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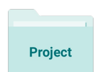

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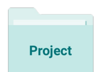

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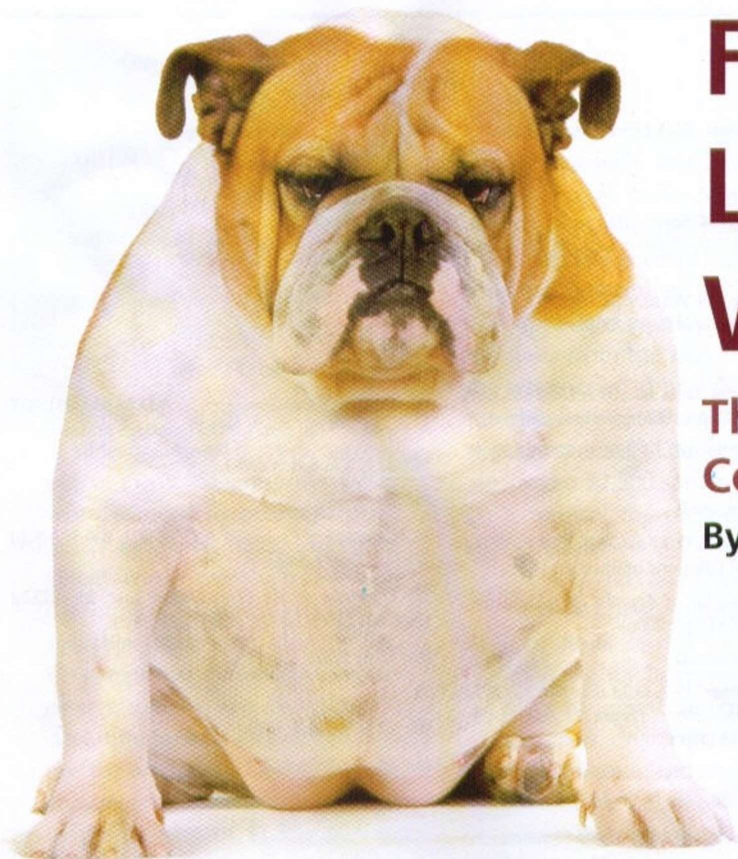

From Lapdog to Watchdog

The Post-SARBOX Corporate Board

By Gwendolyn Yvonne Alexis

So, you have been invited to join the board of directors of a publicly traded company. *Congratulations*! An invitation to serve on the governing body of an established organization is an indication that you have become a jurist of note in the business community. However, before embarking upon this milestone in your legal career, there are a few things to consider.

Sarbanes-Oxley

The Sarbanes-Oxley Act of 2002 (SARBOX)[1] has greatly increased the liability of board members of publicly traded companies for corporate financial reports that mislead the investing public. In this regard, the Securities and Exchange Commission (SEC) does not distinguish between financial statements that fail to disclose important information and statements that contain actual misrepresentations; both shortcomings are deemed to be deceptive practices in violation of the nation's securities laws.

In 2002, faced with what appeared to be systemic accounting irregularities in publicly traded companies, the 107th Congress sought to enact a law that would both deter manipulative corporate transactions and improve the quality of oversight within the corporate environ. On the heels of the massive corporate wrongdoing of "Enron & Progeny," Congress enacted SARBOX, to cast a wide net of accountability within the corporate milieu.[2] Thus, even though accountants and attorneys were targeted as the professionals most culpable for inaction or collusion during this period of massive and pervasive corporate fraud, several other corporate habitués were identified as culpable because of complacency or negligence. Among those faulted were the boards of corporations that became the subject of SEC enforcement actions because of financial statements that failed to accurately reflect the corporate financial picture.

SARBOX accomplishes the objectives of deterrence and oversight by (1) elevating securities fraud to a federal crime cognizable by the Office of the U.S. Attorney, without the need for a referral from the SEC;[3] and (2) clearly establishing that where a board of directors exists, it is the *governing authority* of the corporation.[4] In other words, today's board is saddled with a watchdog function within the corporate hierarchy. And, given the possibility of an imposition of vicarious criminal liability upon the corporation (with a shareholder lawsuit against the board of directors certain to follow), it is incumbent upon the board to exercise due diligence in rooting out corporate wrongdoing. Moreover, clearly evidencing a congressional intent that criminal sanctions serve as a deterrent to corporate wrongdoing, § 805 of SARBOX directs the U.S. Sentencing Commission to review its sentencing guide-

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lines to make sure that they "are sufficient to deter and punish *organizational* criminal misconduct."[5]

Judging from recent headlines, corporate boards are beginning to feel the weight of their new responsibilities under SARBOX. Boards second-guessing management decisions has now become so routine that in a high-profile resignation from the General Motors Corp. board, the parting director accused the board of lacking independence because it accepted management's negative assessment of entering into an alliance with Renault SA and Nissan Motor Co. without having commissioned its own study of the pros and cons of an overseas alliance.[6] In short, the days when the board could be viewed as no more than an appendage to corporate management are past. The post-SARBOX board is striking out on its own and showing an independence of thought that ensures its ability to fulfill its fiduciary duty to the shareholders by carrying out its enhanced oversight functions.

A New Dynamic

Without a doubt, SARBOX has engendered a metamorphosis of the corporate board from lapdog into watchdog. This has resulted in an uncoupling of board interests from those of management, which has introduced a degree of tension into the once harmonious relationship between management and the board. This new board-management dynamic has led to the emergence of certain conditions precedent that must be satisfied if a listed company hopes to attract an elite cadre of accomplished individuals as members of its board of directors. Today, it is expected that, prior to agreeing to serve on the post-SARBOX corporate board, a prospective candidate will want to ascertain that the corporate suitor has the following corporate governance safeguards in place:

Board Audit Committee

An underlying assumption of SARBOX is that each corporate board will designate some of its members to constitute an "audit committee" for the purpose of overseeing the corporation's accounting procedures and financial reporting process. Only outside (independent) directors may sit on the audit committee. A key responsibility of the audit committee is to review company financial reports before they are filed with the SEC, which makes these filings available to the investing public through its EDGAR database. Although in the past, few top-level executives "signing off" on corporate financial statements paused to consider whether they were putting themselves at risk for charges of securities fraud, SARBOX makes it prudent for anyone in the position of vouching for the accuracy of a financial report to consider the possibility of being held criminally liable if the reports are subsequently found to contain inaccurate or misleading information. Violators of the securities laws are subject to heavy fines and imprisonment for up to 25 years under SARBOX-enhanced criminal sanctions.[7]

It should be noted that *securities fraud* does not require *scienter.* It is committed when one endorses company financial statements that contain material misstatements or omissions of fact that induce members of the public to purchase a company's stock or – as was the case with Enron – convinces current stockholders to continue holding a company's stock. Since SARBOX provides that the entire board will be designated as the audit committee where the board does not appoint one,[8] potential board members without financial or accounting expertise will be hesitant to join a board that has not already established an audit committee.

The audit committee has an additional function with respect to whistle blowing under SARBOX: it is designated as the top of the internal whistleblowing ladder for in-house or outside attorneys who have discovered corporate wrongdoing, such as misrepresentations or insufficient disclosures in company financial reports. Under the Code of Professional Responsibility for attorneys practicing before the SEC (adopted by the SEC under SARBOX mandate), attorneys are required to blow the whistle on corporate wrongdoing up the ladder to the audit committee, where satisfactory remedial action has not been taken after an attorney reports wrongdoing to those at the lower echelons of the corporate hierarchy.

"Financial Expert" on Audit Committee

Section 407 of SARBOX requires a company to disclose in its periodic financial reports whether the audit committee has one member who is a "financial expert," defined as someone with "an understanding of generally accepted accounting principles and financial statements." If there is no such financial expert on the audit committee, then a company must disclose the reasons why one has not been appointed. Of course, the need to disclose why an audit committee is operating without a financial expert is tantamount to a presumption that the presence of such an expert is necessary for an audit committee to function as intended. Clearly, where there are found to be material misrepresentations or omissions in a company's financial statements, the board that has failed to include among its members a financial expert (who may have discerned the errors and omissions) will be deemed to have been negligent.

Board Composed of Minimum of 75% Independent Directors

With either SARBOX or "best practices" mandating that key committees such as the audit committee, the nominating committee, and the compensation committee comprise only independent directors, it is difficult for the typical 12-person board to function where outside directors constitute less than 75% of its membership. Clearly,

the potential for conflict of interest rises exponentially where those evaluating the efficacy of management proposals are the very same individuals who developed the proposals and put them before the board!

Board With an Independent Chairman

Part and parcel of a board asserting control over its operations is that the company CEO does not call board meetings or set the agenda. Having a CEO in a position to insinuate himself or herself into all matters taken up by the board is contrary to the notion that the board is fulfilling its fiduciary obligation to the shareholders by keeping a critical eye on management (who is, after all, merely an agent of the shareholder owners). Where a company does not follow the practice of having a non-CEO Chair of the board, it should have a well-established policy of the board going into "executive session" in order to take up certain matters (such as evaluation of CEO performance) outside of the presence of the CEO. In this vein, the New York Stock Exchange has a rule requiring listed companies to hold regular meetings at which management is not present.

Ethics Program That Complies With U.S. Sentencing Guideline § 8B.2.1

U.S. Sentencing Guideline § 8B.2.1, added pursuant to a SARBOX directive, sets forth the requirements for an effective ethics program. An effective program will detect and prevent criminal conduct for which a listed company would be vicariously liable and thus subject to fines and other penalties – such as delisting or trading suspension. If a company has an ethics program in place that complies with the Guideline, it will not incur vicarious liability based upon the illegal acts of its employees in violation of the company's adopted ethics program. Therefore, having a § 8B.2.1 Ethics Program in place substantially reduces the likelihood that directors will become defendants in shareholder lawsuits based upon the misdeeds of company employees. Notably, adoption of a whistle-blowing system is an integral part of the "Compliance and Ethics Program" model set forth in Guideline § 8B.2.1. Thus, a company must have a well-publicized whistle-blowing policy in place in order to reap the benefits of the § 8B.2 safe harbor provision. In addition, the company ethics officer should be a person of significant rank within the corporate hierarchy in order to establish the corporation's commitment to its ethics program.

Open Lines of Communication Between Board and Stockholders

The post-SARBOX board dare not rely solely upon management to convey shareholder concerns. Again, the New York Stock Exchange has set the standard for open communication between shareholders and the board. Since 2003, the Exchange has required listed companies to provide shareholders and "other interested parties" (*e.g.*, outside whistle-blowers) with contact information for the board of directors.

Open Lines of Communication Between Board and Employees

The SARBOX-savvy executive will not join a board if the company restricts the board's access to employees. Walking around the plant floor is an excellent way for board members to acquire first-hand knowledge of the operations for which they are providing oversight. As the corporation's governing authority, the board is the last stop on the whistle-blowing ladder. Thus, it may be assumed that the pathway has been cleared for employees to get the ear of the board where whistle-blowing to individuals lower in the corporate hierarchy has not resulted in appropriate remedial action. However, this is one-way communication that occurs after-the-fact; *i.e.*, problems have already become critical and are therefore much harder to resolve. Far better to maintain open lines of communication and thereby create a situation in which the board can troubleshoot problems before they get out of hand – problems that management might consider too insignificant to put before the full board. (Typically, these "routine difficulties" are handled with internal memos and e-mail correspondence that later surface at the who-knew-what-and-when stage of congressional hearings.)

Board Budget for Consultants

Where the board is acting in areas in which it lacks expertise, such as evaluating a management proposal for incentive bonuses, the board is well advised to utilize outside consultants for advice. As an example, Fannie Mae recently came under fire for accounting violations that resulted in an overstatement of its profits for the period 1998 through 2004. During the investigation of these accounting irregularities, low-level accounting personnel testified that they felt pressured into straying from generally accepted accounting principles (GAAP) in order to report financial results that "hit" the projected profit lev-

An effective ethics program detects and prevents criminal conduct for which a listed company would be vicariously liable.

els necessary for top executives to receive their bonuses.[9] This type of systemic failure illustrates the importance of the board ascertaining beforehand that a bonus structure does not motivate undesirable behavior on the part of bonus candidates and those under their supervision. Structuring compensation packages is an area rife with minefields, as recent options-backdating scandals reveal. Therefore, the prudent board will want to seek outside counsel before approving executive compensation plans.

Since calling in an outside pay consultant is the expected board *modus operandi* when negotiating a CEO's compensation package, getting management to allocate funds to the board for this purpose should not be a problem. However, management may resist if the board also requests that funds be allocated in order for it to consult with its own outside legal counsel at this stage. Yet, in view of the recent rash of board CEO firings, it is clearly advisable for the board to negotiate an exit package in conjunction with the hiring of a new CEO. Otherwise, the sacked CEO could be exiting with sums ranging from $20 million–$40 million to assuage a wounded ego, as several CEOs have recently.[10] Companies can assure potential board members that they will not be hampered in carrying out their due diligence obligations (even where the board is seeking a second opinion on a management proposal) by giving the board its own annual budget, one that it can allocate as it deems necessary to fulfill its fiduciary role.

Code of Ethics for Senior Financial Officers

Although § 406 of SARBOX makes adoption of a code of ethics for senior financial officers optional, it is unlikely that a company without such a code could manage to attract highly sought-after executives to its board. Section 406 requires the company without a code of ethics for its senior financial officers to state in its filed financial reports why it has not adopted such a code. One can only speculate what palatable reason a company could give for letting its senior financial officers operate in an ethical abyss. One cannot even speculate as to who would willingly join the board of such a company.

Conflict of Interest Review Procedure

There is a strong likelihood that a non-insider executive being courted for a board position has a previous history with the suitor company. The executive may be in the employ of (or the owner of) an organization that is a supplier, banker, or customer of the suitor company. Or, it may be that the executive is a personal friend of the CEO, someone in management, or an acquaintance of some other member of the board. Whatever the previous relationship, the potential for benefiting from the new role as a board member is ever present and, therefore, the prudent executive will want to protect herself or himself from conflicts of interest and self-dealing controversies down the line, as these would constitute a breach of fiduciary duty to the company's shareholders. The best protection against conflict-of-interest situations is for the board to have an established system of periodic conflict-of-interest checks for board members (*e.g.*, self-completed questionnaires) that take place at established intervals throughout the year. Moreover, there must be an unequivocal across-the-board policy prohibiting business dealings between the company and its board members or with any companies with which the board members are affiliated.[11]

Conclusion

SARBOX is both praised and cursed as the legacy of Enron & Progeny. As we approach the fifth year of the SARBOX-changed corporate milieu, rumblings of "regulation overkill" are being heard far and wide. And yet, even if a future Congress retreats on some of the mandated internal controls that have motivated the cries of legislative excess, this is unlikely to subdue the stream of oversight that ended the era of the rubber-stamp board. Perhaps this is as good a legacy as any. ■

1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

2. To illustrate, SARBOX targets securities analysts, brokers and dealers in Title V; chief executive officers and chief financial officers in Title IX; attorneys, officers and directors in Title III; board audit committees in Title II; investment banks and financial advisers in Title VII; and external auditors in Title VIII.

3. SARBOX amended the U.S.C. by adding a new section, titled "Securities Fraud." *See* Pub. L. No. 107-204, 116 Stat. 745, § 807 (codified as amended at 18 U.S.C. § 1348).

4. U.S. Sentencing Guideline § 8B2.1, added by SARBOX, provides that the "governing authority" of a corporation is "(A) the Board of Directors; or (B) if the organization does not have a Board of Directors, the highest-level governing body of the organization." U.S. Sentencing Guidelines Commentary, § 8B2.1 (2004).

5. SARBOX, § 805(a)(5) (emphasis added).

6. Monica Langley, *GM Tensions Erupt as Kerkorian Ally Quits as Director*, Wall St. J., Oct. 7, 2006, at 1.

7. 18 U.S.C. § 1348 *amended by* SARBOX § 807.

8. "(B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer." SARBOX § 2(a)(3)(B). Note, however, that where an audit committee exists, it is to be composed only of outside directors. Should this be interpreted as precluding inside directors from becoming de facto members of the audit committee when the entire board is designated as the audit committee because the board does not have a specified audit committee?

9. Office of Federal Housing Enterprise Oversight, *Report of the Special Examination of Fannie Mae* (May 2006) *available at* <http://online.wsj.com/public/resources/documents/ofheo20060523.pdf>.

10. For instance, a panel of arbitrators recently determined that Massachusetts Mutual Life Insurance Co. must pay $40 million to fired CEO Robert J. O'Connell because the CEO's actions, although questionable, did not amount to willful gross misconduct. In another example, a jury determined that Metris Co. should pay fired CEO Ron Zebeck $30.2 million. Joann S. Lublin, *How to Fire a CEO*, Wall St. J., Oct. 30, 2006, at B1, B3.

11. Staying on top of conflict-of-interest situations is extremely important. In 2005, more than half of the board members of the University of Medicine and Dentistry of New Jersey (UMDNJ) were forced to resign after acting Governor Richard Codey signed Exec. Order No. 65 (Nov. 2005) prohibiting anyone transacting business with a New Jersey State college from sitting on that institution's governing board. *No College Trustee Conflicts*, Star-Ledger, Nov. 19, 2005.