

How the outside can help the inside

Corporate counsel can't do it all

By Greg Rogers

Sometimes it's best to look out — outside, that is.

Two principal themes of current corporate reform efforts — board independence and internal control — create an urgent need for independent legal counsel to the board. Although not required by law, boards of directors and audit committees should seek legal counsel from qualified lawyers who do not report to management and who do not otherwise represent the corporation. Moreover, the company's in-house legal department and outside corporate law firms should welcome and encourage this practice.

Recent corporate reforms adopted under the Sarbanes-Oxley Act of 2002 (the Act) and the NYSE and NASDAQ listing standards seek to ensure a meaningful separation of power between management and the board. Underlying the new mandates for boardroom independence is the recognition that a corporation's board of directors and its senior management have different and sometimes conflicting responsibilities and objectives, and that the board must be independent from management in order to effectively fulfill its oversight role.

Like it or not, the board is now expected to be an independent watch-

dog over management. This leads to a second theme of corporate reform — internal control.

Internal control is the primary means by which the board fulfills its oversight role. Broadly defined, internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in three categories — reliability of financial reporting, compliance with applicable laws and regulations, and effectiveness and efficiency of operations.

The sidebar on the next page illustrates the model set forth in the Act by which the audit committee is to provide oversight of financial reporting. This "assurance model" defines the respective roles of the audit committee (leadership and risk oversight), management (internal control system design, implementation and operation), and the financial auditor (independent verification of system design and operational effectiveness).

The assurance model is required for SEC reporting purposes. In addition, the new NYSE corporate governance standards suggest that this model should be applied more broadly to board oversight of legal compliance and risk management.

For now, even where it may not be legally required — for example, in the case of privately held companies or with respect to nonregulatory mat-

ters — the Sarbanes-Oxley assurance model establishes "best practice" for fulfilling the board's oversight responsibilities.

To understand and fulfill the board's increasingly sophisticated risk oversight responsibilities, audit committees and boards will need the assistance of experienced legal counsel. Now more than ever, it is critical that counsel to the board be objective and free from actual or apparent conflicts of interest.

The conflicts of concern here are similar to those presented by accounting firms that provide both audit and consulting services to the same client. They are quite different from and far more pervasive than the conflicts of interest addressed by the Model Rules of Professional Responsibility.

Congress has recognized that accounting firms cannot effectively serve two masters — management and the board — with actual or potential conflicting interests. The Act therefore seeks to ensure that the corporation's financial auditor will be beholden to the board rather than management. Most notably, it requires the financial auditor to report directly to the audit committee, which must itself be composed entirely of independent directors. The Act also severely limits the auditor's ability to perform nonaudit services for audit clients.

Congress stopped short of requiring boards to retain independent legal

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counsel. The Act authorizes but does not require the audit committee to engage its own independent counsel and advisers at the company's expense.

Although the Act does not require independent counsel to the board, when advising the board on oversight matters, the lawyer should be in a position to review and candidly assess management's performance and, when necessary or appropriate, give advice that management disagrees with. Moreover, the board's legal counsel should not be in a position of evaluating his or her own performance.

In-house general counsel and outside corporate counsel cannot serve as independent legal counsel to the board. First, even though a corporation's lawyers technically represent the corporate entity under the ABA's Model Rules of Professional Conduct, in reality, in-house and outside corporate lawyers are beholden to certain

senior executives, not the corporation, and not the board. Second, corporate lawyers are inextricably intertwined with the company's internal control systems and therefore cannot objectively evaluate their own performance in connection with the design, implementation and operation of such systems.

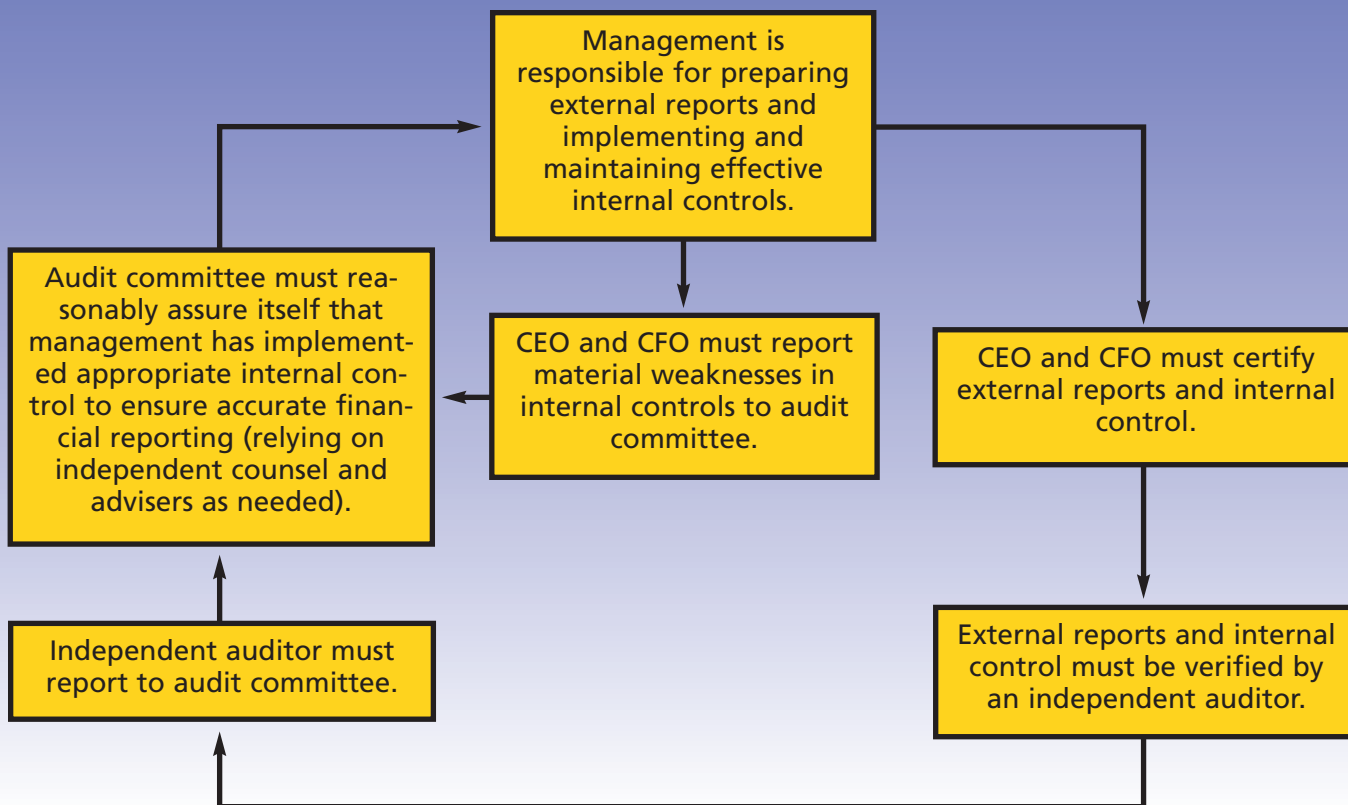
As a practical matter, corporate counsel is obliged to serve the interests of management or to resign or withdraw from the representation. The corporation's in-house general counsel is an employee of the company and reports to the CEO. He or she is hired by the CEO and generally can be fired by the CEO with or without cause. Similarly, outside corporate law firms are hired and fired by management at will. Corporate counsel simply cannot candidly evaluate management or give advice opposed by management without fear of reprisal.

Corporate counsel is further compromised by its inability to objectively

evaluate its own performance. Lawyers play a key role in the design, implementation and operation of corporate internal control systems. In the area of financial reporting, for example, lawyers reporting to management give advice on setting up disclosure controls and procedures, prepare SEC disclosure statements, and issue legal opinions on which accounting determinations are based (for example, the probability of an unfavorable outcome regarding a contingent liability).

With respect to compliance with legal requirements, corporate lawyers assist in the development and implementation of corporate compliance programs, investigate reported legal violations, and advise management on appropriate responsive actions. Given its significant role in the design, implementation and execution of corporate internal controls systems, corporate counsel cannot objectively evaluate the design and operational

Sarbanes-Oxley assurance model



effectiveness of such systems.

Knowing that the role of independent counsel to the board will include evaluation of certain aspects of the performance of existing counsel, should corporate lawyers regard this newcomer as friend or foe?

In most cases, the role of independent counsel to the board is to reduce risk, not to assign blame. Adversarial relations between counsel for the board and existing corporate counsel will be the exception rather than the rule.

From a practical standpoint, independent counsel is not a competitor to in-house counsel or the company's outside law firms. To compete for broader representation of the company would undermine the lawyer's legitimacy as independent counsel to the board. Furthermore, existing corporate lawyers most likely will play a leading role in the implementation of recommendations made by independent counsel.

For these reasons, independent counsel to the board should not be regarded as a threat, either to in-house legal departments or outside law firms.

Most important of all, independent counsel to the board can say things that the lawyers reporting to management cannot (but might wish they could). Such objective and candid communications of actual and poten-

tial problems reduces the risk of future disasters that can embroil corporate legal departments and outside law firms.

If disaster strikes nonetheless, corporate counsel can take comfort in knowing that it is not alone. Ask the lawyers in charge at Vinson & Elkins whether they would elect to perform a so-called "independent investigation" of Enron if they had it to do over again.

Moreover, failure to blow the whistle on corporate misdeeds can present a serious legal problem for corporate lawyers. In its zeal to turn lawyers into corporate watchdogs, Congress and the SEC have placed corporate counsel in an untenable position. When aware of suspected material legal violations involving senior management, corporate counsel is confronted by a Hobson's choice — do my duty or keep my job?

Under SEC rules implementing Section 307 of the Act, lawyers may be required to report suspected violations "up the ladder" to the corporation's highest legal authority, and if necessary to achieve an appropriate response, all the way to the board of directors. Going over the head of your boss or your primary client contact is not a career-enhancing move. Remaining silent, on the other hand, risks loss of professional integrity, as well as SEC enforcement and disbarment.

Independent counsel to the board is undeterred by up-the-ladder reporting requirements because the lawyer reports directly to the board to begin with. There is no higher corporate authority. And if the board elects to shoot the messenger, how much is lost?

Independent counsel can afford to be conservative and brutally honest. In doing so, independent counsel to the board can remove an enormous burden from the shoulders of corporate lawyers reporting to management who lack the same luxury.

In conclusion, sound corporate governance requires effective board oversight, and effective board oversight in turn requires legal advice that is uncompromised by fear of reprisal or the inability to provide objective self-evaluation. Incumbent corporate counsel is inherently compromised in its ability to support the board's oversight role, and the personal and societal consequences of failing to address these conflicts can be devastating.

Waiting for a crisis that demands an independent investigation is too late. In-house legal departments and outside law firms alike should advise corporate boards, and especially audit committees, to retain independent legal counsel now — as a matter of sound corporate governance — before problems arise.