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Being "Best Practice"

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Editor's Note: This is the second in a series of articles discussing the long-term governance implications of the Sarbanes-Oxley movement.

One of the most positive, long-lasting effects of the Sarbanes-Oxley law—and the corporate responsibility movement it prompted—has been the significantly increased board focus on applying "best practices" to boardroom conduct. Yet the concept is prone to misunderstanding and misapplication; just what are best practices, what do they mean and what actual benefit do they provide? And what are the consequences for the board that elects not to apply them? Ten years after the enactment of Sarbanes, those remain useful topics for boardroom discussion.

Broadly speaking, "best practices" refers to a process, method or conceptual approach that has demonstrated an historical record of success, achievement or accomplishment, beyond a level attained by less structured or precise efforts. "Best practices" are designed to identify behavior beyond that required by basic, accepted methodologies or minimum legal standards. They are not intended to reflect the full spectrum of applicable law. As such, they are considered aspirational goals as opposed to legal requirements or mandates. In the governance context, they constitute a series of proposals designed to enhance and improve corporate responsibility and boardroom conduct.

Governance best practices were not invented by Sarbanes-Oxley; rather, the seminal legislation and the scandals by which it was prompted served to accelerate their definition, consideration and adoption. While there would have been governance best practices without Sarbanes and the corporate responsibility movement, it is highly unlikely that they would be as pervasive and influential as they are today. The spark provided by Sarbanes was the crucial recognition that failed governance practices were a significant contributing cause of the Enron/WorldCom spectrum of corporate scandals. Specifically identified governance fault lines at that time included excessive deference by directors to senior executives; excessive reliance on those executives; failure to exercise "constructive skepticism" in the boardroom; failure to devote adequate time and attention to directors' duties and responsibilities; and allowing senior executives to establish board agendas in the broadest sense, without sufficient director input.

Multiple public policy and industry sources responded with roughly similar versions of a dramatically refined set of standards for internal corporate governance. They focused generally on themes associated with director independence; the relationship between the board and the senior

management team; fulfillment of the board's oversight obligations; the audit, compensation and governance committee charters; executive sessions; material transactions with officers and directors; term limits/chair rotation; director training and education; director performance evaluation; board information flow; diversity of director experience; the relationship of the general counsel and the chief financial officer to the board; and several other core recommendations. The underlying goal was to increase the likelihood that board members will act to further the interests of the corporation and its constituents—whether they be shareholders (of for-profit companies) or a charitable class (of nonprofit companies). And in virtually every instance, these themes remain as relevant today as they did when first adopted.

But for what purpose do they really serve? What is the director's incentive to pursue standards above and beyond those that are required by the law? Quite simply, because they're an effective antidote to the disease of director liability. Good faith, *i.e.*, the expectation that directors will at all times act with an honesty of purpose, is fundamental to the satisfaction of the director's basic fiduciary duties. In turn, leading courts view a board's conscientious pursuit of governance best practices as evidence of its good faith. Thus, genuine efforts to achieve and apply good corporate practices can pay directors a "liability dividend;" and in the current climate of individual accountability, that is a powerful incentive, indeed.

Yet, it must be remembered that there remains a fundamental distinction between "best practices" as an aspirational goal, and the satisfaction of fiduciary duties as a legal obligation. On the one hand, achievement of governance best practices may in many cases subsume compliance with fiduciary duties. On the other hand, compliance with fiduciary duties does not always guarantee achievement of particular best practices. The board should thus be assured that the failure to comply with best practices will not, in and of itself, serve as evidence of breach of fiduciary duties or violation of law. It is conceivable that a board could determine, after serious examination, against the adoption of best practices in whole or in part. Just the same, the unwillingness of a board to even consider the topic risks creating a presumption in the minds of third parties, such as a regulator or the media, of indifference to fiduciary obligations and ultimately to the welfare of the organization. It will always look bad!

For that reason, among others, it is vitally important for the board -- either directly, or through its governance committee, to conduct a periodic evaluation of how adoption of "best practices" would advance the interests of the organization. This is especially the case as the memories of Enron, WorldCom and that "rogue's gallery" grow dim, and as some directors fail to "connect the dots" between more current corporate scandals, and failed governance. For "best practices" is not a static concept, frozen in time. Indeed, the universe of governance best practices continues to evolve over time, reacting to commercial developments and incorporating as necessary new concepts worthy of recognition.

So, a decade after Sarbanes, "Being Best Practice" remains a good place for a board to be!

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