Reprinted with permission of the publisher: the National Association of Corporate Directors (NACD), 1828 L Street, NW, Suite 801, Washington, D.C. 20036, 202-775-0509, www.nacdonline.org

Sarbanes-Oxley: Fear, Anger, and Director Liability

By Richard L. Wise and John J. Whyte

Private comments of board members and chief executive officers almost unanimously reflect a view of Sarbanes-Oxley very different from the one they have revealed in their public pronouncements. Indeed, most such comments are laced with a simmering anger or frustration.

According to such views, Sarbanes-Oxley and its extensive and potentially expensive requirements are the product of congressional overreaction to the wrongful acts of a small minority of corporate leaders who are unscrupulous, for which the vast majority of responsible directors and officers must now pay the price. It is a backlash unfairly limiting the traditional independence, flexibility, and power of those charged with managing a corporation's business and affairs.

The legislation was brought about in response to the demands for retribution sounded by the tens of millions of registered voters whose retirement funds were adversely affected by the demise of Enron, WorldCom, and the like, and the admittedly ensuing crisis of investor confidence with which all companies now must contend. Directors in general and audit committee members in particular fear the substantial additional responsibilities with which they have been saddled and, more important, the resulting personal liability which naturally attaches to such responsibility.

Because it is the law, there is, of course, seeming compliance with the enumerated specifics that the law sets out. This "compliance," however, is given only grudgingly, with companies addressing only the exact corporate governance that is required. For example, in the area of whistleblower protection, directors ask not what is the best possible system to protect stakeholder anonymity and provide the flow of critical information, but what it is that other companies are doing. There is generally little sympathy for those who recommend going beyond the bare technical requirements of this new act to do something that we like to call "good governance" or "best practice." After all, if it isn't "technically required," why should a company have to bear the cost and the interference?

On an initial level of analysis, this response is both natural and somewhat justified. Sarbanes-Oxley, aside from its detailed provisions concerning auditors, is primarily aimed at directors and executive officers. With all that these leaders have to do, it is viewed as an untenable imposition that represents yet another layer of meddling by Congress and government agencies, which have never been held in high regard for their efficiency or effectiveness. Indeed, those who run large multinational corporations or serve on their boards are among the best and brightest business people we have. They know better how to run their companies than do politicians. These new dictates, however, carry the implicit criticism that Congress knows better than they do.

While we are empathetic to those views, they are beside the point. In indulging in such anger and fear, directors and management are unintentionally disabling those talents which have permitted them to achieve the innovations and successes that have brought them to the positions they now enjoy. Throughout all of

Director Summary: Directors should view Sarbanes-Oxley as an opportunity, because well-governed companies will have higher perceived value. Don't just meet the letter of law; take this opportunity to comply with its spirit so Congress is not moved to enact further regulatory legislation.

No board of directors would object to systems that would allow it to have more accurate and more reliable information about its company's operations.

literature and history, hubris has been the primary downfall of all tragic heroes. This article, therefore, is an appeal to directors and executives to use their special talents to achieve that opportunity which, as Einstein pointed out, lies at the core of every enigma.

The Problem and the Opportunity

The very nature of Sarbanes-Oxley is misleading. It is written as though it offers some sort of safe harbor. Its detailed requirements and controls mislead companies to believe that, by implementing all of the specific measures and requirements set forth in the Act, they are fully compliant with the Act. However, nowhere in the Act is there any reference to the fact that doing each of the enumerated items satisfies all of its requirements. Putting it another way, if directors and management focus their efforts on *complying* with the enumerated items in Sarbanes-Oxley, they will neither have benefit of any safe harbor, nor have turned their talents toward designing and implementing those changes which must be adopted in order to comply with the intents and purposes of the Act.

More and more, commentators and analysts on the subject talk about the "appearance" of good corporate governance in the same vein that independent auditors have long talked about the appearance of independence. They talk about accomplishing good corporate oversight rather than merely implementing systems. In short, where there is intentionally no safe harbor, corporations must do the right thing. This, of course, raises the basic, fundamental question, namely, "What is the right thing?"

Before answering that question, it is relevant to look also at the opportunity. Another way of looking at Sarbanes-Oxley—as incomplete and as annoying as it may be—is that it reflects the existence of a strong market need. Both institutional and private investors have regular and serious concerns about the reliability and transparency of information on which their investments are based. Stock prices are currently depressed in part due to this lack of confidence. Risks attendant to purchasing corporate bonds and commercial paper similarly must be adjusted based on assumptions about the reliability of the data and information relating to borrowing companies. In light of this, it seems axiomatic that both the cost of funds and cost of capital would be less for any company that has strengthened investor and lender confidence by having demonstrable and certifiable best practice corporate oversight.

Further, aside from the enhanced reputation that such a company would have in the marketplace, it would only take the lowering of such costs by a basis point or two to recoup any added costs of the process in general. We doubt that any board of directors would object to systems that would allow it to have more accurate and more reliable information about its company's operations. Such certainty would give directors markedly increased protection with respect to their own personal liability relating to decisions that they may make in reliance on such information.

The opportunities, therefore, are tangible economic savings and greater director security. The problem that stands in the way of achieving this is how to achieve best practice corporate governance, and hence full compliance with Sarbanes, as opposed to pro forma compliance. Best practice corporate governance requires a company to focus on compliance with principles rather than compliance with the rules. However, to understand how to achieve this, we need to understand better the attributes of good corporate governance itself.

Best Practice Corporate Governance Defined

First and foremost, corporate governance reflects the procedural protocols that define relationships among individuals and among groups of individuals within the business entity. It sets forth the framework and manner in which decisions are made and performance evaluated. As a consequence, an important attribute in all corporate governance models involves the power dynamics among the various individuals and groups that play a role within the corporate organism. Corporate governance, therefore, has two main components:

- Governance related to operations, and
- Governance related to (a) the clear and proper reporting of an operation's decisions and results and (b) the manner in which differences among competing groups are resolved. This latter subject of corporate governance is usually referred to as oversight.

A great strength of the American corporate system is its military-style, command-and-control form of corporate governance for operations. Since this has proved to be so successful from an economic standpoint, it has naturally carried over to the board of directors. However, if one desires to deal with the issues of corporate oversight, a different corporate culture, a different balance of power dynamics, and a more collegial approach to dealing with fellow members and dissident views

Should corporate America fail to answer this challenge, it is likely that Congress will act yet again, this time more severely.

must be instilled. How is this to be achieved? Best practice corporate governance, while requiring customization for each company, has fairly universal elements:

1. The company must have a strong and mostly independent board of directors or board of advisors. The key is independence. Selection of directors or advisors solely from the chief executive's or senior shareholders' friends and family or from those of a like mind does not permit the "cross-pollination" that is necessary to keep an entity strong. There is great truth to the old adage that "in diversity there is strength."

2. To be strong and independent, the board must have strong and fully independent governance committees with their own separate power bases. The committees should meet separately and not in conjunction with regular board meetings to ensure adequate time to perform their responsibilities. They should have their own budgets, counsel, and access to experts, and should have their own detailed charters and protocols for administering their meetings and reaching their decisions. It is most important to stress, however, that these committees are involved only in corporate oversight issues. Operational issues still should be left to the military-style, command-and-control form of governance with advice provided by the board.

3. Independent accounting practices, financial internal controls, and financial reporting "whistle-blower" protection for all levels of management, employees, and well-informed outsiders should be established outside of the management chains of communication or control. In publicly traded companies this is now a function of the audit committee. Ideally, it should also be required for private companies. The audit committee should appoint an outsider, such as its independent counsel, to receive and protect the complaints of the concerned individuals to provide both the reality and appearance of absolute confidentiality.

4. The charters of each of the independent governance committees should be principle-oriented, as opposed to rule-oriented. The charters should state conceptually what the purpose of each committee is and the methodology that it will follow in pursuing that purpose. This statement should direct a committee's focus away from formal compliance, and toward discovering new approaches that better serve the underlying principles. Such an approach also contributes to creating a corporate culture that is comfortable with the concept of challenges to established ideas.

5. A key element of good corporate governance is the institutionalization of programs, processes, and procedures. To do this, each of the independent governance committees must have detailed process flow charts, work lists, procedures aiding committee productivity, and efficient administrative procedures. The availability and transparency of these procedures to board members is important, so that participants will understand how decisions are made, and also will be able to ascertain whether the procedures that have been adopted are designed to yield the best informed and fully thought-out decisions.

6. Essential to effective decision-making is knowledge. All new board members must receive a detailed orientation program not only on the basic business of the company, but also concerning the procedures and protocols of the various committees. Members of particular committees need to receive both committee-specific orientation and continuing education on changes in the industry, accounting pronouncements, regulatory agency requirements, laws and regulations that affect them, and new approaches to good governance in the areas of their responsibility.

Motivation to Act

One final point is that good corporate governance systems have absolutely nothing to do with compliance. Thus, if a corporation is only interested in being able to check off that it has met all of the specific requirements of Sarbanes-Oxley or the new regulations of the Securities and Exchange Commission or Nasdaq and the New York Stock Exchange, it will never address the challenge of determining the form of good corporate governance it should have, and the ways to implement, institutionalize, and protect that system.

Should corporate America fail to answer this challenge, it is likely that Congress will act yet again, this time more severely. We should not want to suffer the consequences of the "Son of Sarbanes-Oxley." ■

Richard L. Wise is a member of the law firm of Eckert Seamans Cherin & Mellott LLC, Boston and has lectured and written extensively on best practice corporate governance and its implementation. Mr. Wise is a member of the Turnaround Management Association. He may be reached at Richard.wise@escm.com.

John J. Whyte is president of Whyte Worldwide PCE, which provides professional corporate executive services to companies in transition. He is currently audit committee chair for Commonwealth Telephone Enterprises. He may be reached at jackwwpce@cs.com.