



Corporate Type

by John Okray

Lawyers as Corporate Board Members: A Paradigm Shift

The pros and cons of lawyers serving on a corporation's

board of directors (lawyer-directors) have been debated over the years using anecdotal evidence. Detractors of lawyer-directors have historically claimed that potential conflicts outweighed the benefits. However, a Cornell Law School research study published on Feb. 15, 2013, (the "Cornell Lawyer-Director Study") provides statistical evidence to suggest that, among other material benefits, having a lawyer-director resulted in an average 9.5 percent increase in a company's value.¹

The Cornell Lawyer-Director Study suggests that lawyer-directors have a positive impact on litigation management and the alignment of executive compensation with shareholder interests. Similarly, reducing incentives on excessive risk-taking suggested a reduction in corporate default risk. Some boards may be realizing this potential to enhance shareholder value; the percentage of large U.S. public corporation boards with lawyer-directors rose from 24.5 to 43.9 percent between the years 2000 and 2009.² This article explores some of the findings in the Cornell Lawyer-Director Study and certain ethical considerations when determining whether a lawyer should serve on a corporate board.

The Cornell Lawyer-Director Study Findings

The study authors describe the general benefits that lawyers may bring as board members, such as the judgment that comes from their training and experience, a better understanding and appreciation for legal and regulatory risks, and an enhanced vigilance regarding their fiduciary duties based on their potentially heightened duty of care and liability. The study analyzed approximately 10,000 factors to conclude that, on average, when a public corporation had a lawyer-director:

Shareholder Value

- The corporation's value increased by 9.5 percent.
- When the lawyer-director was also a company executive, firm value rose by 10.2 percent.

Executive Compensation & Risk Management

- Better alignment between executive and shareholder interests.
- Total CEO compensation was higher, with a 5.5 percent standard deviation increase in salary.
- Executive compensation was more heavily weighted towards salary and with incentive compensation tied to increasing firm value and not excessive risk-taking.
- Having a CEO who was also the chairman of the board generally increased risk taking, however, the detrimental effects were reversed when there was a lawyer-director.
- Corporate risk-taking was reduced to more efficient levels and corporate default/bankruptcy risk was lowered, and these benefits were magnified if the lawyer-director had a more prominent role on the board (such as chairman of the board or chairman of the risk management committee) or if the lawyer-director was an insider (such as a lawyer-CEO who was also a director).

Litigation Management

- The likelihood of stock options backdating litigation dropped by nearly 94 percent.
- The positive effect of patent litigation on firm value increased by 13.2 percent.
- The effect of litigation on bankruptcy risk:
 - Accounting malpractice litigation's impact decreased from 35 percent to 13.5 percent
 - Securities law litigation's impact decreased from 28.4 percent to 5.8 percent.
 - Class action litigation's impact decreased from 17.9 percent to 5.6 percent.

Board Structure & Takeover Protections

- Board entrenchment (e.g., classified board) and takeover defense (e.g., poison pill) features generally lowered stock returns, however, these factors enhanced firm value when there was a lawyer-director. Boards with lawyer-directors had:
 - Increased board size by 3.4 percent.
 - Increased probability of having a CEO-chairman by 3.3 percent.

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- Increased probability of having a classified board by 5.6 percent.
- The authors suggest that these entrenchment features may enhance the recruitment of lawyer-directors who will invest time to understand the business and more effectively advise the CEO, allow boards to focus on long-term profitability over short-term results, and provide the board with greater leverage in negotiating higher acquisition prices.

The study suggests that market participants may not broadly recognize the value of lawyer-directors, creating a potential investment arbitrage opportunity (*this does not constitute investment advice!*). Boards without lawyer-directors may be overemphasizing the necessity simply for independent directors versus the statistically significant incremental value added by the skillsets of lawyer-directors, regardless of whether they are independent.

The authors do not suspect these results would be replicated by simply having a lawyer advising the board rather than serving as a director. Among other reasons for this, they suggest that directors and executives may be more inclined to follow the advice of a colleague who shares equally in the outcome, particularly since lawyer-directors may be held to a higher standard by the courts.³

When Lawyers Serve on the Board of a Client and Other Ethical Considerations

Notwithstanding some of the potential benefits of having lawyer-directors, boards, lawyers, and law firms should proceed with caution when considering a lawyer that directly, or otherwise through her/his law firm, provides legal services to the corporation. While lawyers are not prohibited from serving on the board of a corporate client, the American Bar Association Model Rules of Professional Conduct provide the following guidance:

A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director or should cease to act as the corporation's lawyer when conflicts of interest arise. The lawyer should advise the other members of the board that in some circumstances matters discussed at board meetings while the lawyer is present in the capacity of director might not be protected by the attorney-client privilege and that conflict of interest considerations might require the lawyer's recusal as a director or might require the lawyer and the lawyer's firm to decline representation of the corporation in a matter.⁴



Lawyers should also be aware that their status as a board member for a client could be construed to make them a control person under Section 20(a) of the Securities Exchange Act of 1934, as amended. In *Cammer v. Bloom*, 711 F. Supp. 1264, 1295 (D.N.J. 1989), the court stated “It may be presumed for pleading purposes a director, who was also corporate counsel and assistant secretary, in such a company would have at least some global responsibilities for, and interest in, corporate affairs ... Plaintiffs have met their liberal pleading requirements as to the Section 20(a) claim.” Under exchange rules, the lawyer might also be deemed not to be independent if she/he is a partner, shareholder, or officer of a law firm that has a material relationship with the corporation and/or if she/he has received a material amount of legal fees from the corporation. A board might not want to use up a non-independent board seat for a lawyer that is not also an employee of the corporation.

Other potential issues for lawyers to consider include insurance coverage policy limitations, whether they may be held to a higher standard because of their specialized training and/or knowledge of corporate affairs, not being able to try a case on behalf of the corporate client, a law firm's prohibition from representing a client adverse to a corporation where a law firm lawyer served on the board, and questions regarding attorney-client privilege and whether the lawyer was wearing her/his “director hat” or “lawyer hat”.⁵ Obviously these hurdles may not be as onerous when a lawyer and her/his firm have not provided a corporation with legal services in the past and would not be expected to in the future. For this reason, lawyers at law firms whose practice areas may overlap with a corporation's line of business may have a more difficult time getting permission from their firm to serve as a director. Additionally, in-house lawyers may advise a board against recruiting a lawyer-director with anticipated conflicts related to acting as outside counsel to the corporation.

Conclusion

Boards and their nominating/governance committees may wish to analyze whether adding lawyer-directors could enhance their corporation's value. In this article author's opinion, the benefits

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render the lungs unable to function); silicosis is particularly troubling because there are no known cures and exposure is known to cause lung cancer, respiratory diseases (chronic obstructive pulmonary disease, including, bronchitis and emphysema), and a host of other diseases, including kidney and immune system diseases. OSHA's silica standards are widely regarded as obsolete; having different permissible exposure levels (PEL) for silica in general industry and construction. Adding to this confusion, the method used by OSHA to measure exposure to silica in construction has been rendered obsolete. Since February 2011, the draft silica rule has been under review by the Office of Management and Budget (OMB). If the draft rule becomes final, the rule would: (1) lower the permissible exposure limit for silica exposure; (2) implement extensive "housekeeping" requirements (including prohibiting dry sweeping); (3) require exposure monitoring and establish regulated areas; and (4) require medical surveillance.

A More Robust Confined Spaces Rule for Construction

OSHA's general industry standard for confined spaces is more robust than the current confined spaces standard applicable to construction. There are those who believe that employees in the construction industry are not adequately protected when performing work in or around confined spaces because of the regulatory deficiencies in the construction standard. These concerns culminated in the Confined Spaces in Construction standard which was first proposed in 2007; it is expected that during President Obama's second term the administration may be able to issue a final rule which provides the construction industry the same level

of protection from confined space hazards that exists in general industry.

Power Transmissions

The current standard for electric power, transmission and distribution for construction dates back to 1971. The passing of 40 years has rendered the standard obsolete. A revised rule has been under works for years and in 2012 the final rule was submitted to the OMB for review. The goal in some respects is to make the construction standard more in line with the general industry standard when performing similar work. There is some belief that in the next four years the rule for electric power, transmission, and distribution for construction may finally be adopted.

As we ask ourselves what we can expect from OSHA in the next four years, there is a long list of unfinished business, which may provide for a very active next couple of years. ☺

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to having a lawyer-director who may be keenly sensitive to legal, regulatory, and reputation risk issues are self-evident. However, there is also significant research and increasing public scrutiny regarding corporations implementing governance best practices. In other words, boards may wish to avail themselves of the clear-cut and statistically significant risk mitigation benefits of lawyer-directors, while giving thoughtful consideration to controversial structural factors that can be more prevalent for boards with lawyer-directors, such as classified boards, limits on shareholders' voting rights to amend the bylaws, supermajority requirements for mergers and charter amendments, poison pills, and golden parachutes.⁶ Corporate boards should have members with diverse skillsets and professional backgrounds, and any stigma attached to lawyers as directors appears to have dissipated for good reason. ☺

Endnotes

¹Litov, Lubomir P., Sepe, Simone M. and Whitehead, Charles K., *Lawyers and Fools: Lawyer-Directors in Public Corporations* (Feb. 15, 2013) available at ssrn.com/abstract=2218855 or dx.doi.org/10.2139/ssrn.2218855, hereinafter referenced as the Cornell Lawyer-Director Study.

²*Id.*, see footnote 111 discussing the examination of S&P Composite 1500 companies, excluding financial services companies.

³*Blakely v. Lisac*, 357 F. Supp. 255, 266 (D. Or. 1972), stat-

ing that an attorney also acting as a director knew or should have known about fraud and was held to a higher standard of care.

⁴American Bar Association Model Rules of Professional Conduct, Rule 1.7, Comment 35

⁵Freivogel, William, *An Ethics Primer for Business Lawyers*, June 2009, available at apps.americanbar.org/buslaw/newsletter/0085/materials/ethics.pdf.

⁶Cornell Lawyer-Director Study at 35.