# Editor's Letter

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# Editor's Letter

Governance has been a long-standing, important concern in the corporate world because ways are required to resolve the inevitable agency conflicts that arise between the shareholders and the professional management of a publicly held company. When companies have veered off course and run into financial difficulty, questions raised usually have included: Where was the board of directors? Why didn't they see this coming? Why didn't they challenge the CEO? In recent decades, an important trend has been the growing degree of shareholder activism, spearheaded by the largest institutional investors such as CalPERS and TIAA-CREF. But corporate governance was brought into the public eye as never before by the series of corporate scandals that began with the Enron bankruptcy in December 2001. Because there were so many incidents, it was hard to call them isolated events, but it also was hard to tell how widely the corruption had spread throughout Corporate America. Speaking at the Institutional Investor Corporate Governance Summit: Corporate Accountability on July 14-15, 2003, in New York, James A. Kaplan, CEO, Audit Integrity, expressed his opinion that the great majority of directors in Corporate America are innocent but have not had the tools to do their jobs. CEOs have not always provided complete information to their boards. Board members often have not known the right questions to ask. Accounting rules have become increasingly complicated. Advances in financial technology have outstripped directors' ability to understand what is going on. Nonetheless, the anguish of unwitting small investors and laid-off employees with near-worthless 401k accounts, overly concentrated in their employers' stocks, set off a press frenzy and a public and legislative backlash that led to passage of the Sarbanes-Oxley Act in 2002, followed by a host of new SEC regulations, new corporate governance standards for companies listed on the New York Stock Exchange and Nasdaq, and other guidelines such as the Principles of Corporate Goverance adopted by the Business Roundtable and recommendations of the American Bar Association on Corporate Responsibility.

Delivering the keynote address for the Institutional Investor Corporate Governance Summit, E. Norman Veasey, chief justice of the Delaware Supreme Court, described the result of these recent activities as a sea change in both corporate governance and professional responsibility. With 20-20 hindsight we can see that a huge paradox was developing in the 1990s, with the economy and securities markets overheating on one hand and reform movements in the fields of voluntary best corporate governance practices and lawyer ethics gathering momentum on the other hand. Major corporations like General Motors were strengthening their boards through voluntary best practice codes. Institutional investors were demanding greater independence and accountability of directors, while the Delaware courts were exhorting enhanced standards of director conduct as the right policy and as an arguable safe harbor from state fiduciary liability concerns. The American Law Institute was producing its Restatement of the Law Governing Lawyers, and the American Bar Association's Ethics 2000 Commission was reevaluating the Model Rules of Professional Conduct and recommending changes to modernize and strengthen the state-based regime of lawyer ethics.

Judge Veasey noted that the internal affairs of corporations are governed primarily by the state of incorporation and federal securities laws are designed primarily to regulate markets, principally in the area of disclosure. Delaware law is the default repository for the rich and comprehensive common law on the fiduciary duties of directors and officers, largely because such a large number of corporations are incorporated in Delaware and so many corporate cases are tried in the Delaware courts. Although the reach of the Sarbanes-Oxley Act and the new listing requirements of the NYSE and Nasdaq are extensive, Judge Veasey said that they do not supplant Delaware law entirely. Some federal-state tension is inevitable and time will tell how compatible the new federal legislation and regulations are with existing state corporate law. Questions include whether the new federal mandates may tend to destabilize some of the features of Delaware law that benefit shareholders by giving directors flexibility to take prudent business risks and productive action in highly nuanced fact situations, or whether the one-size-fits-all requirements of Sarbanes-Oxley and the stock exchange rules on the definition of independence could drive away good directors.

This Corporate Governance Guide consists of 23 articles that collect the views of 26 experts who look upon the

state of corporate governance as of late 2003 from all different directions one year after passage of the Sarbanes-Oxley Act. Many of the authors represented here also spoke at the Institutional Investor Corporate Governance Summit. We have the perspectives of lawyers; corporate directors; management consultants; academics; auditors; governance rating services; institutional, private equity, and venture capital investors; a recruiter of executives and directors; a compensation specialist; a D&O insurance underwriter; and an internal corporate governance officer. Running through the articles are a number of common themes including past board inattention, passivity, and lack of leadership; the legal liability of board members for corporate wrongdoings; the criteria for an effective board and board member; a shrinking universe of qualified director candidates; board member independence; the need for board members to understand their responsibilities, to receive sufficient and appropriate information, to ask questions, and occasionally to say "no" to the CEO; separation of the CEO and board chair roles; a balance between rules and the flexibility to exercise judgment; the role of institutional investors in corporate governance; and the convergence of international governance standards.

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We start with two articles that provide both an introductory and a legal perspective. Holly J. Gregory, partner, Weil Gotshal & Manges LLP, notes that the U.S. business system was tested by a perfect storm, including the stock market bubble, conflicted auditors and securities analysts, incentives for managements to boost short-term stock performance, and board deference to imperial CEOs, but it didn't blow up. The recent corporate incidents have served mainly to remind us of long-standing priorities, and the basics of corporate governance remain as they always have been: behaving ethically and honestly. In the view of Ira M. Millstein, senior partner, Weil Gotshal & Manges LLP, greed and conflict prevented various "machines" such as law firms, accounting firms, and investment banks from functioning properly and the corporate machine, particularly the board of directors, needs to work more effectively. Mr. Millstein, among others, calls for a separate and independent leader of the board. Next, Guy P. Lander, partner, Davies, Ward, Phillips & Vineberg LLP, summarizes the most comprehensive securities legislation that has been enacted since the New Deal, including director independence criteria, enhanced audit committee responsibilities, requirements for independent directors on nominating and corporate governance/compensation committees, code of ethics disclosure, prohibition on personal loans, prohibition on interference with auditors, reports of trading in company securities, and shareholder approval requirements. In the Institutional Investor Corporate Governance Summit, Gerald Backman, partner, Weil Gotshal & Manges LLP and chairman of the New York Chapter of the National Institute of Corporate Directors, pointed out that federal securities laws before Sarbanes-Oxley consisted primarily of disclosure statutes. Now we have federal regulations prescribing normative behavior, the biggest change being in the role of the audit committee.

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We have articles by three prominent women, the Honorable Barbara Hackman Franklin, CEO, Barbara Franklin Enterprises; Gwendolyn S. King, president, Podium Prose LLC; and Deborah Hicks Midanek, principal, Glass Associates, who provide the perspective of experienced directors and share their personal experiences in becoming directors for the first time and learning the ropes. Among the many common themes running through these three articles are the need for common sense, curiosity, and a willingness not only to ask questions but even to say "no" from time to time. Then from a consultant's perspective, Michael J. Epstein, director and shareholder, The Recovery Group, comments on the need for directors, in self-protection, to follow the business judgment rule—performing the duties of loyalty, good faith, and reasonableness—when a company enters the zone of insolvency and they are subject to possible litigation. Unfortunately, those liabilities are causing many corporate directors to resign and, from an executive recruiter's perspective, Robert E. Hallagan, vice chairman, Heidrick & Struggles International, Inc., and chairman, Center for Board Leadership, National Association of Corporate Directors, urges companies to take inventories of required director skills, develop board candidate profiles, and maintain search and identification processes.

Richard M. Steinberg, U.S. corporate governance leader, PricewaterhouseCoopers, comments on how more CEOs

now are working with their boards the way they always were meant to: with openness, consultation, dialogue, and receptivity to directors who aren't afraid to ask questions. Peter Clapman, senior vice president and chief counsel, Corporate Governance, TIAA-CREF, explains why institutional investors are asking questions of corporate managements just the way conscientious directors are, and describes how the largest private pension system in the United States has "gently prodded" corporations to make numerous governance reforms. Clapman also notes that there is a limit to how involved his organization can become in a given corporation's affairs when it holds some 1,500 stocks. Among the most important recent accountability reforms have been a redefinition of the roles and responsibilities of the audit committee. Mark Terrell, executive director of KPMG's Audit Committee Institute (ACI), and Scott Reed, a KPMG partner with ACI, explain the required changes in attitude, culture, and overall approach, as well as audit committee members' concern with rising above the minutiae, focusing on the most important business opportunities, risks, and other priorities, and avoiding a "checklist" mentality.

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Picking up on the theme of director independence, Charles M. Elson, Edgar S. Woolard, Jr., Chair in Corporate Governance and director of the John L. Wineberg Center for Corporate Governance, Alfred Lerner College of Business & Economics, University of Delaware, and Christopher Gyves, Wake Forest University School of Law and Babcock Graduate School of Management, JD/MBA Class of 2004, describe the numerous early warning signs provided by the Enron board of directors, which was anything but independent. Another target for corporate criticism has been excessive senior executive pay. Edward C. Archer, managing director, Pearl Meyer & Partners, explains how corporations are reexamining the way competitive information on executive compensation is gathered and organized, defining more meaningful and effective performance hurdles, and aligning director compensation on a more individual basis according to specific responsibilities such as audit committee membership. Among the trends Mr. Archer sees are increasing independence of the compensation committee, less CEO remuneration, more board member remuneration, fewer stock option grants (especially when FASB starts to require that they be expensed), and more restricted stock and outright stock grants—contingent upon performance paramaters. Then William Cotter, chief underwriting officer and senior vice president, National Union Fire Insurance Company, describes how recent corporate malfeasance has added to existing pressures on the D&O underwriting industry, and warns directors who are willing to brave the new environment to check to make sure they have adequate coverage from the most creditworthy underwriters. Given the scope of recent governance reforms and the detailed regulatory, record-keeping, and communication requirements of a properly run corporate governance program, it is not surprising that more than 60 major companies have decided to center those responsibilities with specifically designated corporate governance officers, as reported by Robert B. Lamm, corporate secretary and director of corporate governance, Computer Associates International. Among other benefits, Lamm notes that such a move underscores a company's serious commitment to governance.

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Next, we have articles that address governance issues in smaller companies at three stages. First, Martin Pichinson, cofounder and principal, Sherwood Partners, Inc., explains how start-up technology companies need "chief concept officers," rather than CEOs, supported by board members who often are providers of funds and serve primarily as involved mentors and sources of contacts. Then, as a company begins to grow, Jim Peters, principal, AlixPartners LLC, notes that its board may include private equity investors who, like directors in companies of all sizes, must become involved with management, heed early warning signs of financial difficulty, and—again—not be afraid to ask questions. But even after a company has gone public, according to Dennis I. Simon, managing principal, Crossroads LLC, it still may depend on the leadership of the founding entrepreneur or family and find some of the corporate governance guidelines proposed for large companies, such as separation of the CEO and chair roles and a majority of independent directors, to be difficult to implement.

Then we address the growing demand for services that analyze, compare, and rate individual corporate governance practices and their effectiveness. In articles by Gavin Anderson, CEO, GovernanceMetrics International; Patrick S. McGurn,

senior vice president, Institutional Shareholder Services; Nell Minow, chairman, the Corporate Library, and Andrea Esposito, managing director, and Dan Konigsburg, director, Standard & Poor's Governance Services, present four different rating approaches that include the analysis of factual indicators, interviews with a company's management and directors, and drawing conclusions from directors' decisions.

We conclude with an overview of governance reforms outside the United States by Stephen Davis, president, Davis Global Advisors, Inc., who finds the initiatives of legislators, regulators, and stock exchanges to be ahead of reforms in actual corporate governance practices.

So, as the year 2003 comes to a close, where are we? Will the recent legislation, regulations, and corporate reforms lead to permanent improvements in corporate governance? Or will directors, CEOs, and other corporate constituents slip back into their old ways once the uproar dies down? To what degree will governance reforms such as those seen in the United States spread throughout the world? While acknowledging recent failings, our 26 experts view the effect of corporate governance reforms in 2002 and 2003 with guarded optimism—at least in the United States. Ms. Franklin of Barbara Franklin Enterprises, for example, reminds us to keep perspective. Bad news captures headlines but many boards have been doing good work for a long time. Blending the new with the old, she believes that corporate governance in 2003 is more effective than ever. Professor Elson of the University of Delaware observes continued progress toward independent directors with substantial equity holdings, which were important priorities long before the onslaught of Enron and the other corporate incidents. Speaking on *Louis Rukeyser's Wall Street* on November 7, 2003, Representative Michael Oxley said the recent performance of the stock market is evidence that investors are regaining some of their confidence and Senator Paul Sarbanes said that investors are getting more of a sense that they are seeing honest figures and will be able to make decisions based on reliable data. But Roger W. Raber, president & CEO, National Association of Corporate Directors, speaking at the Institutional Investor Corporate Governance Summit, questioned what has really changed in the corporate boardroom. There are more rules, legislation, and oversight, but public trust has not yet been restored. There are rules on director independence but directors still need to develop independent mindedness. Boards are putting governance guidelines on paper—for example, selection and board evaluation criteria, succession planning, and executive sessions without management—but they still need to work on creating climates of disclosure and cultures of transparency. The bar on directors' financial competency still needs to be raised. CEOs still have a strong role in the selction of directors. Directors still have concerns with their liability and D&O insurance coverage. Directors are receiving more information—and sometimes too much—and need to demand the right information. Boards need to take on greater responsibility in risk oversight. In exercising their "duty of care," they need to know when to seek outside independent advisors. Echoing one of the most important themes in this book, Mr. Raber said that good corporate governance requires, most of all, independent directors who have the courage and integrity to ask difficult questions. So, in all, we have made progress but there is still plenty to do. Mr. Lamm of Computer Associates said at the conclusion to his presentation, "Corporate governance has no finish line."

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