OF COUNSEL

The Legal Practice and Management Report

In This Issue

Sarbanes-Oxley Fallout . . .

A New Balance of Power Means New Boardroom Opportunity for General Counsel

Relax. This article is not just another run-through on Sarbanes-Oxley compliance. We know that you are overloaded with information and advice on that. Instead, let's focus on the opportunities that Sarbanes-Oxley creates for changing the Chairman & CEO/Chief Legal Officer relationship.

Are you ready to take advantage of this opportunity?

The critical strategic implications of Sarbanes-Oxley revolve around two issues: (1) an alteration in the corporate balance of power and (2) how Sarbanes-Oxley will eventually extend to private companies and to nonprofits. With this new change in the balance of power, it is more important than ever for Chairmen/CEOs to properly read early warning signals from the board.

Yet, paradoxically, the potential for board miscues and CEO missed cues have never been greater. The Chief Legal Officer can play a critical early warning role for the CEO/Chairman.

Here are the basic facts.

Sarbanes-Oxley changes the balance of power between CEOs and boards. There will be a formalized checks-and-balances system. Plan on a feisty group of board members who will be asking tough questions of CEOs. The compliant "Good Old Boys from the Club" board will be confined to sleepy credit unions and community hospitals. Even those kinds of companies will have to change over time.

If CEOs are angry over Sarbanes-Oxley, that means that they "get it." But this brave new governance world does not have to be an adversarial one.

Sarbanes-Oxley is the future. Some public companies are openly talking about going private to avoid the costs of Sarbanes-Oxley compliance. Such an overreaction will prove to be a costly mistake if only because, in the near future, public companies doing business with private companies of a certain size will require that these private companies have the same financial transparency and balance of governance power required by Sarbanes-Oxley. They will want critical business suppliers to be as squeaky-clean as they are.

Companies with exit strategies involving their own acquisition will find that compliance with Sarbanes-Oxley is a critical factor affecting the negotiated price. McKinsey & Company has published two studies showing that institutional investors will pay a premium to acquire stock in companies with good governance. That premium ranges from 12 percent in North American to 50 percent in Africa and Eastern Europe. (*www.mckinsey.com\governance*)

A Georgia State University study reveals a direct correlation between corporate governance and corporate performance. The research used the ISS Corporate Governance Quotient (CGQ) to determine the relationship between governance and four key areas: total return, profitability, risk, and dividend payout.

"Our findings reveal that companies with weaker corporate governance perform more poorly, are less profitable, and have higher volatility than do firms with stronger corporate governance," said Georgia State's Dr. Lawrence Brown. "The average difference in annualized returns between bottom decile and top decile companies was 11.9 percent over the preceding five-year period. Board composition proved to be the most important factor."

Paul Gompers, Joy Ishii of Harvard University, and Andrew Metrick of The Wharton School constructed a Governance Index and applied it to 1,500 large firms. They conclude that companies with stronger governance systems have higher firm value, higher profits, higher sales growth, and lower capital expenditures. (*http://www.boardoptions.com/headline_112403.htm*)

There is no reason to assume that public companies acquiring private companies will also not pay a premium for a private company that has good governance.

General Counsel are both legal officers and corporate officers. Most of the time, General Counsel have to balance their legal roles and their business roles. Sarbanes-Oxley is a profound exception to this need for balance in the sense that, by rigorously applying their legal oversight, general counsel directly serve economic business objectives.

Of course, we know the expense of Sarbanes-Oxley compliance. Looking backwards, however, it may be the case that legal compliance and long-term shareholder value were both served by embracing good governance.

Reading the Nod

In the United Kingdom there is an explicit separation of the roles of Chairman of the Board and Chief Executive Officer. Most US students of good governance believe that such a separation has value. Dell and Disney have recently split the roles. In the case of Disney, that decision was not taken without a strong push from shareholders. In any event, there will be no rush to split the roles. US business culture continues to have a bias towards centralization of authority in one person by having CEOs also assume the role of Chairman of the Board.

A Board is a work group. This bias toward centralization has its merits. But there is a dark side: It is difficult for one individual to be the impartial leader of a powerful working group, and the subject of the group's critical discussions, under conditions where the CEO/Chairman's dominance is actually eroding.

Our firm is currently doing research on the early stages of board disillusionment with CEO/Chairmen. During this early stage, it is possible for CEO/Chairmen to assuage or reverse this disillusionment if they "read" the group dynamics signals in a timely fashion. In fact, it has never been more important for CEO/Chairmen to properly read board dynamics, yet it has never been more difficult to do so.

One of our clients, for example, is a global technology company. The Chairman/CEO met with us the day following his termination by the board. "I thought that it was going to be a typical board meeting," he complained. "I knew *some* members were unhappy. I had no clue that the board was *that* unhappy. How could I have missed it? There is only one answer. The board was working behind my back, that's how!"

In discussions with board members, and while observing the board, we found that the CEO/Chairman's complaint was simultaneously true and false. At the board level, there is a time-honored custom for external directors (most of whom are CEOs of large public companies) to be respectful towards the CEO/Chairman. They would not humiliate the CEO/Chairman in front of other board members, just as they would not want to be embarrassed in front of their own boards by external board members. They treat the CEO/Chairman the way that they would want to be treated.

Legal compliance and long-term shareholder value were both served by embracing good governance.

The norm of courtesy at this board includes "The Nod." The Nod is a single downward vertical movement of the chin with a blank facial expression. The Nod could signify, "I agree with you." The Nod could also signify, "I comprehend what you said, but I still disagree." Interpretation of The Nod has to be made in the context of what that board member has said in the past as it may now relate to the issue under discussion.

The board was not initially working behind the CEO/Chairman's back. The members were, however, in the early stages of disillusionment. External directors were providing subtle signals to the CEO/Chairman.

The Nod and its multiple interpretations create a danger of fundamental miscues and missed cues. Our CEO/Chairman simply failed to interpret The Nod correctly. Compounding his miscue, he looked for informal feedback from his strongest supporters instead of asking for feedback from the board as a whole. As the disillusionment process continued, the board eventually did indeed work behind the CEO/Chairman's back, but their doing so was not the root of his undoing.

GC as Ally

In addition to their other competencies, Chief Legal Officers need to become outstanding interpreters of group dynamics. Combine those skills with an understanding of governance issues so that miscues and missed cues can be placed in appropriate business/strategic context. Add to the mix a sanctioned ability to give negative feedback to powerful people when such feedback needs to be given, and the Chief Legal Officer then becomes the CEO/Chairman's most formidable ally.

One might argue that some boards are now following CALPERS recommendations for regular meetings of external board members in the absence of the CEO. The presumption is that such regular meetings will generate real "board sensing" rather than fixation on whichever issues happen to be bothering the loudest board member. The presumption is that such regular meetings will likewise have a lead director who is skilled at giving "straight talk" to the CEO/Chairman.

We hope the CALPERS model proves valuable. Until it does, Chief Legal Officers have the opportunity of having CEO-Chairmen look at them in a new light.

General counsel can be critical board-sensing vehicles for CEO/Chairmen. And better bonding equals better law. The Chief Legal Officer will truly bond with the CEO/Chairman when the CEO/Chairman says: "At the conclusion of this board meeting, I want you to come to my office. I'll tell you what I think happened. And you tell me what you think happened."

As the value of the Chief Legal Officer's group dynamics expertise becomes clear to the CEO/Chairman, closer bonding between the two officers raises the entire status of the legal function within the company.

—Dr. Laurence J. Stybel
and Maryanne Peabody

Dr. Laurence J. Stybel and Maryanne Peabody are co-founders of Board Options Inc. Its mission is helping boards be more effective problem-solving units through the integration of National Association of Corporate Directors standards and behavioral science. Their Web site is www.boardoptions.com.