

**CORPORATE GOVERNANCE AND ORGANIZATIONAL INTEGRITY**

*Meeting of Corporate Committee  
Trans European Law Firms Alliance  
4 and 5 June 2004  
Hamburg, Germany*

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**I. THE CURRENT CORPORATE GOVERNANCE ENVIRONMENT AND THE RESPONSIBILITIES OF BOARDS OF DIRECTORS: A MATTER OF INTEGRITY.**

1. **Corporate integrity is the overriding responsibility of Boards of Directors and senior management.**
  - **What stakeholders need most from Boards of Directors and senior management is assurance of an organization's integrity – including an assurance that corporation's values and culture support that integrity.**

Specifically:

- That the Board of Directors is uncompromising in the selection, evaluation and retention of directors of high integrity and skill, who are knowledgeable about organizational governance and dedicated to the organization's integrity and performance.
- That the Board of Directors is uncompromising in the selection, evaluation and retention of executive management of high integrity and skill, dedicated to the organization's integrity and performance.
- That the corporation's financial statements have integrity – in other words that they can be clearly understood and relied on by those responsible for assessing the financial condition of the company for purposes of investing in it and doing business with it – *e.g.*, its financiers, employees, suppliers and customers, and various regulatory authorities.
- That the Board and senior management recognize their joint roles in assuring that the organization has, and practices, values that support a culture of integrity, fairness, trust, and high performance.

A key element in leadership is trust. Boards and senior executives must be extremely sensitive to the signals they send to the organizations they lead. Signals include who is selected for Board service, who is hired to serve as the

senior executive, what behaviors are endorsed or permitted at the Board, management and staff levels, how people are rewarded, etc.

While reports on Enron, WorldCom, Tyco and a number of other highly publicized examples of corporate misconduct cite a variety of failures, underlying those specifics are often cultures of excess and greed, an imperial executive management team and Boards which appear in many ways to have worked for management rather than the reverse.

- ❑ That the public disclosures and comments of senior management and the Board have integrity and are reflective of the true state of the company's affairs. Consider the ethics of a CEO's touting an organization'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 in 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 a corporation's advisors and consultants, including lawyers and accountants, will act to protect the organization's integrity, and take important issues to senior management and the Board of Directors to assure that they are acted on appropriately.
- ❑ 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 corporation's integrity.
  - ❖ This was extremely problematic for the New York Stock Exchange Board of Directors recently.
  - ❖ This was an issue for the Minnesota Attorney General in his recent investigation of two large health care organizations.
  - ❖ The National Association of Corporate Directors recommends the elimination of "perks" and "benefits" from director compensation.
  - ❖ For years executive compensation has been a troublesome issue for many organizations, and is still very much a focus of regulators, shareholders and the media.
- ❑ That directors and management will avoid actual or perceived conflicts of interest which would detract from the integrity of the company 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 company –

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 is that the ultimate authority for the governed entity is responsible for the entity's integrity. In many of the current corporate scandals the Boards failed because they did not take responsibility for the organizations' integrity. The directors did not see the organization's integrity as an extension of their own integrity – and ultimately that is the critical point.

## 2. **After integrity, what are the key Board responsibilities?**

The National Association of Corporate Directors Blue Ribbon Commission on Director Professionalism identified key director duties as including:

- Approving an organization's philosophy and mission.
- Selecting, monitoring, evaluating, compensating, and, if necessary, replacing the CEO and other senior executives, and ensuring management succession.
- Reviewing and approving management's strategic and business plans, including developing a depth of knowledge of the business being served, understanding and questioning the assumptions upon which such plans are based, and reaching an independent judgment as to the probability that the plans can be realized.
- Reviewing and approving the organization's financial objectives, plans, and actions, including significant capital allocations and expenditures.
- Reviewing and approving material transactions not in the ordinary course of business.
- Monitoring organizational performance against the strategic and operating plans, including overseeing operating results on a regular basis to evaluate whether the organization's activities are being properly managed.
- Ensuring ethical behavior and compliance with laws and regulations, auditing and accounting principles, and the organization's own governing documents.
- Assessing the Board's effectiveness in fulfilling these and other Board responsibilities.

- Performing such other functions as are prescribed by law, assigned to the Board in the organization's governing documents, or required or desirable in the course of governing the organization's affairs.

Boards are also responsible for their own composition, organization and leadership in order to effectively perform the above-described responsibilities. In this regard Boards will often utilize the following governance documents:

- Principles of corporate governance.
- Board charter.
- Committee charters.
- Description of individual director responsibilities.

## **II. TWO REACTIONS TO RECENT CORPORATE GOVERNANCE PROBLEMS BODE WELL FOR THE FUTURE:**

- 1. The emergence of recognized good corporate governance practices, and**
- 2. The evolution of the proactive Board.**

- **First, the emergence of recognized good governance practices.**
  - For many 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 the General Motors Board a decade ago).
    - ❖ Corporate governance practices authored by institutional investors such as TIAA-CREF and CALPERS, and proxy advisors such as Institutional Investors Services.
    - ❖ State and federal legislatures. State corporate laws for the most part do not distinguish between public and private corporations with respect to governance and the duties of directors.
    - ❖ 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 several state Attorneys General.
    - ❖ State and federal court decisions.

- ❖ 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 such as 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.
  - ❖ Corporate Governance Ratings Agencies. Institutional Shareholder Services (61 metrics), Governance Metrics (625 metrics), The Corporate Library, Moody’s and Standard and Poors are providing corporate governance ratings for public organizations. Many of their metrics will also be a source of governance best practices.
- Good governance practices generally speak to the following subjects:
- ❖ **Board organization and leadership.**
    - A Board should have a written charter.
    - Should the Board have a separate chair or other non-management leadership?
    - What committees should the Board have? Independent audit, governance and compensation are required of public companies for all practical purposes.
  - ❖ **Board composition.**
    - A substantial majority of independent directors? What is the Board’s definition of independence?
    - What skills are needed?
    - Who are the organization’s stakeholders? How do we reflect their interests/needs in the director selection process?
    - How do we value “diversity” in our director choices?
  - ❖ **Director selection process.**
    - How are directors selected?
    - 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 size.**

❖ **Board processes.**

- 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 is he or she no longer eligible for service)?
- Should directors submit their resignation on a change of job or other events?

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

- See prior discussion of duties.
- Elect corporate officers.
- 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 (activity segment, organization, governance).
  - Review conflicts of interest involving senior executives and directors, including current and proposed other directorships held by officers and directors.
  - Agree on other corporate actions with respect to which Board wants approval or consultation.
  - Board, committee and director evaluation.
- ❖ **Board compensation.**
- ❖ **Evaluation of Board and Committee performance.**
- Criteria for performance.
  - How frequent?
  - Process.
- ❖ **Evaluation of director performance.**
- Criteria for performance.
  - How frequent?
  - Process.
- ❖ **Committee organization; compensation.**
- Member composition.
  - Member selection process.
  - Committee duties (charter).
  - Committee compensation.
- ❖ **Director protection (indemnification, insurance, etc.).**
- ❖ **Stakeholder interaction/communications.**

- Many of the above-listed good governance practices speak to the creation of a governance environment which will take responsibility for facilitating/monitoring a culture of ethical conduct and legal compliance. This is also true of recent changes in the listing standards adopted by the New York Stock Exchange and NASDAQ.
- The ABA Corporate Responsibility Task Force Report.
  - ❖ The Task Force was charged with looking at corporate responsibility issues raised by a number of high profile corporate accounting and conduct issues which raised questions about the effectiveness of corporate governance, accounting and disclosure of public companies. The Report makes clear, however, that the issues raised are also applicable to private companies and nonprofit organizations.
  - ❖ The Task Force made a number of governance recommendations and compares those with recommendations made by the New York Stock Exchange, NASDAQ, the SEC and other selected organizations:
    - Boards should be comprised of a substantial majority of independent directors.
    - Routine executive sessions of independent directors.
    - Governance Committee comprised of independent directors should identify and nominate the Board's independent directors, and appoint committee members.
    - Audit Committee comprised of independent directors should control the relationship with the organization's auditors. The Report also suggests a number of duties which the Audit Committee should perform.
    - Compensation Committee comprised of independent directors should be responsible for senior management compensation and engagement of compensation consultants.
    - Governance Committee should develop a code of conduct/ethics, and a process for ascertaining compliance.
    - Board or a Board committee should review and approve all material transactions between the organization 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.
    - Institute director education.

➤ Institute Board, committee and director evaluation.

- **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.
- ❑ The current corporate scandals and resulting litigation 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 NASDAQ, governance rating agencies, current court decisions, as well as the positions taken by institutional investors and business groups, and the ABA Corporate Responsibility Task Force.

### **III. SARBANES-OXLEY AND RECENT CORPORATE GOVERNANCE DEVELOPMENTS: THE IMPACT ON FOR-PROFIT AND NONPROFIT ORGANIZATIONS.**

- 1. Broad Impact on governance of various organizations.** Public corporations must comply with Sarbanes-Oxley and the regulations issued by the U.S. Securities and Exchange Commission pursuant to SOX. Beyond the compliance required of publicly-held corporations, SOX and related governance developments are having a broad impact on the governance practices of U.S. organizations.
- 2. Sarbanes-Oxley’s Underlying Principles: a focus on organizational integrity.**
  - The Board is responsible for the integrity of the organization. Vigorous oversight of the organization and its management and greater proactivity are required of Boards.
  - Director independence is essential.
    - ❑ Independence needs to be defined.

- Executive sessions of the Board are an important aspect of Board independence.
  - Organizational resources should be utilized to support independent Board oversight.
- Auditor independence is essential; non-audit services must be scrutinized. Partner rotation and firm rotation should be considered.
- The Board should have an independent audit committee with authority to hire and fire the organization's auditors.
  - Audit Committee members should be financially literate; in larger organizations at least one should be a financial expert.
- The Board should have an independent governance committee to oversee all governance aspects of the organization, including nomination of directors, evaluation of the Board, committees and individual directors, and articulation of the organization's corporate governance principles.
- The Board should have an independent compensation committee which oversees director and executive compensation.
  - Loans to directors and employees should be prohibited.
- A corporation's attorneys' primary duties are to the entity and not management. Concerns affecting the well-being of the entity should be addressed with management and reported up the ladder.
- The organization's financial and business information should fairly present, on a current basis, the condition of the organization. CEO and CFO certifications to certain aspects of the organization's internal controls are required. In some companies "back-up" certifications are being required of other managers.
- The company should have a code of ethical conduct applicable to directors, executives and employees (and independent contractors and suppliers).
  - The Board is responsible for compliance, and should see that procedures and processes are in place to monitor the company's compliance with laws, regulations and its own policies.
  - Conflicts of interest must be avoided, and carefully dealt with when they occur.
- Corporate information must not be tampered with or destroyed if relevant to an actual or perspective government investigation or proceeding, or private litigation.
- Corporate employees who alert the organization to compliance issues must not be the subject of retaliation.

- Board, committee and director performance should be periodically evaluated.
- The Board and its committees should have the authority and resources to hire independent advisors to assist with the performance of their duties.

### **3. Observations.**

- We will continue to see a shift to proactive Boards. Vigorous oversight will become more the norm.
- There is a heightened focus by Boards on governance of the company and the organization and leadership of the Board.
- There is a greater focus on the audit committee, its composition, the definition of its responsibilities, and its performance.
- State legislatures will consider and are considering enacting provisions similar to many of those in the Sarbanes-Oxley Act; or preparing their own version of corporate disclosure/conduct requirements.
- 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 are looking at examples of good corporate governance practices, and bringing those practices to the companies they govern.
- Good governance policies adopted by various organizations 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 is changing. 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.
- After the New York Stock Exchange executive compensation issues, Boards will increase their efforts to manage this subject more appropriately.

- Codes of ethics and compliance policies are being adopted by more organizations, and Boards will more carefully monitor adherence. Given the attention focused on the waiver of certain conflicts of interest by the Enron Board of Directors, Boards will be very cautious about waiving conflicts or suspending ethical conduct policies.
- Document retention policies will be adopted by more organizations, and Boards and management will more closely monitor compliance.
  - Document retention policies apply to written and electronically stored data. Email is worthy of special note, and organizations should address their rights to access and view employee email as well as sending, forwarding and saving email messages.
- Boards and Board committees will more frequently engage independent counsel and other advisors to assist them in the performance of their duties.

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May 25, 2004

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