Corporate and Securities Law

Independent Directors Under New Federal Law and Exchange Rules

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On July 30, 2002, in an effort to restore investor confidence, President Bush signed into law the "Sarbanes-Oxley Act of 2002." Sarbanes-Oxley provides for broad corporate and accounting reform for public companies and the accounting firms that audit them, and seeks to improve the quality and transparency of financial reporting and to increase corporate responsibility and the usefulness of corporate financial disclosure. Sarbanes-Oxley requires public companies to establish an audit committee consisting of only independent members. Proposed NYSE and NASDAQ rules require that boards of directors have an independent majority as well as a fully independent audit committee. Thus, in 2002, director independence has become a central feature of corporate governance.

Sarbanes-Oxley provides that a director is independent if he or she does not: (i) accept any consulting, advisory or other compensatory fee from the public company and (ii) is not affiliate of the public company or any of its subsidiaries.

NYSE proposes requiring that, as to the public company: (i) the board of directors must determine that the independent director has no material relationship; (ii) for former employees, independent auditors and their respective immediate family members, there is a five-year "cooling-off" period and (iii) directors' fees must be the sole compensation independent directors receive. Proposed NASDAQ rules: (i) prohibit an independent director or his or her family members from receiving any payments in excess of $60,000 other than for board of directors service; (ii) prohibit payments to a charity of which an independent director is an executive officer where such payments exceed $200,000, or 5% of the public company's or the charity's gross revenues; (iii) provide that an independent director may not own or control 20% or more of the voting securities; (iv) prohibit former partners and employees of the auditor or any relative of an executive officer from being deemed independent and (v) require a three-year "cooling off" period for a director involved with interlocking compensation committees, or violation of another provision.

It is advisable to appoint two (or more) directors with the least contacts as a corporate governance committee to determine independent directors. This is more appropriate then action by the full board of directors.

Then the board of directors and audit committee must consider how they will function most efficiently. There should be in person deliberations as often as possible, and certain meetings of the board of directors should exclude non-independent directors. The board of directors and audit committee should receive direct reports from legal, financial and executive personnel. They should also receive reports from outside auditors and outside counsel.

The independent directors and audit committee should retain their own counsel. Independent counsel will be helpful in developing procedures to shield the directors from personnel liability as well as assisting in the resolution of difficulties with management and other complex issues.

Directors should review their director/officer liability insurance in order to ensure that their additional duties are covered under their policy, and ensure that governance structures are in place to minimize the premiums and maximize coverage of such insurance.

A classified board of directors should be considered if not already in place, allowing terms of up to three years. This will not only enhance the independence of the board but also bring stability to the board of directors and audit committee and lead to a reduction in pressure.

It is difficult to predict the dynamics between an independent board of directors, audit committee and management. Flexibility is required to allow them to function effectively.

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