circumvented. Securities fraud is often the result of people trying to do what they thought was expected of them or trying to keep their jobs by meeting unrealistic expectations. The vigilance of the audit committee needs to be even greater in tough times, and independent counsel can provide an effective outside aid to the committee in meeting their growing responsibilities to shareholders, regulators, and the public.

The advantage of independent counsel is enhanced by a background and ongoing relationship that gives the independent counsel familiarity with the corporation, its management, business, and operations. This creates a continuity with issues that have been addressed previously by the board or its committees. A good working relationship with the in-house legal and compliance departments is required but takes time to develop. Care must be taken, however, to ensure and maintain this independence, and other relationships or representation of the company or its employees should be generally avoided.

Finally, independent counsel, within the context of section 301 and otherwise, provides an additional level of insurance to members of the board. It is well established that board

members may reasonably rely on management, advice of in-house counsel, auditors, and other experts in meeting their fiduciary responsibilities and satisfying the business judgment rule. Advice from independent counsel provides yet another level of protection or insurance that board members would be well advised to employ.

Conclusion

In conclusion, the role of independent director counsel after SOX continues to develop and grow toward a greater use of such counsel to represent independent members of corporate boards and board committees. Conditions and circumstances calling for such representation obviously change from case to case and, at least so far, have not resulted in a standard operating procedure where such independent counsel become, in effect, shadow general counsel for the corporation. Given the statutory mandate of section 301 for audit committees' retention of outside experts, however, it would certainly behoove audit committees specifically and boards of directors generally to consider the additional protection and advice that independent directors' counsel can provide to the ever-increasing array of complex legal problems and responsibilities of boards of public companies.