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Corporate Governance Still Front And Center – And Corporate Counsel's Role Is Critical

*The Editor interviews **Peter H. Ehrenberg** and **Anthony O. Pergola**, Members of the Firm, Lowenstein Sandler PC.*

Editor's Note: *In this interview, the interviewees provide a preview of some of the issues to be presented at the seminar sponsored by Lowenstein Sandler PC on June 15 [see details on page 34] and to be featured in articles and interviews in Special Sections in this and our June issues. This coverage is part of our effort and that of our participating law firms and legal service providers to provide corporate counsel with an archive of the information necessary to meet the challenges of the New Legal Environment.*

Editor: How does the law define a director's duties?

Ehrenberg: Most of a director's duties are derived from a combination of state statutory and common law. Directors have two primary duties, a duty of loyalty and a duty of care. A duty of loyalty goes to issues of conflicting interests, and the director's duty is to the corporation. The duty of care in New Jersey is directly codified in the statute to require a director to act in good faith in a manner in which an ordinary prudent person would act under similar circumstances.

Editor: How deeply must a director look into a transaction in order to avoid a potential duty of care claim?

Ehrenberg: Directors are required to inform themselves. The "business judgment" rule is premised on directors making informed decisions. However, it gives directors significant latitude. The director needs only to inform himself or herself to the extent that a prudent person would under like circumstances. Also, most states have statutes that say that directors can rely on experts. For example, when directors are looking at audited

financial statements for the company, they can receive comfort from the fact that the outside auditing firm has given an opinion. They are also entitled to rely on in-house experts, such as the company's CFO.

Pergola: The public is beginning to take notice of duty of care issues. Just look at the attention being paid to the Disney case in Delaware. It is clear that the courts, regulators and plaintiffs' counsel expect directors to pay close attention to the norms established by state laws. Directors will receive protection under state law if they do the right thing – and now there is even more of a premium on doing the right thing. Directors who are not paying attention should be concerned.

Editor: When should the board or its committees retain outside counsel or an independent consultant?

Ehrenberg: Basically, boards interact with three types of attorneys from time to time – the company's internal counsel, outside counsel who is retained on a regular basis by the company, and independent counsel who have not previously been retained by the company. In most instances, the decision to seek outside counsel is based on expertise and availability. A board or committee would turn to independent outside counsel when there might be an allegation of conflict if it turned to its regular counsel, whether within or outside of the company. For example, if there were a question regarding work performed by its regular outside counsel.

There are occasions where the audit committee or compensation committee will determine that it is necessary to hire independent counsel. If the audit committee wants to investigate wrongdoing by a senior executive, they will turn to independent outside counsel to conduct an investigation on behalf of the audit committee. It is also appropriate for the compensation committee to use independent counsel as well as independent employee benefit and compensation consultants when negotiating compensation with the CEO or other key officers.

Editor: Are there matters that require a higher degree of care?

Ehrenberg: Most practitioners agree that the big issue in this coming proxy season will be senior management compensation. They are advising public company clients that their boards should be especially careful to document the steps that they have taken to properly inform themselves when fixing the compensation of senior executives.

Editor: What are the standards that a director must meet to be considered independent?

Ehrenberg: It depends on the regulating organization. NASDAQ and NYSE have their own rules on independence. They vary slightly, but in general independence is defined in terms of relationships. Family relationships, employment relationships and other situations where directors may have a conflict of interest are examined. For example, suppose I were a director and had been paid a significant amount of money to work as a consultant on a project. The law is concerned that since I received payment that is meaningful to me, I am not going to be able to render a completely unbiased decision regarding any matter that management favors.

The present emphasis on independence grows out of dramatic high profile cases like Enron. In the wake of those cases, regulators looked for ways to bolster confidence in the capital markets. One of the methods they used was to say that they were not going to allow decisions to be made in a boardroom where the people making those decisions were beholden to management.

The law is based on the theory that the ultimate control of the corporation rests with the shareholders. Under the law, the shareholders pick the directors and then the directors pick the officers. The legal model is a pyramid where the directors work for the shareholders and the CEO works for the directors. In the case of many public companies with widely dispersed stock, that pyramid gets turned on its head. The CEO picks the directors, and the shareholders have no practical alternative to voting for a board handpicked by management. An important step toward conforming the practice to the legal theory was to insist that the board and key committees include a majority of independent directors.

Pergola: The effort by the courts and regulators to put the pyramid back on its shareholder base includes three key initiatives. One, reforming the process for nominating new directors. Two, making directors more accountable for their decisions with respect to the compensation of the CEO and other top-level executives. Three, elevating the role of the audit committee to a primary position so that independent directors are in a position to prevent potential financial statement abuses that mislead shareholders and undermine the capital markets.

Editor: What steps are being taken to ensure that directors are in fact independent?

Ehrenberg: The rules of the regulatory organizations generally require the boards to make findings with respect to their own independence. Directors are asked to complete questionnaires to ferret out information about activities that compromise their independence. Pertinent information developed by these questionnaires is then reviewed with the board.

Pergola: Companies need to remind their independent directors to keep the company's general counsel or corporate secretary informed of changes in status and relationships. They owe that level of candor to the company. Directors should be encouraged to review with one of these officers proposed new activities that might affect their status. Monitoring public information concerning directors is a good practice. Tools like the Internet make monitoring of this kind practical and inexpensive – and ensures that corporations become aware of developments affecting their directors at least as soon as the general public.

Editor: What about executive sessions of the independent directors where members of management are not present?

Ehrenberg: It has long been a practice to provide an opportunity to the audit committee to meet with the company's auditors without members of management being present. This allows the auditors to speak openly and frankly without feeling inhibited and encourages the directors to ask more probing questions. NASDAQ and NYSE rules likewise provide that there should be times when independent directors meet in executive session without members of management present. Although the rules apply to public companies, other companies are also observing these rules as best practices.

Editor: How does the concept of lead director fit into this?

Ehrenberg: Often the position of a lead director is established in situations where a company has a chairman of the board and CEO who is the same person, or where the chairman is not independent. In such situations, the lead director would call executive sessions of the independent directors and lead and set the agendas for such sessions.

Pergola: There is concern that creating a non-executive chairman or lead director would create divisiveness in the boardroom that could detract from the ability of the corporation to pursue its business objectives. When things are functioning as they should, it is important that the collegiality of the board is not lost – which would not be good for shareholders or the markets.

Editor: What are the essential committees of the board?

Pergola: "Must haves" include audit, compensation and nominating committees. Whether or not the company has an executive committee of the board depends on the size of the board and the needs of the company. We have seen many good public companies operate without board executive committees, as well as a number that felt they needed them in order to function.

Editor: Do you have an observation on the number of meetings a board should have?

Pergola: Regular meetings are extremely important and necessary. Also, prospective board members should realize that they will need to be nimble enough to convene, at least by telephone, for special meetings as needed. The number of regular meetings depends to a large extent on the complexity of the corporation's activities and the number of matters that need board action or scrutiny – the underlying principle is that the board meetings must be sufficiently frequent for the directors to fulfill their oversight role. In addition, some corporations arrange for visitations by directors, either individually or as a group, to company facilities.

Editor: Which of the committees should be made up entirely of outside directors?

Ehrenberg: When we are talking about companies that are regulated by NASDAQ or the NYSE, the requirements are clear that the audit committee needs to be entirely independent. They make exceptions for special situations. Take for example, a company that has a majority of independent board members, or has committees that meet independence requirements and then something happens. If the needed independent director resigns, the regulatory organizations provide exceptions to allow companies to get back in compliance.

Editor: Who do corporate counsel and outside lawyers represent?

Ehrenberg: They represent the corporate entity. They do not represent management or shareholders. As counsel for the corporation, corporate counsel would ordinarily be called to advise directors of their duties. However, corporate counsel are not personal counsel for a director when his or her interests may conflict with those of the company; for example, where he or she is seeking indemnification from the company.

Editor: How does the up-the-ladder reporting relationship work under Sarbanes-Oxley?

Ehrenberg: Under the statute and regulations, counsel who become aware of material securities law violations, fiduciary violations and other similar violations are obligated to bring those to the attention of the inside counsel and the CEO. If the matter is handled and resolved at that stage, that is the end of the reporting. If for any reason there is not appropriate resolution at that level, the attorney is obligated to make sure that it goes to the board or a specially designated committee for resolution. The SEC left open the issue of a noisy withdrawal, which would in effect result in the attorney bringing the matter to the attention of regulators. However, amid objections from various bar associations around the country, the SEC was persuaded not to invoke a noisy withdrawal requirement at this time.

Editor: How important is process when determining that a director discharged his or her responsibilities?

Ehrenberg: Process is critical. If you have a good process that demonstrates that the directors took reasonable steps to inform themselves, the courts will apply the business judgment rule even if the board's decision later proved to be wrong. That is what the "business judgment" rule is all about. It is predicated on informed decision making. It is the corporate counsel's duty to ensure that appropriate process is followed in decision making.

Editor: Can a director assume that the minutes and file of documents would provide a paper trail evidencing that proper process was observed?

Ehrenberg: There are many different theories about the taking of minutes. There is no question that minutes should be a way to evidence what was done at a board meeting and the process that was involved in making decisions. However, this does not demand that the minutes be overly detailed. You are trying to encourage full and fair debate so recording every single comment would certainly stifle conversations.

Pergola: It is appropriate for the board as a whole, based on advice of counsel, to decide how verbose the minutes should be. There is no "one size fits all" solution. It is a company-specific, needs-driven decision.

Editor: Does a financial expert who serves on the audit committee have enhanced personal liability?

Ehrenberg: The SEC, in its releases, argues that they do not. The same is true under state law, although there is a recent Delaware case that is troublesome. We have to wait a few years to see if there is any further clarification.

Pergola: Holding financial experts to a higher standard is clearly counterproductive because it will tend to discourage those with a badly needed talent from serving on boards. However, financial experts are concerned about being held to a higher standard, and it is difficult to provide much comfort to them right now.