"Creating the Ultimate Board in the Sarbanes-Oxley/Post-Enron Era"

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The focus on corporate governance issues has never been greater. Investors now look at corporate governance as an important factor when making investment decisions. The SEC and the major stock exchanges have proposed rules regarding enhanced qualifications for directors and improved behavior. The landmark Sarbanes-Oxley Act of 2002 significantly changed how directors and officers manage their companies. A new cottage industry is being created to evaluate and compare the quality of companies' corporate governance and to assist companies in improving their governance practices. Magazines such as Business Week are also rating companies on the quality of their boards and publishing lists of their picks for the best and worst examples of corporate governance.[1]

In response to the new climate, many public companies are seeking to strengthen the composition of their boards. Qualified talent, however, may be in short supply. A report by Spencer Stuart noted that in 2001 there was a 44% increase in newly added directors to the S&P 500, but forecasted a need for several hundred more individuals to fill public board seats with newly mandated independent directors, especially for audit committee service.[2]

Individuals with excellent qualities for board service may understandably be hesitant to accept directorships. Serving as a public director is certainly less attractive and more risky than it has been in the past. This is due to many factors, including:

- Media attention on recent corporate scandals;
- Increased risk of shareholder lawsuits;
- Newly enacted legislation regulating officer and director conduct;
- Heightened scrutiny of board decisions on matters such as executive compensation, stock options, and accounting procedures; and
- Concerns surrounding the availability and quality of director and officer insurance coverage.

The compelling need for strong directors coupled with a shortage of such individuals adds up to nothing less than an immediate crisis for many public companies. In order to keep published ratings high, and stockholder perception positive, and to stay off anybody's "worst ten" list, public companies should take strong pro-active measures to build strong boards and enlist qualified directors.

The following are steps a company might take to build the ultimate board: one that would inspire investor confidence and attract the most qualified individuals to serve as directors. Because most public companies have relatively standard director and officer indemnification provisions and due to the recent uncertainties surrounding the effectiveness of such provisions, our recommended steps do not address these points.

Obtain Solid Director and Officer Liability Coverage. Directors understandably are concerned about their personal exposure for claims alleging perceived wrongdoing in their official capacity. This is especially true in light of the current focus on governance, the volatile litigation environment for directors today, and new and untested statutes and regulations. Public companies seeking highly qualified directors should do their best to provide comprehensive D&O coverage as a selling point. To provide maximum protection to the directors, a "Side A Only" D&O insurance policy can be purchased,

which covers only claims that are not indemnified by the company subject to very broad coverage terms. Such a policy should not become enmeshed in any bankruptcy filing by the company and contains a limit of liability dedicated solely to claims which are of most concern to directors.

Provide Outside Directors With Direct Access to Company Subordinates. Outside directors must have the ability to meet with and obtain information from company employees below the senior management level, and this communication should work both ways. Procedures should also be put in place to allow subordinates to directly submit information to the independent directors on their own initiative. In this way, the independents will have better information about the real workings of the company as well as advance notice of issues that may ultimately come before the entire board. We are aware of at least one software vendor who is marketing an anonymous online reporting system which can be utilized to provide a direct conduit for ethical violations, fraud and claims of corporate abuse to reach independent members of a company's board of directors or its audit committee. Such open communication not only sends a strong signal to the investing public but to its directors as well. It signals that the company is willing to provide its directors with the information necessary for them to oversee management and to make informed decisions at the board level.

Establish a High Standard for Independence. When determining whether a director is independent for its own internal purposes, a company may defer to a standard set by the exchange on which it is trading. It may simply require that "independent" directors receive no direct compensation from the company, which is essentially the standard set under Section 301 of Sarbanes-Oxley for audit committee members. However, in creating a superior board of directors, a company should go further and consider a director independent only if he or she has no economic ties to the company whatsoever, whether as a potential customer, supplier, consultant, co-venturer or as an affiliate of the same. In fact, the ideal "independent" director would also be free of any social or family ties to the company and its management. Setting a higher standard than that required under exchange rules or federal securities regulations would demonstrate the company's commitment to a truly independent board of directors free to perform its oversight responsibilities with fewer economic conflicts of interest.

Require Independence of a Majority of the Board. One statistic certain to be a major factor in rating a public board is its ratio of independent to inside directors. While not required, companies may wish to either voluntarily adjust this ratio in favor of the independent directors or go so far as to amend their by-laws to require a majority of its members be independent. Providing for a majority of independents will insure a potential outside director that his or her voice will be considered by the board as a whole. This will prevent an independent from being in the awkward position of opposing a management decision that is certain to pass regardless of his or her input simply because the membership of the board is stacked in management's favor.

Provide the Board With Funds to Obtain Separate Counsel and Advisors. If the board, and in particular its outside members, are to provide truly meaningful review of management decisions, it must have its own independent professionals providing advise separate and apart from that provided to management. To that end, the ultimate board should be empowered with explicit standing authority to research, interview and retain its own legal, accounting and other professional advisors. There is an unavoidable conflict when an independent director must ask the company's independent auditors if the reports they are providing present a full and accurate picture of the company's financial position. In addition, directors are also subject to potential personal liability for certain actions and decisions, and they should receive advice regarding meeting their obligations and managing any liability risk from a source other than the company's general counsel or outside lawyer. Otherwise, the company lawyer may be in the awkward position of advising a director in ways to minimize his or her personal risk. Oftentimes, the liability a director dodges can land squarely upon the back of the company as a whole or its shareholders, which puts the company's counsel in a conflict of interest quagmire. Attracting good directors would be easier if the candidate knows that the company will provide funds for the board and its committees to obtain the advice and counsel to perform their duties and manage their personal liability.

Require Total Independence for Crucial Board Committees. Section 301 of the Sarbanes-Oxley Act requires a public company's audit committee to be composed entirely of independent directors, as independence is defined in the Act. Such complete independence is not required by the SEC for any other board committee. However, a superior board would require such total independence of its other important committees as well, such as the nominating committee and the compensation committee. This would insure that such matters as executive compensation, stock options, and selection of future outside directors were determined without undue influence from management or insiders.

Prohibit Compensation Interlocks. When directors serving two different companies are in a position for each to set the compensation of the other by serving on interlocking compensation committees, it is referred to as compensation interlock. While federal securities law requires disclosure of compensation interlocks, these arrangements are not prohibited.[3] In creating the ultimate board, compensation interlocks should be prohibited as being inherently suspicious. A company reduces the opportunity for and likelihood of shareholder lawsuits when it takes steps to avoid situations where claims of self-dealing and conflicts of interest can be easily implied.

Limit Director Service on Multiple Boards. Another empirical statistic is how thinly a company's directors are spread in serving on multiple boards. When directors serve on numerous boards, investors are left to assume that "professional" directors do not have sufficient time available to give full attention to each of the companies for which they serve. A superior board would strike a balance between allowing directors to serve other companies and recognizing that such service is impaired when spread over more than a few directorships.

Establish Regular Meetings of the Independent Directors Without Management Present. The ultimate board will not wait until a significant event or crisis to cal a meeting of its independent directors. The outside directors should be called on to meet together on a regular basis to keep themselves familiar with the operations of the company and any current issues it may be facing. Such meetings should be held without management, and should include reports from both management as well as subordinates within the company who may have relevant information for the independents to consider. Where the federal securities laws require disclosure of directors who fail to attend at least 75% of board and committee meetings, the ultimate board would require no less than 75% attendance from its members.

Increase the Frequency of Audit, Compensation and Nominating Committees. These crucial committees should meet regularly and not merely as needed to approve items required by federal securities laws or to rubberstamp a compensation or nominee decision. Regular meetings foster familiarity with the specific concerns of the company as well as improve the working relationships between members of these committees as they focus on the very specific issues before them.

Provide Training to Inside and Outside Directors Alike. The ultimate board will train directors in how best to serve the interests of the company, to recognize the fiduciary duties they owe to its shareholders and to handle the often complex ethical, financial and personal challenges faced by public directors in the new millennium. Many companies are instituting such training, as evidenced by increased demand for director boot camps and other training methods in recent months.[4] Any board training must provide directors with insight into recognizing when there are potential conflicts between the interests of the director on the one hand and the interests of the company and its shareholders on the other. It is crucial that directors learn not only how to identify ethical trouble spots but also how to deal with them effectively, whether by avoiding them altogether or by disclosing their existence and obtaining the appropriate approvals from non-interested directors or even the company's shareholders.

Conduct Periodic Director Review and Evaluation. Once a superior board of directors has been assembled, processes must be in place to ensure it continues to perform well. These procedures could include periodic evaluations by the company's nominating committee to determine if the basic composition of the board continues to represent a diverse mix of individuals with background and experience that remain relevant to the company's business and industry. It could also include a form of peer-review or director self-evaluation to ensure that each director is actively carrying out his or her duties and otherwise making a positive contribution to the oversight of the company.

In the current economic climate, many investors are equating good corporate governance with sound investment prospects. In the end, we predict that companies which fail to take aggressive action to strengthen the real and perceived integrity and independence of their boards will pay the price both in terms of poor public perception as well as falling stock prices. Forward-looking management will strongly consider implementing these and other actions as ways to boost investor confidence in their company and provide valuable corporate oversight to its management.

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[1] Louis Lavelle, "The Best and Worst Boards." Business Week, October 7, 2002, p. 104.

[2] Spencer Stuart Report Says 25% of S&P 500 Lack Required Nominated/Governance Committees on Boards of Directors. PR Newswire, October 1, 2002.

[3] See Item 402(j) of Regulation S-K.

[4] Louis Lavelle, "The Best and Worst Boards." Business Week, October 7, 2002, p. 104.