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New Year's Resolutions For Independent Directors

By Harvey L. Pitt, Compliance Week Columnist—January 27, 2004

The last three years have seen an exponential increase in corporate implosions. The defalcations at Enron, WorldCom, HealthSouth, Ahold, Parmalat and countless other global companies have produced:

- Stringent new legislation, in the form of Sarbanes-Oxley;
- A plethora of new rules and regulatory requirements from the SEC, the NYSE and Nasdaq;
- A spate of prosecutions and enforcement actions by the DOJ, SEC and some state prosecutors intent on acquiring higher office; and
- An increase in the number of private class actions instituted and the dollar amounts required to settle those cases.

In the wake of these scandals and the legislative, regulatory, prosecutorial and private litigation responses, some independent directors have been left wondering whether board service is a liability-laden fool's errand and how they can possibly comply with all the new legal and regulatory requirements.

Since we've just turned the corner on a new year, it seems appropriate to offer some New Year's resolutions independent directors might consider adopting.

1. **Limit the number of boards and audit committees on which you serve.**

   By now, it should be readily apparent that the expenditure of considerable effort and time is necessary to do a meaningful job as an outside director. By definition, this means there's a limit to the number of public companies on which any single individual can, or should, sit, and the number of audit committees on which any individual can effectively serve.

   While the NYSE, for example, effectively proscribes (through the imposition of evaluation and disclosure requirements) service on more than three audit committees, thoughtful individuals should limit their service as outside directors to no more than three public company boards, or only two if they serve on both companies' audit committees.

2. **Review and re-assess your criteria for determining the companies on whose boards you presently sit.**

   In the old days, independent directors were often selected by, at the behest of, or with the concurrence of, the CEO. There's nothing inherently wrong with that methodology, but

friendship ties and other associations with members of management or the board are an insufficient basis upon which to predicate service as an independent director.

Independent directors need to assess whether they can make a meaningful contribution to a company, whether they have the requisite knowledge and skills to understand the business of the companies on whose boards they sit, and whether they have performed sufficient due diligence to be satisfied that the companies on whose boards they sit are governed with integrity and transparency.

3. **Review the qualifications and qualities of your fellow independent directors.**

   Benjamin Franklin's timeless counsel — "we must all hang together, or most assuredly we will all hang separately" — is now the stark reality for independent directors of public companies.

   No matter how qualified an individual is to serve on a particular board, or a particular board committee, those qualifications will not do a bit of good if his or her independent director colleagues do not meet the same high standards.

4. **Re-evaluate and re-assess the company's senior management and the inside directors.**

   There's a real danger that Sarbanes-Oxley will lull public investors into believing the new standards for, and greater powers of, independent directors, will prevent future instances of the type of financial reporting chicanery we've observed the past three years. The truth, however, is that no matter how diligent, intelligent, capable and persevering independent directors are, they have very little chance of detecting financial frauds.

   This places a premium on evaluating the credibility, integrity, transparency, collegiality and morality of senior management and inside directors. It requires a serious and comprehensive effort.

5. **With the other outside directors, conduct a meaningful evaluation of the board, board committees and individual directors.**

   Many companies already have instituted an annual evaluation process for the board as a whole in governance guidelines adopted this past year. This is a good time to review, and to begin implementing, the evaluation process.

   What's needed is an honest assessment of the board's strengths and weaknesses, and a time-efficient game plan for addressing any weaknesses or troublesome areas uncovered. This will include a review of the board committees that exist and their charters, to ensure that the board is functioning at the highest level of current best practices.

   Corporations should have, at a minimum, audit, compensation, nomination and governance committees, each of which is comprised exclusively of truly independent and qualified directors.

6. **Ensure that corporate boards on which you sit provide easy access to appropriate internal and external expertise and advice.**

   Today, public companies must make external expertise and advice available, on request, to the independent directors serving on audit committees. But it is in the interest of independent directors that each of the four major committees — audit, compensation, nomination and governance — has on retainer appropriate independent external experts and advisors.

   In its proceedings involving Chancellor Corporation, the SEC recently criticized outside directors who, the agency said, weren't sufficiently proactive. Having advisors who exclusively serve one or more of the four major corporate committees (and perform absolutely no work for the company at management's direction or behest) is a sensible step to ensure that outside directors are performing their functions in accordance with their legal obligations, and sound business practices.

   Apart from external advisors, independent directors should have unfettered accessibility to in-house expertise and capacity, without being required to go through senior managers.

7. **Compensation committees should re-evaluate their "pay-for-performance" policies, including the use of options and restricted stock.**

   Executive compensation, a "hot button" issue in the latter half of 2003, will continue to draw scrutiny in the new year. It's in the interest of both independent directors and senior managers to rethink the standards for performance pay, by tying compensation to integrity, transparency, corporate ethics, and objective performance standards.

   I covered this topic in my October 2003 column for Compliance Week, in which I list six key points that directors and officers should consider regarding compensation policies and procedures.

   At the same time, consideration should be given to ensuring both that the company's proxy materials adequately and clearly describe both the quantitative and the qualitative aspects of compensation decisions, and that all the directors understand exactly what the levels of compensation are, the standards for awarding bonus compensation, and the amounts accruing under deferred compensation plans.

8. **Independent directors should be schooled in, and have a definitive gameplan for exercising "collegial oversight" of management.**

   At present, many independent directors fall into one of two extreme camps — those unduly deferential to senior managers, barely exercising any realistic oversight of managers and the performance of their obligations, and those unduly adversarial in their approach to management, for fear that partnering with management will somehow taint them in the eyes of regulators, prosecutors or shareholder activists.

   Those extremes are, respectively, unlawful and pernicious.

It's not just appropriate, but critical, that independent directors be a source of support and utility to senior managers. Being a director is not something that comes naturally; it requires tutoring, and continuing updates to take advantage of the latest trends in effective governance.

9. **Audit committees should establish adequate whistleblowing procedures to conform to both the letter and the spirit of the new Sarbanes-Oxley requirements.**

   Section 301 of SOX requires audit committees to establish procedures governing the receipt, treatment, confidentiality and anonymity of employee and other complaints regarding accounting, internal controls or auditing matters. While many companies view this provision of SOX as a nuisance, it really is in the interest of public companies to approach this requirement with creativity and a positive attitude.

   By creating a mechanism for employees and others to raise concerns, companies have the ability to persuade those with concerns to air them first within the company, where the company has an opportunity to address any inappropriate or illegal conduct before it turns into a full-fledged crisis.

10. **Boards should have, at the ready, a blueprint for succession planning.**

    Having the right CEO at a company's helm often makes the difference between success and failure. However, judging by the fact that many corporate CEOs seem to turn over as rapidly as NFL head coaches these days, finding the right person is crucial. Thus, it's critical that a succession plan for a new CEO be developed, and that an interim emergency plan be in place at all times.

    Responsibility for this important function should be assigned to either the entire board, or nomination or governance committees. Too often, boards have been passive in this context, ceding responsibility to management. If a company doesn't have talent within its ranks to step in to the role of CEO during an emergency situation, or for a longer term, then the board or an appropriate committee should recruit the necessary talent.

    It's always preferable to have an inside candidate take on the role of CEO. Succession planning also should cover other key management positions.

11. **Independent directors should, as a group, satisfy themselves that their company has an effective disclosure process that results in full transparency.**

    As a result of the corporate scandals, both the SEC and SOX have placed a greater emphasis on "real time" disclosure. The SEC has already adopted significant new requirements for 8-K disclosures.

    Companies need to have in place an effective discipline for identifying important information, data and trends, and making sure that the board, and those responsible for crafting corporate disclosures, are constantly in the loop regarding current developments.

12. **The board and senior management should be prepared to address the next corporate crisis before it arises.**

    It is, by now, a well-established fact that bad things do happen to good companies. Unfortunately, many companies assume that they can't prepare for a crisis whose subject and timing are not known and unknowable. That assumption can mean the difference between survival and demise, both for the corporation and its senior managers.

    Crises can be anticipated, and subject matters can even be predicted. At least once a year, both the board and senior management, should separately game plan confronting a crisis, and ensuring that everyone is prepared to deal with his or her responsibilities. Above all else, the "Al Haig" issue — namely, "who's in charge?" — is one that must be resolved before the crisis arises, not after.

The aftermath of so many corporate defalcations calls to mind Dickens's apt observation, in a Tale of Two Cities, that this is both the best and the worst of times for corporate America.

But out of every crisis comes an opportunity, and the start of a new year is a perfect time for independent directors to assess their companies, their own performance, and resolve to ensure that the fate that has befallen less diligent companies does not come to pass for the companies on whose boards they sit.

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