

Board Governance Series

VOLUME V 2005

A KEY EDUCATIONAL RESOURCE FOR TODAY'S BOARDS OF DIRECTORS



- 6 Section 404: Lessons Learned and a Look Ahead
- 10 Structuring “Unassailable” Executive Compensation Programs
- 12 Guidelines for Board Evaluations
- 14 Eight Essential Steps to Building Ethical Corporate Cultures
- 18 A Legal Victory for Boards in Troubled Times
- 20 New Areas of Focus for Compensation Committees

CORPORATE
BOARD MEMBER
MAGAZINE

NASDAQ[®]

LRN

PRICewaterhouseCOOPERS LLP

SIBSON CONSULTING

WEIL, GOTSHAL & MANGES LLP

CORPORATE
BOARD MEMBER
MAGAZINE

Board Governance Series is
© 2005 by *Corporate Board
Member* magazine.

Editor **Deborah Scally**
Copy Editors **Kimberly Crowe**
Sarah Kirkell
Art Director **Alli Oar**
Graphic Design **Melissa Musgrove**

For information about *Corporate Board Member* magazine, contact Board Member Inc., 5110 Maryland Way, Suite 250, Brentwood, TN 37027; (615) 309-3200, fax (615) 371-0899. The opinions expressed are those of the participants and are not necessarily endorsed by *Corporate Board Member* magazine. Nothing in this supplement should be construed as legal or accounting advice.
www.boardmember.com

Dear Corporate Director:

In the aftermath of all that has occurred since the Sarbanes-Oxley Act took effect, there's little doubt today's corporate directors are ready to focus on more substantive issues: overseeing strategic growth, managing risk, and increasing shareholder value. Even so, as directors move forward, it is important to incorporate the lessons they have learned into the fabric of the boardroom.

To assist in this effort, *Corporate Board Member* and The NASDAQ Stock Market proudly present volume 5 of our Board Governance Series—a collection of insights from leading U.S. experts on corporate governance. This series of special supplements complements our online webcast series, designed to educate directors on the most current and critical issues shaping the corporate governance environment.

Each year, this series continues to garner enthusiasm from corporate boards and governance experts across the country. We invite all board members to visit the websites of our prestigious contributors and to access online the specific webcasts featured in this publication as part of their ongoing continuing education.



A handwritten signature in black ink, appearing to read 'TK Kerstetter'.

TK KERSTETTER
President
Corporate Board Member



A handwritten signature in black ink, appearing to read 'Robert Greifeld'.

ROBERT GREIFELD
President and CEO
The NASDAQ Stock Market

SERIES PARTNERS

LRN

PRICEWATERHOUSECOOPERS LLP

SIBSON CONSULTING

WEIL, GOTSHAL & MANGES LLP

SERIES HOSTS

CORPORATE BOARD MEMBER MAGAZINE

Corporate Board Member is a leading information resource for senior directors and officers of publicly traded corporations, large private companies, and Global 1000 firms. The bimonthly publication provides readers with decision-making tools to deal with the corporate governance challenges confronting their boards. *Corporate Board Member* extends its governance leadership through conferences, director training programs, roundtables, an extensive database, and timely research.

The magazine maintains the most comprehensive, up-to-date database of directors and officers serving on boards of publicly traded companies listed with The NASDAQ Stock Market, New York Stock Exchange, and American Stock Exchange. Headquartered in Brentwood, Tennessee, with editorial offices in New York City, *Corporate Board Member* is published by Board Member Inc. and is the sister publication of *Bank Director* magazine, a leading information resource for officers and directors of financial companies. For more information, visit www.boardmember.com.



NASDAQ is the world's largest electronic stock market. With approximately 3,400 companies, it lists more companies and, on average, trades more shares per day than any other U.S. market. It is home to category-defining companies that are leaders across all areas of business including technology, retail, communications, financial services, media, and biotechnology. For more information about NASDAQ, visit the NASDAQ website at www.NASDAQ.com or the NASDAQ NewsroomSM at www.NASDAQnews.com.

WEB ACCESS PROVIDER



WEB ACCESS

Board Governance Series

Gain access to the **Board Governance Series** by clicking on the series logo at any of the hosts' or series partners' websites. There is no charge to view the webcasts.

SERIES PARTNERS

LRN

LRN provides governance, ethics, and compliance management solutions that inspire and reinforce ethically aware, responsible conduct and set higher standards in organizations throughout the world. Our Governance and Ethics Management System(tm) (GEMS(tm)) offers global corporations an integrated solution for corporate governance, risk, ethics, and compliance management. GEMS(tm) includes our flagship Legal Compliance and Ethics Center(tm) (LCEC®), a web-based education solution. LCEC® offers more than 200 courses covering over 3,600 topics, and has helped millions of employees around the world become better informed, act more responsibly, and work more productively. And our decade long record in Expert Legal Research and Analysis delivers unparalleled legal research at significant cost savings to leading legal departments around the world. Visit www.lrn.com.

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP is committed to helping enhance corporate governance, audit committee performance, and the quality of corporate reporting. For more information and to access publications about corporate governance, see www.pwc.com/uscorporategovernance.

PricewaterhouseCoopers (www.pwc.com) provides industry-focused assurance, tax and advisory services for public and private clients. More than 120,000 people in 139 countries connect their thinking, experience and solutions to build public trust and enhance value for clients and their stakeholders.

"PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

SIBSON

A DIVISION OF SEGAL

Sibson Consulting is a management consulting firm. For more than 40 years, the firm has specialized in the development and implementation of custom solutions that help companies maximize the return on their human capital investments. Sibson is a division of The Segal Company. Visit www.sibson.com.

WEIL, GOTSHAL & MANGES LLP

Founded in 1931, Weil, Gotshal & Manges LLP has evolved into a leading international law firm, offering expertise in a wide range of practice areas. With an extraordinary talent base of more than 1,000 attorneys in 16 offices around the world, Weil Gotshal serves a broad array of clients across multiple industries.

Among its many specialized legal services related to corporate governance, Weil Gotshal offers a program for boards designed to assist them in ensuring that, before a crisis arises, senior officers and board members are able to assess all material internal and external risk factors facing the corporation. For more information, visit www.weil.com.

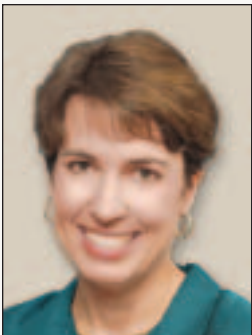
CONTENTS



6

Garrett L. Stauffer
PricewaterhouseCoopers LLP

Section 404: Lessons Learned
and a Look Ahead



10

Blair Jones
Sibson Consulting

Structuring “Unassailable” Executive
Compensation Programs



12

Holly Gregory
Weil, Gotshal & Manges LLP

Guidelines for Board Evaluations



I4

Dov L. Seidman
LRN

Eight Essential Steps to Building Ethical Corporate Cultures



I8

Martin J. Bienenstock
Weil, Gotshal & Manges LLP

A Legal Victory for Boards in Troubled Times



20

Blair Jones
Sibson Consulting

New Areas of Focus for Compensation Committees

Section 404: Lessons Learned and a Look Ahead

Garrett L. Stauffer, partner responsible for knowledge management and thought leadership surrounding Section 404 implementation at PricewaterhouseCoopers LLP, discusses what board members should learn from the first year of Section 404 implementation and what to expect in the year ahead.



Garrett L. Stauffer
Partner
PricewaterhouseCoopers LLP

Reviewing 404 Implementation

With the first quarter of 2005 just completed, we can begin to evaluate the implementation of Sarbanes-Oxley Section 404 requirements. I'd like to discuss three topics. The first concerns the initial effort it took to do the implementation; the second involves how investors are reacting to the results; and the third includes points to consider for companies preparing now for their first 404 implementation.

First, I'd like to discuss the substantial effort most companies experienced in implementing 404. I had a controller of a Fortune 500 company tell me about 18 months ago that the more you know about Section 404, the bigger the project gets, and the more you know about Section 404, the less control you seem to have. I've seen that situation play out time and time again since then. Companies are clearly expending significant levels of effort. Their efforts have doubled and, in some cases, tripled over their original estimates. It's not unusual to hear of companies spending more than 100,000 person hours of internal time to complete the 404 process. Yet, with all that effort, we still have companies that weren't able to meet the deadline. Some of those companies have elected to use the 15-day extension period allowed by the SEC, and others have taken advantage of the new SEC exemptive order, which allows for a 45-day deferral for companies that have less than \$700 million in market capitalization.

What caused that significant increase over the initial estimates? To start, a significant amount of deferred maintenance had built up in companies. This is the first time many companies ever attempted to evaluate their internal controls to this extent. That process has resulted in a significant amount of catch-up to document and evaluate the

design of internal controls over financial reporting. Second, there was a significant learning curve for everyone—both management and the external auditors. The rules were new, the guidance around the rules was limited, and interpretations evolved as the year went forward. And finally, remediation was more extensive and took longer than most people realized. In this first year, it wasn't unusual to see companies with hundreds and sometimes thousands of control deficiencies. Since this is a point-in-time standard, if the company was able to remediate the deficiency before year-end, the control then became "effective." And while it was important that companies go through the remediation of these controls, it took substantially longer than expected.

Investors' reactions also need to be considered. Often when material weaknesses have been announced, market values have dropped. However, we've also seen cases where market values increased when the material weakness was announced. And in many cases where market value dropped initially, there's been a partial or full recovery of market values after a short period of time—say a month or two. We're also seeing investors reacting differently to different types of material weaknesses. A process-specific deficiency, such as account reconciliations, does not seem to cause the same concern with investors as a deficiency in a pervasive control, which results in significantly more investor concern. Specific process controls can be remediated quickly and only relate to narrowly focused areas, whereas a pervasive control deficiency could taint the overall control environment.

The third area I'd like to talk about involves lessons directors and management should consider if their

companies have yet to implement their first 404 process.

- Start early. As I've discussed, this process involves a considerable effort and it will take longer than expected.
- Be smart in attacking the process. Train up-front. Do not try to train on the job, as this is ineffective and has proven to be very inefficient.
- Make sure only key controls are tested. Many companies have gone into much greater depth, testing non-key controls, and that proves to be very inefficient and ineffective.
- Coordinate the process with the external auditors. Make sure there's agreement up-front on the scope of the work, the level of testing, and the documentation requirements.
- Consider the outsourcing arrangements the company has entered into—where you outsource processing of transactions to third parties, like payroll processing. Few realize how many processes companies have actually outsourced over the last five to 10 years, and it's important to identify those early to make sure they don't become problems at the end.
- Make remediation a top priority. All companies will find control deficiencies and must allow enough time to remediate those control deficiencies so they can have a clean system of internal controls at year-end.
- Finally, it's important to manage expectations—between financial management, senior management, and the audit committee. As I said, this will take more time than anybody is willing to admit up-front and there will be more deficiencies than anybody expected. This needs to be

understood by everybody involved if companies are to get through the process with few, if any, surprises.

The implementation of Section 404 has been a significant effort. Many have questioned whether the benefits received are worth the cost. We have seen profound changes in the attitude and behavior of everyone involved in the process. However, we do believe that efficiencies can be gained and modifications to the process must be made.

A Look Ahead to 2005

Now that many companies have put the first-year implementation of Sarbanes-Oxley 404 behind them, the question that needs to be asked is what are the future challenges around 404? I have two that I'd like to discuss. One is creating a sustainable process, and another is realizing the benefits of effective internal control.

First, let me talk about creating a sustainable process. Most companies treated this first-year implementation as a one-off project, taking an "all-hands-on-deck" approach. That approach was inefficient and cannot be sustained long term. There are a number of considerations companies should review as they look to make their second-year process more effective and efficient.

The first area I'd like to discuss is the reevaluation of remediated controls from 2004. Many companies used manual processes—what I would call work-arounds—to resolve problems uncovered in the first year. In many cases, these remediations were, at best, band-aids to try to keep the deficiency from being a problem at year-end. Now, companies need to sit back and evaluate those remediated controls to make sure they are imbedded and incorporated in

the overall control process and not one-off efforts—which will prove to be inefficient and will be difficult to sustain.

Second, recognizing that the company now has documentation in place, it's important to make sure that documentation remains relevant. To do so, the company needs to assign individuals the responsibility for ensuring the documentation is current, updated, and available. Maintaining proper documentation will require clear standards and protocols, which should include a centralized, automated repository process that will ease the effort going forward.

Next, the company needs to imbed the 404 process within the organization. The business process owners need to be accountable for the evaluation and documentation of their individual internal controls. Many believe that continuous self-assessment is the way to sustain this process in the long run rather than doing a one-off approach.

LESSONS LEARNED FROM YEAR ONE

- Start early.
- Train up-front, rather than on the job.
- Test only key controls.
- Coordinate with external auditors.
- Consider all outsourcing arrangements.
- Make remediation a priority.
- Manage expectations between financial management, senior management, and the audit committee.

Finally, the company needs to evaluate and shift reliance from manual controls to automated controls. Companies have found, as they've gone through this first year, that many of their key controls, maybe as much as 70% to 90%, are manual in nature, even though they may have invested heavily in technology. It's important to create and leverage a strong information technology process to allow the 404 evaluation to be as efficient as possible.

Let me now turn to realizing the benefits of effective internal control. First, an effective internal control system over financial reporting will increase investor confidence, provide reliable financial statements, and

understanding of internal controls, companies should be able to reduce any gap in controls and clearly eliminate the redundancy that many have experienced in the control area.

A final benefit relates to the overall acquisition process. Many companies have enhanced their acquisition process by evaluating controls before the deal is done. They are looking at the controls in an organization as they perform their due diligence and, many times, are mandating that control deficiencies be remediated before the deal is closed. This allows for a much smoother post-integration process and eliminates the costly aspects of remediating control deficiencies from acquired companies.

“An effective internal control system over financial reporting will increase investor confidence, provide reliable financial statements, and minimize the risk of fraud.”

minimize the risk of fraud. However, there are a number of other benefits and opportunities management should consider. One is the ability to standardize and simplify processes. As companies went through this first year, they realized they had many redundant controls and overlapping systems and processes. Many times this was caused by nonstandard and decentralized processes. It's important that a company evaluate its processes and standardize them. Some companies may choose to develop shared service centers or other centralized processes that will make the overall internal control process more effective and efficient. In addition, it's important that a company improve its awareness of internal controls and establish accountability for internal controls at all levels. With this new

In summary, companies have made a significant investment in their first year around implementation of 404. Now what they need to do is sustain that process over the long run. To do that, it's important that management and the audit committee remain focused on achieving the most effective and efficient process in evaluating the company's internal controls over financial reporting.

Structuring “Unassailable” Executive Compensation Programs

Blair Jones, senior vice president and practice leader, Leadership Performance & Rewards for Sibson Consulting, reviews how corporate boards can structure compensation programs that support their strategy execution.

When it comes to executive compensation plans, so many companies these days have taken the approach of “following the leader,” thinking it will keep them safely under the radar. Unfortunately, such thinking can lead to a lost opportunity. You might stay out of harm’s way, but you also could miss the chance to use executive compensation to move your business forward.

As we speak with boards and management teams about what they can do to make their programs as unassailable as possible, we focus on three tactics. First, create compensation pay levels that are business-based and informed by the business strategy. Second, when designing the compensation program, take into account the organization’s unique business characteristics, talent characteristics, and performance and rewards strategy. Third, monitor the pay/performance relationship closely and make necessary adjustments over time. Let me give more detail about each tactic.

With pay levels, the typical practice has been to examine a peer group and see what that market is paying. Common wisdom says if you’re attracting talent from or losing talent to a certain market, make sure you’re on par with the pay levels within that market. However, we believe that transitioning to where a company needs to be today demands following a set of “new rules.” In line with these rules, we’re encouraging companies to examine how certain roles differ in their ability to impact the business strategy. Then, use that information to decide how best to apply the market data. For example, in the retail industry, Wal-Mart’s business strategy is based on being the low-cost provider. Given that strategy, operationally-focused roles like supply-

chain management are most important in that business situation. In contrast, Saks Fifth Avenue has a strong merchandising focus, so merchandising roles have a high value to Saks. In examining the market data, Wal-Mart might want to direct higher pay to operations-based roles whereas Saks might want to pay more for merchandise-based roles. The other, less strategic roles could then be managed at a lower pay point. This approach enables a company to take a limited universe of pay dollars and use them to greater effect, so that the roles most important to achieving the business strategy are the ones in which the most dollars are being invested.

Tactic two has to do with plan design. It involves creating designs that are unique to a given business. Again, the typical practice is to look toward the marketplace for direction. Perhaps the market seems to be shifting away from options and toward restricted stock. Restricted stock may work for some companies, but clearly it is not the answer for every company. Rather than focus on the market, it’s better for companies to look at their unique business strategies and business characteristics. For instance, is a company going through a growth stage or is it a mature company? Each stage would have different pay design implications. Is the company going to create value through dividends, or is it going to create value through stock-price growth? Talent characteristics must also be considered. For example, what type of people is the company trying to bring into the organization, and how stable is that population? Is the hiring profile focused on entrepreneurial individuals or people who will be loyal to the company and build a career over time? Do the business units operate fairly autonomously? If yes, it may be wise to motivate those business units



Blair Jones
Senior Vice President and
Practice Leader, Leadership
Performance & Rewards
Sibson Consulting

differently across the corporation. A company also needs to consider its performance and rewards strategy. Is it a priority to build ownership over time? Does the company need to drive change right away? The answers are going to be different for every company; therefore, the compensation design should be different too. We don't let competitors drive our business strategy so why should we let them drive our compensation strategy? By looking at their own unique factors, companies can assemble designs that truly complement their unique purposes.

The third tactic in making a pay program unassailable is to examine the pay/performance relationship and to constantly monitor and adjust it. Again, traditionally companies have looked to the market for reassurance

higher than individual's pay should be. To address these kinds of issues, companies are examining the pay/performance relationship in different ways. For instance, they look at how much value is being shared with executives through compensation dollars relative to what is being shared with shareholders. Companies also are looking at how much of their earnings and cash flow are being paid out in cash-based programs—in other words, how much productivity are they getting from their pay? The idea is not to search for a magic number, but rather to explore a variety of different angles in the pay/performance relationship. It's important to understand how those dollars are being shared among employees to ensure they are being used to the greatest effect. Depending on what a

“We don't let competitors drive our business strategy so why should we let them drive our compensation strategy?”

that their pay is “OK.” More recently, companies have asked, “How does our pay align with our performance?” Every March, the *Wall Street Journal*, analyzes how companies pay their CEOs and how the pay relates to company performance. The time has come to be more creative in how that pay/performance relationship is assessed. Alignment has served companies well over the past decade, but the market has taken a major uptick in recent years. If companies continue to align pay with peer groups, what happens if those peers overpay? There's no way to adjust for that overpayment. In another example, say someone is performing at the top of the market, it's hard to know how much

company finds, it can go back and influence the pay levels and pay designs.

Of course, you can never ensure that your pay program is going to be entirely unassailable. But it's helpful to think about what would happen if your company's CEO was featured in the national, regional, or local list comparing CEO pay to performance. What story could you tell about how the CEO's compensation package is constructed and how that pay design supports strategy execution? That's the true test of unassailability.

Guidelines for Board Evaluations

Holly Gregory, partner at Weil, Gotshal & Manges LLP, provides a practical overview of full board and individual evaluation programs and the role they play in continually improving a company's corporate governance culture.



Holly Gregory
Partner
Weil, Gotshal & Manges LLP

Board evaluation became a topic of some interest in the governance world about 12 years ago, when the board of General Motors implemented an annual self-evaluation provision in its board guidelines. Since that time, a number of other companies have adopted board evaluation processes as a means to help directors think about their own effectiveness at least once a year and to discuss how the board is progressing and areas for improvement. Until about three or four years ago, board self-evaluation was still a practice that was adopted by a minority of large public companies. But the changes that came about with the listing rule reforms two years ago and the subsequent increased focus on effective governance practices have resulted in a significant growth in the number of boards of public companies that engage in some form of board evaluation.

There are a number of ways boards can evaluate themselves. The key to effective evaluation is to find a technique that complements the culture of the particular boardroom. For example, many boards rely on paper-based surveys or individual interviews of directors to gather information. These tools work well in situations where it is unclear whether directors would be comfortable sharing their thoughts in an open session about how the board is functioning. As boards become more comfortable with the process, we often find them moving toward evaluations that are less paper- or interview-based and more focused on having a high-quality, open discussion in the boardroom about board effectiveness.

The first guideline for board evaluation is that the evaluation should be constructed by the board itself (or a designated board committee). While a lot of boards look to outside consultants

or facilitators, the board or a board committee—usually the governance committee—should be engaged in thinking about what process will work best. Active engagement in evaluation design by the board or a board committee helps not only ensure the best fit between design and culture, it also helps ensure buy-in from the board. Evaluation should not be a process that is imposed by an outsider.

The second guideline is, no matter what process a board uses to gather information for the evaluation, at the end of the day the evaluation should encompass a robust discussion among the full board about how the board is functioning and how it could improve. The tools used to collect information need to be viewed as the means, not the end. The ultimate goal for the board is to actively deliberate about how it functions and how it can improve.

A number of different methodologies can be used to gather information for the board evaluation. Interview processes can be used where the lead director, a committee chair, or an outsider comes in and talks with each director individually. Interviews are very helpful in a boardroom where there may be tensions—and where there is concern that it would be difficult to have people come together in an open board setting and honestly discuss what may be on their mind. At the same time, this process is more time-intensive and can be more costly—especially if you are relying on outside consultants to help facilitate it.

Another methodology many boards use is a paper-based survey or questionnaire. Typically each director fills out the survey and sends it to someone (often, but not always, an outsider) who compiles the data and reports back to the board. This process

provides a vehicle for directors to share views and yet feel their identity is protected—so, again, they may be more comfortable in critiquing aspects of the board’s functioning—and it is less time-intensive than interviews. The concern with the use of surveys is that they may be discoverable in litigation. That concern needs to be considered both in the decision to use such tools and in the formulation of survey questions and the determination of related process issues. Who collects the information? How long are the materials retained? How is information compiled and reported back to the board? Is it done in a written report? Is it done in an oral report? For example, some boards have directors send their survey responses to a lawyer who analyzes the

evaluation questionnaire as a means of board evaluation. Facilitated discussion not only alleviates concerns about the paper trail, it also helps directors engage in a more dynamic discussion. It is also far less time-intensive and costly than other methods. Of course, it presumes a board that is comfortable with open discussion.

Until now, we’ve been talking about the evaluation of the board as a whole. Another form of evaluation involves assessing individual directors. Boards often do this as part of their renominating process. Although this process has often been done by the nominating committee in an informal setting, we are seeing more interest in formalizing it, again, often using paper-

composite so that the individual director can compare his or her own views of performance against what peers view to be areas that need improvement.

The most important things to remember about board evaluation are as follows: first, it should be board driven; second, it should result in a dynamic discussion followed by action concerning the areas identified for improvement; and third, it doesn’t require rocket science to undertake. The key is to find a process that works for the board—one that will encourage the board to have a robust discussion around how it governs and what it could be doing more effectively.

“The key to effective evaluation is to find a technique that complements the culture of the particular boardroom.”

information and provides a report and recommendations orally to the board, in part to preserve the argument that the material is privileged. (There are no assurances that a court will agree.)

Another concern with the use of paper-based surveys is that the person who reports the results back to the board often becomes viewed by the board as the expert on how the board functions, when in truth that expertise resides with the board. This may create difficulty in facilitating a dynamic discussion at the point at which the outsider comes in and reports to the board on the evaluation results. This is one reason I encourage boards to turn to a facilitated board discussion—without the use of surveys—around the topics that would typically be on an

based surveys. It is important to remember, however, that if directors in a peer-to-peer evaluation seriously critique a board member and no action is taken—either to help that board member change behaviors that have been criticized or to consider asking the director not to stand for renomination—that inaction may cause problems down the road if evaluation materials are discovered in litigation.

While individual director evaluation is not yet practiced by as broad a range of companies as board evaluation, we are seeing increasing interest in this type of evaluation. Individual evaluation is most helpful when it incorporates both a self-assessment by the individual director and peer evaluations formed into a

Eight Essential Steps to Building Ethical Corporate Cultures

Dov L. Seidman, chairman and CEO of LRN, outlines the major steps corporate boards need to take to implement a self-governing ethical culture.

These are indeed remarkable times. Any newspaper you pick up will have headlines with the words “character,” “culture,” and “do the right thing” and show CEOs doing the “perp walk.” Other CEOs get pushed out—even though they made the numbers and they didn’t violate a law or company policy—because they acted in some way to bring their company into disrepute. We see other CEOs traveling abroad to apologize for ethical breaches, rather than legal infractions, in their companies.

Today, corporate leaders and boards of directors are focusing seriously and profoundly on steps they can take to foster corporate cultures that will not only win in the marketplace but will also be driven by ethics—so those companies can continue to win over the long haul. Everybody wants to be number one, everyone wants to be differentiated or unique. Companies used to accomplish that with what they produced—having the best mousetrap or the best-fastest-cheapest product. But today there are tremendous forces pushing toward commoditization. So how do businesses differentiate themselves?

Long ago, companies figured out that the way to stand out had to do with *how* they do things, rather than in *what* they produced. TQM, Six Sigma, Process Reengineering, Quality Control, Zero Defects, Just-In-Time Inventory—these and other methods are all recognitions by companies that their business models—how they do things—are more important than what they do. Today, the most foundational “how” of all, is the how of ethics: how we treat others, how we conduct ourselves, and how we engender trust and loyalty within our workforces and with our key stakeholders—customers, suppliers, dealers, and investors. Here is a list of things you can focus on to help you

enforce and foster corporate cultures that are both winning and enduring.

The first step is to recognize that the time has come to move beyond simply complying with the strict letter of the law and to embrace the spirit of the law—the underlying ethical principles that animate the law in the first place. It’s also time to recognize that in many cases, the law represents the floor—it’s about what we can do, what is legally permissible. It’s important to focus on the ceiling—what ethical principles we should embrace in guiding our behaviors.

This issue came to light in March last year, when the U.S. Federal Sentencing Commission met. They came together to study their ad hoc advisory committee’s findings about compliance programs, which have been in effect for the last 14 years since the federal sentencing guidelines were first introduced. Even though millions of dollars have been spent on putting the apparatus of compliance with laws and rules in place, the ad hoc advisory committee found little evidence of effective compliance programs.

There is a great irony here. We’ve become so attached to the law that we look to it for everything. We look to it for what we can do—for legal permissibility. But legal permissibility is not permission, and when you get this attached to the law, it puts too much pressure on ingenuity, on inventiveness, and on finding loopholes. Today, loopholes have become nooses, and I believe the scandals that we’re seeing day-in and day-out are occurring because institutions and their leaders fail to ask the most important question of all: Even though I can do it, should I do it?



Dov L. Seidman
Chairman and CEO
LRN

The next step is to move beyond proxies or surrogates to culture. We have a longstanding tradition when individuals come before the judicial system and life-or-death decisions are made on very direct, piercing evaluations of an individual's character. But when it comes to corporations, we have not had such a direct relationship. We've used proxies and surrogates for their cultures. We've used the due diligence standard: Have they taken steps? Have their leaders put programs in place?

What we're seeing today in these transparent times is that it's possible to move beyond these programs and go directly to the culture. When Justice Department officials cart off computer hard drives and study millions of e-mails, they get a very direct sense of the health of the culture. It's one thing to say your company has a hotline available to allow people to come forward and report misconduct—but what if 99% of the employees say they are too scared to use it or trust its confidentiality? Simply having a hotline program does not mean you have a great culture, and we are now in a time where we can directly assess cultures.

Therefore, the next step is to decide what kind of culture you want to have. The culture I believe most companies find themselves in today is one of "informed acquiescence." This typically means a subset of the compliance or HR officials informs or educates the rest of the employee population as to the laws of the land and company policies. Through carrots and sticks, we motivate employees to follow those laws. When we ask them what they are doing, they say they're following the company's laws—they are acquiescing or conforming to the company. They are not necessarily following what they believe in; they

are not following their heart. Today, however, the apparatus of informed acquiescence isn't working. The bureaucracy of compliance can't keep up with human ingenuity. It can't keep up with the new regulations. It can't keep up with the global complexity of business. And people can't walk around with thousand-page manuals, looking up every compliance or noncompliance activity to direct their actions or decisions.

The culture we need to move toward is one of self-governance. In a self-governing culture people commit to a set of underlying principles and ethical values. When they are committed to those values, they do the right thing. In this way, not doing the right thing would be betraying themselves, not just the company. In this type of culture, compliance is no longer a program or process, it's an outcome.

Achieving self-governance—rather than informed acquiescence—is difficult, but we've got great historical analogs for similar successes. It used to be that injuries on the job, if not deaths, were considered the cost of doing business, and quality defects were the cost of doing business. If you wanted higher quality, it would cost you more, yet we have found a way to design quality into every manufacturing process from the get-go, and we've found a way to do the same with safety. If someone walks down to a factory floor not wearing a hardhat, anyone should be able to hand them one, not just the factory foreman. We've made it a part of everybody's job. Likewise, anyone can stop an assembly line if they think a quality defect is about to happen. Like quality and safety, ethics is a value. We must find a way to take this soft topic of ethics and make it hard—find a way to measure it, talk about it, and design it into every

single business practice and make sure that it affects every decision and every action we take.

The next step on the road to fostering self-governing cultures is education. When people understand the rules, and more importantly, the ethical underpinnings of those rules, they understand the dos and don'ts and are educated about how to flex their ethical muscle—how to ask important questions such as, "What will this look like on the front page of the newspaper?"

Just refer to the Golden Rule: How would I feel if everybody did that? What would this look like in terms of the reputation to my company? When people understand how to wrestle with dilemmas and resolve and recognize conflicts of interest, they can then

THE ESSENTIAL STEPS

- Embrace the spirit of the law.
- Move beyond a proxy for ethics and directly assess the culture.
- Decide what kind of culture is needed.
- Educate everyone to foster a culture that's self-governing.
- Emphasize vigilance and personal responsibility.
- Foster an environment with an abundance of trust and verify that trust is warranted.
- Integrate and celebrate ethics and values throughout the organization.
- Have leadership embrace the cultural transformation and continually invest in it.

self-govern. At that point, everybody can take responsibility to foster a culture that's self-governing, and that's healthy and winning.

Doing the right thing is often inconvenient. It's often unpopular. It's often unprofitable. Will an abundance of education cause people to develop enough ethical muscle to do the right thing even if it's inconvenient; to make the right call when it counts because they've practiced? It's time to attach the concept of *how* we do everything to every thing we do. Each time we are in a meeting, there is always time to pause and ask, "What is the ethical underpinning of what we're doing? Is it the right decision, and should we do it even though we can?"

The next step is to focus on creating cultures that are vigilant and full of individual responsibility, where each person takes responsibility first and foremost for their conduct and for the conduct of those around them. Why does the Department of Homeland Security publish the terrorist alert to everybody? It already knows the terrorist threat. But it is trying to create awareness and, therefore, vigilance in all of us with respect to terrorism all around us. Similarly while it's important for every individual who is part of a corporation to be alert, first and foremost, to whether his or her own conduct is proper and ethical, he or she should also be aware of the conduct of those around them. Studies show that five out of five employees, when they see a frayed wire or an exposed pipe, report it. They believe they have a responsibility to keep their environment safe. However, when studies look at misconduct, three out of five employees do not report misconduct happening to their left and to their right. How do we move to an environment where everyone sees perceived misconduct as equally

dangerous as a frayed wire or an open pipe and comes forward to report it to the proper channels? Leadership has to create and reward such behavior. If they do, everyone benefits because they are making the right decisions, and every interaction they have with a colleague—by speaking to them or by email, with a customer or with an investor—is affected by the values and principles that make up that corporate culture.

A further step is to foster environments that have an abundance of trust. It's been said that trust is like the air we breathe. No one notices when it's there, but everyone notices when it's absent. The more trust there is in the room, the better teams perform, the better people work with each other. The more trust there is in our relationships, the healthier and more enduring they are. The same goes for customers, suppliers, dealers, investors, and employees. Moreover, when relationships are governed by trust, both customers and investors reward your company.

At the same time, though, we need to create cultures that are full of trust because they drive us forward. It's important to verify that this trust is warranted. Technology platforms now are being built that integrate all the various compliance and governance processes to help boards of directors, management teams, and compliance officials to be in a position to gain real insight into the ethical health (or lack of it) of their environments. These systems allow leaders to see how cases are being managed when allegations are brought forward, evaluate activity levels on electronic hot lines or help lines, and look at certifications on key company policies to see what exceptions to those certifications have been brought forward and how they've been handled.

One might say, if you have trust, then why do you need to verify? It's simple: Every city has its crime. Every corporate culture can have a few bad apples. It's not so important to worry about them in particular. Rather, it's more important to worry about creating cultures where bad apples don't survive and thrive. It's important to look at that culture and ask: Who's being promoted, who's making decisions, who's being rewarded? What is being celebrated, what is being punished? It's crucial for leaders—boards of directors—to preside over cultures that have an abundance of

It's important when I talk about celebrations and rewards to recognize that doing the right thing is often hard. It's inconvenient and, in some cases, doing the right thing means coming home without the deal. But precisely at those times, it's important for leadership to recognize that difficulty and reward that behavior. If leadership wants to underscore the values and principles that can make sure this culture can endure successfully over the long haul, it must celebrate people who make tough ethical calls, even if it means not making the numbers in the

there today with longstanding traditions of investing in do-it-right cultures, and they are benefiting in these times when it's become, ironically, so practical to be principled.

“The culture we need to move toward is one of self-governance...In this type of culture, compliance is no longer a program or process, it's an outcome.”

trust, but at the same time, they've got to be able to step in and assess it and gain meaningful insight as to whether these cultures are, in fact, self-governing and working.

Integrating and celebrating ethics and values is another meaningful step. Heretofore, it was the job of just a few individuals to ensure a company was fostering a “do-it-right” corporate culture. However, once again it's important to integrate how we do things into everything we do. It's time to integrate ethics into every company policy and practice—recruiting employees, orientation programs, promotion policies, and dismissal policies. It is only through integrating how we do things into every practice—celebrating and rewarding the behaviors we desire and disciplining those that we don't—that we will create environments where everyone is engaged in conduct of the highest standards.

short term. It's crucial for leadership to set the tone that ethics matters more than anything.

The final step takes us back to the beginning. Instilling a sense of ethics is not a project—it's a perennial investment. It's a cultural transformation and a leadership initiative. It's about boards of directors, CEOs, and all company leaders understanding there is not a single lever you can pull that will move your culture along the spectrum from informed acquiescence to self-governance. It involves a constant, deep, profound commitment—day-in and day-out—making sure that you create an environment that is self-governing, and one in which the behaviors you want are rewarded, one in which there's trust, education, and integration. It will take at least 10 years, but you should start now. The good news is, there are companies out

A Legal Victory for Boards in Troubled Times

Martin Bienenstock, partner at Weil, Gotshal & Manges LLP discusses how one key judicial decision has helped boards in times of trouble avoid threats from creditors and do what's best for the entire enterprise.

Toward the end of 2004, the Delaware Chancery Court came out with a major decision that changes fairly significantly the duties and exposures of directors in troubled situations. Until then, the mainstream thinking, certainly since the Delaware Chancery Court's 1991 decision in *Credit Lyonnais Bank Nederland, N.V. vs. Pathe Communications Corp.*, was when a company approaches the so-called zone of trouble or zone of insolvency, the fiduciary duties of the directors and officers either shift from shareholders to creditors or expand to incorporate duties to both shareholders and creditors. Creditors were thus emboldened to make demands on management and directors when they thought the corporation might otherwise make a decision that exposed their debt to more risk while taking a chance there might be an upside for shareholders. As a result, the notion grew that if you have a company that is in trouble, or might get into trouble by increased leverage, creditors would have a better chance at enforcing fiduciary duties against directors and senior management. Up until now, that notion has been fortified by both state courts and bankruptcy courts.

In the recent *Production Resources Group LLP vs. NCT Group Inc.* decision¹, however, the conventional thinking among directors, officers, and lawyers who specialize in counseling boards in times of trouble changed. The *Production Resources* decision explained that *Credit Lyonnais* was not intended to impose on directors and officers new duties to creditors. Specifically, the court wrote: "In other words, *Credit Lyonnais* provided a shield to directors from stockholders who claimed that the directors had a duty to undertake extreme risk so long as the company did not technically breach any legal obligations." What the

court in *Credit Lyonnais* explained was that directors would be shielded from suits by stockholders for having made business decisions that took into account obligations to creditors. The latest jurisprudence explains it's perfectly appropriate for directors who want to keep their companies out of bankruptcy to take creditor obligations into account, and if shareholders want to sue them for making conservative decisions, as opposed to making decisions with the biggest potential upside for shareholders with the biggest risk for creditors, directors and officers will be protected.

Additionally, under many states' laws, it's perfectly valid for a corporate charter to exculpate directors for business judgment mistakes, and the Delaware court tried to fortify the notion that it doesn't want to take away that level of protection for directors and management, especially when a company might be in trouble. That's when decisions made by directors and officers are most taxing; that's when they are the most complex; that's when the decisions are the hardest. A corporation might make a decision geared toward keeping the company out of bankruptcy, and it may go into bankruptcy anyway. Most states don't want their directors and officers sued for having made that mistake. That's what the business judgment rule is all about—insulating directors and officers from liability when they are properly counseled, go through proper deliberations, obtain adequate information under the circumstances, and make decisions according to what they believe is in the best interest of the enterprise. And the enterprise is really what it's all about—this latest decision out of Delaware explains that directors and officers have a duty to do the best thing possible for the enterprise. This includes the shareholders and share value for sure, but it also allows for



Martin J. Bienenstock
Partner
Weil, Gotshal & Manges LLP

satisfying creditor obligations, retaining employment of its employees, being a competitor in the marketplace, managing growth opportunities, and attending to any special needs of the community or the country if those steps are in the ultimate best interest of the enterprise. Directors should be able to take all that into account without fear that they'll be sued by shareholders.

Ironically, the bottom line to this clarification is that the directors, the officers, the company, and its creditors are all better off. It's clear why directors and officers are better off, because this jurisprudence effectively says they will not be sued or will be sued less

take into account what's best for the entire enterprise: All levels of creditors, employees, customers, the community, the future viability of the company, and shareholder value.

¹ (863 A.2d 772 (Del. Ch. 2004))

“The latest jurisprudence explains it’s perfectly appropriate for directors who want to keep their companies out of bankruptcy to take creditor obligations into account, and if shareholders want to sue them for making conservative decisions ... directors and officers will be protected..”

meritoriously by creditors claiming directors have fiduciary duties to them in times of trouble. It's not as intuitively obvious why this jurisprudence is also in the best interest of creditors, but in fact, it is. The creditors that are most likely to threaten officers and directors in times of trouble are not the senior secured creditors, because they are largely protected by their documents. It's more likely to be subordinated creditors who, at the expense of the senior creditors, want directors and officers to take certain risks. This jurisprudence helps avoid threats to directors and officers from different creditor segments and allows them to

New Areas of Focus for Compensation Committees

Blair Jones, senior vice president and practice leader, Leadership Performance & Rewards for Sibson Consulting, discusses the structural and design issues compensation committees need to be aware of in 2005.



Blair Jones
Senior Vice President and
Practice Leader, Leadership
Performance & Rewards
Sibson Consulting

We've been in a period of change relative to executive compensation levels for the last two to three years, and there's no indication that the amount or pace of change is going to slow in the near future. However, it's likely that the focus will shift. So much of the attention in recent years has been on long-term incentives (LTI). In part, the corporate scandals of the last few years put the spotlight on stock options and the role they may have played in contributing to the disastrous outcomes. Attacks on LTI design also have been driven by shareholder concerns about pay for nonperformance and by option expensing and increasing shareholder dilution. As we look ahead, we see four trends emerging.

The first area of change is in annual incentive design. Interestingly, companies that have changed their LTIs often have done so in isolation—without considering their annual plans. In reality, annual incentives and LTIs should work in concert. In essence, annual incentives focus on the near-term actions necessary to achieve the long-term goals. Thus, annual incentives should have key drivers of longer-term performance imbedded within them. Boards and management must work together to identify the right measures and goals to make annual incentives effective and to link them appropriately to the LTIs—this is the heart of incentive design. Without the right measures or the right goals, the incentive design will be sub-optimized. Measures are a good place for companies to focus if they have their long-term program in place. Companies should ask: What can we do on an annual basis that will lead us to those longer-term performance goals?

Goal-setting is a bit of a balancing act. Companies have traditionally approached goal-setting in one of two ways. Some companies come at it from

the top-down, asking, "What is Wall Street's expectation and how do we meet it?" Unfortunately, top-down goals don't allow for much ownership outside the executive suite. And often, if performance against goals isn't tracking early in the year, employees give up. The other goal-setting approach is bottom-up. But a bottom-up approach can encourage people to sandbag, resulting in not enough stretch and insufficient performance. The challenge for boards, as they approach annual incentive design, is to balance those two perspectives: determining what the company must do from a top-down perspective, while assessing what it realistically can do bottom-up over the course of the year-long performance period.

A second trend has to do with a heightened interest in retirement compensation, particularly SERPs and deferred compensation. Over the last 10 years or so, the media focus on executive pay has highlighted direct compensation—base salary, annual incentives, and the present value of long-term incentives. About a year ago, the *Wall Street Journal* actually labeled SERPs and retirement income "stealth pay" because they weren't in the spotlight. Now, particularly in the wake of the New York Stock Exchange scandal, boards are asking more questions about how their actions on the direct compensation side actually affect what happens on the retirement side. They also are attempting to understand the implications under different scenarios of what that income might be.

Tally sheets are one tactic boards can use to get the complete picture of compensation, both for the CEO and the executive group as a whole. A tally sheet presents an accounting of executive compensation over several years and

under different scenarios. For instance, a tally sheet might include base salaries and annual incentives for the last three years, plus long-term incentives and gain opportunities for the same three years. It also could illustrate what the likely realized gains might be under various price scenarios. Added to that value would be retirement income at different points in time and potential payouts if executives were terminated or retired, or if a change in control occurred. Tally sheets help boards avoid any real surprises as they identify all of the implications of their pay decisions. In turn, this information can help boards make more-informed decisions going forward.

Yet another area of increasing interest is pay levels. The relationship between CEO pay and worker pay has been getting attention, but the absolute pay focus goes beyond that relationship. Shareholders are more interested in the

significant rethinking and change over the last two to three years. To some extent, shareholders have been patient, awaiting the results. But they are beginning to ask, “What payoff did we get as a result of the change?” To respond, boards need to examine recent compensation changes and evaluate the resulting performance to demonstrate that these program changes have helped move the business forward. If the anticipated results didn’t happen, then the board should take the opportunity to adjust the programs and get them back on track. For instance, a number of companies introduced service-vested restricted stock as a partial replacement for stock options. While few companies replaced stock options altogether, a number considered restricted stock less leveraged and viewed it as an antidote to the shorter-term thinking often attributed to stock options. So, have shareholders gotten something for that type of the change?

on some of the promises made over the last few years. Board members should make sure that they have done more than just shift compensation around or tinker with pay delivery. It’s time to make sure the executive pay program makes a difference for the business and shareholder returns.

“Shareholders are more interested in the absolute levels of payouts and whether they are justified relative to the returns that have been generated.”

absolute levels of payouts and whether they are justified relative to the returns that have been generated. Given this growing inquiry, board members, and the compensation committee in particular, need to examine what the company is paying out under different performance scenarios and how those payout levels are justified by the results that are being delivered for shareholders.

The final area of interest, very related to pay levels, relates to the pay/performance relationship. As mentioned, executive compensation in most companies has undergone

Anticipating such questions, boards can be proactive and begin to test the programs and track results to determine whether the changes have had the intended effect or whether the programs need a mid-course correction to get back on track.

Common wisdom views executive compensation as a litmus test on corporate governance. As a result, compliance-oriented issues and getting executive compensation in order have topped board agendas. Now, however, both shareholders and shareholder advisory groups are looking for delivery

NEW AREAS OF FOCUS

- Annual incentive design
- Retirement compensation: SERPs and deferred compensation
- Pay levels
- Pay versus performance

Board Governance Series

A KEY EDUCATIONAL RESOURCE FOR TODAY'S BOARDS OF DIRECTORS



VOLUME I



VOLUME II



VOLUME III



VOLUME IV



**Volume V
Is Now
Available!**

CORPORATE
BOARD MEMBER
MAGAZINE

NASDAQ[®]

**24-page full-color,
easy-to-read supplement
\$19.95**

BOARD GOVERNANCE SERIES ORDER FORM

VOLUMES I THRU V

PLEASE SEND ME

	QUANTITY		TOTAL
<input type="checkbox"/> SUPPLEMENT VOL. I	_____	@ \$19.95 each	_____
<input type="checkbox"/> SUPPLEMENT VOL. II	_____	@ \$19.95 each	_____
<input type="checkbox"/> SUPPLEMENT VOL. III	_____	@ \$19.95 each	_____
<input type="checkbox"/> SUPPLEMENT VOL. IV	_____	@ \$19.95 each	_____
<input type="checkbox"/> SUPPLEMENT VOL. V	_____	@ \$19.95 each	_____
SHIPPING/HANDLING	_____	@ \$5.95 each	_____
TOTAL AMOUNT DUE			\$ _____

NASDAQ members receive a 10% discount. Orders of 6 or more receive a 10% discount.

MAILING INFORMATION

Name _____ Title _____

Company _____

Address _____

City _____ State _____ Zip _____ Country _____

E-mail _____

PAYMENT INFORMATION

- Check enclosed payable to
Board Member, Inc.
- MasterCard
- VISA
- American Express

Name on Card

Card Number

Expiration Date

Signature

Bill Me

RETURN ORDER FORM

FAX (615) 371-0899

PHONE (800) 452-9875

MAIL *Corporate Board Member
c/o Board Governance Series
5110 Maryland Way, Suite 250
Brentwood, TN 37027*

ONLINE [www.boardmember.com
/network/board_governance/](http://www.boardmember.com/network/board_governance/)

5110 Maryland Way, Suite 250
Brentwood, Tennessee 37027
(615) 309-3200
www.boardmember.com

CORPORATE
BOARD MEMBER
MAGAZINE