Audit Committees: Independent Advisors are No Longer an Option

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When Congress passed the Sarbanes-Oxley Act of 2002 (SOX) following a series of corporate scandals, it dramatically changed the regulatory landscape for publicly traded corporations. Notable changes directly impacting boards of directors include substantially increased responsibilities of, and demands placed on, audit committees, comprised of independent directors. Congress's action also led to a heightened profile for corporate lawyers, both in-house and external counsel, who have come under unprecedented scrutiny. Regulators, shareholders, and commentators have placed at the feet of directors and corporate gatekeepers responsibility for failure in corporate boardrooms. Despite these changes, most audit committees have resisted consulting with independent counsel and experts, absent some exigency that necessitates a crisis-management response.

As the SOX provisions work their way through the corporate governance and judicial systems, their full implications become clearer. SOX's limited legislative history provides little guidance and challenges boards and their advisors, regulators, and courts to ascertain and interpret its intent and application. Though only a few years have elapsed since its passage, things will never be as they were before. In large part, an unprecedented vigor attendant to regulatory enforcement actions against, and criminal prosecutions of, directors and counsel have contributed to a new reality.

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Director Summary: The Sarbanes-Oxley Act places special demands on the audit committee. The authors posit that, while audit committees meet their responsibilities, many directors remain reluctant to engage outside counsel or other experts, except in cases of crises, and this is a mistake. Wisely chosen outside experts can provide independent, objective advice and freedom from potential and real conflicts of interest.

The New Reality

That new reality intrudes most prominently in the boardroom. By mandating new responsibilities for corporate directors, especially independent directors, Congress made the position of director much more demanding, while only vaguely defining the position's tasks. For example, SOX Section 301 charges audit committees with the creation and oversight of systems where allegations of accounting and financial irregularities can be raised and addressed. Congress provided no guidance, however, as to how audit committees should do so. As a result, many have fallen back on standards and expectations developed under the Sentencing Guidelines for Organizational Defendants. The governing compliance programs memoranda, issued since 1999 by Deputy Attorneys General, recite the Department of Justice guidelines for prosecuting corporations, criticism of failed oversight as presented in enforcement actions by regulators, and deferred and non-prosecution agreements entered into by the Department of Justice with corporate defendants, which set forth strict expectations for compliance.

Even new responsibilities that the statute established for other corporate officers create different and heightened expectations for corporate directors. SOX Section 307, for example, required the SEC to enact rules in the form of professional standards for attorneys who practice before it, pursuant to which lawyers for a company can report "up the ladder" within the company "evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof." The reporting chain set out in the statute as a default goes up through the internal law channel to senior management and, ultimately, to the board of directors if not appropriately handled at lower levels within the company. With the inevitable intense scrutiny by prosecutors, regulators, self-regulatory organizations (including the stock exchanges, which impose conduct rules contractually through their listing standards), and private parties and

their counsel, any hint of conflicts of interest or failure to meet increasingly stiff standards can lead to litigation, regulatory inquiry, or other proceedings.

Prerogatives Regarding Counsel

When issuing its implementing rules for Section 301, the SEC indicated that:

> An audit committee must have the necessary resources and authority to fulfill its function… To perform its role effectively, therefore, an audit committee may need the authority to engage its own outside advisors, including experts in particular areas of accounting, as it determines necessary apart from counsel or advisors hired by management, especially when potential conflicts of interest with management may be apparent.

Audit committees' reticence to avail themselves of expert assistance independent of in-house counsel, regular outside counsel, or other professionals who work with the company, including financial experts, may constitute a grave mistake.

Audit committee charters typically parrot this language and confer authority to engage independent experts. Yet, audit committees typically retain separate advisors (particularly counsel) only after regular outside counsel first recommends such retention, certainly a necessary decision if the conduct of senior management is called into question. Most often, regular outside counsel will endeavor to conduct the investigation first, justifying the decision on the basis of familiarity and efficiency. The decision to engage independent counsel often seems based on a fear that doing anything else could subject the work or advice of lead in-house counsel or outside counsel to scrutiny by the third-party reader (most often the Department of Justice or the SEC), rather than focusing on the directors' need for independent advice. That specific and direct need for advice, however, is precisely why the SEC empowered audit committees to retain independent experts. Audit committees' reticence to avail themselves of expert assistance independent of in-house counsel, regular outside counsel, or other professionals who work with the company, including financial experts, may constitute a grave mistake.

The Need for Independent Counsel

A board committee, such as the audit committee, that needs, or simply would benefit from, counsel should not (and probably cannot) rely on the company's regular counsel selection procedure for several reasons. First, a conflict between the audit committee's needs and those of the company may exist, because the committee's need for expert assistance likely will arise in the context of an investigation or other inquiry that implicates one or more employees (possibly even senior executives) of the company. Corporate officers and employees who are involved in the ordinary-course-of-business counsel selection (even the general counsel or chief legal officer) report to management. Consequently, the committee's choice of counsel should be insulated from the possibility of inappropriate pressures or considerations, or even the appearance of such. Second, the company's present counsel, internal and external, frequently recommend other lawyers with whom they have established personal relationships. Although such counsel may walk-the-walk and talk-the-talk of independence, such relationships unquestionably can impair the objectivity of such counsel or taint their credibility.

What issues might trigger audit committee involvement? How might the responsibilities of the audit committee create actual or perceived conflicts of interest with the rest of the company or, at least, justify the committee's retention of legal counsel of its own? Why should an audit committee not rely on the normal processes of the company for the selection of counsel?

Several scenarios best highlight the need for an independent selection mechanism. Section 301 requires that the audit committee establish a mechanism for lodging complaints about and overseeing the response concerning the company's accounting or financial practices while protecting the anonymity of the reporting person. The credibility of such a critical process hinges on a fair evaluation of the complaint, necessitating actual (and perceived) independence.

The subject matter of a communication implicating consideration or action by an audit committee might relate to how the company's executives manage corporate financial or accounting affairs. Or, it might involve a breach of the company's code of conduct or ethics, which, albeit not a violation of law, may require stern action against the offender. In most, if not all, corporations, the law department reports, and is subject to, the control

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of management. It would be a conflict of interest for the law department to manage an investigation involving members of senior management to whom the in-house lawyers report. Is the rational alternative to consult with outside counsel who work closely with, and receive fees approved by, those senior managers or that law department? Here, even the selection, management, and supervision of outside counsel by the law department might not be appropriate. Even if the audit committee were to select its own counsel, completely independent of corporate management, even the processing of that counsel's invoices by the law department could prove problematic.

Another example relates to the company's independent auditors. The audit committee must oversee the appointment, compensation, and work of the registered public accounting firm retained by the company. Once the audit committee makes the appointment, however, the auditors work closely with corporate management in auditing the corporate financial statements. The auditors report to, and interact with, the audit committee, but they principally deal with the company's financial or accounting staff.

An issue with respect to the independent auditors could rise to the audit committee in several ways. Management and the auditors could disagree on the accounting treatment of certain items, or the company's outside auditors' and management's views on various accounting principles applicable to company operations might diverge. This might require that the audit committee function as mediator or arbitrator. And, in the current environment, auditors are known to demand acceptance of their interpretations and applications as prerequisites to the issuance of their opinions. As a result, the audit committee could find itself looking very critically at the conduct of management in respect of the latter's dealings with, or for that matter the conduct of, the outside auditors.

If, in any such situation, the audit committee requires the assistance of legal or accounting expert advisers, it will need advisors whose advice is untainted by existing relationships with corporate management, regular counsel, or the independent auditors. Such a relationship, for legal counsel in particular, carries with it professional obligations of loyalty, confidentiality, and responsibility. The audit committee must have access to counsel necessary for the committee to satisfy *its* obligations—not management's, outside counsel's, or the independent auditors'—under the dictates of Sarbanes-Oxley. The audit committee also must bear in mind the expectations of other interested constituencies and audiences, such as shareholders, financial advisors and lenders, regulatory agencies, and vendors.

When the Need Arises

An audit committee's need for independent legal counsel likely will arise in situations that demand swift action. Exigencies usually do not permit detailed planning; audit committees would, therefore, benefit considerably from advance preparation. Crises confronting audit committees often surface following the end of a fiscal quarter and during the press to complete a financial statement review or audit. As a consequence, the audit committee will have little time within which to find the legal expertise that it needs. How can that committee reconcile the demand for fast action while assuring itself that it has available the necessary legal talent, free from potential conflicts of interest? The answer lies in the methodology for, and preselection of, independent advisors.

Counsel Selection Criteria

What type of counsel would the audit committee need? How should these independent directors go about identifying candidates? Where might they find those candidates? Will independent counsel and other experts need to work with the company's other outside counsel and auditors? If so, in what way? Without knowing the context in which the need for counsel might arise, independent directors cannot answer those questions in any detail or with certainty. However, the recognized keys to crisis management are readiness and preparation, so they should begin to think about such issues before the need arises.

Lawyers are not fungible. Regardless of reputation and ability, no one lawyer fits every situation. Directors should take into account relevant background, personality fit, and frequency and type of interaction with the company's inside or outside counsel. Of paramount importance is counsel's ability to communicate responsively and responsibly with directors, understand the sensitivities and regulatory framework in which the company operates, and command fully the respect of regulators (and prosecutors)

who could be following quickly with requests (or demands) for information. The approach should be that this counsel or that expert will now be *our* counsel or expert, not the company's or the full board's.

Is cost an important criterion? The cost of corporate investigations can range from as little as $50,000 well into tens of millions of dollars. Will counsel insist on parading in a team of lawyers and an army of accountants? While some situations warrant a "scorched earth" investigative approach, most do not. Audit committees would prefer to deal with one or two lawyers, with only one or two experts assisting the lawyers. Cost can, and should, be a consideration; separate counsel or financial experts need not break the bank while providing the necessary independence.

Next, do the directors wish to secure ongoing advice or simply fill an episodic need? Will the need likely recur with any predictability? The answers go to the core of Section 301 of SOX and independent advisor analysis. Consider having a corporate governance and conduct "doctor" weighing in periodically on the compliance and procedural health of the company, much as you might secure a periodic medical checkup.

When audit committees do choose to place on retainer and consult periodically with their own independent experts, they can take precautions to address understandable concerns of management. For sensitive matters, such as internal investigations, the experts should submit bills directly to the audit committee chair or special-matter liaison for approval and provide simply a summary invoice to the company for payment. The audit committee's expert should agree to accept no work from the company other than the independent audit committee representation for a pre-determined period, preferably at least one year, to address the concern of the company's regular outside counsel about other lawyers "poaching" the client, and to ensure independence. The experts, however, must be subject to both budgetary and subject-matter control by the audit committee. The decision to give additional responsibility to the experts must rest entirely with the audit committee.

When the independent audit committee meets, its members should ask themselves this question: "Who is providing us—and us alone—the independent advice we require?" Section 301 contemplates the benefit that an audit committee can realize from unrestricted access to its own independent advisors. By availing themselves of this statutory right, and focusing on the benefits proactively, audit committees will be well-prepared, before crises erupt, to act wisely to protect against such crises and, ideally, to avert them altogether.

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Conclusion

Corporate directors find themselves in the crosshairs of prosecutors, regulators, shareholders, and others when companies encounter significant difficulties. At those times, the directors need counsel who do not hold allegiance to conflicting masters. When the need arises, directors do not have the luxury of engaging in a drawn-out or leisurely search for counsel or relying on the company's selection of counsel on their behalf.

For those two compelling reasons, independent directors must think about what counsel they might need and where they might find counsel long before the need crystallizes. Additionally, audit committees should consider establishing ongoing relationships with independent experts both for crisis assistance and prophylactic compliance advice. The benefits of such ongoing counsel could prove invaluable for independent compliance and governance, and for when a crisis does arise. ■

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Ed. Note: For further reading on crisis, Board Leadership for the Company in Crisis *is a classic. Winner of the Burton Legal Writing Award from the Library of Congress, it's a must read. www.nacdonline.org/publications.*