

PRESENTATION TO THE COLLABORATIVE  
*CORPORATE ETHICS, GOVERNANCE AND ENTREPRENEURIAL LEADERSHIP*  
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I. INTEGRITY, OR LACK THEREOF, IS AT THE HEART OF TODAY'S BUSINESS SCANDALS AND LACK OF CONFIDENCE IN THE MARKETS IN PARTICULAR AND BUSINESS IN GENERAL.

- This environment affects all business: large, small; public, private.
- Integrity is an issue of governance, leadership and ethics.
- I place the responsibility for these matters ultimately on Boards of Directors and senior management.
  
- What stakeholders need most from Boards of Directors and senior management is assurance of an organization's integrity.

Specifically:

- **That financial statements have integrity** – in other words that they can be clearly understood and relied on by those responsible for assessing the value of the organization – and that the value of the organization can be relied on by its owners, financiers, regulators and others who do business with the company, including employees, suppliers and customers. It's hard to square a Board's duties of financial oversight with the massive use of off balance sheet financing techniques, earnings overstatements and revised financial results currently in the news.
  
- **That the public disclosures and comments of senior management and the Board have integrity** and are reflective of the true state of the organization's affairs. It is incredible to have CEOs touting a company's stock as undervalued and a good buy in the months preceding a bankruptcy filing, and in Enron's case, particularly after having received a letter from a Vice President expressing her concerns that Enron could implode an accounting scandal.
  
- **That senior management**, selected and regularly evaluated and compensated by the Board, **would above all responsibilities see that the company's business was conducted in a manner which would serve rather than detract from its integrity.**

- **That accounting, legal and consulting firms engaged by the company will conduct their activities in a manner that will serve rather than detract from the company’s integrity.**
- **That the compensation and perks awarded to Board members and senior management, which directors alone approve, will not in actuality or perception co-opt their judgment, compromise their independence or detract from the organization’s integrity.**
  - ❖ This was an issue for Attorney General Mike Hatch in his recent investigation of Allina.
  - ❖ The National Association of Corporate Directors recommends the elimination of “perks” and “benefits” from director compensation.
- **That directors and management will avoid actual or perceived conflicts of interest which would detract from the integrity of an organization and its governance.**
- **That management has in place compliance systems and procedures that will give it early warnings of activities that would threaten the integrity of the organization** – and when the warning comes that the Board will investigate the issue independently and without restrictions that might compromise the investigation.
  - ❖ I have read Sherron Watkins’ letter to Ken Lay. I have also read the nine-page rather dismissive letter written by Vinson & Elkins in response to a request that it investigate Ms. Watkins’ allegations. That response stands in sharp contrast to the 200+ page report of the Special Investigative Committee of Enron’s Board of Directors issued with the assistance of independent counsel. The Powers Report was extremely critical of the Board, certain members of senior management, Vinson & Elkins and Arthur Andersen.
- The bottom line of governance, of Enron, of Arthur Andersen, of the analysts and ratings firms, of the brokerage and investment banking firms, of banks, of the SEC (the independence and aggressiveness of which has been challenged because of Harvey Pitt’s prior relationship with the major accounting firms) and other regulatory agencies is that the ultimate authority for the governed entity is responsible for the entity’s integrity. **In many of the current corporate scandals the Board failed because it did not take responsibility for the organization’s integrity. The directors did not see the organization’s integrity as an extension of their own integrity – and I think ultimately that is the critical point.**

II. THERE HAVE BEEN MANY REACTIONS TO THE CORPORATE SECTOR PROBLEMS IN THE NEWS. I WANT TO DISCUSS TWO OF THEM WHICH I BELIEVE BODE WELL FOR THE FUTURE:

**1. The emergence of recognized corporate governance best practices, and**

**2. The evolution of the proactive Board.**

- First, the emergence of recognized best governance practices.
  - For several years there has been emerging a body of “best practices” in corporate governance. The sources are many:
    - ❖ Corporate governance practices articulated by Boards of Directors (this got a huge public push from General Motors several years ago).
    - ❖ Corporate governance practices authored by institutional investors such as TIAA CREF and CALPERS.
    - ❖ State and federal legislatures.
    - ❖ Various regulatory agencies, e.g. the Internal Revenue Service, the SEC, and the Comptroller of Currency.
    - ❖ Various self-regulatory organizations such as the New York Stock Exchange and NASDAQ.
    - ❖ State and federal officials charged with enforcement – note the recent actions of the New York Attorney General and Minnesota Attorney General Mike Hatch.
    - ❖ Various business organizations such as the Conference Board and Business Roundtable.
    - ❖ The National Association of Corporate Directors which has issued a number of blue ribbon commission reports on matters like director professionalism, executive compensation, director and executive evaluation, detection of fraud, etc.
    - ❖ The American Law Institute’s Principles of Corporate Governance.
    - ❖ The American Bar Association Task Force on Corporate Responsibility.
  - Best governance practice generally speaks to the following subjects:
    - ❖ **Board size.**

❖ **Board composition.**

- How many management members?
- If a family controlled business, how many family members?
- How many independent directors? What is the definition of independence?
- What skills are needed on the Board?
- Should a retiring executive continue as a director?

❖ **Director selection process.**

- Is this a management dominated process? Or is it controlled by the Board of Directors, and in particular by independent directors in an effort to bring more independence and objectivity to the nomination/selection process?
- Current best practice is an independent governance/nominating committee.

❖ **Board organization.**

- Boards should have a written charter.
- Should the Board have a separate chair or other non-management leadership?
- What committees should the Board have? Audit? Governance (nominations)? Compensation?

❖ **Board process.**

- How many meetings per year?
- Who sets the Board meeting agenda? How is director input obtained?
- Regular executive sessions?
- What materials are expected and how far in advance?
- Who is invited to attend Board meetings?
- Board access to senior officers and advisors.
- Board meeting minutes.

❖ **Board service conditions.**

- What should be the length of a term of service (e.g., one, two or three years)?
- Should terms be staggered?
- Should there be term limits (e.g., number of consecutive terms which a director may serve)?
- Should there be a retirement age (e.g., once a director reaches a certain age he or she is no longer eligible for service)?
- Should directors submit their resignation on a change of job or other events?

❖ **Board compensation:**

- How and what should the Board be paid?
- Review annually?

❖ **Evaluation of Board performance.**

- How often?
- What process will be used?

❖ **Evaluation of director performance.**

- How often (if at all, it's usually done at time of consideration of nomination for another term)?
- What process will be used?

❖ **Committee organization; compensation.**

- Member composition.
- Member selection process.
- Committee duties (charter).
- Committee compensation.

❖ **Board duties. Are these in writing?**

- Vigorous oversight.
- Elect corporate officers.
- Annual CEO evaluation and compensation.
- CEO/management succession planning.
- Review/approve strategy.
- Review/approve annual budget.
- Review/approve capital expenditures (or capital expenditures above certain dollar amount).
- Review/approve transactions not in ordinary course of business.
- Review quarterly operating results against plan/budget.
- Review/approve shareholder distributions.
- Elect and compensate directors.
- Authorize committees and committee membership.
- Approve committee charters and compensation.
- Review/approve Board meeting minutes.
- Approve governance principles, codes of conduct and compliance policies.
- Director orientation and education (industry, company, governance).
- Review conflicts of interest involving senior executives and directors, including current and proposed other directorships held by officers and directors.

❖ **Board/management relations.**

- Agreement on matters requiring Board approval, matters which are the province of management and matters where there is shared responsibility.

❖ **Board protection.**

- Articles of incorporation.
- Bylaws – indemnification.

- D&O insurance.
- Proper procedures and process.
- I want to comment specifically on the Sarbanes-Oxley Act which was passed in the late summer, the New York Stock Exchange proposed listing standards relating to corporate governance, and the ABA Corporate Responsibility Task Force Preliminary corporate governance recommendations. Again, we are looking at these because they were written to address corporate governance issues and are evidence of articulated best practices which public and private companies should consider.
  - Sarbanes-Oxley.
    - ❖ Prohibits eight types of consulting services by public company auditors.
    - ❖ Requires rotation of audit partners after five years, and a study of the rotation of audit firms.
    - ❖ Requires retention of audit records for five years.
    - ❖ Makes Board audit committees responsible for hiring and overseeing auditors.
    - ❖ Provides strict independence standards for Board audit committee members.
    - ❖ Requires audit committees to have one member who is a “financial expert” and to disclose that person’s name.
    - ❖ Provides that each member of the audit committee must be independent, and defines independence stringently.
    - ❖ Prohibits efforts to fraudulently influence, coerce, manipulate or mislead auditors for the purpose of making financial statements misleading. We are well aware of the pressure put on auditors by CEOs and CFOs to make accounting judgments favorable to the company’s financial statements.
    - ❖ Makes it unlawful for a registered public accounting firm to perform audit services for an issuer if a key officer of the company was employed by the accounting firm and participated in an audit of that company during the one-year period preceding the date of initiation of an audit.
    - ❖ Requires that management acknowledge responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting and annually assess the effectiveness of the internal control structure. The company’s auditing firm has to attest to, and report on, management’s assessments of internal controls.
    - ❖ Requires the SEC to issue rules for disclosure of off balance sheet financing.

- ❖ Prohibits most loans to directors and executive officers.
- ❖ Requires the SEC to issue rules requiring disclosure of whether a company has a code of ethics for senior financial officers.
- ❖ Requires real time disclosure of material changes in the business or financial condition of companies.
- ❖ Requires certifications by the CEO and CFO that:
  - A filed report fully complies with the applicable reporting requirements.
  - The information in the filed report fairly presents, in all material respects, the financial condition and results of operations of the company.
  - The officers have reviewed the report.
  - The report does not contain a material misstatement or omission.
  - The officers are responsible for establishing the organization's internal controls, have evaluated the effectiveness of the controls recently and have reported their conclusions about the effectiveness of those controls.
  - The officers have disclosed to the organization's auditors and the audit committee any deficiencies in the controls and any fraud on the part of employees who have a significant role in maintaining those controls, and have stated in their report whether there were changes in the controls, including any corrective actions taken with respect to the controls.
- The New York Stock Exchange corporate governance proposals.
  - ❖ Requires that each listed company must have a majority of independent directors on its Board, and goes on to provide a stringent definition of independence.
  - ❖ Requires that there be regularly scheduled executive sessions of the Board.
  - ❖ Requires that the nominating/governance committee be comprised entirely of independent directors, and certain documentation of the nominating committee's responsibilities.
  - ❖ Requires companies to have a compensation committee comprised entirely of independent directors, and again sets out requirements for the committee's functions.
  - ❖ With respect to audit committees, which are already required to be independent, the proposed standards add a requirement that directors' fees are

- the only compensation audit committee members can receive from the company.
- ❖ Increases the authority and responsibility of the audit committee including granting it the sole authority to hire and fire auditors and approve any non-audit services. Again, the Exchange requires that audit committee perform a specified number of duties.
  - ❖ Requires shareholder approval of most equity compensation plans.
  - ❖ Requires that companies adopt and disclose corporate governance guidelines and details seven subjects that the guidelines should address, including director orientation and continuing education.
  - ❖ Requires that companies adopt and disclose a code of business conduct and ethics for directors, officers and employees and disclose any waivers of the code. The Exchange further requires that the code address certain specified subjects of concern.
  - ❖ Requires that a CEO certify to the Exchange each year that he or she is unaware of any violation by the company of the Exchange's listing standards.
- The ABA Corporate Responsibility Task Force Preliminary Report.
- ❖ Appointed on March 28, 2002, by the ABA President to look at the roles of lawyers, executive officers, directors and other key participants in the system of checks and balances which are intended to enhance the public trust in corporate integrity and responsibility.
  - ❖ The Preliminary Task Force Report states that it is clear that corporate governance at a number of public companies has failed dramatically. It cites as clear failures **(i) overstatements of earnings and equity, (ii) management assurances to employees whose retirement accounts are invested in company stock that the company is financially sound when in fact it is not, (iii) executives aware of corporate problems selling their securities to an unaware public, (iv) insiders borrowing large sums from their companies using only inflated stock as security and (v) directors, auditors and lawyers failing to discover or avert — and sometimes condoning or contributing to the creation of – gross financial manipulations and fraud.**
  - ❖ Task Force governance recommendations:
    - Boards should be comprised of a substantial majority of independent directors.
    - Routine executive sessions of independent directors.

- A Governance Committee comprised of independent directors should identify and nominate the Board's independent directors, and appoint committee members.
  - An Audit Committee comprised of independent directors should control the relationship with the company's auditors.
  - A Compensation Committee comprised of independent directors should be responsible for senior management compensation and engagement of compensation consultants.
  - The Governance Committee should develop a code of conduct/ethics, and a process for ascertaining compliance.
  - The Board or a Board committee should review and approve all material transactions between the company and a director or senior officer.
  - The Corporate Governance or Audit Committee should have regular meetings with corporate officers responsible for implementing internal controls, a code of ethics and a compliance policy.
  - Consider independent Board leadership.
  - Consider term limits for directors and committee members.
  - Institute director education.
  - Institute Board, committee and director evaluation.
- ❑ Recently the SEC has proposed rules of conduct for lawyers who discover corporate wrongdoing which involve a progression of disclosure to senior management, to the Board or a Board committee and ultimately to the SEC. Under the proposed rules attorneys may be required to resign their representation of a client under certain circumstances.
- **Next, the subject of proactive Boards.**
    - ❑ It used to be the law and the practice that directors were not responsible for discovering problems; they were only responsible to act once there had been some kind of a "triggering event" – something that called their attention to a matter which needed to be addressed.
    - ❑ That started to change with the development of the Federal Sentencing Guidelines which reduced corporate penalties for infractions where it could be demonstrated that the corporation had taken reasonable steps to avoid the conduct of which the corporation was accused.

- Board proactivity got a further push from a Delaware court decision in the *Caremark* case where Chancellor Allen articulated the proposition that Boards cannot wait for a triggering event, but must act proactively to assure that management puts systems and processes in place, and engages in active monitoring, in an attempt to avoid illegal conduct, and to pick up warnings of such conduct.
- And I believe the current corporate scandals are underscoring the importance of, and need for, proactivity at the Board level. This is supported by the Sarbanes-Oxley Act with its certification requirements and criminal penalties, the listing standards such as those proposed by the New York Stock Exchange and those anticipated from NASDAQ, as well as the positions taken by institutional investors and business groups, and the ABA Corporate Responsibility Task Force.

### III. HOW WILL SARBANES-OXLEY AND THESE VARIOUS OTHER CORPORATE GOVERNANCE DEVELOPMENTS AFFECT THE PRIVATE COMPANIES?

- We will continue to see a shift to proactive Boards. Vigorous oversight will become more the norm.
- We will see an increasing focus on ethics, organizational culture and leadership of the Board and management.
- We will see certification broaden, particularly for the CEO and CFO.
- State legislatures will consider enacting some or all of the Sarbanes-Oxley Act; or will prepare their own version of corporate disclosure/conduct requirements.
  - California is the first state to do so. Governor Gray Davis signed the California Corporate Disclosure Act at the end of September. The Act applies to California-incorporated corporations as well as those incorporated elsewhere that are qualified to do business in California.
- Regulators will look at the best practices articulated by other regulatory agencies and self-regulatory organizations and begin to incorporate these into regulations affecting, and settlements with, companies.
- Without regard to what the regulators do, Boards of Directors will begin to look at corporate governance best practices and bring those practices to the organizations, public or private, that they govern.
- Best practice standards applicable to other companies will become benchmarks for regulators as well as litigants.
- The subject of conflicts of interest, already a focal point for the press, will receive even more scrutiny from Boards, regulators and litigants.

- Loans to insiders will draw more attention.
- Non-audit services provided by auditors are being increasingly scrutinized, and this is true of services provided by other consultants as well, to minimize conflicts and insure objectivity.
- The amount and structure of Board and committee compensation will change. While we may continue to see undifferentiated compensation among directors at the Board level, such will not continue to be the case at the committee level, particularly in the case of committees which bear substantially increased responsibilities.

#### IV. WHAT CAN BOARDS LEARN FROM THE CURRENT GOVERNANCE PROBLEMS?

- **Integrity is everything.** It is the root of stakeholder and public confidence in an organization. Organizational integrity starts at the top, i.e., the Board of Directors and senior management.
- **Organizational culture and Board and management leadership is critical.** Boards must take more responsibility for insuring that the Board and management has appropriate leadership, and that leadership is held accountable. The Board must actively monitor the culture of the organization to assure that it reflects ethical values and trustworthiness.
- **Boards must take more responsibility for compensation, perks and incentives.** The media and several institutional shareholders have flogged this subject for years. And it's critical that Boards do a better job. Recent disclosures of compensation levels and perks paid to senior management of troubled companies have incensed the public and their political representatives. Compensation plans for senior executives and other managers must be reviewed to assure improper behavior is not incentivized. Boards must realize that excessive director and executive compensation reflects poorly on their independence, integrity and judgment. Finally, some business groups may be addressing the problem; see the September 17, 2002, Conference Board Blue Ribbon Commission report on executive compensation.
- **Boards must carefully assess actual and perceived conflicts of interest.** Conflicts of interest in general, but particularly involving directors, senior management and key advisors, must be carefully assessed, and independent advice sought where necessary. This was a major problem with several of the Enron special purpose entities. Like the compensation issues, unresolved or poorly resolved conflicts of interest reflect badly on Boards' independence, integrity and judgment.

- **Directors must pay close attention to their core duties: care, loyalty, compliance and oversight.**
  - ❑ **Care in every decision.** Be informed. Directors shouldn't approve matters they don't understand. Real or perceived pressures shouldn't overshadow the duty to make an informed judgment.
  - ❑ **Loyalty.** The interests of the company always come first. Directors shouldn't use their position or the confidential information they gain for their or others' benefit. Boards must avoid being compromised by compensation or benefits which could actually, or be perceived in hindsight to, compromise their judgment.
  - ❑ **Compliance.** Pay attention to the company's governing documents, policies and agreements, and the laws and regulations to which the company is subject. It is difficult to enforce a company's code of conduct and standards of legal compliance if the Board and management don't conduct themselves accordingly.
  - ❑ **Oversight.** A Board's job isn't to manage; it's to vigorously oversee and evaluate management. The CEO reports to the Board, not the other way around. An adversarial relationship with management is counterproductive. Collaboration is essential. But personal relationships and compensation can't be allowed to obscure the need for vigilant oversight.
- **Boards must strive to understand risks.** Every business has internal and external risks. Policies and procedures for assessing and monitoring risks are essential, and directors must assure that they are in place and functioning well. Risk managers should have direct access to the Board.
- **Boards must pay attention to warnings.** A number of Enron employees expressed concerns about the company's financial practices and condition. The initial reaction to Sherron Watkins' warning letter was inadequate. The investigation of her concerns was very limited in scope. Warnings need to be heeded and promptly investigated. Investigation means a thorough effort to obtain all relevant information, using independent resources where necessary to assure objectivity.

In this regard the ABA Task Force Report will also be valuable because it tackles another controversial subject: namely, internal and external lawyers' duties to prevent or rectify corporate misconduct. Suffice it to say that the ABA Task Force sees the importance of lawyers being proactive in this regard and recommends changes in certain Model Rules of Professional Conduct to underscore this duty. Lawyers, as well as accountants and other advisors hired by an organization, need to remember that the organization is their client and its best interests must be served even if that entails conflict with a representative of that organization.

- **Boards must confront problems promptly and forthrightly.** History provides ample lessons of the disastrous consequences of cover-ups. The U.S. Sentencing Guidelines offer incentives for effective discovery of, and dealing with, problems. As

the Arthur Andersen prosecution and the Sarbanes-Oxley Act have underscored, companies should be extremely careful about altering or destroying information if governmental investigations or litigation may reasonably be foreseen, and Boards should see that appropriate policies are in place in this regard.

- **Transparency is good; obscuring reality is bad.** Transactions, schemes or practices which make it difficult for those who rely on the company's financial information to clearly understand that information will be questioned. Boards need to be increasingly aware that if third parties' decisions are made based on potentially misleading omissions or information, litigation and government investigations may ensue.
- **Targets are good; quarterly earnings obsessions are bad.** Agreed that plans, targets and accountability are good. But not when the targets are unrealistic or the pressures or incentives to achieve them so great as to result in deliberate distortions, or the use of "cutting edge" accounting or business practices. A recent survey by *CFO Magazine* found that 17% of CFOs, many from the nation's largest companies, had been pressured by CEOs one or more times in the last five years to misrepresent financial results. Directors need to be aggressive about investigating and ending that pressure.
- **Monitor corporate disclosures.** Boards are increasingly aware of the company's responsibility for accurate, complete disclosure to banks, creditors, insurance companies, government tax and regulatory authorities and others who rely on or require the company's business and financial information. Boards must also be aware of the many ways in which the company provides information, e.g., public comments by management, management conduct, media interviews, analyst updates, press releases, websites, broadcast or directed email, regulatory agency filings and a multitude of forms and applications for other third parties.
- **Reputations take years to build; moments to lose.** For most companies their reputations and goodwill are among their most valuable assets. Boards must be alert to individual and corporate conduct which compromises a company's reputation for integrity and trustworthiness with employees, suppliers, customers, lenders and stockholders. As we've seen the consequences of a breach of trust can be brutal.
- **Good governance practices.** Good governance in actuality, not just in appearance. The Boards of many companies now in the news are populated with individuals who have excellent credentials. Usually the appropriate Board committees are in place. However, good governance is about organization, process and **EXECUTION**. And finally **EVALUATION** -- evaluation of management, principally the CEO, evaluation of the Board, and evaluation of directors.