

Directorship

November 2006

www.directorship.com

Cox Postpones A Key Decision

Securities and Exchange Commission Chairman Christopher Cox is scrambling to find a solution to the legal quandary over letting shareholders have more say in fielding board candidates. The issue is so fundamental that victory has been dubbed "the Holy Grail" of governance continued on page 9

Private Equity Under Scrutiny

If the 1980s were the decade of leveraged buy-outs, this is the one of management buyouts via private equity firms. Such deals account for more and more corporate ownership changes and more and more capital. Among recent examples of public companies gone private have been hospital chain continued on page 8

Did GM's Board Act Properly?

As predicted (*Directorship*, October 2006), General Motors' negotiations with the Renault-Nissan alliance did not produce any agreement. GM demanded multibillion-dollar "dowry" payments from Renault and Nissan, saying they had far more to gain from any alliance than GM did. CEO Carlos Ghosn called that "ridiculous." continued on page 6

GM CEO Rick Wagoner



HP: It's Not Over

Carly Fiorina says HP's board blowup is a symptom of long-running problems, and there's no quick fix. **By Joan Warner**

Just as former Hewlett-Packard CEO Carly Fiorina was heading out to promote her new memoir, *Tough Choices*, the HP board imploded over a leak and surveillance scandal. She talked to *Directorship* about the similarities and differences between HP's board now and at the time of her abrupt ouster in 2005. She also suggests that an even more thorough housecleaning may be necessary for the leadership to recover fully. Here are highlights from an

exclusive interview:

Would it be fair to say that Hewlett-Packard's board is dysfunctional?

Absolutely.

What are roots of that? How did it happen?

I think boards get dysfunctional when personal agendas outweigh public responsibility. And I think that can happen, unfortunately, any time, with any group of people, continued on page 14

TECHNOLOGY SPECIAL REPORT

The SEC Goes Tech

By Peter Galuszka

Shareholders who want to find out if their chief executive's compensation is out of whack have their work cut out for them. They have to slog through the 10-K forms and proxies of peer companies via EDGAR, the Securities and Exchange Commission's data base, comparing pay packages and looking for comparable performance measures. Scrolling down hundreds of computer screens and printing out can take days, or even weeks.

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Wanted: Backbone In the Boardroom

By William J. Holstein

Bill George, former chief executive of Medtronic, says today's boards are too willing to fire their CEOs and should resist short-term demands for better performance. He serves on the boards of Exxon Mobil, Novartis and Goldman Sachs and teaches at Harvard Business School. Here are highlights of a conversation:

Is there a risk that boards are pulling the trigger on CEOs too fast?

I think there's definitely a risk. In the old days, I thought that CEOs stayed too long. When they got up around a 15- to 20-year period in terms of tenure, they started to think they were the institution and were spend- continued on page 16

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New: Governance
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Accounting issues to
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keep you updated on
critical aspects of
governance.

Book Excerpt
How Good Leaders Fail
to Take Advice: In this
exclusive excerpt from
Dan Ciampi's new book,
Taking Advice, a CEO,
though wooed by the
board, fails to listen to his
advisers and ruins his shot
at the chairmanship.

Directorship Calendar
Events for November and
beyond:

◆ Nov. 14-16:
Compensation
Committees: New
Challenges, New
Solutions, Boston

◆ Jan. 21-23, 2007:
Directors, Management &
Shareholders in Dialogue,
Naples, Fla.

More Online Resources

Who's News: Weekly
updates of board mem-
ber and CEO comings
and goings

Options —The List: The
latest names in the back-
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Directors and the Media

Like it or not, boards are going to have to learn to engage in the public debate.

Virtually all the directors I've spoken with about George Keyworth's leaks from the board of Hewlett-Packard condemned his conduct. Nearly every director believes that what happens in the boardroom should stay in the boardroom.

But it's not that simple, and here's why. Boards are being drawn into the public debate about how America's companies are governed. Sarbanes-Oxley means they now are much more active in managing earnings releases and issuing guidance to Wall Street. And the activist groups, whether single-cause advocates or more financially oriented hedge funds and pension funds, are targeting boards. (To get a taste of what's coming, see what organized labor has to say, page 24.) These players are adept at using the media to frame the debate. They are, for example, demanding "accountability" from boards—and who can be against accountability?

So in this climate, it's inevitable that boards are being drawn into the public marketplace of ideas. A chairman or a lead director may be designated as spokesman. And more public relations firms are advising boards on how to communicate publicly.

Here's where this will inevitably lead. Whoever is designated as spokesperson will have to learn how to develop and maintain relationships with the media. Press releases just don't cut it. To be effective in shaping media perceptions, the most sophisticated players know how reporters work, they understand what kind of pressures reporters are under, and they know how to tell reporters what they need to. They can speak the language.

That's exactly what the vast majority of activists know how to do. They have allies in the media whom they've been feeding information for years. That's one reason

the media coverage of many major companies has been so negative. The company's own internal PR people are embattled and paralyzed, caught in the crossfire. Senior management typically avoids dealing directly with the press, and directors have been entirely invisible. They have ceded the field of battle.

So if directors are now going to join the fray, you will have to manage relationships with the media. Some information will be entirely on the record and can be authorized and approved in advance by either your company's internal PR people or by PR advisers to the board.

But inevitably, the reporters are going to ask more questions. You will then have to learn how to go off the record. If you stonewall and keep repeating the officially sanctioned answers, you'll lose credibility. You will have to learn how to spin.

If you do it well, I believe you can prevail in the media wars, because the media are much more malleable than many directors think. But how will directors learn how to do this? How can you make sure that your communications with reporters are in sync with what management is saying? And if your communications with reporters are construed as "leaking," will you be violating Regulation Fair Disclosure? Will the class-action lawsuits start flying?

These tough issues can't be avoided. Shareholders and governments are demanding that directors explain their actions, and that means engaging with the media. The sooner boards figure this out, the better off you'll be.

William J. Holstein

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Quick Hits



Rick Wagoner said “non merci” to Carlos Ghosn at Renault.

Did Wagoner’s Board Act Properly?

continued from page 1

As negotiations were falling apart, even before an Oct. 15 deadline, investor Kirk Kerkorian, who owns 9.9 percent of GM’s stock, urged the GM board to hire an independent third party to evaluate Renault-Nissan’s proposal. The board, under the leadership of lead director George Fisher and Chairman and CEO Rick Wagoner, declined and instead supported management’s position. That sparked controversy in some boardrooms. “I was shocked that the board did that,” says one director of three public companies, none of which have relationships with the auto industry. “The stakes in this case are too big to put

all your trust in management.”

Other directors attending a *Directorship* roundtable in New York agreed that the GM board should have sought a different point of view. They warned that it may have opened the way for a lawsuit challenging directors on whether they met their fiduciary responsibility.

Jerry York, who was Kerkorian’s man on the board, resigned, saying he had “grave reservations concerning the ability of the company’s current business model to successfully compete in the marketplace.” He said he had “not found an environment in the boardroom that is very receptive to probing much beyond

the materials provided by management.”

GM’s share price fell after the alliance talks collapsed, meaning Kerkorian’s potential gains from his \$1.7 billion investment in GM declined. But he still appeared to be in the black.

Another investor is involved in the mess at Delphi, GM’s largest parts supplier. Delphi is trying to emerge from Chapter 11 and a key player is David Tepper, head of Appaloosa Management, a hedge fund that owns 9.3 percent of Delphi’s stock. Tepper is betting that Delphi can whip the United Auto Workers and come out of bankruptcy in fighting form.

U.S. Bubble Watch...

Students of financial markets often look for signs of excess. Well, look no further. Whenever private equity firms start buying casinos whose debt is downgraded to junk status, it’s time to watch out. In fact, Apollo Management and Texas Pacific Group are offering an incredible \$15 billion for gambling company Harrah’s Entertainment.

Other interesting financial tea leaves: There is so much money in hedge funds chasing deals that the funds are not making much money. You could park your money in a 5 percent CD and do better.

Sensing that, it seems that the hot money is shifting into the Dow Industrials, which are at an all-time high. The rest of the market hasn’t had nearly as much of a run-up. So caution is the word—the asset-class flippers will not be happy for long.

...And in China

Halfway around the world, the madness continues. China’s biggest bank, Industrial & Commercial Bank of China, is due to raise nearly \$22 billion in an IPO on Oct. 27. Hong Kong billionaires and Middle East investors are hot for the stock. Everyone else seems to have better sense—China isn’t even close to having Western standards of transparency.

Novelesque

We couldn’t make this stuff up. Kobi Alexander, the Israeli-born former chief executive of Comverse Technology, who faced criminal charges for backdating

JEFF KOWALSKI/BLOOMBERG NEWS/LANDOV

stock options at his company, fled the country and tried to find safe haven in Windhoek, the capital of Namibia. The southwest African country just happened to lack an extradition treaty with the U.S. Eyebrows were raised when tens of millions of dollars were transferred into Namibia in Alexander's real name. He started living there openly with his wife and enrolled his children in school. Interpol notified the Federal Bureau of Investigation and feds were able to persuade the Namibians to arrest Alexander while he was having lunch at a posh country club. His actual extradition is still pending. John Le Carré, where are you?

Shareholder Wars

Activists aren't making much headway on two fronts in their efforts to exert greater clout over boards.

On one front, the New York Stock Exchange quietly backed away from a plan that would prevent brokers from voting their clients' shares in proxy battles unless the holders give voting instructions. Brokers routinely vote for management. And an estimated 80 percent of public company shares are held by brokers in "Street names." Why the change of heart? "It's more complicated than they thought," says one NYSE adviser.

Elsewhere, governance activists are trying to persuade mutual funds, which also control huge chunks of equities, to vote in favor of more shareholder resolutions, not just support management. Thanks to rules put in place three years ago by the

SEC, the funds' voting habits can now be analyzed. The Corporate Library says the biggest mutual funds supported management 92 percent of the time in the fiscal year ending June 30. But so far, there's not much sign that mutual funds are going to climb on the shareholder bandwagon.

Option Madness

The options scandal also claimed the job of William McGuire, UnitedHealth chairman and CEO, the most prominent victim to date. The tech sector is getting hit harder as CEOs, CFOs and general counsels are pushed out. The latest techies to go were five top officers at McAfee and CNET Networks. At least two dozen officers or directors have departed and more are inevitable as audit committees finish internal investigations. The only happy people are the lawyers and forensic accountants.

Steve Jobs knew Apple Computer manipulated some stock option grants, but wasn't aware of the accounting implications. Jobs apologized and said the manipulations were "completely out of character" for Apple. Will the Feds buy it?

Roiling Revlon

Like an aging star who gets facelift after facelift, Revlon keeps changing CEOs. In its latest makeover, the board deposed Jack Stahl and replaced him with CFO David Kennedy, who will be the third chief since 2000. The stock is down more than 60 percent since February,

250 people have been laid off, and Revlon yanked its Vital Radiance product line from store shelves.

Here's a suggestion for board chairman Ronald O. Perelman: Hire some women. It's a cosmetics company, for Pete's sake! Only three of Revlon's 12 directors are female, and its senior management team boasts two women out of 15 people. Do your shareholders a favor and get with the program.

Exxon Goes Soft

Surely, the earth has moved. Exxon Mobil, hardly known for being sensitive to its critics, said it will require the resignation of any director who doesn't get a majority of votes in an uncontested election. The decision isn't likely to knock anyone off the board. But the fact that Exxon's board would accept the concept of majority voting is still noteworthy. The company said it was responding to a resolution to require majority voting that received 52.2 percent of shareholder votes earlier this year.

Is Cisco Back?

John Chambers goes into Cisco Systems' Nov. 15 annual shareholder meeting with some wind at his back. The stock finally seems to be moving. It's north of \$24 for the first time in a long time.

Chairman John Morgridge will step down and Chambers will assume that title. Don't cry for Morgridge, though; he still owns a full 1 percent of the company.

Activists will be watching the

vote on a proposal by the AFL-CIO to require that future equity grants to management be performance-based.

Flipping Analysts

Jeff Kindler has finally found something that really scares him. The new CEO of Pfizer spent years at McDonald's and says for a long time the most frightening experience in his career was standing behind a McDonald's counter when three school buses filled with hungry children pulled up. "Now I'm thinking," he said in his first speech as Pfizer's CEO, "the only thing scarier than three busloads of hungry kids is a roomful of analysts." He made the wisecrack to analysts attending a Bank of America conference in San Francisco. It wasn't clear at press time how many laughed.

Domestic Dispute?

Do Jack and Suzy Welch disagree with each other over the proper role of shareholders in shaping boards? In their column in the Oct. 9 issue of *Business Week*, the superstar duo wrestled with the thorny issue of "Whose company is it?" A careful reading reveals some of the language of shareholder activists—"A company is for its shareholders. They own it. They control it." That must be from Harvard Business Review's Suzy. But the column also warns that "companies can wind up in a real mess if they start reacting to the varied stakeholders who claim a piece of the company." That sounds like vintage Jack. This couple must need more pillow talk.

“Material Information” Doesn’t Belong in Blogs

COMMENTARY

BY PETER GALUSZKA

Jonathan I. Schwartz is a major blogophile. The pony-tailed CEO of Silicon Valley server powerhouse Sun Microsystems has his own corporate blog. So do 4,000 other of some 38,000 Sun employees who share their innermost thoughts each day with anyone willing to read them.

But Schwartz feels short-circuited. He has complained that he cannot use his blog to announce Sun’s quarterly performance numbers or disclose a material transaction, and he has written to Securities and Exchange Commission Chairman Chris Cox, requesting that Regulation Fair Disclosure admit blogs as acceptable media for the dissemination of critical corporate statements.

An SEC spokesman responded favorably, possibly because Cox wants to be known as the patron saint of digital corporate governance (see page 1). Current regulations do, in fact, allow for

the use of blogs to inform shareholders of critical developments, as long as they reach a wide audience, the spokesman said.

But before we chalk one up for

free speech, but it is often bad for content. Too often, blogs are dominated by crackpots who deluge readers with their views regardless of whether they are in-

countants, lawyers and public relations wordsmiths. Yes, the process is cumbersome, and the result might be in corporate-speak, but at least it’s vetted for investor consumption, which certainly isn’t true of the hip shorthand in MySpace.

Employees who spend a lot of time blogging might actually be a red flag. To be sure, many companies have corporate blogs, which may encourage internal communications and could even foster creativity. But one might ask Schwartz how much shareholder value he creates by spending time on “Jonathan’s Blog.”

The Internet already has a role in reporting corporate news. Press releases appear on corporate web sites and are shipped to the public relations newswires, which are available online. But directors and executives should take a skeptical view of using blogs as a way to spread important news. Corporate statements released so informally could be confusing at best—and potentially incriminating at worst.



Jonathan Schwartz, CEO and president of Sun Microsystems

the cybergeeks, let’s put this in context. Particularly at a time when the Hewlett-Packard scandal has put a spotlight on corporate communications, companies should keep an eye on the downsides of blogging. Blogs are super-democratic. Anyone with a mouse and Internet access can comment. That may be good for

formed or logical. Imagine having to plow through thousands of words of meandering nonsense to find out that a company whose shares you own is about to merge or that quarterly earnings are about to take a big slide.

When corporations have important news to release, they typically run it through a mill of ac-

Private Equity Firms Under Scrutiny

continued from page 1

HCA and food service firm Aramark.

But while the media buzzes that MBOs are good for business, there’s increasing evidence to the contrary. Several developments are casting a pall over private equity deals. Academic studies suggest that executives may be fiddling with their books pre-deal, and the Feds are prob-

ing whether major equity firms have informal schemes to dampen competition.

Some experts think boards should keep a keen eye out for management schemes to stall corporate performance—possibly positioning the company for a cheap sale when the stock tanks. Professor Sharon Katz of the Harvard Business School found that in a recent

study of 60 companies that went private, the firms registered lower accounts receivables over the two years prior to the sale. “They are manipulating earnings downward to get a lower price,” Katz says.

Now, the U.S. Department of Justice is probing a number of private equity groups, including such big names as Silver Lake Partners and

Kohlberg Kravis Roberts. Justice seems to suspect that when an MBO gets under way, equity firms have an informal understanding not to meddle with one another. They may set up consortia that are supposed to bid on specific companies, then drop out of bidding at the last minute or discourage competing bids from outsiders, thus depressing the

AP PHOTO/MARCIO JOSE SANONHEZ

Cox Postpones A Key Decision

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by the president of the American Federation of State, County and Municipal Employees, which has been pushing for more ballot access for shareholders.

After AFSCME's huge union pension plan won a federal appeals court victory in early September, Cox quickly scheduled a mid-October meeting to clarify the language that caused the turmoil—and that the court had called ambiguous. Jubilant shareholder rights groups figured the fast-tracking was intended to give them plenty of time to get their candidates on election slates for the 2007 proxy season. But just a week shy of the meeting, the SEC rescheduled it for Dec. 13.

The play for more time underscores just how politically explosive the issue is. Cox wants to show support for shareholders. But he also wants to avoid the fate of his predecessor, William Donaldson, whose moves to liberalize shareholder nominations in October 2003 were quickly shot down by powerful corporate groups such

as the Business Roundtable.

Cox faces a bitterly divided staff at the commission, sources say. Plus, the Second Circuit Court of Appeals in New York included some pointed language, clearly aimed at the wishy-washy SEC. The court overturned a lower court decision against AFSCME's pension plan, which had sued insurer AIG for rebuffing union proposals to allow shareholders' board nominations on the proxy ballots. The court blamed the SEC for interpreting Rule 14a-8 inconsistently.

The "nastiness" of the ruling left many in the SEC "shell-shocked," says a well-connected lawyer who advises many boards. The SEC staff "wants to put Humpty Dumpty back together," but the commissioners—three Republicans and two Democrats—are sharply divided on governance issues. "Cox places a huge emphasis on consensus" among the commissioners, says this lawyer, but "it's going to be very difficult to reach consensus on this issue."

Rule 14a-8 spells out the circumstances under which companies may reject shareholder proposals. One of the 13 cases is if the proposal "relates to an election for membership on the company's board of directors or analogous body."

Historically, the SEC had allowed some latitude on shareholder director candidates, but it shifted policies in 1990 without explanation and started favoring management exclusions. The appeals court slammed the SEC for the inconsistency. It also made a key distinction between allowing shareholder candidates in specific elections and allowing them as a matter of policy. Judge Richard C. Wesley ruled that while the former is a reason for exclusions, the latter is not. Unless the SEC challenges the ruling with new policies, the court's decision stands. That could lead to a flood of shareholder proposals on director candidates next proxy season.

While it is not known exactly what Cox will propose on Dec.

13, the SEC did give a hint when it announced the postponement. It said that an open meeting of the commission will review "revisions to our rule concerning shareholder proxy initiatives."

The SEC added that at the same meeting, it will "permit discussion of how the Internet can advance the dissemination and exchange of information among shareholders and companies, and thereby improve the entire proxy process" (see Commentary).

It may make sense that Cox, an ardent advocate of using high technology in governance, will turn to the Internet for a solution. One argument against allowing shareholder nominees has been that it would create a paperwork nightmare. But if the nomination process along with supporting documents can be conducted electronically, much of that argument loses merit. Whatever the outcome, Cox seems on the verge of making his most important decision yet—one that will truly reveal what he's all about.

purchase price.

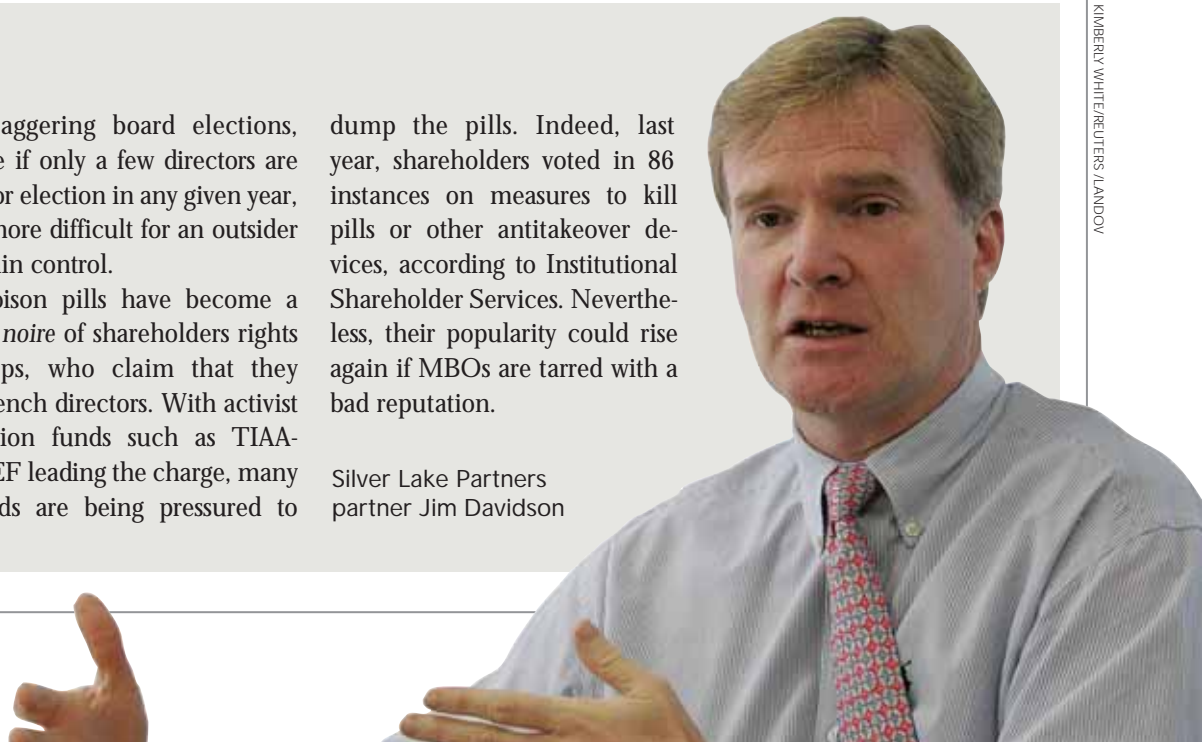
In response, boards may start dusting off "poison pills," the antitakeover devices invented in the early 1980s to thwart unwanted suitors. The pills can take several forms, including granting all employees stock options that vest when a takeover occurs—raising the threat that that staff will bolt as soon as a takeover succeeds. Another ploy

is staggering board elections, since if only a few directors are up for election in any given year, it's more difficult for an outsider to gain control.

Poison pills have become a *bete noire* of shareholders rights groups, who claim that they entrench directors. With activist pension funds such as TIAA-CREF leading the charge, many boards are being pressured to

dump the pills. Indeed, last year, shareholders voted in 86 instances on measures to kill pills or other antitakeover devices, according to Institutional Shareholder Services. Nevertheless, their popularity could rise again if MBOs are tarred with a bad reputation.

Silver Lake Partners partner Jim Davidson



KIMBERLY WHITE/REUTERS/LANDOV

Governance

Directors Criticize CEO Comp ...

An increasing number of directors indicate that CEO pay is “too high in most cases,” according to the 10th Annual Corporate Board Effectiveness Study conducted by the University of Southern California’s Marshall School of Business and search firm Heidrick & Struggles. The sponsors claim it is the largest U.S. study of board directors, with responses from 768 directors at approximately 660 of the 2,000 largest publicly traded companies.

The nearly 40 percent of respondents who agreed that the majority of CEOs are overpaid “is a significant increase over prior years’ study results,” said Edward E. Lawler, III, director of USC’s Center for Effective Organizations. Perhaps not surprisingly, “an overwhelming

majority [81 percent] favor increasing the link between CEO pay and performance.”

Interestingly, the same large proportion believe that a significant power shift is occurring in the boardroom, with 81 percent of directors reporting that CEOs have “less control over their boards” than before. And the majority of directors (84 percent) say that boards are spending more time on “monitoring activities and less on strategy.”

Other highlights:

Directors see very few proposed reforms having a significant effect on controlling CEO pay. The main exception is mandatory shareholder approval of compensation programs.

Despite the new SEC disclosure regulations and the fact that they expect to be spending

more time addressing CEO compensation issues, 64 percent of directors expect to see continued increases in CEO cash compensation. Fifty-eight percent expect an increase in stock-based compensation. But 85 percent say they expect to see the linkage between compensation and performance increase.

Seventy-five percent of boards now have an independent director who serves as lead or presiding director—a dramatic increase from 49 percent in 2003 and 32 percent in 2001.

Fifty-seven percent of directors say they are more hesitant to serve on other boards. Inside directors are more hesitant than outsiders. And 53 percent limit the number of boards on which CEOs can serve, up from 23 percent in 2001.

But Their Own Pay Is Soaring



Lehman Brothers’ board chairman Lloyd Blankfein is among the best paid directors in the U.S.

Median annual compensation for directors of major U.S. companies surged 12 percent from 2005 to 2006, to \$204,000, mark-

ing the third year of double-digit growth, according to a new report from compensation consultancy Pearl Meyer & Partners. The findings are based on public filings by the 200 largest U.S. industrial and services companies.

Director pay now tops \$100,000 at all but six of the major companies studied and exceeds \$400,000 at nine companies. “Director pay will continue to grow, in tandem with boards’ more public and activist role in corporate oversight,” said Joseph Rich, president of Pearl Meyer & Partners, now an arm of Clark Consulting. “The structure of pay is also changing, as boards parallel a trend in executive pay programs by shift-

ing more of their own equity-based compensation from stock options into full-value grants.”

The study found that median pay for service on the compensation committees was up nearly 18 percent to \$6,000 this year, while median pay for audit committee member service was up 9 percent to \$10,900. Rich said he expected continued increases, particularly for members of those two committees.

The average value of equity awarded to directors rose by nearly 10 percent. But on average, the value of option grants to directors declined for the fourth year in a row, while full-value stock grants soared to more than \$82,000.

Boardroom Snapshots

Q: Does the CEO keep the board informed about significant matters?

A: To a very great extent (58 percent)

Q: Does the board monitor the company’s culture?

A: To some extent (37 percent)

Q: Do board members voice opinions that conflict with the CEO’s?

A: To a great extent (44 percent)

Q: Does the board help develop internal candidates for senior management positions?

A: To some extent (35 percent)

Source: USC’s Center for Effective Organizations, Heidrick & Struggles

Director’s Pay

\$400,000 a year and up (in descending order)

UnitedHealth Group

Goldman Sachs Group

Lehman Brothers Holdings

Pulte Homes

Medco Health Solutions

Oracle

Exxon Mobil

Occidental Petroleum

\$100,000 a year or less (in ascending order)

Sears Holding

D.R. Horton

Sun Microsystems

United Auto Group

Tech Data

Source: Pearl Meyer & Partners

DANIEL ACKER/BLOOMBERG NEWS /LANDOV

GMI Rates Governance By Country

American companies rate fourth in the world in terms of their governance practices, according to ratings of 3,800 global companies issued by GovernanceMetrics International in late September. For the first time, GMI analyzed 321 companies from 35 emerging markets and found that they lag significantly behind world leaders. Still, there are some surprising standouts, particularly South Africa and Poland (see table).

The U.S. ranked behind Canada, Britain and Australia and just ahead of Ireland. Some 38 countries received GMI's highest rating of 10.0. Three companies—Colgate-Palmolive, BCE of Canada and PepsiCo have been among the top-

ranked in every GMI survey since 2003.

The 321 emerging-market companies had a collective ranking of 4.30, far behind leading companies. Only two companies from those markets were above average—Taiwan Semiconductor Manufacturing and Goldfields of South Africa.

In particular, emerging market companies lagged behind in terms of having a majority of independent directors, having an audit committee consisting of independent directors and having a compensation committee of any sort.

Still, there were some surprises. Venezuela, Thailand, the Philippines, Turkey and Mexico all had higher ratings than

France, for example. One possible explanation is that GMI analyzed fewer companies in Venezuela (one) than it did in France (99). Comparing a small handful of relatively strong players in emerging markets against a much larger sampling from bigger economies could account for some of the statistical curiosities.

It was also noteworthy that some of the most competitive economies in the world—Japan, China and South Korea—ranked so low, 37, 42 and 45, respectively. A plausible explanation is that Japan, China and South Korea have established that they can compete despite the fact that, and perhaps because, they have dramatically different corporate governance models. —WJH

Networking Works for Women Directors

Women want to earn their way into boardrooms and are more likely to be successful if they support and promote each other, according to a survey of women board directors conducted by search firm Heidrick & Struggles and Women Corporate Directors, a national network of nearly 200 female board members at 400 firms. The survey findings were the result of comments from 77 women directors at 165 public companies who are members of WCD.

“The good news is Heidrick has seen an increase in the number of director searches targeting women across the U.S.,” said Theodore Dysart, managing partner, Americas, of the Global Board of Directors Practice. “However, the reality is that

women still lag far behind their male counterparts.” The 15 percent of Fortune 500 corporate board seats held by women in 2006 is an increase of less than 1 percent since 2003.

Despite the slow inroads women are making, women do not want to be handed board seats simply for the sake of equality; a full 76 percent of respondents said they oppose a legal quota mandating an increase in the number of women occupying public company board seats.

Instead, survey participants said, women can help each other gain access to the boardroom, according to the survey. Almost unanimously, 99 percent of respondents said that sitting women directors can make a dif-

ference in helping their peers gain board seats. Sixty-four percent said they have taken steps to make sure that women were included in the pool of candidates considered for boards on which they sit. “Women board members play a key role in helping women seeking positions by mentoring and networking with potential board members and being vocal by making recommendations to their board,” said Susan Stautberg, co-founder of WCD.

At least 90 percent of the female board members surveyed said they regularly network with other women they think would make good directors. But only 54 percent report that at least one of the women they recommended was actually elected.

Governance Top 45

1	Canada
2	Britain
3	Australia
4	United States
5	Ireland
6	New Zealand
7	Netherlands
8	South Africa
9	Poland
10	Venezuela
11	Peru
12	Finland
13	Argentina
14	Czech Republic
15	Thailand
16	Germany
17	Singapore
18	Italy
19	Switzerland
20	Norway
21	Philippines
22	Sweden
23	Turkey
24	Mexico
25	Hong Kong
26	Austria
27	Spain
28	Russia
29	Malaysia
30	Belgium
31	India
32	Denmark
33	Hungary
34	Taiwan
35	France
36	Portugal
37	Japan
38	Chile
39	Israel
40	Indonesia
41	Brazil
42	China
43	Greece
44	Colombia
45	South Korea

Source: GMI

An SEC Warning to Japanese Banks



Mitsubishi UFJ Financial Group celebrates the merger that created it in Tokyo. The SEC is investigating allegations that its New York City branch has allowed money laundering.

For the first time since pulling out en masse in the early 1990s, Japanese banks are poised to come back to the American capital markets. Their ambition is to compete head-on with U.S. and European investment banks a few years down the road, structuring deals, selling exotic investment instruments and trading for their own accounts, as well as offering loans. They are awash in money that they rake in at close to zero interest from Japanese depositors, who believe that a bank savings account is by far the safest place to put a nest egg.

But to compete credibly with their American counterparts, Japan's banks will have to get up to speed with dramatically tougher regulatory and governance practices. The giant Mitsubishi-UFJ Financial Group is a case in point. The Securities and Exchange Commission is investigating its U.S. subsidiary,

Bank of Tokyo-Mitsubishi UFJ Trust, and the group's New York branch for their outdated computer monitoring system, which has apparently failed to stay on top of Russian money laundering transactions, a senior official of the group told *Directorship* recently.

The SEC has told its Japanese counterpart, the Financial Services Agency (FSA), that it would send investigators to Tokyo in October to conduct a joint investigation, the official said. The FSA and Mitsubishi-UFJ Financial Group spokesmen declined to comment on the record.

It's not the first time that the group has been reprimanded by the SEC. In 2004, the SEC told Union Bank of California International of Los Angeles, the group's Los Angeles-based subsidiary, to improve its anti-money-laundering monitoring system. But the latest swoop comes

at an inopportune time for Mitsubishi-UFJ. It is gearing up to launch a U.S. financial holding company to support its ambition of expanding its investment banking business. "The only reason why the SEC hit Mitsubishi-UFJ is that its shares are listed on the New York Stock Exchange, while those of Sumitomo-Mitsui and Mizuho financial groups are not," speculated one foreign banker in Tokyo. "All the Japanese banks have been out of the global capital market since the early 1990s because of the busting of the bubble economy. They are very disoriented."

The SEC penalty, likely by year-end, may be a slap on the wrist on Mitsubishi-UFJ, with little immediate impact on its business. Even so, it should be enough to send a message to all Japanese bankers to clean up their compliance acts.

— By Toshio Aritake

Kabuki on Corporate Tax

New Japanese Prime Minister Shinzo Abe is mostly walking in the shadow of his predecessor, Junichiro Koizumi, but he differs on one major economic issue: taxation, including taxes imposed on Japan-based subsidiaries of U.S. companies. While Koizumi had made a priority of eliminating the government's budget deficit by 2011, Abe doesn't have the luxury of pursuing that goal too aggressively, or he may risk derailing the current economic expansion. Politically, what's at stake is that Abe wants to lead his Liberal Democratic Party to victory in next summer's national elections.

So Abe has appointed Kaoru Yosano, the pro-bureaucrat former economy and fiscal minister who had trumpeted balancing the budget, as chairman of the LDP tax commission. That effectively gags Yosano from speaking out for fiscal reform. The LDP barons gave the highly visible post to Yosano so that "he cannot present his pro-bureaucrat [and possibly pro-tax hike] case to the party tax commission, since he will be the chairman, not a member," says Fujio Ando, who heads the research department of Chiba Bank Asset Management.

The new prime minister himself shows limited interest in economic affairs, ceding clout to chief cabinet secretary Yasuhisa Shiozaki, a former Bank of Japan official. So a balanced budget may be years away.

— T.A.

People

Alan Greenspan has often resembled a Cheshire cat, concealing what he really thinks behind a clever grin. But now that he's left the Federal Reserve, he's demonstrating some refreshing bluntness. He told a Boston business audience that Sarbanes-Oxley was a "nightmare." He said SOX hampered business, discouraged risk-taking and was driving foreign companies to seek listings in London rather than New York. The only part he praised was the rule that CEOs had to personally certify their companies' financial reports. "The rest we could do without," Greenspan said. What other truths might lurk behind that smile?

Michael Dell and **Kevin Rollins** have reached out to a former board member, **Tom Luce**, to rejoin Dell's board of directors, apparently to help guide it through a Securities and Exchange Commission investigation into its share-repurchase program. Luce, 66, a lawyer who was a founding and managing partner of Hughes & Luce, served on Dell's board from 1991 to 2005 before stepping down. He served on the audit committee. Dell has delayed its fiscal second-quarter financial report because of the probes into the share-repurchase program. The stock is below \$25, down from a high around \$40 last year.

AIG is bringing in new blood. **Robert B. Willumstad**, 61, who lost out in the beauty contest to succeed **Sandy Weill** at Citigroup, is the new chairman of

the board, replacing **Frank Zarb**, who was chairman when the board sent **Hank Greenberg** off into the night. Zarb remains on the board. President and Chief Executive Officer **Martin Sullivan** remains in charge of running the company.

AIG also named **Virginia "Ginny" Rometty** of IBM to its board. The 49-year-old fast-talking dynamo is senior vice president of the Global Business Services arm of IBM. Another woman in a senior position will be **Anastasia D. Kelly**, who is the new EVP and general counsel. She previously served in a comparable role at MCI/WorldCom.

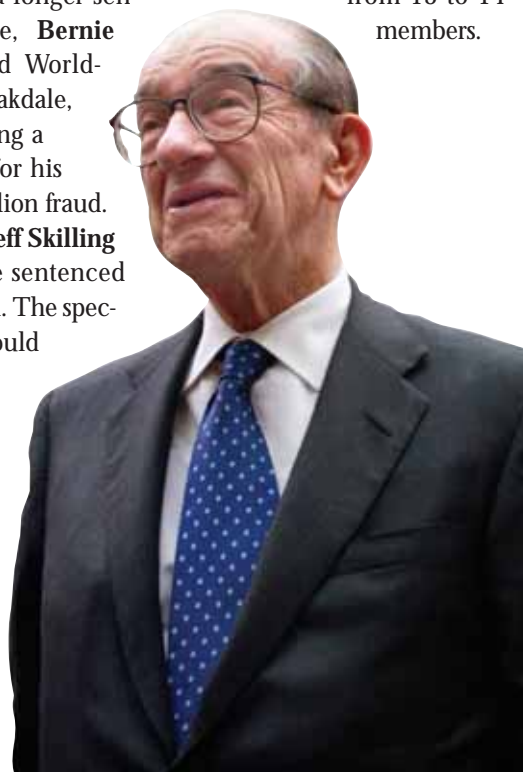
Bye-bye, boys. **Andy Fastow**, who dreamed up the special-purpose entities that helped sink Enron, received a surprisingly light sentence of six years. His cooperation with prosecutors helped him beat a longer sentence. Meanwhile, **Bernie Ebbers** of the old WorldCom arrived in Oakdale, La., to begin serving a 25-year sentence for his role in that \$11 billion fraud. Next up: Enron's **Jeff Skilling** is scheduled to be sentenced Oct. 23 in Houston. The speculation is that he could get 20 years.

Elsewhere in the bad boy department, a federal judge refused to throw out cor-

Alan Greenspan shows his stripes.

ruption convictions of former HealthSouth CEO **Richard Scrushy** and former Governor **Don Siegelman**.

What is Hormel Foods up to? The Minnesota-based company, which brought the world Spam (hey, Hormel wouldn't still be in business if people didn't buy the stuff), has put two academics and a toy guy on its board. Joining are **Elsa A. Murano**, 47, vice chancellor of agriculture at Texas A&M University, and **Hugh C. Smith**, 66, a professor at the Mayo Clinic College of Medicine and a consultant at Mayo Clinic. Is Hormel thinking of engineering organic Spam? That might make a weird sort of sense, but we're mystified why **Robert C. Nakasone**, who ran Toys "R" Us into the ground, is also joining. **Robert R. Waller**, 69, and **John W. Allen**, 76, are retiring. The board will grow from 13 to 14 members.



New Board Appointments

Bristol-Myers Squibb

James M. Cornelius

Interim CEO

R. Sanders Williams

Dean, Duke University School of Medicine

Corporation for Public Broadcasting

Chris Boskin

Former board member, KOED (San Francisco)

David Pryor

Former senator and governor, Arkansas

Delphi

Martin E. Welch

EVP and CFO, United Rentals

FedEx

Seven Loranger

Chairman, president and CEO, ITT

General Dynamics

John C. Ulrich

Vice president

Krispy Kreme Doughnuts

Andrew J. Schindler

Former chairman and CEO, R.J. Reynolds Tobacco

Owens Corning

F. Philip Handy

CEO, Strategic Industries

Joseph F. Neely

CEO, Gold Toe Brands

Ralph F. Hake

Former chairman and CEO, Maytag

Alliant Energy

Darryl B. Hazel

President, Ford Customer Service

Safeco

John Hamlin

SVP, global online business and global brand marketing, Dell

Terra Industries

Dennis McGlone

Former president and CEO, Copperweld

James Kroner

CFO and CIO, Endurance Specialty Holdings

Q&A



HP: It's Not Over

continued from page 1
which is why focusing on the board's dynamics and having up-on-the-table conversations about the source or the existence of dysfunction are so important.

As I mentioned in my book, the Hewlett-Packard board until the late 1990s really was not an active board. What board members said to me when I arrived was, "Dave [Packard] was the dictator in the boardroom.

We all did what Dave wanted." So I think there was a period of time when the board was fairly passive. Then there was a period of time when the board became very active. The decision to spin out Agilent required a lot of active discussion. I think the culture, however, had become a culture of conflict avoidance. People had a difficult time talking about tough issues directly. And so this pattern of conflict avoidance

meant people would take things underground. I found it around my executive table, and I found it around the board table.

So was conflict avoidance the common denominator between what is currently going on and what happened to you?

Two things, to me, cause dysfunction. One I've already spoken about, when people's personal agendas become all-consuming. The other is when other people stop talking candidly, openly and directly. Debate and disagreement in the boardroom are paramount to a healthy business. And not everybody is comfortable with that. Some people feel threatened by direct dialogue. I think directors need to understand that respectful, open debate and discussion about what you agree on as well as what you disagree on are part of the job.

HP's board has five vacancies. What has to happen now?

I believe for the sake of the company—which is a company I love—there has to be up-on-the-table conversation about what has happened here. My personal view is that it can't be swept under the carpet. People have got to talk about what happened. I think the difficulty in the boardroom is it's a very small group of people now. They are embattled, and they have to fill a bunch of seats.

Will five new board members be enough, or does HP need a deeper housecleaning that that?

I'm not there. I don't know what's going on in that boardroom. My supposition would be right now that there's not necessarily complete alignment about what has to happen next. I doubt that the dysfunction has all disappeared just because three people have left.

One would assume that for the sake of continuity, a total turnover wouldn't be practical.

I'm not suggesting that's the right answer. I don't know what the right answer is. What I do know is that a lot of straight talk has to happen now.

One theory floating around is that the board had a closed mentality, sort of like a Silicon Valley club. Do you buy that?

When I was there, my view was—and this is why I had great trepidation about bringing Tom Perkins back—not just that the mandatory retirement age rule was one the board had agreed on and I didn't see any reason to break the rule, but more important I didn't think more tech expertise was what we needed. I thought what we needed was big-company operational expertise. I've spent 30 years in big, complex companies, and they are different in nature from small technology startups. Of course, I believe that you need some people who understand technology. But Hewlett-Packard isn't a startup in Silicon Valley anymore. It's an almost \$9 billion global colossus.

We've heard that having Mark Hurd serve as chairman may be a mistake, that an independent chairman might be a better idea. What do you think?

Let me take it out of HP's specific situation for a moment. I personally don't believe there's a silver-bullet answer to how a boardroom best works. I think in some situations, a separate chairman and CEO works well, and in others the combined job works well. I think it has more to do with how the people around the board table operate. Having said that, my observation would be it's not clear to me how in this partic-

ular case that particular answer is responsive to the issue that apparently exists. It may be, but it's not intuitively obvious to me.

What's your impression of the role played by [outside counsel] Larry Sonsini?

When I was there, Sonsini was a great counselor to me and to the board. I consider him also a very good friend. My experience with him is that he tried very hard to understand various points of view. That's my impression of him.

If financial results and board structure aren't adequate measures, how do you do an objective assessment of board function?

I would focus first on, what do they spend their time on? Of course, a board has to review the financials of a company. But in my view, the board needs to be spending most of its time not on what's already happened but on the leading indicators. So those are: Do we have ethical issues we need to consider? Where are our risks? What's happening with leadership development? What's happening with customer satisfaction? Are we still executing against our strategy? Are there other strategic alternatives we should be considering? Whom do we have in which chairs, and do we have the right people in the right jobs? In a technology company, what's our rate of innovation?

There are some leading indicators that point to the ongoing health of the business. And I think, first, board members should be spending their time on the right things. Second, you can't cut any corners on rules of governance. You can't skim a 10K—an example from

my book. You've got to know what's in it and sign off on it.

Do you think pressure from special interests like labor and religious groups, hedge funds and pension funds is interfering with board and CEO decision-making?

I think there's a danger in that. Not because those groups don't have a legitimate interest in the impact of a company. I happen to strongly believe that a global company has huge impact, and I think directors need to be thinking about what that impact is on the environment, on the community, for their own enlightened self-interest. But I think the model that some people have in their minds is our political system. And our political system is designed to move very slowly. It is designed to not move at all until there is an emerging consensus among many interest groups about what the right thing to do is. That's not how a business can operate in a competitive environment. We need to talk plainly about the fact that if we want American companies to compete on a global stage, they have to be businesses, not political organizations. We're in different spheres.

What are you going to do next?

I kind of made myself a promise that I wasn't going to make a decision about another full-time commitment until after I got this book out and saw this process through. I may go back and run a company again. I may move off into public service. I suspect – I hope – I will serve on boards of companies that are interesting to me and that I have admiration for. I think that's a worthy cause. **D**

Directorship Plays "Fill the HP Board"

Directorship approached leaders at top executive search firms with the question, "What would you do if you were tasked with reconstituting Hewlett-Packard's board?" Many declined to participate, citing conflicts. For example, Christian & Timbers' Steve Mader couldn't comment because HP is a major client. Gerry Roche at Heidrick & Struggles also cited ties to the company, as did Andrea Redmond, co-head of Russell Reynolds' board practice, who placed Hurd in his current position.

But a few agreed to play the game. Julie Daum, head of the board practice at Spencer Stuart, thinks HP needs an independent chair. "It just seems to me that they need a fresh start," she says. "Most of the people there have been involved for a while." Two examples: Richard Hackborn, who was named lead independent director in September but had been with the company for 33 years before retiring in 1993; and CFO Robert Wayman, who served as interim CEO after Carly Fiorina's departure. Daum says HP should "make a statement" with an independent chair beyond reproach, but finding one won't be a cakewalk. "It's not a long list of people."

Should Hewlett-Packard throw out the whole crew and start from scratch? Chuck King, head of Korn/Ferry International's Global Board Services Practice, doesn't think so. "There are some very good people on that board," he says. For instance, "Bob Ryan is a terrific

guy, a very bright financial guy, who comes from one of the best-governed companies in the country, Medtronic."

Roger Kenny, co-founder of Boardroom Consultants, was willing to suggest five candidates to fill the vacancies, along with his analysis of each:

◆ Jack Krol, former CEO of DuPont. Krol was appointed lead director of Tyco after its meltdown. "Here's a heavyweight white knight who has unquestioned independence and integrity. He did the work at Tyco, including convincing some board members to leave who didn't want to."

◆ Edward Kangas, former CEO of Deloitte & Touche. "He was a stabilizing force at Tenet Healthcare and is an experienced team builder. He's not afraid to wade into a swamp."

◆ Steve Reinemund, former CEO of PepsiCo. "He has the time now, and this is the guy who took on Coke and won. He would be a strong mentor to Mark Hurd, and he sits on other high-profile boards."

◆ Connie Horner, guest scholar at The Brookings Institution. "Connie is a director's director. She really understands governance and she has a low tolerance for compromise on ethics."

◆ Nigel Morris, co-founder and former president of Capital One Financial. "He's a business builder, and he understands technology. He'd also be a mentor to Hurd."

Q&A

Wanted: Backbone In the Boardroom



continued from page 1

ing more time burnishing their legacies than they were building the company for the next decade. In some cases, they were just hanging on until they reached 65. But today, there is a tendency for CEO tenure to be too short. In any major corporation, it takes five to seven years to make major changes.

Why do you think boards are so willing or eager to cut

short a CEO's tenure?

In many cases, there is perhaps an overreaction to pressures from the stock market. The stock market has become very short term in its orientation. It's getting more so, with the bulk of the hot money being held by hedge funds, who are demanding short-term results. A lot of boards are getting very nervous if their CEO is not achieving those results.

Which particular CEO de-

partures have been premature?

One that was clearly premature, but it was not for performance, was Steve Reinemund at Pepsi. He'd only been there five years. He's a terrific individual, and I'm very sorry to see him go out. He clearly made that call, I'm sure. It was clearly not for performance. In other cases, we have short-term moves because individuals have gotten involved in embarrassing situations where they were shooting themselves in the foot, like the situation at Bristol-Myers Squibb.

So some CEOs bring it on themselves?

That's very true. Clearly, that was the situation at Hewlett-Packard. There are cases where a board has to act. In those cases, I commend boards for acting.

What can boards do short of pulling the trigger on the CEO?

Boards have to do a far better job on selection of CEOs, and that means a much better job on the succession process. I feel that many boards are not doing a good job of that. There's been a clear shift, which I certainly salute, away from searching for the savior from outside to focusing on inside candidates and inside succession. Boards need to spend a lot more time on that, as a board like General Electric already does, in order to ensure the proper selection.

But short-term market pressures seem to be intensifying, and many directors seem worried about having their personal wealth on the line.

I don't think it's a question of their financial liability. I think it's more a question of responding to public pressures. But in my opinion, that's not what they're elected to do. They are elected to serve the corporation

and all its shareholders for the long term. They need to be clear that the corporation and all its shareholders are best served by long-term plans, well-executed. Those cannot be accomplished in the short term. There is no such thing as changing the culture of a significant corporation in six to 12 months. It takes much longer than that.

What is the key to helping boards resist short-term pressures?

I think having a strong board culture and strong board chemistry are part of the answer. Board members should be clear about the long-term objectives and track their progress against those objectives. They should not look to analysts and short-term investors for their inputs about how things are going. Back in my Medtronic days, if I had followed what the analysts wanted me to do, we would have split off the neurological business and the cardiovascular business, and some investment bank would have made some money, but we would never have built Medtronic.

I don't hear many people talking about "board culture." What do you mean by that?

Not enough people talk about board culture or board chemistry. That has to be built over time. Each board has its own culture. The question is, is it positive or negative? Do board members spend any time outside the board meeting getting to know each other? Do you build a clear understanding with the CEO of the expectations? Do you get to know the management enough that you really know the corporation?

I'm a strong advocate for having offsite board meetings to talk

about company strategy. This builds a much stronger culture. All three of the boards I'm on have been observing this practice for several years. It does take a lot of time.

You've been working on a new book about leadership. What are your latest findings on how boards groom talent?

Any board that fails to groom internal succession candidates is not doing its job. There are of course times, as there were at IBM, when they brought in [outsider] Lou Gerstner to save the company. But if you look at Xerox, they went outside, and the person was a huge failure. Ann Mulcahy, the internal candidate who had been passed over, saved the company. We tend to look at a résumé of an outside candidate as being superior to that of the inside candidate, where we know all their warts. But that's a huge mistake.

At Procter & Gamble, directors go out on field trips and meet high-potential candidates. Is that one of the keys?

That's one of the keys. You should get to know the up-and-coming senior executives in settings that are little more informal than the boardroom. You don't see the full person in the boardroom making a presentation for half an hour.

You seem to be suggesting that many directors want to go to six or eight meetings a year, and that's all they want to do. Is that part of the problem?

It is. And too much of the time in those six to eight meetings is spent on Sarbanes-Oxley and asking, "Are we hewing to the latest accounting rules or regulations?" rather than asking, "Are we building the organization for the long term?" I think

boards are changing. I think they're becoming much more conscientious about their jobs. In the post-Enron era, the problems have got their attention. And even having a couple of boards being sued has everyone's attention. That's not necessarily good—it's much harder to recruit directors today. Boards are earnestly trying to do a better job, but there is this danger of overreacting to Wall Street.

What do think went wrong at Hewlett-Packard?

HP has been my role model of a company for 30 to 40 years.

pany to hire Carly Fiorina, and then they brought in Mark Hurd. There was no one under Fiorina ready to step up. Hurd has done an outstanding job. It's amazing at how quickly he has picked up the HP culture and is carrying it forward. He's tough-minded. He's taking out costs that are excessive and getting it back to being a more competitive company, like it was 10 years ago.

Was the board so flawed that a meltdown was inevitable?

A [company] like HP should never be in a situation where it

"Board members should not look to analysts and short-term investors for their inputs."

I have enormous respect for Dave Packard and Bill Hewlett. I think they were just giants of leaders. In fact, maybe that's part of the problem. Maybe it started way back then. They were so strong and so capable that they never built a board like a General Electric did or an Exxon did. Everyone relied on them. Plus, they've had a tendency for many years of taking executives who had retired from the company and keeping them on the board. I think that is a bad practice.

That's part of the problem. Good governance produces good long-term results. Boards that don't put it in place are putting themselves at risk of being too dependent on one, two or three people. The tragedy of HP was that they had so many outstanding executives, yet they felt they had to go outside the com-

pany to hire Carly Fiorina, and then they brought in Mark Hurd. There was no one under Fiorina ready to step up. Hurd has done an outstanding job. It's amazing at how quickly he has picked up the HP culture and is carrying it forward. He's tough-minded. He's taking out costs that are excessive and getting it back to being a more competitive company, like it was 10 years ago.

What would your advice be to him now, as CEO and chairman of the board?

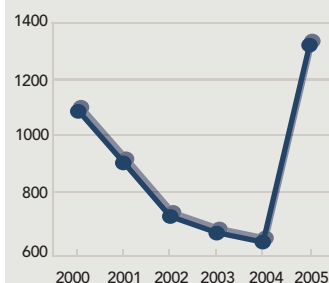
Hurd needs to bring in a lot of new blood. One or two new directors would not change the culture of the board. He needs to put together a 12-person board where he's got five or six new people who are really outstanding and totally independent and who've had no prior connection with Hewlett-Packard but are well thought of in the business community. They should have a reputation for understanding how you build a company for the long term. They can be technical, probably not from the financial community. It's a major rebuilding job. **D**

Musical Chairs in The Corner Office

U.S. companies are on track to fire or lose a record 1,400 chief executive officers in 2006, up from 1,322 last year and 663 in 2004, says Challenger, Gray & Christmas, the executive recruiting firm based in Chicago. "The days when you learn from your mistakes are over," says John Challenger, head of the firm. "The results have to be immediate, strong and consistent." Recent departures have occurred at Bristol-Myers Squibb, Ford Motor, Kraft Foods, Nike, Pfizer and Viacom.

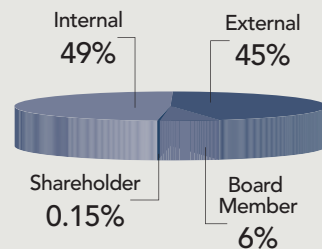
And even though the conventional wisdom now holds that CEOs should be groomed internally, the firm found a surprising percentage are still coming in from outside.

Annual CEO Departures



Chief Executive Succession

January - August 2006



Source: Challenger, Gray & Christmas



The SEC Goes Tech

continued from page 1

But with the new interactive data system that the SEC plans to adopt for its EDGAR filings, all this information will be just a few mouse clicks away. Users will be able to select companies by name, click once for CEO pay packages and click again for, say, compound annual growth rates. They could easily compare—in any of several chart formats—the pay and performance of other CEOs. It might take only a few minutes.

SEC Chairman Christopher Cox believes the new system will empower shareholders, mutual fund investors, directors and executives with more information faster than ever before. It will allow them to make informed de-

isions and further democratize corporate governance. The new system might even revolutionize SEC record-keeping, to the point where cumbersome 10-Ks and 10-Qs are finally made obsolete. “This would allow average Americans to view exactly what they want. It would liberate information trapped inside documents,” Cox told an SEC roundtable on Oct. 3.

The key is XBRL, or eXtensible Business Reporting Language, which consists of strings of new coding attached to the financial documents that public companies and mutual funds file with the SEC. The codes “tag” specific bits of financial data so they can be retrieved and massaged in ways not possible in the

old system. In September, Cox announced \$54 million in contracts that will help the SEC rebuild its data system to accommodate XBRL and to help write tags for existing SEC filings.

About two dozen companies, including Altria and Xerox, are participating in a pilot program through which they will make their required SEC filings interactively through a test version of the new digital system. Corey Booth, the SEC’s chief information officer, says that the pilot project, which will last at least a year, will give the system’s developers some real-world feedback about how it works and how much it costs to implement.

Liv A. Watson, vice president of global strategies for EDGAR Online, co-developed the language eight years ago and helped introduce XBRL on the Chinese stock exchanges in Shanghai and Shenzhen. She now is vice chairman of XBRL-US, an oversight consortium with 1,300 members. Watson says it will probably take about two years for the new system to be widely adopted among U.S. companies. As an open-source system, XBRL is free of licensing fees, and companies can make money through subsequent add-ons. Companies offering support packages include enumerate Solutions, Lipper, Rivet Software and I-Metrix.

So far, executives of companies in the SEC pilot program seem to like what they see. One is Indra K. Nooyi, who became CEO of PepsiCo on October 1. The \$32.5 billion soft drink giant has been using the interactive data system for several months, and its implementation has been a snap, Nooyi told attendees at the roundtable. “The language is very intuitive and easy to apply,”

she said, noting that by using it, Pepsi was able to file its most recent quarterly reports 14 days before the deadline.

Costs were minimal. “It required a much smaller investment than we thought,” she said. Initial installation of the interactive data cost \$5,000 and took 60 to 80 worker-hours. Subsequent cash outlays have been no more than a few hundred dollars, and time requirements were “relatively painless.”

If a giant like Pepsi can deploy interactive data so cheaply, the benefits should be even greater for smaller companies. That has been the case for Crystal International Travel Group, the smallest company participating in the SEC’s pilot study. Filing 10-Ks and 10-Qs is “so burdensome for a small company,” says CEO and President Fabrizio Busso-Campana. “People stop working on their real work and start working only on the filings.”

Busso-Campana says that adapting to the new system cost his Morristown, N.J.-based firm a matter of extra worker-hours rather than major cash expenditures. “If you can follow Excel [a popular spreadsheet program], you can use XBRL,” he says. Among the benefits is that the new system generates fewer human errors. “We completed our third quarter ending April 30 with only one formatting error,” he says.

The upgrade has been a long time coming. The EDGAR system, which hosts more than 700,000 filings every year, has scarcely changed since it was implemented in the early 1980s. And SEC-required documents are filed in the same prosaic format that was adopted when the commission was founded in

1934. All EDGAR did was replicate the documents for electronic retrieval.

XBRL could potentially change all that. Interactivity will not only facilitate instant comparisons of specific financial metrics like return on equity, net revenues, operating margins and so forth. It could also eventually usher in an age of real-time reporting. Cox has said that the concept of the quarterly report, which dates back to the SEC's formation, could become irrelevant. If that happens, the whole culture of managing to an earnings-per-share estimate issued four times a year might gradually evolve into one where corporate performance is judged on a continuum.

For directors, interactive data will make it cheaper and easier to learn about their own companies, as well as the competition. Should they have to make quick decisions about an issue, they can tap into vast information resources in a more intelligent and efficient way. The interactive data system can extract just about any financial figure from any filing required by the SEC. The user simply needs XBRL software and Internet access to the EDGAR system.

The potential benefits don't stop with directors. Small and medium-sized companies could get a leg up in the capital markets. Budget-cutting on Wall Street has reduced or eliminated research coverage for these businesses, even though they often represent fast-growing sectors of the economy. But by making their financial data easily available—not to mention free—the SEC may raise their visibility among institutional and other investors.

Mutual funds, which the commission regulates, are certain to be affected by the new EDGAR language. The interactive format will make it much easier for investors and analysts to track and compare the performance of thousands of funds and the companies in their port-

folios. They can't be extracted. That is a major problem, because key corporate information and explanations for certain events are often contained in footnotes. Cox claims that now that the SEC has signed contracts to help with implementation of XBRL, the footnotes issue will be resolved in

The Budget For XBRL

The SEC is spending \$54 million to make EDGAR interactive. Here's the budget breakdown:

- ◆ \$48 million to upgrade the SEC's EDGAR database to handle interactive data. The lead contractor will be Keane Federal Systems of McLean, Va., with subcontracts to Bearingpoint, Microsoft, Rivet Software, EMC and Akami.
- ◆ \$5.5 million to XBRL-US, a consortium of technology companies and consultants, to create a digital standard for interactive data. Involved will be writ-

ing XBRL "taxonomies" or labels that will be tagged to U.S. GAAP-based data supplied by companies filing required SEC documents.

- ◆ \$500,000 in separate contracts to Rivet Software and Wall Street On Demand to create new interactive investor tools that will be available free of charge to the public seeking specific data from SEC files.

Source: Securities and Exchange Commission

folios. "XBRL will make it possible to have links to all mutual funds," K.J. Martijn Cremers, an assistant finance professor at the Yale School of Management, told the roundtable.

Not least, the new language will help the overtaxed SEC. Sarbanes-Oxley requires that the agency review every publicly listed company at least once every three years, and the commission doesn't have the budget to hire armies of additional staff. Interactive financial data will certainly ease its oversight duties.

As promising as this seems, however, there are still some bumps ahead for interactive data. One issue is that the language hasn't been applied to the footnotes attached to SEC filings, so

about six months. But Pepsi's Nooyi said the inability to turn footnotes into interactive data "makes pure benchmarking very challenging."

Another issue is that the SEC allows considerable leeway in how companies define some of their accounting terms. SEC CIO Booth says this issue will gradually be resolved as the system gains more widespread use. "Our rules have been to strike a balance between a structure and let the companies tell the stories they want," he says. One major plus, he says, is that interactive data will help standardize new rules on reporting stock options, which have become controversial, and make analyzing stock options faster and easier.

Despite Pepsi's positive experience, Nooyi worries that the SEC pilot project, which can be expanded, is too small to generate the critical mass needed for the system to take off. "You have to have momentum very quickly," she said, noting that XBRL has already been around for eight years. It took EDGAR 12 years from its inception to become the mandatory format for required SEC filings, and more than a decade before consumer product bar-coding caught on.

U.S. companies could get a push from their counterparts abroad. Watson of the XBRL consortium notes that after she worked with the Chinese bourses for five years, "every company in China uses XBRL, and they are absolutely ahead of the U.S." The system has also made major inroads in Spain, and all Dutch companies report in the format. As global stock markets become increasingly integrated, the need for smart and interactive stock data will grow, Watson believes.

For all his enthusiasm about an interactive EDGAR, Cox so far has stopped short of requiring companies to adopt the new digital language, trusting in the marketplace to accept it voluntarily. Setting the system up so that it is open source and basically free "will make companies pick it up and run with it," he anticipates.

Cox may be a little too optimistic. Pepsi's positive experience notwithstanding, large-capitalization U.S. companies whose financials are already widely covered may have little incentive to reformat all their SEC filings. It remains to be seen how strongly CFOs and CIOs will push for change. But if Cox is right, interactive data could become as routine as filing 10-Ks and 10-Qs. ■

Q&A



The Boardroom As Classroom

John Deere's CEO says he learns priceless lessons from serving as director for other companies. **By William J. Holstein**

Chief executive officers who sit on multiple external boards can absorb crucial knowledge and experience that they can apply to their own companies, says Bob Lane, chairman and CEO of Deere and Co., the \$20 billion (sales)

manufacturer based in Moline, Ill. He sits on the boards of Verizon Communications (compensation committee) and General Electric (audit.) He also defends CEOs against accusations that they are overpaid and destroy jobs. Here are highlights of a conversation:

Is being an active CEO and sitting on two other boards too much of a time commitment for you?

No. After I had the privilege to be elected chairman of Deere six years ago, because of the Deere name, a lot of companies contacted me about going on boards. But there was a lot of work to do that year, and I had a lot to learn. In consultation with our board, I elected not to go on any boards for four years. It was eventually the Deere board that came to me and said, "We think it would serve Deere well if you served on one or two [other] boards." I ended up following their advice and doing that. I learn a great deal in that process.

Most directors these days are concerned about their CEO being too engaged on too many boards. So what was your board's thinking about that?

You mentioned being on "too many boards," and that is the question. There may have been some excesses when people were serving on too many boards. But in my case, being on two boards, I see it as positive for Deere. I see not only the corporate governance issues and how others deal with those—and that helps me ask the right questions of our own people and helps me lead our own board—but I'm also exposed to [different] kinds of approaches to innovation, to investment, to dealing with the global issues in the world and the global political environment. That contributes a great deal. It's amazing. It would be hard to find ways to be exposed to that kind of input on such a regular and consistent basis.

What have you learned?

I can't be too precise, but I can certainly talk about invest-

ments in new technologies. If you think about all the investment that's going on in new technologies at Verizon Communications and GE and how that is going to affect people's lives, I get digital insights that help us accelerate our innovation process.

What have you learned about governance?

I get to sit on an audit committee and a compensation committee. So I'm aware of activities beyond what we do in our own business, which I believe is at the forefront of transparency and appropriate governance of the corporation by the board. This is not about the CEO. It's about the board of directors having appropriate oversight of the CEO. I think Deere does that well, and I think our board thinks so. I think I also have an opportunity to see that demonstrated elsewhere.

How do you manage the time commitment?

It's not that different from the way I manage my entire job. When I went on those two boards, I explicitly discontinued a number of activities. I ended up with a template in writing to people saying I was unable to do this or that. I discontinued six different activities I had been involved in outside the company. So I did make some adjustments.

What have you learned about the role of audit committees at GE? They seem to be the most powerful committees these days.

I wouldn't want to specify about power, but they are important committees and I take the work seriously, as do the other members of the committees. The Deere audit committee is something to be very proud of.

What other lessons have you

gleaned? Have you learned about board composition or Sarbanes-Oxley?

All of that. Ultimately, I'm asked by our shareholders to use good judgment and to be able to draw out best judgment from both the management team and from an experienced board. I am anxious—and I don't do it perfectly—to continue to learn how to do what I do, which is lead our board and lead our senior management group more effectively. Watching others do the same thing is like a continual benchmarking exercise.

Are major boards still struggling with the difficult climate created by Sarbanes-Oxley and all the class action lawsuits?

My impression is that there is a very serious attempt to have our businesses be both globally competitive on a sustained basis and compliant with all appropriate laws and regulations in ways that are sustainable over time. Is it perfect? No.

What is the challenge?

The challenge is to balance that out. You don't want to have the world's most well-governed, least competitive businesses. The challenge is to be compliant and have procedures and processes in place that make risks transparent to investors and cause employees to want to make the right decisions. Certainly, work is being done to do that. But at the same time there is a global challenge to competitiveness, which ultimately causes everyone to do better.

As a CEO and a director, how would you describe the relationship between board and CEO?

The board is not the pal, if you will, of the CEO. The board provides an encouraging

environment where a CEO is carrying out his responsibilities correctly in the eyes of the board. He or she can be nurtured and developed. But you're also totally accountable to that board. For example, I don't have any contract. The board could say to me tomorrow, "Thank you very much." I serve at their pleasure.

Some would say that relations between CEOs and boards have become less focused on advice. Do you think the pendulum has gone too far toward process?

I think that's a possibility. If competitiveness were to slip, that would not be a good sign. I think it's very possible that both can be done at the same time. Ultimately, good compliance supports good competitiveness.

Turning to compensation, are some American CEOs getting paid too much?

I think it's possible. My sense is that the issue is: Is compensation aligned to long-term sustained performance, not just a pop in performance? If it is not tied to that, then maybe there are questions.

What's the key to structuring it in the right way?

In our case, we divided it up into three segments—short-term, medium-term and long-term incentives. It wasn't rocket science. Our short-term incentive applies to all salaried employees, and it's all rooted in operating return on operating assets. It's how we earned on the basis of what we invested. Every employee is rewarded on how well they invested shareholders' money.

Is the problem that some of the compensation packages that have attracted so much attention are based on share

price, and that might not be the right criterion?

It could be. Or it could be that it's not based on long-enough term results. In our

Serving With Luminaries

As a director on three boards, Lane can soak up wisdom from many other seasoned executives. Here are just a few:

On Deere's Board

◆ Vance D. Coffman, former chairman of Lockheed Martin

◆ Dipak C. Jain, dean of the Kellogg School of Management

◆ Richard Myers, former chairman of the Joint Chiefs of Staff

On GE's Board

◆ Alan (A.G.) Lafley, chairman and CEO of Procter & Gamble

◆ Ralph Larsen, former chairman and CEO of Johnson & Johnson

◆ Rochelle B. Lazarus, chairman and CEO of Ogilvy & Mather

On Verizon's Board

◆ Donald T. Nicolaisen, former chief accountant of the SEC

◆ John R. Stafford, former chairman and CEO of Wyeth

◆ Walter V. Shipley, former chairman and CEO of Chase Manhattan

Source: Directorship

case, the midterm incentive was new to us. It is a payment on the absolute creation of shareholder value. That is based on a sustained four-year performance, and our company has a long history of sometimes doing well for

a short period of time and then losing it all. For example, we lost more than \$2 billion in shareholder value added from 1999 to 2003. That was more than twice what we had earned in the entire 1990s.

Was your own compensation adjusted downward during that time?

This program was not in effect at that time. But it was impacted. If the share price hadn't come back, a lot of stock options and restricted stock that had been given would not have materialized. But now the new program says that if we lose a lot of shareholder value, then you never get the pay, even though it was fully approved. It's not paid out until you earn it over a rolling four-year period.

Two issues—CEO compensation and the offshoring of jobs—have damaged the image of CEOs. Do you feel you are fairly compensated, and are you doing what's right for the American economy?

I believe the work that we're doing is going to improve the human condition. It's going to contribute not only to the flourishing of people in our own environments where we work but ultimately billions of people around the world. Now, does that mean every single individual is necessarily advantaged? No. It's in the total that it's better. Some individuals may have to make adjustments. When we have to close a factory, I don't enjoy that. But I also know that it's the right thing to do. We explain to our employees that building a sustainable great business is the key that unlocks enormous opportunity for our company and our employees and our customers. **D**

Q&A

The Voice of a Powerful Union

AFSCME's 1.4 million members want better returns on the \$1 trillion they invest.

By William J. Holstein

Richard Ferlauto, director of pension and benefit policy at the American Federation of State, County and Municipal Employees, is one of the architects of organized labor's effort to persuade corporate boards to alter the way they grant compensation to chief executive officers. This year, he targeted Home Depot CEO Robert Nardelli. And he has been at

Richard Ferlauto: His union has more questions for Home Depot.

the center of AFSCME's case against AIG, arguing that shareholders have the right to nominate directors whose names appear on a company's proxy (page 1). Here are highlights from an interview:

Are you the most active union in terms of pressing for change in the corporate boardroom?

I would say we're among the most active, and some people would say we probably are the most active.

This past proxy season, how many resolutions did you bring before shareholder meetings?

We began with 25 resolutions, and 16 went to a vote. We're focused very tightly on board composition and board accountability issues and the processes that are involved in the creation of an effective corporate board. As an indication of all that, we look very closely at executive compensation to see that it is aligned with performance and with shareholder interests.

Did you withdraw the other 14?

We came to some type of understanding with the board.

What were your most visible wins?

We had agreements with a number of boards where we filed resolutions to hold annual elections for directors, rather than staggered elections. Five of the six companies we had filed resolutions with ultimately agreed that they would hold annual elections. They included 3M, Wachovia and JPMorgan Chase.

Why are annual elections important to you?

It goes directly to the issue of board accountability. The best way to hold board members accountable to shareholders is to have them face shareholders every year in an election. At least at this point, shareholders don't have the power to nominate directors and have them placed on the proxy. One way shareholders can indicate how they feel about a particular board is by withholding votes or voting against a director.

Are you in favor of the concept of majority voting, in which directors would have to get more than 50 percent of shareholder votes, not just a plurality?

Yes, we are. We are aggressively pursuing majority voting. In fact, and I'd label this as an indicator of our success, in companies that have not moved to a majority voting

standard, rather than filing the traditional type of precatory, or voluntary, proposal, which companies would be free to accept or reject, our strategy has been to file amendments that are binding in the corporate bylaws. That would then require action. We were successful there at United Technologies, which accepted the language of our proposal and put our language directly in their bylaws without going to a vote. At a number of companies, we did very well in terms of the vote numbers.

How do you use your pension fund to give you leverage?

I wouldn't say it's leverage in any way. We're looking to improve corporate governance practices in general as a way of achieving higher shareholder value and increasing the returns for our funds. We have 1.4 million members. They have their retirement assets invested in the public pension systems across the country. They have over \$1 trillion of assets invested there.

Separately, there has been pressure on the defined benefit systems of public funds, claiming that some are not as well funded as they should be. So gaining as high a return as we can is essential for taxpayers and for our members to ensure that they get the benefits they need to retire. Corporate governance is a way of promoting higher and stronger returns on these investments.

Does it also give you an avenue to seek to unionize these corporations?

We have no private-sector members. For us, return is important. AFSCME as an institution has a pension fund, which is fairly modest compared with the public funds that we maintain for our employees. That pension fund has about \$800 million in it, as opposed to the \$1 trillion of our members' as-



sets. We use our plan as a corporate governance activist fund that seeks to improve corporate governance and therefore shareholder returns broadly through the marketplace.

Was Home Depot your most visible fight of the season?

Yes. Through our AFSCME pension plan, we identified the worst corporate governance performers within the Standard & Poor's 500, and we looked at two issues—board accountability and CEO compensation. We looked at measures that would reform the board in terms of composition, so that it accurately reflects the interests of shareholders.

Were you at the shareholder meeting?

I was the guy who asked where the board members were. [CEO Robert Nardelli] opened up the meeting and made a very brief comment, saying it was time to elect the directors. I said, "Mr. Nardelli, if directors are up for election, I think it would be important to have

them introduced." After a minute or so, these two bouncers cut me off.

Did you gain anything from the confrontation? Was that a win?

It's not a win or a loss at this point. We were looking to reform pay practices at that company and to create a board that is much more independent of the CEO. We continue to be engaged with the company. One of the things we've done is file a "books and records" demand under Delaware law. We've requested certain internal documents, and we're negotiating with the company over them.

What do you hope to find?

There are three different types of documents we've requested. One, we want to see documents related to the backdating of the stock options issue, which has arisen, to see if there were any discussions at the board level about it and who was responsible for it. Two, we want to know if there was any discussion about how the

CEO's compensation was determined, given the total disconnect between Mr. Nardelli's pay package and the stock performance of the company over the past six years. Three, we want to know about the decision-making processes.

Mr. Nardelli said it was his decision not to hold the board meeting. It seems to me that that's a good indication of why the role of chairman and CEO should be split. We want to see if other internal decisions had been made in which Nardelli sets the agenda and restricts the board from acting in ways that are more in the interest of shareholders.

Isn't all that confidential, inside information?

It's confidential unless a judge makes a determination that it can be released because shareholders need that information to make informed fiduciary judgments about their investments in the company. Delaware corporate law, Section 220, allows this books and

records request for this confidential information.

What were your other important battles of the past season?

The most significant has been CEO compensation. We've been concerned for a number of years about CEO compensation being an indicator of a board that isn't doing its duty to its shareholders. We've been looking for mechanisms to signal that concern. We've historically been successful requiring a cap on golden parachutes, which is severance compensation. We won a majority proposal at Emerson Electric this year on that issue. Another type of resolution would require restricted stock grants to be performance-based. At JPMorgan Chase, we won a majority vote on that issue.

What is your agenda for 2007?

Next year again, our aim is to promote this type of shareholder advisory vote on compensation while looking further at mechanisms to reform the composition of the board itself. **D**

Best Practices

AFSCME's Blockbuster Season

The AFSCME Employees Pension Plan filed 25 shareholder proposals for the 2006 proxy season. Nine were settled and withdrawn, meaning that the companies agreed to take action without a shareholder vote. Here is a summary:

Advisory Votes on Executive Pay. Put compensation reports to an advisory vote. The motion carried more than 40 percent of voting shareholders at US Bancorp, Home Depot and Countrywide Fi-

nancial. Bank of America settled. **Majority Vote Standard.** Amend company bylaws to require that directors be elected by a majority, not a plurality, of shareholders. The proposal won more than 50 percent at Honeywell and Qwest, although for technical reasons it was not approved. United Technology settled.

Performance-Based Measures for Restricted Stock. Add performance-based vesting measures to restricted stock, which is traditionally awarded based on length of service. Bristol-Myers Squibb and Time Warner settled. At JPMorgan Chase, the

proposal won 53.4 percent. **Severance Policy Proposals.** Limit the amount of compensation senior executives can receive in the event of change in control and/or involuntary termination. The proposal won nearly 60 percent at Emerson; Raytheon strengthened its severance policy.

Classified Boards. Eliminate the board structure that puts directors into different classes with only one class up for election each year. Wachovia, Mellon Financial, Washington Mutual and 3M settled. At SunTrust, shareholders voted 56.1 percent in favor.

Equity Compensation Holding Policy. Implement policy that executives must maintain a percentage of after-tax shares from equity compensation plans rather than cashing out. FMC Technologies settled.

Solicitation Expenses. Allow shareholders to recoup costs of nominating directors for fewer than half the board seats, provided the candidates receive a threshold percentage of the vote. American Express, Bank of New York and Citigroup applied to the SEC for a "no action" ruling; the SEC rejected their requests.

Source: AFSCME

Q&A

Declaring War On Lawsuit Abuse

The American Justice Partnership fights for tort reform, state by state.

The American Justice Partnership was launched in January 2005 under the auspices of the National Association of Manufacturers to stop abuses of the legal system at the state level and to lobby for tort re-

form. Bernie Marcus, co-founder of Home Depot, helped create the AJP, which is chaired by Steven B. Hantler, assistant general counsel at DaimlerChrysler. Here are highlights of a conversation with Marcus and Hantler:

We can't resist asking you, Mr. Marcus, about your statement that you couldn't create a Home Depot in today's business climate. Why not?

Marcus: It's not only because of our tort system, but also for many other reasons. Congress, state governments and the regulatory system have absolutely turned their backs on the free enterprise system. Sarbanes-Oxley is probably one of the worst laws I've ever seen in my life. It's taken the risk factor out of business. When we started Home Depot years ago, everything we did was

Bernie Marcus thinks SOX is among the worst laws ever written.

a risk. When we doubled in size, it was a major risk. If we had to worry about being sued every inch of the way, or worry about a board that was not willing to back us, we could never have become what we are. But today's boards are risk-averse. Why would you want to take a risk when you're putting your own wealth at risk?

And having total outside boards doesn't make a lot of sense to me. When we started Home Depot, our board was made up of shareholders. They contributed. They were involved. Whatever happened to the company had a great effect on their assets. You always knew you got the right information. You always knew you had a board watching you all the time. Having a college professor on the board may look great, but it doesn't help your business too much.

Hasn't there been a slight decline in the number of class actions being filed?

Marcus: I read recently that part of the decline can be attributed to the lawsuits not filed by Milberg Weiss, which is under indictment. However, we still have a lawsuit epidemic in this country. The good news is that more businesses are beginning to recognize that the litigation epidemic is a terrible drag on the economy and their business.

If you are a director on a board, I would like you, at the next board meeting, to ask the CEO, after he or she goes through all the numbers, including profits, return on investment and all that, "What does litigation cost us every year?" It's an enormous number for large and small companies, but it's not on the balance sheet. It's nowhere in the P&L. It's like it doesn't exist.

How much does it cost?

Hantler: It was \$246 billion in 2004 and is approaching \$264 billion for 2005. What's not reflected in those numbers is the damage to share value and company and product reputation when companies are under the withering assault of the trial bar. The reserves that companies are having to hold have gone up exponentially, and that money is not hitting the bottom line.

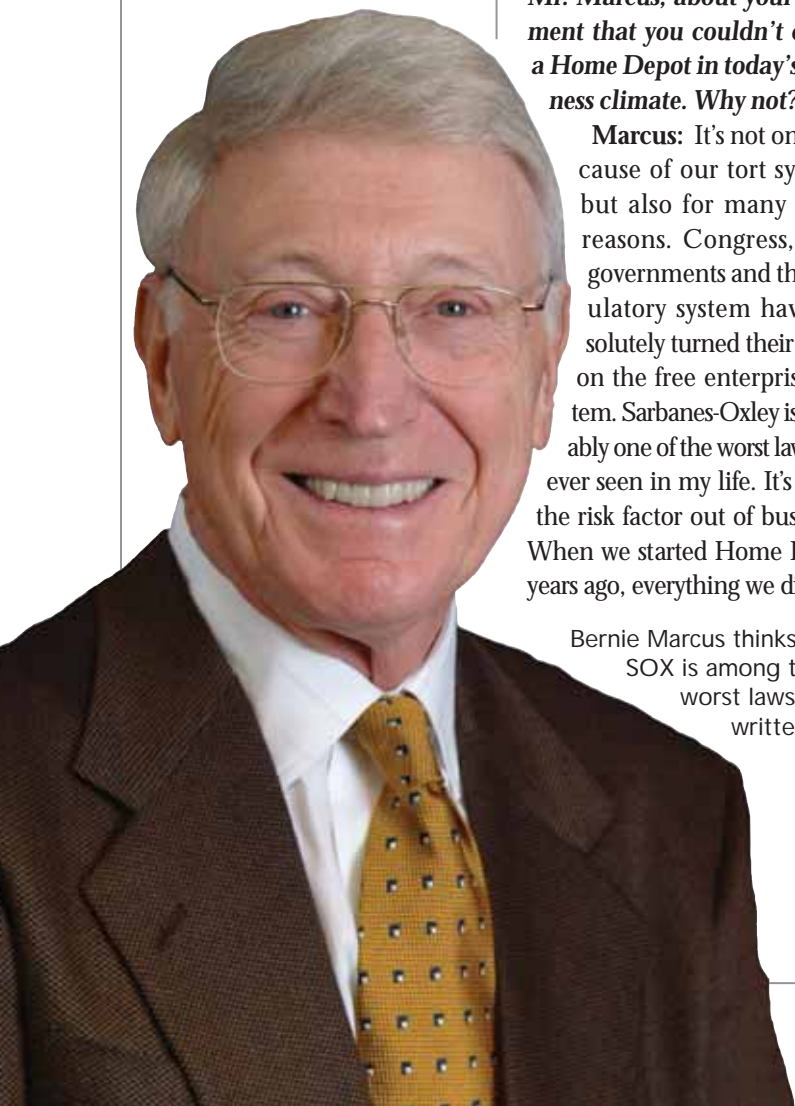
In your view, what has to happen?

Marcus: I went to the Securities and Exchange Commission at one point and asked them whether they would insist on every company having that number as part of their balance sheet. Shareholders should know what a threat this is to the system.

What did the SEC tell you?

Marcus: We got no answer from them. I've had private discussions with many CEOs, and they all say that they wish something like that would happen. Until the guys in Washington understand how serious this matter is, they're not going to react. What we have started is a state-by-state program. We've been able to bring together a coalition of about 60 national and state organizations, including the National Association of Manufacturers, the Council of State Chambers, the Council of State Manufacturing Organizations, the American Tort Reform Association, the Manhattan Institute and many other trade and tort reform groups.

There is a common enemy out there. Plaintiffs' lawyers are well-organized. They help elect activist judges at the state level. Most companies don't want to get involved because it doesn't look right. It may not look right but it's having a dramatic impact on their business.



Hasn't one of the big abuses been "jurisdiction shopping," where the class action lawyers simply shop to find a friendly judge?

Marcus: There are many legislatures that have passed tort reform, but it too often gets thrown out by activist state Supreme Courts. For years and years, activist judges have been elected with the support of the plaintiffs' bar. There are people entrenched in all sorts of places. You go to one of the "judicial hellholes"—and the entire state of West Virginia has been designated a hellhole—and you're a dead duck. We've been able to get tort reform in various states by focusing on state races. We've been able to do it in Alabama, Michigan, Texas, Georgia, Illinois and Mississippi, to name just a few states. We don't go near national politics. We're interested in the state battles.

What are the broader economic effects of the lawsuit epidemic?

Marcus: It goes into the price of every product. We all scream about pharmaceutical costs. I just had a prescription filled. It was a lot of money for a 30-day supply of pills. But the truth is, that manufacturer somewhere along the line is going to be sued for \$6 billion, \$7 billion, \$8 billion. The company has to build up its war chest. Every product we sold—for example, lawn mowers, ladders, hammers—there's a dollar amount built into those products from the manufacturers.

Hantler: I honestly believe that this climate has caused companies to close their manufacturing plants and go overseas. Even if the price of the product is equal to what it would cost here,

it's still less expensive because you don't have to deal with much of the lawsuit epidemic with your operations overseas. I think that's one reason China is doing such good business.

Just how powerful are the class action lawyers politically?

Marcus: It's not just the class action lawyers, it's the entire plaintiffs' bar. They've been organized for a number of years. They're perpetuating their trade. They're good business people, very entrepreneurial. They recognize that making an invest-



Steven Hantler: Litigiousness in the U.S. drives manufacturing overseas.

ment in court races and in attorney general races is good for them. They go state by state. They know whom they're going to support. They throw money into the pot. They are very well organized.

Is new investment your ultimate weapon in persuading states that it's not in their best interests to create a negative environment?

Marcus: The ultimate weapon is bringing together all the business interests to fight a concerted fight. Some heroic companies are fighting back, particularly in asbestos. What we're saying to everybody is that it's time to get involved in this fight.

Which companies are leading?

Hantler: We don't disclose who contributes to AJP. But DaimlerChrysler is willing to have me talk to the media and be involved. We're a company that is actively involved in tort reform.

Do you want to roll back all the protections that consumers have?

Hantler: Not at all. We need a strong system of torts where injured people can receive justice and fair compensation. But that's not what's happening in our legal system today. It's become a litigation lottery, where people want to get \$20 million, \$50 million or \$100 million. We call it "jackpot justice." There's no predictability or fairness.

And you think that boards of directors have a stake in this fight?

Hantler: Yes. I spoke to the CEO of a major insurance company who told me that because of certain tort reforms enacted in the state of Ohio, he could release \$50 million to \$100 million from reserves to income. Not only will tort reform make the system fairer, it will also allow companies to reserve the proper amount. If tort reform succeeds, it will clearly affect the bottom line.

Marcus: Sure. That money goes back into building the business and creating jobs. There are cases where people should be sued. There are places where people have been wronged. They should be able to go to court. We don't want to stop that. But having been exposed to some of these frivolous lawsuits, I've seen people just look at you with puzzled eyes, and they don't understand this can be happening in America. **D**

By the Numbers

How the States Stack Up

Legal Climate (from best to worst)

1	Texas
2	Colorado
3	North Dakota
4	Ohio
5	Michigan
6	Utah
7	Kansas
8	Virginia
9	North Carolina
10	Georgia
11	Nebraska
12	Tennessee
13	Wyoming
14	Washington
15	Alaska
16	Delaware
17	Indiana
18	New Hampshire
19	Iowa
20	South Dakota
21	Mississippi
22	Hawaii
23	Idaho
24	Minnesota
25	Louisiana
26	New Jersey
27	Oregon
28	Missouri
29	Arkansas
30	Wisconsin
31	Arizona
32	Illinois
33	Nevada
34	Maine
35	California
36	South Carolina
37	New Mexico
38	Oklahoma
39	Kentucky
40	Alabama
41	Massachusetts
42	Florida
43	West Virginia
44	Connecticut
45	Montana
46	Maryland
47	Pennsylvania
48	New York
49	Rhode Island
50	Vermont

Source: Pacific Research Institute

Risk Management: One Size Doesn't Fit All

Directors say that processes for safeguarding company assets and reputation must be customized. **By William J. Holstein**



Talking risk:
Tom Plaskett,
Greg Radner
and Blythe
McGarvie

Business leaders face many serious questions. How does a chief executive officer best pilot an organization? When does it make sense to have a separate chairman and CEO? What is the best balance in the relationship between a CEO and a board? In each case, the frustrating but correct answer is: "It depends."

That also emerges as the right answer as to how a board should manage risk. Directors attending a roundtable entitled "Risk Management and the Boardroom" found that no single committee structure should be universally adopted. At some companies, it makes sense for the risk function to report to the

audit committee. Other companies find they need a committee other than the audit committee devoted to risk. And at least one, the giant municipal bond insurer MBIA, spreads the risk management function over three committees. One is the credit risk committee, because the insurer takes such huge positions in financial markets, said board member Debra Perry. "I think there is a great deal of benefit that comes from spreading the wealth, so to speak, in risk oversight," Perry said. At yet other companies, the entire board manages the risk function directly.

Each company and each industry also face different "baskets" of risk. It may make sense in

one industry to identify and manage currency risks; but in another setting, that may not be necessary. Some companies may face regulatory or compliance risks, while for others the greater risk is technological change.

A final piece of the riddle is that different risks need to be managed differently. It may be adequate for management to make an annual presentation to the board on a particular risk; but for other baskets of risk, boards may find that they need much more elaborate "risk mitigation" systems that catalog risks and rank them on a quadrant of probability and potential impact. "I think there is a tremendous sense of consensus about this whole area," said

Tom Plaskett, chairman of Novell and a director at RadioShack and Alcon Labs. "First, it's complicated and second, one size doesn't fit all."

The roundtable, held at the Union League Club in New York, was sponsored by Eisner LLP, a New York-based accounting and auditing firm, and Thomson Financial, which provides services to senior management and boards.

Risk management is high on the minds of board members these days partly because of intensified regulatory and financial market scrutiny, but also because of self-inflicted wounds such as those suffered at Enron and WorldCom and, most recently, at companies that backdated stock options. The legal climate also has aggravated the ever-present risk of suits. Natural disasters like Hurricane Katrina and the threat of terrorism round out the picture of an increasingly hazardous business world.

Directors these days are expected to grasp the essentials. "Probably not more than 10 years ago, the requirement for being a director was primarily knowing somebody in management or a significant shareholder," said Eisner's Neil Goldenberg. "But today, you are required to really understand the regulatory environment and the risks and rewards."

Here are other key issues debated at the roundtable:

◆ How much information is enough and how much is too much? Before a meeting, management typically presents large "board books" to each director that are filled with huge amounts of information. Some directors said managements overwhelm them, either intentionally or simply because they haven't thought through the types of information that are really essential. "A lot of compa-

nies have taken the view that, 'We're going to give the directors everything,'" said David Meachin, a director of Lyondell Chemical, which has annual revenues of \$20 billion. "But do we really need all this stuff? Shouldn't management be highlighting for us the things we should be looking at?"

Despite the flood of information—or perhaps because of it—many directors are still not getting what they need. "In our discussions with a lot of boards, the lack of relevant or timely or useful information still is a critical barrier to effective boards and also carries a lot of significant risk," said Greg Radner, Thomson Financial's senior vice president.

One area where information has exploded is the flow of financial data to audit committees, said Eisner's Goldenberg. Reports that used to be two pages long are now 20 to 30 pages long. "It's become much more voluminous," he said, "because you have not just U.S. accounting, but you have international accounting, you have the Securities and Exchange Commission, and you have the Public Company Accounting Oversight Board. These are all moving targets and, quite frankly, the situa-

tion is just going to get worse because they're revisiting a lot of concepts that have been out there for a long time." Ultimately, directors at the roundtable agreed that they need to work with management to achieve the right balance in the flow of information they receive.

◆ How can a culture of trust be established? If the climate created by Sarbanes-Oxley and new stock exchange rules results in mistrust between management and a board, that obviously is hugely negative. Boards and managers can take many small steps to create a framework of meetings and exchanges that create trust. One is having CFOs meet with audit committees or governance executives meet with governance committees—without the CEO being present. Creating stronger relationships between a board and an entire top management team, not just the CEO, is one way to build trust and an open flow of information.

"There should be no surprises—in either direction," said Susan Ness, CEO of Greenstone Media and a board member at Adelpia Communications. "Management should make sure that directors are not surprised by something they

learn about the company in the press or after the fact; and directors should make sure that any issues and concerns are shared with management so that they are not taken by surprise."

◆ How can directors understand the broader competitive environment that their companies face? Blythe McGarvie, who sits on Pepsi Bottling Group's board as well as those of Accenture and St. Paul Travelers, argued that directors should not merely rely on reports from management. "I read the analyst reports that give an overview of an industry almost as frequently as I read about my own companies, because that's where I learn a lot," McGarvie said. "If you're not doing that, you need to start doing it so you know what the risks are out there."

◆ How can directors be smarter about risks without discouraging management from taking smart, money-making risks? Said Meachin of Lyondell Chemical: "My biggest concern about Corporate America at the moment is that we're going to end up with the most pristine, wonderful ability to regulate and govern ourselves. But the Chinese are going to have all the customers."

There should be no mistaking the fact that management is in charge of running the company, said Jim Cederna, a director at Mine Safety Appliances, based in Pittsburgh. "I know in our board's case," Cederna explained, "we look very closely at the annual survey that we do, which is also given to the management about how is the board performing its oversight duties without stepping into the management's role? That's a very thin line to walk."

However boards seek to manage risk, they can rest assured that more people are going to be watching. Pat McGurn, senior vice president at Institutional Shareholder Services, said ISS is interested in adding risk management to its checklist of 65 governance items it watches. "We've been trying to work with a number of different groups—legal, auditing and otherwise—to come up with a framework for analyzing how companies work to mitigate risk especially in the boardroom, with the idea of potentially adding it to the metrics that we use for examining governance," McGurn said. If ISS does add a risk management indicator, it will loom as a more important issue than ever. **D**

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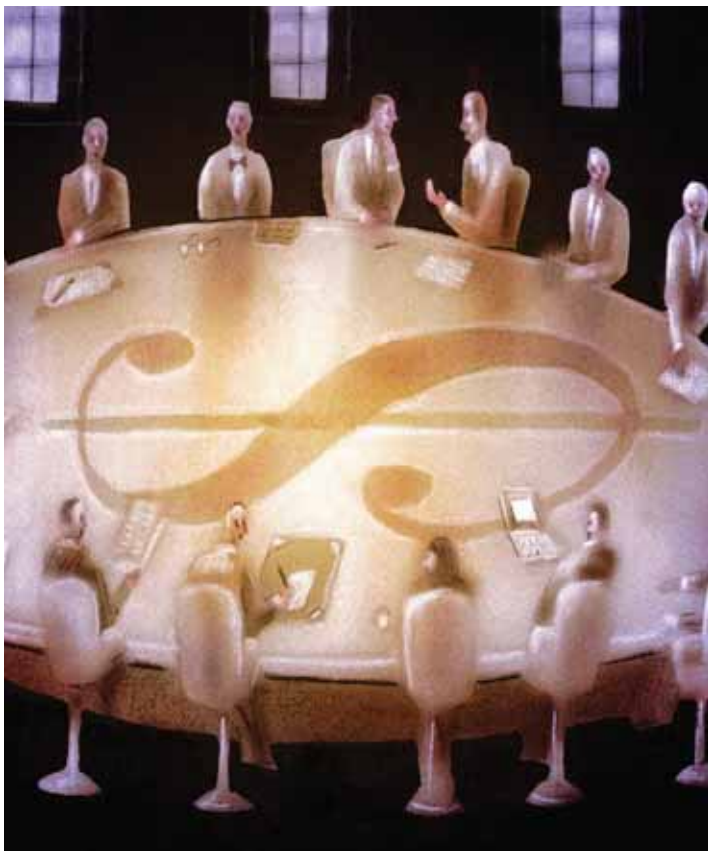
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Governance and Your Debt Rating

Board effectiveness and creditworthiness can often overlap. By Laurence P. Hazell



In early 2004, Standard & Poor's Ratings Services expanded its review of governance practices at rated issuers. As the announcement noted, many corporate failures have exhibited a combination of an aggressive management culture and weak board oversight that could potentially impair creditworthiness. Strong corporate governance, on the other hand, can mitigate perceived risks in corporate strategy or management culture, thereby contributing to ratings stability.

Although issues such as

ownership structure, management practices and financial disclosure policies are integral features of credit analysis, S&P's ratings process had not traditionally identified them with corporate governance. But since the expanded review was inaugurated, Standard & Poor's credit analysts and governance specialists have seen that the links between credit quality and certain elements of corporate governance can be extensive.

Equity owners' rights are relevant to credit analysis because

of the complementary role a company's equity owners (public or private) play in financing activities and growth. For example, corporations with unequal common-stock voting rights could have diminished access to investment capital. Either they might command a lower stock price, or they might attract fewer investors. That could augment the role of creditors in financing the corporation's activities, which in turn could lower its credit rating.

Even an issue like executive compensation can affect a credit rating. The size of the pay package relative to corporate earnings is not really the issue for us. Rather, it is what executive compensation programs and awards indicate about the quality of board oversight. For market observers, such decisions provide a litmus test of board effectiveness.

Other governance characteristics also require analysis. For example, this year we have been scrutinizing the uptake of majority voting initiatives at publicly listed U.S. corporations. We examine the pluses and minuses these proposals could represent for a company's creditors, especially where they combine with other initiatives, such as annual elections for all board members and the removal of "poison pills." Although shareholders might welcome such measures, from a credit perspective they could have negative consequences, including emboldening activist investors (including hedge funds and private equity groups) to attempt debt-financed dividends or buyouts.

On their side, how can an issuer's board members make use of credit ratings? Directors

have the duty to ensure that their corporation assumes acceptable risks and that these risks are managed appropriately. Credit ratings can provide a useful point of reference in risk management.

A rating analysis incorporates many dimensions. Key elements include corporate structure; features of the industry; management effectiveness; and the impact of regulations and public policy. These are analyzed in the context of historical performance, together with a forward-looking review of how resources are being used to competitive advantage.

While the principal users of ratings are bond investors and other creditors, shareholders and other stakeholders also take an interest in them. Consequently, for a company's directors, understanding the relationship between ratings and the market pricing of risk is a useful tool in reaching conclusions about a borrowing program's viability, or the organization's overall ability to finance a strategic initiative like an acquisition.

Yet corporate officers and directors should be careful not to manage the company to a specific rating. A good credit rating is not especially desirable for its own sake, any more than a high corporate governance rating is a management *raison d'être*. Rather, the board should take a pragmatic approach to the credit rating as a resource in determining strategy and competitive prospects.

Laurence P. Hazell is director of Governance Services in Standard & Poor's Corporate and Government Services department.



The First Thing We Do, Let's Fire Some Lawyers

An overload of specialist attorneys is balkanizing the American boardroom.

By James C. Woolery

Take it from a lawyer: American directors are over-lawyered. Sarbanes-Oxley, formal investigations, informal investigations, standing committees, special committees—these are terms by now all too familiar in the boardroom. The response—an increasing reliance on a myriad of legal specialties, law firms and other experts—is balkanizing the boardroom, unnecessarily separating directors from senior management and weighing them down with legal and procedural minutiae that prevent them from taking the broad view their oversight role demands.

Multiple law firms circle the same issue in the name of managing conflicts of interest; bills creep ever higher; and little is accomplished despite hours of conference calls and hundreds of pages of reports. In fact, boards and managements are becoming so overwhelmed with legal process that they may be taking their eye off the core challenge of taking business risks to make money for the benefit of stockholders. What should directors do?

Less is more. Hire firms and lawyers with general expertise and maintain relationships with them. Relationships with a history foster candid dialogue and sound advice; mercenary, project-driven hires do not. Directors should be familiar with the firm and lawyers who advise them. Regular access by outside counsel to directors should be the norm. Too often management has excluded outside counsel until a crisis develops. The result? A strong relationship with outside counsel never develops. Individual directors seek outside assistance from a firm with whom they are familiar and comfortable. If directors are uncomfortable with regular

counsel, the company should change its counsel. It is far less expensive than having multiple firms with different expertise operating on several fronts in a crisis.

Directors direct/managers manage. Managements have time and resources that directors do not. Boards should avoid a knee-jerk reaction to hire counsel other than company counsel until that need for separate counsel becomes real. This reality most often appears after management and regular counsel have presented on a matter. Following review, directors may tap separate counsel to oversee the project on their behalf—or to investigate separately. Cooperation between outside firms should be an absolute requirement. The best law firms are regularly asked and proficient at working closely with other firms. They will not hesitate when a client asks them to work in a cooperative manner with other members of the bar.

Broad experience is best for the boardroom. Firms and lawyers with general corporate and litigation expertise are better in the boardroom than narrowly focused specialists. Lawyers used to give advice to directors with strong doses of commercial logic and business judgment. Risks and resources were prioritized. As the typical project goes from 30,000 feet to 5,000 feet in scope, everything appears to matter. Lawyers with specialties built around specific issues think and act like everything matters. It doesn't. "Why should we care about that?" boards should ask, with a view towards costs and benefits to stockholders. If lawyers know their brief, the answer will be swift, crisp and compelling.

Know the ending. Lawyers should be required to sum up the movie for direc-

tors before it starts. It is surprising how often, in the name of getting started quickly, directors do not demand to know whether they will be watching an action or a comedy in three or five acts, and how it all should end. The likely ending is one of the most empowering pieces of information that enable directors to *direct*. This advice should come from managers and outside lawyers, not just managers. Of course, the outcome of an investigation or other inquiry may not be known in advance, but the step-by-step process for arriving at a result is knowable. Lawyers should be asked for a timetable and should define expected deliverables. Directors should have some view as to whether they will seek a recommendation from counsel as to proposed action or not. Board work is process-driven. Lawyers should outline the process and decision tree to be presented to directors up front and in detail.

Twenty years ago, most public companies were advised by one or two prominent firms on boardroom matters, with a knowledgeable senior lawyer advising them internally as well. During the 1990s, power shifted to management, and with it the general counsel who often tightly controlled boardroom access by outside lawyers. Specialists rose up offering a menu of law firms and lawyers. Scandals erupted, and directors asked for that menu, with each director becoming his or her own general counsel. A senior internal lawyer and one experienced outside firm with direct access to board members is still the best choice for most—if not all—of the issues directors face.

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CEO Term Limits: An Idea Whose Time Has Come

Determining just how long a CEO should remain in the job helps create the right management culture.

By Steve Mader

I often worry about boards being too reactive when they need to be engaged in discovering possibilities. But that is the nature of committee, or group, dynamics, and the current regulation environment only amplifies the reactionary tone. I think CEO succession is one of the critical subjects that can fall victim to this.

Think about it—other than forced dismissal for performance transgressions, why do CEOs depart? Many depart at mandatory retirement age or at a time when they just want to do it. I wonder how often those circumstances really fit the board's needs and agenda.

I think age is irrelevant, but tenure is very relevant. Governed by traditional means, CEO terms can be too short or too long. Aside from performance aberrations that need addressing, there is an optimum time to serve. Hence, the concept of term limits.

The principle is not controversial; I believe the majority of active CEOs today endorse it, and some boards try to practice a form of it by way of the contractual terms of their relationship to the CEO. What is controversial is finding a definition for optimum tenure, which should vary with the particular circumstances.

Mandatory retirement is a form of term limits and an archaic idea, but it is still common because it is a way to impose a change without confronting the notion that the change could be good for the organization, i.e., it's more comfortable. Sometimes it gets rid of leaders too quickly, sometimes too slowly. We saw the "too quickly" version recently in Europe where the CEOs of BP and BMW have made big performance differences to their companies in a short time, but will soon retire at the compulsory age.

I really believe the more expensive as-

pect of the problem of not addressing term limits is the "too slowly" version. The penalties of a leader in place too long are often subtle and hard to measure. And boards don't have much appetite for disrupting a good thing. Michael Eisner gave us one of the greatest value creation performances of the past quarter century at Disney. But his first decade was remarkable and his second was unremarkable. Bob Iger has breathed new life into it and the board is strengthening beautifully now as well. Some form of term limits at Disney would have been a good thing.

While an optimum term of service is elusive, examples do provide us with some confidence builders. Two years of evolving transitions and transformations after taking the job and four to six years of working a game plan is probably a good frame of reference. We find succession management at good companies like Caterpillar, UPS, Deere and IBM fit pretty well in this envelope, more or less.

The price of CEO terms that last too long goes deeper than the obvious performance metrics. There is the missed opportunity of a different vision, never heard and never realized. There is the price of impatient leadership turnover. There is the underdevelopment and underutilization of talent suppressed. And here is one we really need to think about: There is the price of not redeploying fine leaders to different organizations where they can make the same level of contributions that their successors will make in their previous organizations. This can involve repeating their CEO role, serving on other boards or deploying their skills to the broader community. We need more leadership everywhere; we can't afford for it to rust, and neither can the people who have it to give.

Our schools, our government and our community services need the toughness, shrewdness and accountability that is bred in our business leaders.

For the many corporate boards that have not embraced a form of CEO term limits, it is not only possible, it is responsible. The same solutions to term limits don't work everywhere, and boards are paid for their resourcefulness in turning this good idea into their own applied reality.

But the mechanisms are not the shrewd part of the exercise; it is really the state of mind that is the critical part. It is the state of mind of the CEO—knowing that his or her identity is not all wrapped up in the position forever and that there are new and even better challenges out there. It is the state of mind of the CEO that someone else could be even better at the "next leg" and that's a good thing. It is the state of mind of the board that succession is really an opportunity, and that the courage to embrace it has its own reward.

Much more has been said and written about term limits for board members themselves, and whether they should take their own medicine. There is no wisdom about CEO term limits that would not apply to directors, but I'm not sure the reverse is true; continuity, balanced group dynamics and competencies make boards think twice about the real cost of director term limits. This is a road to travel more cautiously while boards navigate to calmer water on big governance issues. Top among those issues are executive performance, compensation, succession and hence, CEO term limits.

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Is Corporate Social Responsibility Responsible?

No, if companies spend shareholder assets on unprofitable causes.

By Betsy Atkins

The concept of corporate social responsibility deserves to be challenged. It seems that political correctness has obfuscated the important business points. It is absolutely correct to expect that corporations should be “responsible” by creating quality products and marketing them in an ethical manner, in compliance with laws and regulations and with financials represented in an honest, transparent way to shareholders. However, the notion that the corporation should apply its assets for social purposes, rather than for the profit of its owners, the shareholders, is irresponsible.

The corporation’s goal is to act on behalf of its owners. The company’s owners—its shareholders—can certainly donate their own assets to charities that promote causes they believe in. They can buy hybrid cars to cut back on fossil fuel consumption or support organizations that train the hard-core unemployed. But it would be irresponsible for the management and directors of a company whose stock these investors purchased to deploy corporate assets for social causes.

It would be very easy to carry out a litmus test of the market for corporate social responsibility. For example, Apple could sell one iPod for \$99 and another for \$125. The company could announce that the extra \$26 from the more expensive iPod would be spent to promote specific social causes, such as education, environmentalism, etc. Such a test would account clearly and honestly for how shareholders’ money was being used and would allow the market to drive the outcome. If consumers wanted to pay the extra \$26, voting with their wallets for a cause they believe in, they could.

Interestingly, such a litmus test already exists, albeit not in the private sector. Be-

ginning in tax year 2002, the state of Massachusetts gave taxpayers the option of checking a box on their 1040s to pay a higher rate, with the extra funds going to social services. Out of the \$16 billion that Massachusetts residents paid in taxes that year, only \$100 million came from people who volunteered to pay extra. That’s less than 1% of the market—sobering when one considers that Massachusetts is a state with a high degree of social consciousness. In point of fact, when it comes to actually voting with their wallets, consumers prefer not to be directed to do so. They like to contribute individually, to charities they believe in and wish to support as individuals, not as part of a huge pool. They certainly do not expect the for-profit corporations in which they invest to deploy corporate assets for social causes.

Thus, it would be a questionable use of corporate assets for a company to invest its shareholders’ money in a “green” headquarters that cost an extra \$100 million. The goal of reducing pollution by building an environmentally friendly headquarters may be a worthy one—but the corporation hasn’t asked shareholders whether they want their assets spent that way. In fact, it would be not only irresponsible but deceptive.

Management is charged with making informed decisions to invest corporate assets for uses that will efficiently achieve corporate goals. These include growth, profitability, product innovation, and anything else that drives the shareholders’ return on investment as measured by the stock price. What quantifiable outcome could a green headquarters produce? How could the corporation justify, in a quantifiable way, the use of shareholder assets?

There are practical reasons why corporations should cloak themselves in the politically correct rhetoric of social responsibility. But marketing should not be confused with significant deployments of corporate assets. For example, British Petroleum’s marketing campaign, which is all about looking for alternative energy sources, makes the consuming public feel good about purchasing BP products. But if BP had redeployed billions of dollars into environmental investments that yielded no profits, and its stock plummeted, one would certainly expect the investing public to transfer its money to a competitor.

What the investing and consuming public really means by “social responsibility” is:

- ◆ Be transparent in your financial reporting.
- ◆ Produce a quality product, and don’t misrepresent it.
- ◆ If you know something about the product that endangers the consumer, be forthright and let the public know.
- ◆ Do not use predatory practices in offshore manufacturing, such as child labor.
- ◆ Do not pollute your environment or other environments, and adhere to laws and regulations.
- ◆ Be respectful, fair and open in your employment practices.

In other words, corporate social responsibility actually refers largely to what the company does *not* do. I think this is a clarification that should be understood by all constituencies.

Betsy Atkins is CEO of Baja Ventures, a VC firm focused on technology and life sciences. She serves on the boards of Reynolds American, Polycom, Chico’s FAS, SunPower, and several private companies.

The Right Way To Hire An Investigator

The recent furor at Hewlett-Packard has focused attention on public companies' use of private investigators—a practice far more widespread than may be commonly understood. Public companies engage private investigators for a variety of reasons: background checks on potential key hires; due diligence for investments or acquisitions; scrutinizing suspicious claims and claimants in litigation; tracking down a debtor's concealed assets; counteracting business espionage or theft of corporate assets or intellectual property; and obtaining information on participants in a proxy contest or unsolicited takeover.

The HP outcry and the ensuing criminal charges by the California attorney general against HP's chairman and a senior internal counsel, among others, call for a reappraisal of companies' procedures in using private investigators. In appropriate circumstances, this is a legitimate and sometimes necessary practice. Accordingly, focus should be on applying the lessons of HP: first, by ensuring that corporate directors and officers understand the risks involved when hiring a private investigator; second, by selecting a reputable, qualified firm to conduct the investigation; and third, by conducting and supervising the investigation in a way that protects the interests of the company and its directors and officers.

The principal risks are now broadly understood. They involve the possibility of criminal or civil charges if the investigation is conducted improperly, as well as the risk of negative

publicity. They also involve the potential for aggressive countermeasures by targets of the investigation, which in some cases may include hiring their own investigators.

However, the HP scandal underscores the difficulty of determining the legality of specific investigative techniques. The core activity at the heart of criminal charges in HP is "pretexting"—the use of trickery to obtain third parties' personal information. Although there are few laws specifically prohibiting pretext-

doing rather than to prevent leaks to the media.

What do you need to consider in hiring and overseeing an investigative firm?

- ◆ Make sure the firm is reputable and licensed. The private investigation industry is replete with people unsophisticated in the legal, ethical and public relations issues faced by large corporations. Major law firms and accounting firms are experienced in dealing with investigators and can provide recommendations.

- ◆ Hire outside counsel to oversee the investigation. After HP, few internal counsel will relish the role of principal legal counsel in this situation. Moreover, depending upon the nature of the investigation, it may be advisable to use a law firm other than the company's regular outside counsel. If there are issues concerning the investigative techniques to be used or the objectives sought, the involvement of outside counsel should provide an important safeguard to the integrity of the investigative process. In addition, having outside counsel hire the investigator may allow for protection of the investigator's work as attorney work product.

- ◆ Ask for regular reports on the status of the investigation in order to ensure that it is proceeding in accordance with the plan and that any issues that arise are addressed promptly. The private investigation may yield additional leads that require modifications to the original scope of work. These should be handled with the same degree of care as the initial plan.

By following these principles, companies can continue to realize the benefits of private investigations while reducing the risks of legal entanglements and negative publicity.

Get the investigation plan in writing and hire outside counsel to oversee the process.

ing, the California attorney general filed charges under an obscure public utility law, as well as various other criminal fraud laws. (In response to HP, California has passed an anti-pretexting law that will take effect in 2007.) Yet even if an investigative technique is not demonstrably illegal, it may offend common-sense notions of ethical behavior. In that circumstance, prudence dictates extreme caution.

While the risk of negative publicity cannot be disregarded, the extent of this risk will depend upon the parties involved, the purpose of the investigation, and the manner in which the investigation is carried out. The public reaction to the HP investigation may well have been greatly muted had the purpose been to prevent insider trading or to expose corporate wrong-

- ◆ Proceed only with a written engagement letter. The letter should detail the scope of the work and contain provisions that make clear the investigative firm's obligation to comply with the law. The engagement letter also should include provisions to limit the common practice of subcontracting to other firms without the client's consent and ensure that any subcontractors are subject to the same obligations as the primary firm.

- ◆ Have a full understanding of the process. Discuss the scope and nature of the investigative techniques with the investigator. Ask for a written plan of investigation. Having a written plan that has been reviewed by outside counsel should provide significant protection to the client, a benefit that far outweighs any burden on the investigator.

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Refocusing the Audit Committee's Agenda

Don't be surprised if your audit committee has some "control issues" these days. After two-plus years of overseeing Sarbanes-Oxley and Section 404 compliance processes, which today are widely in place, many audit committees say they are dissatisfied with their ability to carry out their proper function. They want more accountability from management and more tightly focused agendas for themselves.

When polled during the 2006 Audit Committee Issues Conference, co-sponsored by KPMG's Audit Committee Institute (ACI), more than half of audit committee members said they were only "somewhat satisfied" or "not satisfied" that management provides them with the information they need to oversee corporate accounting judgments and estimates. Some 80 percent said they wanted—or needed—to spend more time discussing this issue. And more than half were not fully satisfied that "management's discussion and analysis" presented a clear picture of the company's financial

condition and the results of operations—the most recent and possibly most challenging of the Securities and Exchange Commission's reporting requirements.

In short, many audit committee members want a better understanding of this area of SEC reporting and, in particular, the processes used by management to arrive at its judgments and estimates. While audit committee members clearly have a growing appreciation for the importance of management's accounting judgments, as well as how difficult it can be to determine certain estimates, they want more oversight of accounting policies and processes and more oversight of risk management.

Risk management is largely uncharted territory for many audit committees, but awareness of this issue is growing. Furthermore, audit committee members expect their involvement in risk management to increase. More than 70 percent of audit committee members, directors and senior executives surveyed by ACI said their company's process to identify signifi-

cant risks could be better, and only one in four were "very satisfied" that the board and audit committee effectively oversee the significant financial and nonfinancial reporting risks facing the company. More than 80 percent were not fully satisfied with the adequacy of the information and reports that management provides the committee regarding the status of its risk management efforts. An essential task for every audit committee is understanding precisely what its risk oversight responsibilities are vis-à-vis the full board and other committees.

Agendas drive activities. As the touchstone for all audit committee activities—both at audit committee meetings and during the year—the agenda and agenda-setting process determine where and how the audit committee focuses its time and attention. That said, nearly 40 percent of audit committee members surveyed say they're only "somewhat satisfied" or "not satisfied" with their committee's agenda-setting approach. More than half of the participants at

our annual Issues Conference were not fully satisfied that their audit committee's 2006 agenda appropriately addresses the issues that require their attention and oversight. Moreover, some 75 percent of those polled say they are either somewhat or very concerned that the time devoted to compliance activities detracts from the overall effectiveness of the audit committee.

Well-designed agendas can help audit committees:

- ◆ Identify and stay focused on their priorities.
- ◆ Ensure their activities and charter responsibilities are in sync.
- ◆ Take sufficient time for quality discussion.
- ◆ Ensure good communication and information flow.
- ◆ Facilitate periodic self-evaluations and ongoing education.
- ◆ Communicate their expectations to management and auditors.

The bottom line? Expect more audit committee members to ask, "What's on the agenda and why?"

Wanted: More Director Education

Chalk it up to the increasing complexity and scrutiny of financial reporting and accounting issues: Audit committee members today undoubtedly spend more time "doing their homework." But chances are they're not following a formal curriculum. In ACI's annual survey of audit committee members, more than 60 percent say their companies do not provide periodic in-house edu-

cation. At companies that do, more than 80 percent of committee members devote fewer than eight hours to it.

Robust orientation and ongoing education are essential to ensure audit committee members have the depth and breadth to carry out oversight. (The New York Stock Exchange requires listed companies to address director orientation and education in their cor-

porate governance guidelines.)

Topics will vary, of course—from industry and regulatory issues to business and accounting practices—but the hallmarks of a good education program are participation of management, internal and external auditors, corporate counsel, and outside "experts," as well as a curriculum to meet members' needs.

Also, new-member orientation—or "on-boarding"—can

be key to helping new members become familiar with the workings of the committee and the board, as well as the company's financial management, operations and key areas of risk.

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More Protection Can Only Be Good

A flash poll suggests that being a board member takes nerves of steel.

By Glenn Curtis



Directors are not only increasingly worried about their personal exposure to risk through board service; they also feel somewhat paranoid. Those results jumped out from a flash poll conducted by Thomson Financial and *Directorship* magazine in September,

in which 40 directors from public companies expressed their concerns about personal liability and revealed what they, and the companies they serve, are doing about it. (See results, right.)

Regardless of size, the companies that insure individual board members against legal damages vastly outnumber

those that do not—87 percent to 13 percent, in fact. And a full 64 percent of respondents said their companies had increased D&O coverage recently.

Perhaps quite obviously, firms as well as individual board members are growing increasingly cognizant of the risks. Nevertheless, well over half (59 percent) of board members polled said they obtain coverage above and beyond what their companies supply, such as umbrella insurance, Side A insurance or errors and omissions coverage. The significant number who do not may feel that their corporate coverage is adequate, or they may be aware that many individual umbrella policies specifically exclude accusations of financial wrongdoing, such as inappropriate or misleading disclosure of information. “Untested and unknown,” one respondent wrote. Thus, many directors may feel such insurance doesn’t offer much of a shield.

At the same time, many feel the need to protect their personal assets from potential seizure as a result of litigation. Fully 34 percent of polled board members maintain some kind of trust, and a further 16 percent say they place personal assets in a spouse’s or another person’s name. And 10 percent say they have “other” plans or mechanisms that protect assets from garnishment or seizure, such as “entering into indemnification contracts with the company and in appropriate circumstances having the company create a rabbi trust or other bankruptcy remote mechanism and placing sufficient assets in them,” one respondent wrote.

Thus, 60 percent of directors

are worried enough about losing personal wealth as a direct result of board service that they try to shield at least some assets from lawsuits. Clearly, they have a reason, because 38.5 percent have either been named in a suit while serving on a board or think they are currently at legal risk.

Board members also have given thought to how companies can make their jobs less dangerous as individual directors. When asked to choose the best ways to lower risk, 64 percent said corporations should establish a central spokesperson and eliminate any and all director contact with the public, and 56 percent said companies should impose stricter controls over both external and internal communications. And half thought investor relations education for board members would help them avoid lawsuits.

All three responses suggest that public relations is a field much on directors’ minds. A majority still seem to believe that careful image management is key to limiting risk. Yet increasingly, shareholders are sensitive to being locked out of dialogue with directors—witness the uproar after Home Depot’s annual meeting. And many investors dislike being “spun.” So, putting communications through too many filters could wind up causing more problems than it solves.

Currently, almost 53 percent of respondents—a fairly high percentage—said all external communications were vetted by the CEO. Fellow directors approved a third of communications. But another third said “nobody” cleared communications before dissemination to

the public. Again, that's a big percentage, and a surprising one given the prevailing legal environment. Another 18 percent said an investment relations officer approved them; 5 percent said "other"; and in at least one case, a respondent interpreted that to mean that directors "don't speak to the press at all unless there is a divergence of defense."

Half of the polled directors weighed in with additional suggestions for reducing risk. They include outside legal and audit reviews of board and committee procedures to ensure fiduciary duty compliance, companywide risk management systems with board involvement and "better qualified directors."

When asked the most likely source of future potential lawsuits, almost 80 percent named investors. Only about 8 percent named the SEC or NASD, and 5 percent feared that suits might originate from employees; nearly 3 percent cited fellow officers and directors, suggesting a new dynamic that not only do board members have to maintain a high level of diligence for their own conduct but also in their interactions with each other.

And as for the potential causes of such suits, an overwhelming 76 percent ranked making decisions in conjunction with the board as their primary or secondary source of concern. The increased circulation of board minutes, due to the Internet and other venues, as well as increased scrutiny of board meetings by the press, seems to have heightened such fears. Some 58 percent of respondents cited joint decision-making with another party and the scrutiny it

would attract as a primary or secondary concern.

Another 30 percent of respondents cited relations and interaction with the public as a primary or secondary concern. Those who ranked another concern as their primary or secondary—51 percent—picked filing requirements and scrutiny from the SEC and NASD. Just 30 percent picked public relations as primary or secondary, the lower number perhaps reflecting the fact that board members view the chief executive as the company's public mouthpiece. Another 17 percent chose internal

mentation of board decisions and discussions are being made.

More broadly, however, directors had some suggestions for how to protect themselves if board decisions are later questioned or scrutinized. They include increasing transparency of rationales in decision-making, as well as publishing quarterly reports and employing software tools that allow collective keeping of files and notes. But other responses diverged, ranging from "Keep excellent minutes!" to advocating that directors not make their record-keeping too diligent lest they at-

"Do not leave notes to yourself in files that could be damaging."

communications with employees as their primary or secondary concern for the source of a potential suit.

So, how to avoid all this paranoia in the first place? Most directors (86 percent) think improving corporate culture is key, and in particular emphasizing honesty and integrity in order to prevent misconduct, including detailing potential conflicts of interest with greater frequency. The remaining directors polled said either using an outside auditor as an additional policing vehicle or imposing restrictions on internal and external communications would be most beneficial. Very few said they would encourage the practice of "whistle-blowing" as a top priority.

But they did note overwhelmingly (72 percent) that preparedness prior to board meetings was key to best practices and to ensuring that the necessary docu-

ment culpability. "Do not leave notes to yourself in files that could become damaging when taken out of context during litigation," one respondent wrote.

Others suggested that there's not much a director can do to avoid scrutiny, other than to behave above reproach and maintain the highest ethical standards. "The curious and 'anti' crowd will always ask and probe," one respondent said.

In general, however, directors are feeling somewhat victimized. "I do find it ironic," one respondent wrote, "that at the very time that many are criticizing boards and senior management for what they believe are excesses in compensation, not only is much more being asked of senior managers and directors, but their exposure to significant liability is increasing pretty dramatically." That sums it all up right there. **D**

At a Glance

How Directors See Their Risk

Are you personally insured by your company for any litigation that may arise from your work as a director?

Yes87.2%
No12.8%

Do you maintain umbrella insurance or errors and omissions coverage beyond what your company provides?

Yes59%
No41%

Have you been personally named in a suit while serving as a director, or do you think you have been put at risk for suit?

Yes38.5%
No56.4%
Possibly5.1%

What do you consider the likeliest source of potential future litigation?

Investors79.5%
SEC/NASD7.7%
Employees5.1%
Officers/other directors 2.6%
Other5.1%

Who, if anyone, clears your communications with non-board members?

Chief executive52.6%
Other directors31.6%
An IR officer18.4%
Other5.3%
Nobody34.2%

Source: Thomson Financial, *Directorship*

Help Nardelli Help Himself

It's become a new sport in the press: Which chief executive officer will be the next to go? Small wonder. The latest estimates are that seven CEOs are leaving or getting fired each business day.

But there's one CEO on the hit list who deserves to survive—Bob Nardelli of Home Depot. What he's done at Home Depot is remarkable. He inherited a loose assembly of individual stores that did their own purchasing and their own hiring and firing, and integrated them into a real company. It surely would have gone over the edge of the cliff if Nardelli had not injected General Electric management disciplines. He has doubled revenues to roughly \$80 billion and increased earnings nicely.

It's not his fault that Wall Street changed its mind about Home Depot, no longer regarding it as a rocketing growth business but rather as a stable consumer retailer. That lowered the company's P/E from a blistering 70 to a not very exciting 12, where it stands today.

Yet his detractors have seized upon the poor performance of the stock without regard to the cause. Shareholder activists

make the simplistic argument that Nardelli is overpaid, ignoring the fact that his options and restricted stock are underwater if he can't get the stock to move.

Nardelli also has been hurt by his ill-fated decision not to have his directors attend the annual shareholder meeting and to restrict discussion time during the Q&A. This has been widely portrayed as high-handed and arrogant.

No single interest group should turn a shareholder meeting into a circus.

We at *Directorship* have a habit, not often practiced these days, of hearing both sides of the story—which we did in an interview with Nardelli (September 2006) and with his leading union critic (see page 24).

What we know is that AFSCME approached the company and threatened to disrupt the annual meeting. It then

orchestrated an attack by feeding information to *The New York Times*, which ran a vicious front-page hatchet job. And AFSCME leaders attended the meeting and confronted Nardelli.

So why won't Nardelli explain why he did what he did? CEOs and directors who think that he ought to survive, and that the French Revolution-style string of guillotings ought to stop, should help Nardelli understand that in today's climate CEOs must be able to articulate to their friends and enemies alike the value of what they are doing. So far, Nardelli has stonewalled. As long as he does that, the media are going to suspect that he's hiding something. Just wait until the 2007 proxy season.

So we will come out and say what Nardelli won't: Labor often tries to turn a shareholder meeting into a circus, at least in part to bully management to acquiesce in the union's desire to organize the workforce. Under the false guise of shareholder's interests, they wish to make a travesty out of one of capitalism's sacred rights, the annual meeting of shareholders. That's the message Nardelli and friends need to communicate.

The Riddle of GM's Board

We think the board of General Motors was right not to commission an independent evaluation of Kirk Kerkorian's wild scheme to bring in Carlos Ghosn as a white knight to rescue the car maker. Some directors believe the board had a responsibility to do that, but we argue that boards have to apply the test of common sense. If an idea is reckless and far-fetched, why waste shareholder money on evaluating it? Kerkorian's goals have been and remain entirely transparent—to generate a burst of enthusiastic headlines so that he can cash out and go back to Las Vegas.

But here's what we don't understand—why has the board been so slow

to focus on the real challenges that GM faces? It would be a tragedy if the board merely got rid of Kerkorian's go-fer, Jerry York, and didn't get serious about whip-

Getting rid of Jerry York was great. But GM directors still have real work to do.

ping GM into fighting form. "GM has been failing for 25 years," says Michael Watkins, a professor at INSEAD and well-known author. "They've postponed the hardest decisions." Those would involve rationalizing the number of

brands—the market has long ago lost the ability to distinguish between a Pontiac and a Buick, for example. The decisions would require faster movement to close more plants and also would require an even more frontal assault on the company's so-called legacy costs. Toyota is simply not going to relent. It recently announced that it plans to continue spending \$10 billion a year building new capacity. The Japanese juggernaut is obviously going for the knockout punch.

So we hope that GM's board itself decided not to launch the independent review, rather than simply accepting management's opinion. And we hope that GM will now seize the moment to undertake an historic transformation so that it can survive and compete.