

Independent counsel for the board

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Boards of directors are increasingly called upon to exercise independent review and judgement of management activity. Independent investigations may be required when financial reporting improprieties have been alleged, in the face of derivative claims by shareholders, upon allegations of illegal or inappropriate conduct by the company or management, or when management may be financially or otherwise interested in transactions proposed for the company, as well as in other situations.

As boards grapple with these and similar situations, the use of independent counsel to the board will become increasingly common. Inside counsel to the company will, in turn, need to determine what role they can play in the selection, monitoring and support of outside counsel to the board without jeopardising the independence of that counsel.

When retaining outside counsel is advisable

The Sarbanes-Oxley Act contains provisions which require companies with exchange listed securities to empower the audit committee and other independent committees of the board to hire independent counsel and other advisers. Other US federal securities laws either require or encourage independent advisers to directors in order to ensure their independence. For example, the Investment Company Act of 1940 has independent counsel requirements in order to have effective approval of certain conflicts of interest. As suggested above, independent counsel may be necessary when a board is called upon to review claims of impropriety by management or when approving transactions in which management may be interested.

Results from a survey completed by *Corporate Board Member* magazine in early 2003 indicated that more than 35 per cent of boards had hired their own lawyer as a board adviser since Sarbanes-Oxley was implemented.

For example, consider the investigation into a former employee's allegations against The Coca-Cola Company. In April 2003 the former employee alleged in a letter to the company that the Fountain Division, which accounts for one-third of US sales, improperly reported expenses as marketing allowances instead of rebates. The employee further claimed that the company discriminated against women and minorities.

Coca-Cola's response to those charges was to retain the services of an independent counsel. The independent counsel investigated the allegations, and Coca-Cola was able to report that the counsel found no basis to the former employee's claims regarding the Fountain Division. Nor did the independent

counsel find any evidence to support the claim that the company practised discrimination.

The primary thrust of corporate governance reform in the United States and elsewhere has been to increase the level of independence and independent review by directors of management activity. A natural outgrowth of that increased scrutiny of independence is the increased use of independent advisers, including counsel, to the board.

In light of these developments, independent counsel should be made available to boards and their committees whenever those boards or committees feel the need for independent advice. Retaining independent counsel for boards and committees should not depend on specific statutory or other legal requirements.

Once a board has reached the decision to retain independent counsel, a number of questions will need to be addressed:

- What role should inside counsel have in the process?
- What should the selection process be and who should undertake it?
- How should the performance of independent counsel be monitored?

Each of these points is addressed briefly below.

What role should inside counsel have in the process?

When the need for independent counsel arises, it is because the board needs to avoid any conflict of interest, or the appearance of a conflict of interest, that might otherwise arise from relying on the advice of inside counsel or regular outside counsel to the company. Accordingly, it would not be appropriate for inside counsel to be given the responsibility of selecting independent outside counsel for the board. Having control over the selection of independent counsel to the board could jeopardise the ‘independence’ of the lawyers selected.

Although it would be inappropriate for inside counsel to undertake the selection process, inside counsel may provide valuable assistance to the board in this regard. Appropriate roles for inside counsel in these circumstances might include:

- preparing criteria for the board to use in the selection process;
- establishing a process for determining the degree of independence various candidates may have;
- developing a process for determining the degree of specialised knowledge various candidates may have; and
- preparing a list of firms or lawyers which appear to inside counsel to be appropriate candidates for review by a board, with full disclosure to the board of the independence and other qualification standards used in developing the list.

One question that is likely to arise in the selection process is what criteria should be used for determining the appropriate level of independence. There is no established or universally recognised standard for independence under these circumstances. The American Bar Association has indicated that the engagement of independent counsel “should be structured to assure independence and direct reporting to the board of directors or committee”.

While no specific criteria for the independence of counsel are available, the independence criteria appropriate for boards generally can be used by analogy. The essence of the inquiry should be to determine that the counsel selected has no financial, social or other significant or material connection to the company or to the board of directors or to any of the senior management of the company, in order to assure independence. In an ideal setting, counsel would have no connection with the company whatsoever. That may, as a practical matter, be impossible in many situations. Accordingly, the board will need to determine *de minimis* levels of relationships that may be acceptable.

In determining whether the appropriate level of independence is present, the board may wish to consider whether counsel or their affiliates:

- have served as an officer or director of the company, or any other entity in connection with the matter under investigation;
- have ever had an attorney-client relationship with an officer or director of the company, or any other entity in connection with the matter under investigation;
- have ever represented an entity in connection with an allegation that the entity participated or bore responsibility for alleged wrongdoing by the company;
- have ever represented an entity in a situation adverse to the company;
- have any business, financial or family relationship with the company, or a current or former officer or director of the company, that would be reasonably likely materially to affect the independence of the independent counsel; or
- have any equity interest in the company or any other entity in connection with the matter under investigation.

What should the selection process be and who should undertake it?

The very nature of the relationship of independent counsel to the board requires that the selection of independent counsel be undertaken by the board or the committee of the board directly. The purpose of the selection process should be to identify counsel that is independent and well qualified generally to undertake the advice and investigation required.

Unfortunately, many directors are not experienced in the selection of counsel. If directors are faced with having to undertake the selection process under tight time constraints and without any significant preparation, there is significant risk

that qualified counsel may not be selected or, if qualified, may not be sufficiently independent to withstand later scrutiny.

For this reason, advance planning is particularly important in the selection process. There are at least three levels of advance planning that may be undertaken. First, the criteria for determining qualifications and independence could be established, at least in part, in advance so the board would be ready to apply these to various candidates as the need arose. Second, a pool of qualified law firms or lawyers could be established in advance so that the vetting of independence and competence qualifications could be significantly more streamlined when the need for counsel actually arose. Finally, a board could choose to retain independent counsel in advance of any specific need for counsel.

The advantages of advanced planning in this manner should be obvious. The board will substantially increase the likelihood of obtaining the advice of qualified and truly independent counsel by setting up the criteria in advance. The board should be more comfortable with the selection process in this manner and thus be more likely to rely confidently on the advice being given. It should be easier for inside counsel to participate effectively in the process in advance without unduly jeopardising the independence of the counsel finally selected.

While the advantages of preparing in advance are significant, such preparation does not guarantee that either the independence of specific counsel or their qualification for the particular facts that give rise to the need for independent counsel will be met.

How should the performance of independent counsel be monitored?

As mentioned above, it is essential to the maintenance of the independence of counsel that the performance and activity of counsel be the responsibility of the board or committee that retained it. Accordingly, counsel should report to that board or committee, and not to inside counsel.

Moreover, billing for independent counsel should be reviewed and approved by the board or committee, and not by inside counsel. In this respect, if the company has set up internal control procedures for the payment of legal fees that would otherwise require inside counsel review and approval, those internal control procedures may be required to be modified to allow for a different process under these circumstances. It should, however, be appropriate for clerical activity to be undertaken by inside counsel and their staff to

assist the board in assuring that appropriate support for the billing and the like is available prior to approval for payment.

One important role for inside counsel to perform under these circumstances is a support role for independent counsel. This will run the gamut from providing support services such as clerical and logistical help, to facilitating review efforts by the board itself. The degree to which inside counsel may be directly involved in this will depend on the confidentiality of the material being reviewed.