

**PRESENTATION: WOMEN ON BOARDS PROGRAM**  
*Jointly Sponsored by the*  
*National Association of Women Business Owners*  
*and the Minnesota Chapter of the National Association of Corporate Directors*  
*Wednesday, November 5, 2003*

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I. CURRENT DEVELOPMENTS IN CORPORATE GOVERNANCE.

- **More people are realizing that governance is a discipline different from management.** It's about oversight.
- **Assuring corporate integrity** – the Board's No. 1 job.

By integrity, I mean 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.

- 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.
  - ❖ I have also read the investigative reports respecting Enron and WorldCom. While these reports cite many failures, underlying these specifics was a culture of excess and greed, an imperial executive management team and Boards which worked for management rather than the reverse.
- **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 was challenged because of former Chairman 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.**
- **The emergence of recognized corporate governance standards.**
  - **Sources:**
    - ❖ 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, 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 the New York Attorney General and Minnesota Attorney General Mike Hatch.
  - ❖ State and federal court decisions.
  - ❖ Various business organizations such as the Conference Board and Business Roundtable. On February 6, 2003 the Better Business Bureau released an exposure draft of “Standards for Charitable Accountability.”
  - ❖ 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.
  - ❖ 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 companies. Many of their metrics will also be a source of governance best practices.
- **Subjects:**
- ❖ **Board organization and leadership.**
    - A Board should have a written charter.
    - Should the Board have a separate chair or other non-management leadership? In contrast to business organizations this is more often the case with nonprofit organizations.
    - What committees should the Board have? Audit? Governance (nominations)? Compensation?
  - ❖ **Board size.**
  - ❖ **Board composition.**
  - ❖ **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 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?**

- Assuring the integrity of the organization. Vigorous oversight.
- Overseeing the culture and values of the organization.
- Elect corporate officers.
- Overseeing the organization's human capital policies.

- Annual CEO evaluation and compensation.
  - CEO/management succession planning.
  - Oversight over the compensation and retention of other key management and compliance personnel.
  - Review/approve strategy.
  - Review/approve annual budget.
  - Review/approve extraordinary expenditures (or extraordinary expenditures above certain dollar amount).
  - Review/approve transactions not in ordinary course of business.
  - Review quarterly operating results against plan/budget.
  - 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, business segment, company, governance).
  - Review conflicts of interest involving senior executives and directors, including current and proposed other directorships held by officers and directors.
  - Agree on other organization actions with respect to which Board wants approval or consultation.
  - Board 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.

❖ **Stakeholder interaction/communications.**

❖ **Orientation and education of directors.**

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

- ❑ 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 of the New York Stock Exchange and NASDAQ (which were approved by the Securities and Exchange Commission on November 4, 2003), 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.

## II. WHY DO BOARDS FAIL?

- **Poor understanding of duties and how to execute oversight.**
- **Poor organization and leadership at the Board level.**
- **Inappropriate reliance on, and deference to, management.**
- **A lack of independence – definitionally and behaviorally.**
- **A lack of awareness of the organization’s culture and values, and their implementation.**
- **A lack of appreciation for the signals Boards send to the employees of an organization regarding ethics and values.**
- **Inappropriate reliance on experts and advisors.**

## III. ASSESSING THE RISKS OF CORPORATE DIRECTORSHIPS.

- **Governance risks.**
- **Management risks.**
- **Industry/business risks.**
- **Financial risks.**
- **Regulatory risks.**
- **Due diligence is essential.**

## 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. Some business groups have started to address the issue; 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 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.

- **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 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.
- **Schizophrenia is helpful.** Directors must be schizophrenic; constantly vigilant on the one hand; constructively collaborative on the other.
- **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 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 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, education and **EXECUTION**. And finally **EVALUATION** -- evaluation of management, principally the CEO, evaluation of the Board, and evaluation of directors.