

***POST-ENRON CORPORATE ACCOUNTABILITY
FOR COMPANIES BIG AND SMALL
Hamline University School of Law
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***“The Board’s Role in Compliance”
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I. CORPORATE COMPLIANCE AND THE RESPONSIBILITIES OF BOARDS OF DIRECTORS: IT’S ABOUT INTEGRITY.

- 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 the 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 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 culture that values integrity and ethical behavior begins with the tone at the top.

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/promoted to serve as a senior executive, what behaviors are endorsed or permitted at the Board, management and staff levels, how people are rewarded, and how employees, suppliers, customers, shareholders and the stakeholders are treated.

While reports on Enron, WorldCom, Tyco, Global Crossing and a number of other highly publicized examples of corporate misconduct cite a variety of

failures, underlying those specifics often were 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.
- 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 benefits paid to Board members and senior management, which directors alone approve, will not in actuality or perception co-opt their judgment, compromise their independence, detract from the corporation's integrity, or have a corrosive effect on the company's culture. Behavior and actions which negatively impact integrity and culture undermine the company's ethics and compliance initiatives.
- That directors and management will seek to avoid actual or perceived conflicts of interest which would detract from the integrity of the company and its governance, and if they occur that they will be dealt with promptly and appropriately.
- 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.
- 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.
- 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.

II. BOARDS AND COMPLIANCE – WHAT CAUSES THE FAILURES? LESSONS FROM ENRON, WORLDCOM, TYCO, ADELPHIA, GLOBAL CROSSING, HEALTHSOUTH AND HOLLINGER.

- Directors often don't really understand their oversight roles.
 - They may be good managers, but they aren't good overseers.
- Boards don't thoroughly assess organization, business, financial, legal and personnel risks.
- Many directors don't understand what it means to be a fiduciary.
- Non-management directors are often intimidated by management, uncritically reliant on the views of management and advisors, or passive. This was apparently the case in Enron, WorldCom, Tyco, etc.
 - Blind faith in CEO and management team.
 - Belief that if the company hires a well credentialed CEO, CFO, name accounting firm, law firm or investment banker, etc., the directors can rely without oversight or inquiry. That isn't the law.
 - Failure to probe management, lawyers, accountants, advisors.
 - Failure to get to know second and third tier employees.
 - Failure to effectively evaluate CEO performance, and to interact with CEO regarding evaluation of senior management.
- Failure to understand/monitor the corporate culture.
 - Result was, in many cases, a culture of "me first," arrogance, greed.
 - Result was a culture where people didn't bring concerns about wrongdoing forward.
 - Tight control of information; development of information silos.
 - Discouraging dissent.
 - High performers were rewarded and exempted from compliance with the values and policies of the organization.
- Failure to appreciate the signals Boards send about the values and ethics of the organization.
 - Who they recruit for the Board.

- ❑ Who they hire as CEO. Who the CEO hires/promotes into senior management positions.
 - ❑ How they compensate management versus how management compensates the employee base.
 - ❑ What behaviors they reward. What behaviors they sanction (or fail to sanction).
- Failure to appreciate and use the oversight tools at their disposal.
- Failure to observe good governance practices.
 - ❑ Board is passive, not a proactive overseer.
 - ❑ Board members don't embrace their responsibilities; don't exhibit commitment, judgment, leadership, courage.
 - ❑ Board co-opted by pay, perks, relationships - i.e., not sufficiently independent or objective. Many of the directors were hand-picked by the CEOs and were friends, had business relationships, served on each others' Boards, etc.
 - ❑ Insensitivity to conflicts of interest.
 - ❑ Committee failures.
 - ❖ governance: re independence.
 - ❖ compensation: excessive amounts; perks; loans; no, or superficial, CEO evaluation.
 - ❖ audit: financial statements (these are the company's statements, not the auditors); compliance.
- Failure to perform legal duties.
 - ❑ Oversight.
 - ❑ Good faith.
 - ❑ Care.
 - ❑ Loyalty.
 - ❑ Compliance.
- Poor appreciation and handling of conflicts of interest.
- Failure to heed, or react appropriately and promptly, to warnings.

- ❑ Board awareness of warnings.
 - ❑ Board led investigations.
- Board education.
 - ❑ Insufficient knowledge of the company and industry.
 - ❑ Insufficient knowledge about governance.
 - ❑ Insufficient knowledge of their duties and their liabilities.
 - ❑ Insufficient knowledge of corporate strategy.
 - ❑ Insufficient appreciation of business risks and vulnerabilities.
 - ❑ Lack of appreciation for, and often resistance to, the importance of continuing education to enhance their directorship knowledge and skills.

III. SEVERAL REACTIONS TO RECENT GOVERNANCE PROBLEMS EVIDENCE A RECOGNITION OF THE BOARD'S ROLE IN COMPLIANCE:

1. The emergence of recognized good corporate governance practices.
2. A resurgent focus on organizational values, ethical conduct and compliance.
3. The evolution of the proactive Board.

IV. HOW CAN BOARDS USE GOVERNANCE TO IMPROVE THEIR ORGANIZATIONS' ETHICS AND COMPLIANCE ENVIRONMENTS?

- Governance is a discipline different from management. It's about proactive, vigorous oversight. Who populates Boards? Often it's people who have excelled at management. The challenge is developing excellence at governance.
- Integrity is everything. It is the root of stakeholder and public confidence in a company. Organizational integrity starts at the top, i.e., the Board of Directors and senior management.
- Board oversight of the corporate culture is critical. Boards must understand and take responsibility for the corporate culture. In this regard Boards must assure that the Board and management have appropriate leadership that is committed to and accountable for the existence of an ethical, compliant culture.
- 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 organizations have incensed the public and their political representatives.

- Boards must also be aware of the corrosive effect on the corporate culture, particularly trust, which can result from poor compensation practices at the Board and management levels. In this regard the issue is not just the amount of compensation; it is the incenting of certain performance. Boards should review compensation plans for senior executives and other managers to assure improper behavior is not incentivized.
 - Boards must realize that excessive director and executive compensation reflects poorly on their independence, integrity and judgment.
 - The bottom line is that Boards must assure that management establishes the compensation and incentives for any group in the context of an overall compensation philosophy for the organization which is in fact, and perception, fair.
- 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. Like the compensation issues, unresolved or poorly resolved conflicts of interest reflect badly on Boards' independence, integrity and judgment, and can have a corrosive effect on the corporation's culture.
 - Boards must pay more attention to the organization's human capital. Boards have always accepted responsibility for the organization's financial capital. They must devote equal attention to the organization's human capital.
 - Directors must pay close attention to their core duties: care, loyalty, good faith, 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 organization 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.
 - Good Faith. Directors must act in good faith. Generally directors may not be indemnified by the organization if their act or failure to act was not in good faith.
 - 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 message of compliance doesn't start with the Board and senior management, both in terms of emphasis and conduct.

- 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, pay attention to warnings and confront problems promptly and forthrightly. Policies and procedures for assessing and monitoring risks are essential, and directors must assure that they are in place and functioning well. 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. History provides ample lessons of the disastrous consequences of cover-ups. A cautionary note: When conducting an investigation pay close attention to issues of attorney-client privilege.
- Boards must use the tools at their disposal to effectively execute their oversight responsibilities.
 - Selection of capable directors, known to be ethical and screened for past legal and ethical issues, knowledgeable about governance and oversight, who have the time, energy, knowledge, judgment, leadership and courage to effectively discharge their responsibilities.
 - Selection of a CEO, known to be ethical and screened for past legal and ethical issues, who is experienced and committed to building a corporate culture that is ethical and compliant, and holding the CEO accountable for the development of that culture.
 - Selection of independent Board leadership with the knowledge and skills to assist the Board in meeting its responsibilities.
 - Periodic independent assessments of the company's culture, ethics, values and compliance, and the effectiveness of training programs designed to instill appropriate corporate values, familiarize employees with the company's ethics and compliance expectations and assure those expectations are met.
 - Insistence that management have in place processes and procedures for preventing and detecting violations of laws, regulations, company governing documents and company codes of ethical conduct. Oversight over, and periodic assessment of, the efficacy of those processes and procedures.
 - Oversight over the evaluation, hiring, firing and compensation of employees who are key to assessing and shaping the corporation's financial reporting, human resources, risk assessment, investor relations and ethical and legal compliance environment. *E.g.*, the CFO, controller, internal auditor, risk manager, internal

counsel, investor relations officer, compliance officer. Periodic one-on-one interviews with the responsible individuals are an essential check.

- Independent contact with key corporate advisors: outside counsel, independent auditors, various consultants.
 - Engagement of the independent auditors and compensation consultants; oversight over the engagement of outside legal counsel and other key advisors to assure that the loyalty of these advisors is to the company and not the personnel at the company who engaged them.
 - Engagement of independent counsel and consultants to advise the Board, or Board committees, on matters with respect to which the Board requires a “second opinion” or advice from a service provider who is not regularly engaged to serve the company under management’s direction.
 - Use of tools such as business intelligence and balanced scorecard software to assist with monitoring.
 - Use of corporate and outside investigatory and research resources to scan backgrounds of key people and organizations.
 - Use of search firms to assist with the identification and screening of director and CEO candidates.
- 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 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 organization’s responsibility for accurate, complete disclosure to banks, creditors, insurance companies, government tax and regulatory authorities, the securities markets (in the case of publicly-held companies or organizations which issue publicly-held debt) and others who rely on or require the organization’s business and financial information. Boards must also be aware of the many ways in which the corporation provides information, e.g., public comments by management, management conduct, media

interviews, press releases, websites, broadcast or directed email, regulatory agency filings and a multitude of forms and applications for other third parties.

- Boards must be extremely conscious of the signals they send to the organizations they govern. Signals which come from their own conduct, who they nominate as directors, who they hire as the CEO, what conduct they endorse, what values they espouse directly and indirectly, how they deal with behavior which is antithetical to those values, and situations which test those values – it's about the culture of the organizations for which they are ultimately responsible.
- Directors need to be schizophrenic. Vigilant overseers, on the one hand, and effective, constructive collaborators on the other.
- Boards must focus on reputational value as reputations take years to build and moments to lose. For most organizations their reputations and goodwill are among their most valuable assets. Boards must be alert to individual and organizational conduct which may compromise a company's reputation for integrity and trustworthiness with its various stakeholders. 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 organizations now in the news are populated with individuals who have excellent credentials. Often the appropriate governance documents and Board structures are in place. However, good governance is about organization, process, education and **EXECUTION**. And finally **EVALUATION** -- evaluation of management, principally the CEO, evaluation of the Board, and evaluation of directors.

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