

DM EXTRA!

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Annual NACD Conference Examines Recent Dramatic Changes in Boardroom

Experts analyse reforms and flag trends.

Director Summary >

In October 2004, the NACD held its annual corporate governance conference, "Board Leadership: Evolution or Revolution," drawing nearly 500 registrants and featuring more than 24 sessions. The following are highlights from the conference, as reported recently in Corporate Governance Highlights, a publication of the Investor Responsibility Research Center of Washington, D.C.

Boardroom Dynamics Transformed by Governance Reforms

Panelists in a workshop on "The Effect of Governance Reforms on Boardroom Dynamics" identified both positive and negative effects on boardroom dynamics resulting from recent governance reforms, providing those in attendance with a predominantly positive view of

the current changes in board chemistry and the renewed commitment to board independence and accountability.

Panelists Lorin Letendre of the Princeton Group and Louise Slater of Consolidated Systems asserted that a healthy board dynamic is key to board effectiveness and is the next frontier in the research of board development. Having defined board dynamics as "the quality of interactions among directors and between directors and management," the panelists detailed their outlines of healthy and unhealthy board dynamics, focusing on the need for open discussion and diverse perspectives on boards. In order for a board to have a healthy, effective chemistry, directors must bring divergent perspectives to the table, and must be confident and comfortable with asking tough questions

About NACD

National Association of Corporate Directors (NACD), an independent not-for-profit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, closely held, and private firms. NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.



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Former Chancellor William Allen
Delaware Court of Chancery

of management, agreed the panelists. Directors also must understand their role as strategic overseer and must avoid micromanaging the company or pushing hidden agendas. Conversely, the panelists said, an unhealthy board has directors that defer either to management or to dominant directors, lacks diversity, and does not understand its oversight role.

The panelists, as well as those in attendance, said recent governance reforms requiring a majority of independent directors have contributed to healthy board dynamics by affirming the importance of independence and giving independent directors grounds to play a more assertive role on boards. According to many attendees, the reforms have given independent directors a legitimate right, if not a duty, to play a stronger role in asking questions of management. Conversely, some attendees voiced concern that dominant CEOs may be threatened by directors who challenge management’s position and may attempt to “freeze out” certain directors. Overall, however, both panelists and participants seemed to agree that the new focus on independence and accountability has made room for more divergent perspectives and discussion, which are necessary for healthy board chemistry and effectiveness.

The panelists also agreed that the executive sessions now required of boards allow for less structure and more candor, and noted that most good boards were already conducting such sessions before the reforms took hold. Panelists and participants said directors are more willing to challenge each other and to speak freely in the executive sessions. However, panelists also said that in order to avoid distrust and maintain healthy board chemistry, directors should maintain open lines of communication by keeping CEOs informed of the executive session agendas and discussions.

Many workshop attendees said that, as a result of the reforms that now require financial experts to serve on audit committees a “class system” on boards is emerging, under which audit committee members are the “ruling class”—a sort of senior committee of the board. According to these participants, the additional legal liabilities facing the audit committee, as well as the additional work and compensation for audit committee members, has created increased tension and uneven participation on boards. Attendees also discussed the danger of financial expertise being pigeonholed in the audit committee, and of other directors deferring to audit committee financial experts. Slater and Letendre, as well as conference attendees, responded that nonfinancial experts should be valued as audit committee members, and further noted that all directors should be financially literate. Letendre added that having the full board meet with the company’s auditors is helpful in creating even levels of board participation as well as in keeping the full board informed of audit matters. Several attendees also suggested rotating committee memberships approximately every three years to maintain a more equal distribution of board work.

Courts Subject Directors to Greater Scrutiny

Panelists in a session on “Director Liability in a Changing Marketplace” said the courts are more closely scrutinizing the actions of directors and officers in terms of whether they have complied with their fiduciary duties to shareholders. One of the panelists, **Joseph Allerhand**, a partner at the law firm of **Weil, Gotshal & Manges**, commented that, before even considering recent changes in legal standards to which directors may be held, it is evident that under the existing standards for directors that courts are examining directors more closely. Because judges read the newspapers every day, they too have become sensitized to the recent corporate scandals involving fraudulent reporting of financial statements, he said. As a result, judges are less likely to dismiss at an early stage of litigation claims of fiduciary duty violations that have been brought by shareholders where there is the potential for fraud.

The panel discussed the changes brought about in corporate law by recent Delaware court decisions in the **Disney**, **Oracle**, and **Emerging Communications** cases. One panelist, former Chancellor of the **Delaware Court of Chancery William Allen**, commented that the Disney case legitimized the notion that directors could potentially be held liable when they have breached their “fiduciary duty to act in good faith” by showing a “deliberate indifference” toward their responsibilities as directors. The central claim in the Disney case is that Disney’s board

breached its fiduciary duties by its ill-considered approval of a severance package totaling more than \$100 million for short-lived Disney President **Michael Ovitz** in connection with his 1996 termination. The panelists noted that further court decisions in the Disney trial, which is set to begin Oct. 20, 2004, may add more clarity to when directors may be held liable for approving excessive executive compensation.

John Olson, a senior partner with the law firm of **Gibson, Dunn & Crutcher**, also cited the Disney case when he spoke on a panel entitled, “Facing Executive Compensation Head On.” He said that in letting the case go forward, the Delaware Chancellor made his decision based on the theory that the board was involved so little in the negotiations over Ovitz’s compensation that it may be guilty of a lack of good faith. The basis for his decision is important because if it is ultimately determined that the board lacked good faith, directors would not be subject to a limit on damages, and they could not be indemnified by the corporation, he said. Cases like the Disney case should be focusing compensation committees on process and the quality of the information they are receiving, said Olson.

The panel on director liability agreed that directors are unlikely to be held personally liable to shareholders when they do act in “good faith” and when they truly are “independent.” The panel commented, however, that the definition of independence under Delaware corporate law has become more restrictive as a result of cases such as the one involving Oracle. In that case, directors serving on the company’s special litigation committee were held to not be independent because they were faculty members at **Stanford University**, a school to which Oracle had made charitable contributions and to which certain Oracle officials had academic ties. Some believe this decision expands the prior law on independence, which, many say, held that independence was lacking only where directors had direct financial interests in a transaction. Former Chancellor Allen commented that a good way to understand the new context of director independence is that directors should not consider themselves independent when the relationships they have might lead to them to consider anything other than the merits of the transaction on which they are voting.

Allerhand discussed another case that can be interpreted as increasing directors’ liability. In the Emerging Communications case, the Delaware Court of Chancery established a higher standard of judicial review for directors with specialized knowledge. In the case, shareholders challenged a transaction in which Emerging Communications (ECM) CEO, **Jeffrey Prosser**, sought to purchase the 48 percent of Emerging Communications that

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Gen. P.X. Kelley

he did not already own. The court held that, in part because the transaction was undertaken at an unfair price, Prosser had violated his duty of loyalty to the corporation. The court also found that director **Salvatore Muoio** violated his duty of loyalty because “he voted to approve the transaction even though he knew, or should at the very least have had strong reason to believe, that the \$10.25 price per share merger price was unfair.” Muoio had been a securities analyst covering communications companies at **Gabelli & Co** from 1985 to 1995, worked at the investment bank **Lazard** from 1995 to 1996, and subsequently opened his own financial advisory firm. As a result, the court held that “Muoio possessed a specialized financial expertise, and an ability to understand ECM’s intrinsic value that was unique to the ECM board members.”

Expectations of Directors Changed Dramatically

In a session on “Audit Committee Effectiveness vs. Oversight: Drawing the Line Between Compliance and Micro Management,” the panel discussed recent changes to audit committees. Panelists **Mark Terrell**, of **KPMG’s Audit Committee Institute**, **General P.X. Kelley**, former commandant of the **U.S. Marine Corps** and a director on three corporate boards, and **Brian Pastuszewski**, co-chair of securities litigation at **Testa, Hurwitz & Thibault**, all agreed that the enactment of the **Sarbanes Oxley Act** and the creation of the **Public Company Accounting Oversight Board** have been two of the most significant changes to audit committees since **Arthur Levitt’s Blue Ribbon Committee** on audit committees in 1998. Kelley added, “Nothing sharpens focus as much as the threat of being hung in a fortnight.”

Prior to 1998, there were no SEC enforcement actions against directors, noted Pastuszewski. “Now outside directors have a bull’s eye on their backs,” and some directors are being investigated, not for downright fraud, but for “simply being asleep at the wheel,” he added. For the first time in history, the three branches of government—justice, legislative, and executive—are working together to identify and prosecute white collar crime, which has changed the risk-reward ratio and has increased directors’ interest in director and officer insurance and cor-

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and Chair of the President's
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porate indemnification. Other panelists pointed out that the audit committee and its chairman now have a job description and specific authority that they did not have before.

All agreed that if there is an active, concerted effort to bend the rules, especially if the auditor is complicit, fraud can occur no matter how diligent an audit committee is. One panelist said the solution can be found in corporate culture, standards of behavior, a respect for the rules and rewards for good behavior.

Culture Sets the Tone

At a workshop on "Tone at the Top: The Essential Ingredient in Building and Maintaining an Ethical Culture," retired Chief Justice of the Delaware Supreme Court **Norman Veasey** summed it up when he said, "It's all about culture."

Veasey, along with panelists **Keith Darcy**, president of the **Center for Integrity** and chairman of the **Better Business Bureau Foundation**, and **Peggy Foran**, vice president of corporate governance and secretary for **Pfizer**, discussed how boards can lead the way in setting a tone of corporate integrity and ethics. They stressed the importance of a board and CEO who firmly believe in ethics, fair play and integrity. "Culture," said Darcy, "is how things get done."

Foran said that when evaluating the tone at the top, it is important to look closely at the patterns and signals that employees see coming from leadership. Boards should take the opportunity to talk with second- and third-tier employees and should live the values of integrity and transparency. She also stressed the importance of having a culture of doing the right thing. "Don't do what's required," she said, "do the right thing."

James Comey, Deputy U.S. Attorney General and Chair of the President's **Corporate Fraud Task Force**, said in a keynote speech that when determining whether to charge a company with fraud, the task force considers if the company has a fundamentally sick culture or one that

can be saved, how the company reacted to the reporting of wrongdoing, and whether the company's management is willing to work with the task force to catch the wrongdoers. At **Computer Associates**, he explained, the task force gave the company an 18-month deferral. If, in that time, CA turns itself around, the task force will drop all of the charges, but if it does not, the task force will prosecute. Comey explained that it is important to take such steps because, "You can't prosecute your way to a healthy corporate culture."

New Requirements May Lead to More Diverse Boards

Four experts on board composition spoke about the importance of nominating the right directors to form an effective board. All of the panelists agreed that the traditional method of finding new directors for a board is to ask the current members if they know someone who might be a good candidate. They acknowledged that this method essentially perpetuates all-male boards with overlapping skills and is less efficient than planning strategically for what skills and qualities would fill in gaps in knowledge and experience on the board.

Patricia Flynn, a director on the boards of **American Express Funds** and **Boston Fed Bancorp**, spoke about the staggeringly low numbers of women on corporate boards. She pointed out that women have an expanding role in the economy and offer a valuable perspective to boards. Flynn added that corporate governance changes like the SEC's requirements that companies disclose their nominating procedures and that boards include more independent directors will result in an increase in the number of women directors.

Both **Theodore Dysart**, a board consultant from **Heidrick & Struggles**, and **Robert B. Stobaugh**, professor emeritus of **Harvard Business School**, underscored the need for directors to use a skills matrix to think strategically about what expertise is missing on a board and then recruit candidates accordingly. They stressed that a good board member is willing to ask tough questions without being adversarial.

In a lively and candid presentation, **Nell Minow**, corporate governance activist and cofounder of **TheCorporateLibrary.com**, connected unbalanced boards with poor corporate governance and excessive board compensation. She asserted that the way a director is recruited to a board makes that person a different kind of director. She cited renowned director **Warren Buffett**, who is considered a terrific director on many boards but who, after voting for an excessive compensation package on the **Coca-Cola** board, was quoted as saying, "Collegiality trumped independence."

Two Perspectives on Board-Shareholder Communication

Shareholders believe that communication between the board and investors is complicated by management's intense opposition to shareholders' gaining access to board members, compounded by a board structure that is not designed to allow for free communication with investors, said participants in a session on "Shareholder Relations: Greatest Challenges and Best Practices." Those panelist with experience as executives responded that most investors, especially large investors, are concerned with communicating with the board only when a major issue or crisis arises, and that this lack of interest is illustrated by the generally low participation of institutional investors at companies' annual meetings.

Free communication with directors and investors may be restricted by SEC Regulation FD, which requires that material facts be disclosed publicly and not to select groups, other panelists noted. Greater education of board members on the requirements of Reg. FD and access to corporate counsel, however, were suggested as a means for addressing any potential liability concerns that might result from investor-board communication. Other suggestions for improving communication between investors and the board included reforming and streamlining the procedures for director nomination, providing financial analysis of company performance from the shareholder point of view, webcasting annual meetings, and expanding board issues and concerns to include not only those of shareholders, but those of each of the company's stakeholders from employees, to customer, to vendors.

Preparing for Option Expensing

A session on stock option expensing discussed the most effective ways to implement the **Financial Accounting Standards Board's** requirement that corporate financial statements reflect the cost of stock option grants, which is scheduled to go in effect in June 2005. **Donald Delves**, president of compensation consulting firm the **Delves Group**, recommended that stock options be replaced with performance-based restricted stock or long-term cash incentive plans and that in order to balance the recognized costs and the perceived value of granted options, the upside growth potential of granted options be capped. **Michael R. McAlevey**, chief corporate and securities counsel for **General Electric**, discussed the need for expensing disclosure requirements, concluding that since the expense of options must be included in the footnotes to the company's financial statements, the real aim of expensing options is to address the corporate governance issue of excessive executive compensation.

New Challenges Confront Today's CEOs

Richard Hill, chairman and CEO of **Novellus Systems**, said the most onerous demands on CEOs in today's corporate environment include corporate internal controls, corporate certification, and option expensing.

Speaking at a session on, "The Impact of Governance Reforms on Corporate Performance and the Capital Markets—a CEO's Perspective," Hill described the internal controls put in place by the Sarbanes-Oxley Act (specifically rule 404) as expensive and cumbersome, diverting resources and management's attention away from development and focusing too much on the filings and statements that must be made under the rule.

In addition, Hill said CEOs cannot attest that their companies' financial statements are completely accurate because of the time that must be taken in order to do so. At best, CEOs can say that the financial statements of their corporations are accurate to the best of their knowledge. The risk involved in putting a CEO's career on the line to attest to the accuracy of the financial statements is causing company's to put higher levels of cash in reserve to buffer any miscalculations that may be made, thus taking away from the company's growth and development.

Granting stock options to employees is an investment in human capital, and it is very difficult to place monetary values on such human capital, Hill said. The benefit of the "option culture" in growing industries, especially the technology industry, helps drive economic growth, and provides valuable incentives to all employees of a corporation, he asserted. Expensing will inevitably cause companies to grant less options, Hill predicted. Executives will not be hurt by this because companies will attract them in other ways, but, rank and file employees will be left out of possible benefits and corporate ownership, he warned. In addition, Hill expressed concern about expensing stock options if those options expire without value—which has often been the case over the last few years with poor overall market performance. He pointed out that in situations where this is the case, employees are not receiving any compensation, but the company still must reflect this as compensation on its balance sheet.

International Directors Must Educate Themselves

At a session on "The Role of the International Director," the panel agreed that few resources exist for educating directors on how to be international directors. Panelist **Paula Cholmondeley**, who sits on the boards of **Dentsply International** and **Terex**, highlighted the differences between the board structures of many European

markets, but emphasized there is no clear “best standard” governance model that a director can follow.

With updated stock exchange listing rules and new regulations for corporate governance and accounting standards enacted in recent years, international directors will have to create their own program to educate themselves on how to be an international board member and will have to familiarize themselves with the local governance codes, regulations, accounting standards, as well as the home country’s board room styles.

Ralph Evans, CEO of the **Australian Institute of Company Directors**, said there is an educational gap for international directors in the areas of board structure, global principles, and transparency. Evans suggested that to perform their due diligence, directors should educate themselves on the local stock exchange listing rules and how familiar principles, such as director independence and legal frameworks, are expressed in that market.

Communicating Good Governance to Shareholders

In another session on “Governance Ratings and the Power of the Proxy,” the panel asked, “What is the best way to communicate good governance to shareowners?” The three panelists, **Peter Clapman**, senior vice president and chief counsel for corporate governance at **TIAA-CREF** and **International Corporate Governance Network** chairman; **Michael Emen**, senior vice president at **NASDAQ**; and **Patrick McGurn**, vice president and

special counsel at **Institutional Shareholder Services**, offered a variety of answers to that question.

Each of the panelists mentioned many of the changes emerging in corporate governance in the past several years, and the need for investors to be reassured that issues have been addressed. All of the panelists concurred that changed behavior is a method of communication. Clapman noted that institutional investors, in particular, “have a great stake in the public perception of the integrity of the market as a whole,” since they rely on broad market performance. He added that, “Certain corporate governance issues can only be dealt with through a larger regulatory process.”

He explained that when working with companies on governance issues, TIAA-CREF examines which companies in its portfolio raise serious corporate governance issues, and those companies are approached on a confidential, private basis. Then, he said, a dialogue takes place between TIAA-CREF and the independent directors. Clapman added that the “public will never know these interactions took place.” Clapman was also quick to note that if a company is unwilling to address concerns raised, “TIAA CREF is prepared to file shareholder resolutions and vigorously pursue them.”

Pat McGurn noted that what once was the ceiling has now become the floor, and defended corporate governance rankings, noting that they are “risk management tools, not return management tools.”

DMX Guest Editor: Investor Responsibility Research Center

This *DMX* is provided by the Investor Responsibility Research Center, Washington, D.C. (www.irrc.com), leading provider of impartial, independent research on corporate governance, proxy voting and corporate responsibility issues. Portions of this material appeared in *Corporate Governance Highlights*, Vol. 15, No. 2 (October 22, 2004). IRRC offers guidance on proxy voting, company profiles for portfolio screening and other corporate needs, and helps corporations make decisions that reflect their investment philosophies.

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