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Director training: what should it cover and who should lead it?

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The landscape of corporate law has changed dramatically in recent years. We can all recognize at least a few of the historical markers along that path of change, which carry names like Enron, Adelphia, Parmalat and WorldCom. We may even have read some of those judicial decisions, such as *Caremark.*[1] Some of those markers carry names that are less well recognized (Unocal and Omnicare appear in the titles of significant cases out of Delaware in which the courts dealt with directors' duties), but they have also changed the liability picture for corporate directors. In addition to that turmoil in the judicial context, directors of corporations face considerably more responsibility and potential liability in the corporate ethics and compliance area due to the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")[2] and the Sentencing Guidelines for Organizational Defendants.[3]

Directors do expect the companies that they serve to take steps to reduce and control that increasing liability. Moreover, the companies' own interests militate in favor of shielding their directors from that potential liability. Companies' general counsel or chief legal officers should lead the effort to provide their companies' directors with as much protection in this area as possible in order to meet their (the lawyers') responsibility in that regard.

Can companies reduce that potential risk for their directors? If so, what steps should they take? Can the directors take any ameliorative actions in that regard?

Increasing potential liability and ethics and compliance responsibilities for directors

Several trends in recent years highlight the increasing exposure of corporate directors to potential liability and to increasing responsibility for their companies' ethics and compliance programs. Lawsuits filed after the demise of several corporate scandals have led to settlements by corporate directors that included payments by those directors, from their personal assets, of considerable sums.[4] The listing standards of the public stock exchanges require that corporate boards assist their companies' managements to oversee their compliance programs.[5]

One of the most significant markers on the road to possible liability – and certainly among the significant standards for board behavior – is the Sarbanes-Oxley Act. Among other things, Sarbanes-Oxley imposes on the audit committee of a public company the burden of establishing and overseeing a mechanism for "the receipt, retention, and treatment of complaints received by the [company] regarding accounting, internal accounting controls, or auditing matters."[6] The United States Sentencing Commission, in its 2004 changes to the Organizational Sentencing Guidelines, provided that directors "shall be knowledgeable about the content and operation of … and shall exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program."[7]

The revised Guidelines reflect the Sentencing Commission's expectation that directors will adopt a more proactive posture vis-à-vis corporate ethics and compliance issues.

Under *Caremark*, "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."[8] In other words, by ensuring that the company's management establishes an effective and ongoing compliance program (*Caremark's* "corporate information

—continued on page 754

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DIRECTOR TRAINING

Continued from page 753

and reporting system"), a board of directors can insulate itself from second guessing by a court if, despite that compliance program, company employees violate a law or engage in unethical conduct. *Caremark* and the Sentencing Guidelines both place directors in a more central role in that regard.[9]

What compliance training is required for the board and corporate employees?

This increasing exposure of corporate directors to liability to the government or to private litigants leads to the question of how to best protect them from that potential liability. One important protective measure consists of training that is appropriate to their needs. Such training for directors has assumed greater significance than ever before.

The United States Sentencing Commission released the Sentencing Guidelines for Organizational Defendants in 1991 (the "Guidelines").[10] In those Guidelines, the Commission provided incentives for the creation and implementation of corporate compliance programs, rather than relying solely on punitive punishment as it had in developing the sentencing guidelines that applied to individuals. One of the attributes necessary for a compliance program to be considered "effective" in the Commission's view was that the "organization must have taken steps to communicate effectively its standards and procedures to all employees and other agents." Effective training would have met that standard.

The 2004 changes to the Guidelines included several provisions that relate to the increased importance of ethics and compliance training for an effective program. First, the Sentencing Commission made training a *necessary* component of an effective compliance program rather than an *optional* means of effecting the communication that constituted one of the seven core attributes of an effective program. Second, the Commission required that such training be delivered to the board of directors, all employees and, as appropriate, agents of the business.[11] Those changes led to the conclusion that training of directors, in addition to all corporate employees, now constitutes a necessary element of an effective ethics and compliance program.

On what subjects should companies provide training to their directors?

In order to design an appropriate "curriculum" for directors of your company, you need to satisfy several different standards. Careful analysis will enable you to choose the topics that will have the most benefit for your company and individual directors on your board.

The listing standards of the New York Stock Exchange and Nasdaq provide that listed companies must adopt codes of conduct for all of their employees (including their directors). The thrust of those requirements and of the compliance-related provisions of Sarbanes-Oxley (pursuant to which those requirements were adopted) suggests that training on the company's overall code of conduct and compliance program is at least advisable, if not mandatory.

The Guidelines provide some instructive pointers here also. For example, the organization should provide training to all of its employees and agents, including the members of the governing authority (i.e., the board of directors), that is "appropriate to such individuals' respective roles and responsibilities."[12] Some training may be appropriate for all employees and other agents of a company (I think of this type of training as "foundational courses," appropriate for broad delivery; examples that come to mind include anti-harassment training, instruction regarding appropriate communications within the organization and the proper use of company information systems). Other training, however, should be much more targeted to specific groups of employees or agents whose jobs involve them in areas with specific risks of a legal or operational nature unique to their roles or at least more unusual within the organization ("at risk" courses"). Examples of "at risk" training might include antitrust training for sales representatives and discussion of global anti-corruption efforts and the scope of the federal Foreign Corrupt Practices Act for corporate representatives who interact with representatives of foreign nations.

What subjects might be appropriate to the roles and responsibilities of the directors? Substantive topics such as rules regarding directors' conflicts of interest, insider trading and antitrust concerns might constitute appropriate subjects for director training. The subject of the first section of this article – the changing landscape of potential liability for corporate directors – certainly includes some salient topics for directors to cover, like directors' duty of care and the scope of the business judgment rule.

Another provision of the Guidelines also helps us answer that question about appropriate topics for training of directors. As noted above, the "governing authority" should "be knowledgeable about the content and operation of the [organization's] compliance and ethic program" and shall receive periodic reports "on the effectiveness" of that program.[13] The training for directors, then, should include information about the company's own compliance program. What risks have been identified in the company's business and how have those risks been mitigated or eliminated by mechanisms included in that program? Has the company's compliance profile changed as a result of its compliance efforts?

Who is responsible for insuring that the board and employees receive adequate ethics and compliance training?

The American Bar Association Task Force on Corporate Responsibility is-

—continued on page 755

DIRECTOR TRAINING

Continued from page 754

sued a report in which it stated "that a prudent corporate governance program should call upon lawyers – notably the corporation's general counsel – to assist in the design and maintenance of the corporation's procedures for promoting legal compliance."[14] Although that Task Force focused on mechanisms to enhance the flow of information between the general counsel and the directors, its rationale supports a prominent role for the company's in-house lawyers in educating the directors regarding those legal issues that relate to compliance risks encountered in the company's operations.

That responsibility emanates from "the basic values of the legal profession,"[15] and parallels, to some degree, the general fiduciary duty that corporate executives (of which the general counsel or chief legal officer is one) owe the corporation.[16] The role of the general counsel as overseer or manager of the company's legal risks and legal posture certainly supports that responsibility since directors who possess the information necessary for them to properly handle the company's affairs should result in less legal risk for the firm.[17] Congress also expressed the view that lawyers for companies occupy a singular position that carries with it considerable responsibility for the organization's compliance with law when it drafted Sarbanes-Oxley. In that statute, Congress called on the Securities and Exchange Commission to "issue rules … setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way."[18] The Commission's rules require lawyers to serve, to a degree, as the consciences of issuers of publicly traded securities by requiring that those lawyers report their concerns about violations of the securities laws upward within the organization. The Commission almost went so far as to require lawyers to "noisily" withdraw from representing the company if their concerns in that regard are not satisfactorily addressed.

Conclusion

In short, in-house counsel occupy a unique role in Corporate America. That role makes them well situated to assist their companies to take measures that can reduce, if not eliminate, some of the enhanced risk that their directors now face. A failure to do so might even constitute a failure of fiduciary duty. ◆

Endnotes

1 *In re Caremark International Inc. Derivative Litigation*, 698 A. 2d 959 (Del. Chan. 1996).

2 Pub. L 107-204 (enacted July 30, 2002).

3 See http://www.ussc.gov/FEDREG/05_04_notice.pdf.

4 In the case filed after the demise of WorldCom, for example, the settling directors paid $24.75 million from their personal funds.

5 See Schwartz and Freedman, "Audit Committee Oversight of Company Compliance," *The New York Law Journal,* January 22, 2004.

6 Title 15 U.S.C. §78f(m)(4) (Section 10A of the Securities Exchange Act of 1934, as added by §301 of Sarbanes-Oxley).

7 §8B2.1(b)(2)(A).

8 *Caremark,* 698 A. 2d, at 970. Directors owe the company a "duty of care" and a court reviewing an act of the directors will accord the directors' decision deference so long as the directors "'acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'" *Aldina v. Internet.com Corporation,* 2002 Del. Ch. LEXIS 156, p. 8.

9 The court in *Caremark* approvingly cited the original Sentencing Guidelines for their creation of incentives that promote the implementation of compliance programs (see 698 A. 2d, at 969: "The Guidelines offer powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts"). Whereas that court ultimately absolved the company's directors because, though they had assured the establishment of such a reporting system, they did not know about the violations of law that underlay the company's settlement with federal agencies, the revised Guidelines may make such an argument by directors more difficult. Now, they must "exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program" and the official to whom operational authority for the compliance and ethics program has been delegated "shall report periodically … to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program." Pleading ignorance of an ongoing violation of law may become much more difficult in light of the Guidelines' strictures.

10 See Murphy, The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics, 87 Iowa L. Rev. 697, 700-701 (2002).

11 See §§8B2.1(b)(4)(A) and (b)(4)(B) of the Guidelines as added by the Commission in April 2004.

12 *Ibid.*

13 §§8B2.1(b)(2)(A) and (b)(2)(B).

14 See "Report of the American Bar Association Task Force on Corporate Responsibility" (issued March 31, 2003), p. 21. That Task Force added that "[p]roviding information and analysis necessary for the directors to discharge their oversight responsibilities, particularly as they relate to legal compliance matters, requires the active involvement of general counsel for the public corporation." *Id.*, at 32-32. Information "necessary for the directors to discharge their oversight responsibilities … as they relate to legal compliance" encompasses education regarding those issues.

15 *Id.*, at 21.

16 See, for example, *Barbieri v. Swing-N-Slide Corp.*, 1997 Del. Ch. LEXIS 9 *4 (1997).

17 At least some regulators believe that the compliance function should exist independent of and not report to the legal function: "The OIG believes it is generally not advisable for the compliance function to be subordinate to the … general counsel, or comptroller or similar financial officer. Separation of the compliance function helps to ensure independent and objective legal reviews and financial analysis of the company's compliance efforts and activities." Department of Health and Human Services Office of Inspector General, OIG Compliance Program Guidance for Pharmaceutical Manufacturers, 68 Fed. Reg. 23731, 23743 n. 13 (2003). A determination of the appropriate organizational relationship (reporting, etc.) between the legal and compliance functions does not, however, necessarily impact the analysis of the role of in-house counsel in the training function, especially in respect of the company's directors.

18 See §307 of Sarbanes-Oxley.

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