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Corporate Law

The Appropriate Time For Separate and Independent Counsel

Public companies need to be in the know

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July 30th marked the sixth anniversary of the Sarbanes-Oxley Act (SOX). SOX brought about considerable changes in corporate governance and regulation and ushered in the era of the (mostly) independent board. Looking back, we have seen an increasingly punitive and hostile attitude toward public companies develop, motivated in part by ongoing news of corporate scandals, one after another. As a consequence of these scandals, SOX, new SEC rules, stock exchange listing requirements and evolving expectations of directors under state law, anxiety continues to grow in corporate boardrooms.

In response to this increasingly regulated and litigious environment, boards, board committees and directors of public companies have been seeking legal advice more frequently and on a recurring basis from independent counsel, in addition to seeking legal advice from in-house or regular outside corporate counsel. This trend raises a number of interesting questions and continues to spark discussions among academics and practitioners alike. What are some of the specific situations in which there is general agreement on the need for independent counsel? When should an individual director seek his or her own individual independent counsel?

Board committees, whether standing or special in nature, often require separate and independent counsel. SOX explicitly requires that all public companies authorize their audit committees to engage independent counsel and various stock exchanges have established similar requirements for compensation committees. In our experience, many public companies provide their board's audit, compensation, nominating and corporate governance committees with the authority to retain independent counsel on a standing basis — not only in a crisis situation.

Even prior to the introduction of recent corporate governance reforms, boards have engaged independent counsel to avoid actual or perceived conflicts of interest. Many conflict-of-interest transactions are regulated through the rules provided in each state's corporate statute. The common feature of such statutes is the required review by the company's disinterested and independent directors of the conflict transaction with the assistance of independent counsel.

In 2006, the SEC amended its disclosure rules for related-party transactions to include a discussion of the company's "policies and procedures for the review, approval or ratification" of related-party transactions. It is, therefore, more important than ever that public companies' boards re-examine their procedures for dealing with related-party transactions and other conflict situations.

Examples of conflict-of-interest situations include management buyouts, tender offers and financings involving management, parent-subsidiary mergers, the compensation and removal of senior executives, internal or governmental investigations, indemnification and D&O insurance issues, and crisis situations such as financial restatements.

Consequently, independent directors at public companies stand a better chance than ever of finding themselves asked to serve on a "special committee" of the board. In many transactions involving a potential conflict of interest, such as a proposed management buyout, applicable corporate governance standards and current law generally suggest

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that a board create a special committee of disinterested and independent directors who are free of any financial or other interest in the transaction and that such special committee engages independent counsel.

Each special committee will have been formed because of its own unique set of facts and will face different challenges, but whatever the committee's situation; its actions will be the subject of after-the-fact examination, usually in a litigation setting. This means that special committee members should pay particular attention to process, especially in connection with their selection of advisors. It is important for special committees to select independent legal counsel that will be in an unfettered position to assist the committee in its role as an independent negotiator on behalf of the public shareholders. When reviewing the qualifications of potential special committee counsel, the committee will need to carefully evaluate such counsel's independence, including a review of all such counsel's past and current relationships with the company and with its management, to determine if any relationships could cast doubt on such counsel's ability to adequately represent the independent special committee and the company's public shareholders.

A special sub-set of conflicts of interest are those situations in which a public company's board is required to conduct an internal investigation to deal with suspected or alleged wrongdoing. In an independent investigation, the control over the investigation may be by the board or by one of the board's committees. The board or board committee in turn engages independent counsel without a prior relationship to the company or to the individuals being investigated to assist them with their inquiry. This structure helps to provide public shareholders with the assurance that corporate decisions will be made based on unbiased sets of facts and independent legal analysis of the actions at issue. In addition, regulators and enforcement officials, by and large, will recognize an investigation carried out by independent legal counsel under the supervision of independent directors as a more credible process than other alternatives, often leading to better outcomes for the company.

Another situation which may confront a public company's board that will require the assistance of separate and independent counsel is the commencement of shareholder derivative litigation. In a typical shareholders' derivative action, unhappy shareholders demand that the company take action against directors, officers or others for alleged wrongdoing that has harmed the company. If and when the company refuses to take such action, the shareholders may bring an action against the alleged wrongdoers and join the company as a defendant.

In the case of a derivative suit, generally, the company has a number of potential responses: it can allow the plaintiff to proceed with the litigation on its behalf while at the same time attempting to protect its personnel from discovery excesses; it can decide to try to obtain a stay of the litigation in order to conduct its own investigation, creating a special litigation committee for that purpose, and, if that investigation concludes that the suit is without merit, the company can then move for dismissal of the derivative suit; or it can commence settlement discussions with the plaintiffs, generally under the supervision of the board's independent directors or a special committee. Each of these options raises conflict issues requiring a board's full attention. In making their decisions, the disinterested and independent directors on the board or who comprise the special litigation committee will rely heavily on their advisors, most importantly the special litigation committee's counsel. Moreover, courts are much more likely to find a special litigation committee independent and follow their recommendations if the committee has retained separate and independent counsel who has not represented the individual defendants or the company in the past.

When a company faces lawsuits or governmental investigations, individual directors also must consider whether their interests and those of the company are best served by their retaining separate counsel. If a director is not named personally as a defendant, it may be appropriate for the counsel representing the company to represent its board members as well. However, a lawsuit naming a director as a defendant implicates his or her own personal interests, which may differ in many respects from those of the company and the company's officers. In such a case, or in any case where the interests of the director and the company are potentially adverse, a director should seriously consider retaining separate and independent counsel.

For example, when counsel engaged by the audit committee conducting an internal investigation brings a board member in for questioning, that director needs to be cognizant of the fact that the counsel represents the audit committee, not the individual director. What the board member says to that counsel may not be privileged. When that counsel later communicates with the government, he or she will act in the company's best interest, which may or may not be in the best interest of the individual director.

If the matter includes an investigation in which the SEC or another regulator is involved, directors again need to determine whether or not they need to engage their own counsel. This is particularly true today due to the trend towards "deputization" — witnesses in internal investigations may be charged criminally with obstruction of justice and making false statements during interviews conducted by private lawyers because they knew that the lawyers' interview notes would be turned over to the government. Moreover, directors may need their own counsel in order to protect their personal interests against the prospect of future litigation and to be fully advised regarding their individual issues as well.

The corporate governance changes that have been brought about by pressure on boards from activist shareholders and shareholder advocates, as well as the technical requirements that have been imposed by regulatory and legal reforms, continue to change the board's role from solely steering strategy and advising management to monitoring and enforcing corporate compliance, performing due diligence and conducting investigations. In their new and expanded roles, directors are being called upon increasingly to exercise independent review and judgment of management activities. A natural outgrowth of these activities is the increased use of independent counsel for the board, board committees and for individual directors of public companies. ■