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Governance Aftershocks Continue To Plague Corporations

Regulators And AGs Come Down Hard On Public Companies

COUNSEL TO COUNSEL COVERAGE

BY ROBERT VOSPER

DALE SCOTT was shocked to hear that Sarbanes-Oxley had become law in July 2002.

"I remember reading the first announcement of Sarbanes," said Scott, executive senior vice president and general counsel of Manulife Financial Corp., a Canada-based financial services company that recently merged with Boston-based John Hancock Financial Services Inc. "It was stunning in its complexity. I wasn't sure how corporations were going to be able to comply."

Neither did GCs on the other side of the border.

When general counsel in the United States heard the news, many felt like Mike Tyson had just punched them in the gut. In a relatively short period of time, they would have to review all corporate polices, revamp compliance-training procedures, overhaul the board, implement controls for financial reporting, and calm the nerves of panicked executives. For about 12 months, many GCs stateside spent every waking hour dealing with governance issues.

Two years later, GCs finally feel like they have a handle on Sarbanes-Oxley. In fact, many now realize the procedural changes dictated by the Act aren't as bad as they initially thought—and a few even believe they are a good thing.

"If you aren't doing anything wrong, then Sarbanes-Oxley is really just an administrative burden," Scott said.

That doesn't mean GCs are home free.

According to a number of law firm and in-house lawyers who attended a recent Martindale-Hubbell Counsel to Counsel forum in Toronto titled "Beyond Sox: Ongoing Challenges of Corporate Governance," GCs still are dealing with the aftershocks of Sarbanes-Oxley. Those ranged from battling it out with power-hungry regulators to keeping audit committee members from running out the door.

At A Glance: Martindale-Hubbell's Counsel to Counsel Forum

"Beyond Sox: Ongoing Challenges of Corporate Compliance"

Chair:
- **Dale Scott**
  Executive Senior Vice President & General Counsel
  Manulife Financial Corp.

Law Firm Co-Hosts:
- **Davies Ward Phillips & Vineberg**
- **McMillan Binch**
- **Paul, Weiss, Rifkind, Wharton & Garrison**

Facilitator:
- **Deborah McMurray**
  Deborah McMurray Associates

A Regulatory Frenzy

One of the most difficult issues facing GCs—especially those working in the financial sector—are regulators and state attorney generals seeking to flex their new-found muscles and, sometimes retroactively apply today's governance standards to past corporate indiscretions. In the process, a few have become overly opportunistic.

"For many regulators, it's a revenue-generating exercise," one panelist said. "Some of these guys are jumping on the bandwagon. They are all trying to outdo each other."

And most agreed that when a regulator or state attorney general comes after you, there is very little you can do to stop them.

"You have to realize that once they bite you, they won't let go until they've taken a pound of flesh, so avoidance of problems is important," said Scott, who was the chair of the Martindale event.

Scott also had some advice for companies targeted in high-profile regulatory investigations. First, they need to avoid becoming a poster child for the investigation. It is in a company's best interest to seek a quiet resolution that won't be seen as noteworthy or significant. And if you are among a group of companies targeted within a certain industry, you might want to consider settling.

"You have to cut the deal first, set the precedent and walk out the door," Scott explained. "It might be traumatic at first, but your business will stabilize as soon as you are no longer in the news."

As an example, he pointed to Eliot Spitzer's investigation of the mutual fund industry. The first companies to settle took a brief beating from the media, but emerged relatively unscathed. Some of the other companies have tried to mount a defense, and in the process have paid a hefty price, both to their financial health and public image.

"Regulators are sending a message that if we are coming for you, you'd better settle with us and get it over with," Scott said. "Don't string it out."

Scott also suggested that you have outside counsel vet all compliance polices and procedures, and bring them in to help during any significant internal investigations of corporate wrongdoing. That way, if a regulator shows up at your door, you can demonstrate that you are proactively

dealing with any internal problems.

"Regulators will realize that you are not a bad guy and that you don't have systemic problems," Scott says. "You can demonstrate that you had advice from outside counsel and used outside counsel to review polices and procedures."

And although the hysteria over Sarbanes-Oxley has subsided, outside counsel still need to be in the loop. According to the panel, there is little hope that regulators and state AGs are going to go away anytime soon.

"I think you will see an increase in these investigations until the economic recovery is far along," said John Henry, senior vice president and general counsel of Boston-based Investors Financial Services Corp. "In some states, tax revenue is down so much that officials are actively looking for new sources of revenue. And these states are going to get addicted to these settlements because it's easy money. They aren't going after voters or mom and pop stores. It's a political win for the attorney general and it's big dollars for relatively little work on the part of the state."

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> —Dale Scott
> General Counsel
> Manulife Financial Corp.

(Clockwise from top left): **Andrew Foley**, partner at Paul, Weiss, Rifkind, Wharton & Garrison; **Carol Hansell**, partner at Davies Ward Phillips & Vineberg; **Dale Scott**, executive senior vice president and general counsel at Manulife Financial Corp.; **Richard Borisoff**, partner at Paul, Weiss, Rifkind, Wharton & Garrison; **John Tobia**, vice president and general counsel at Aastra Technologies Ltd.; **John Henry**, senior vice president and general counsel at Investors Financial Services Corp.

Boardroom Blues

While taking it on the chin from regulators, companies also are facing battles in the boardroom, as they struggle to find and retain outside directors to serve on audit committees. In the past year, some companies have tripled the amount of material audit committee members are expected to review prior to each meeting. In addition, many have added two to three more meetings annually.

"Those serving on audit committees are dropping off," Scott said. "They don't like the amount of preparation time they are putting in. People are reluctant to serve because they think it is too much work and too much risk."

Companies also are having difficulty finding people qualified to serve.

"If you could pay them a million dollars to serve on an audit committee, you might be able to get the right people," said Richard Borisoff, a partner at Paul, Weiss, Rifkind, Wharton & Garrison. "However, that is clearly not practical."

Small public companies also are having trouble finding independent directors, and those that are successful are discovering that independent directors can do more harm than good. For instance, one panelist explained how three independent directors recently ganged up against management at his client's company. Apparently, the directors were making decisions that would enable them to sell their stock at a premium. This example is perhaps extreme, though most of the panelists did agree that independent directors often lack knowledge of the company's business.

"A problem that companies face is that they can't find independent directors who know anything about the company and its business," said Carol Hansell, partner at

Toronto-based Davies Ward Phillips & Vineberg. "It's hard for them to find (people with) the right characteristics who also know what the drivers of success are for the company."

The good news is that directors seem to understand this.

> **... the focus shouldn't be on compliance for the sake of compliance.**
>
> —John Tobia
> General Counsel
> Aastra Technologies Ltd.

According to a recent survey of U.S. corporate directors conducted by *The McKinsey Quarterly*, respondents believed that more than a quarter of the directors on their boards were performing either poorly or just adequately [see "The Director's Opinion"]. In addition, only 30 percent of respondents believe directors completely understand what is going on in the companies they govern. And 73 percent support more director control over the agenda [see "The Director's Opinion"].

One solution is to conduct formal evaluations of directors and the board as a whole. The goal is not so much to identify poorly performing directors, but to ensure board members are getting all the information they need.

"Through evaluations, our board decided it wanted more information in a written format and less time spent on oral presentations," Scott said. "The focus of board self-performance reviews should be on how to provide individual directors with the information and means to better understand the business and to maximize their contribution to the board oversight role."

Back To Business

Other lingering governance headaches identified by the panel included the management of whistleblower systems, the rising cost of D&O insurance and CEO certifications.

However, panelists seemed to agree that most companies have come to grips with Sarbanes-Oxley and have all the necessary polices and procedures in place. The next step, the panelists contended, is to ensure compliance procedures and corporate policies are integrated into the company culture and that the CEO supports them.

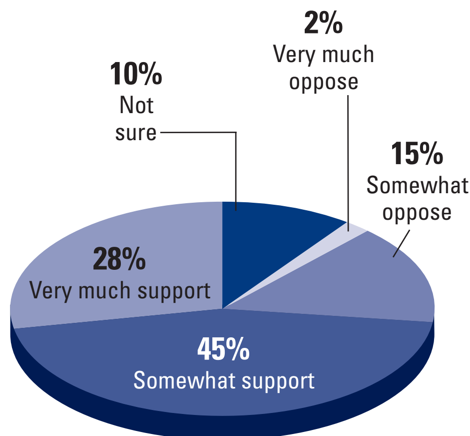
"We believe the focus shouldn't be on compliance for the sake of compliance, but on how best to create long-term value for our shareholders," said John Tobia, vice president and general counsel of Aastra Technologies Ltd., a Canadian-based telecom company. "We believe the implementation of corporate governance practices should be aligned with business objectives so that companies implement the necessary structural changes to become effective and efficient organizations."

When that happens, companies can begin to focus on their core mission: making money and creating value for shareholders.

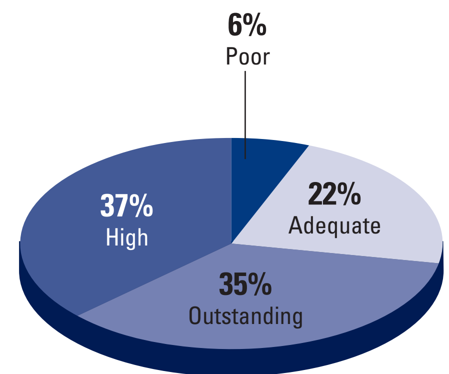
"Sarbanes-Oxley compliance has been a burden on many companies," said Andrew Foley, partner at Paul, Weiss, Rifkind, Wharton & Garrison. "But when the right procedures are in place and the various charters, structures and committees are in place, the burden will recede a little bit and people will be able to get back to business."

The Director's Opinion
Results from a 2004 McKinsey Quarterly survey of directors

Do you support or oppose more director control over the agenda?



In your opinion, what percentage of directors on your board meet the following performance levels (high, outstanding, adequate or poor)?



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