Board Governance Series

VOLUME VIII 2006

A KEY EDUCATIONAL RESOURCE FOR TODAY'S BOARDS OF DIRECTORS

CORPORATE BOARD MEMBER MAGAZINE | NASDAQ®

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BOARD MEMBER
MAGAZINE

Corporate Board Member is the leading information resource for senior officers and directors 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 further extends its governance leadership through an online resource center, conferences, roundtables, 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 New York Stock Exchange, NASDAQ Stock Market, and American Stock Exchange.

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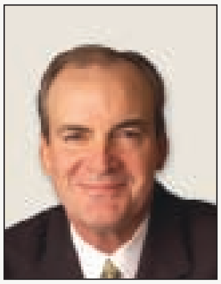
Dear Corporate Director,

Today's boards of directors are working harder than ever before, proactively identifying and averting crises while simultaneously dealing with increased scrutiny from outside constituencies. Along with their escalating responsibilities and strategic issues that require more time and attention, directors today face many more questions about compensation plans and related disclosures.

Corporate Board Member and The NASDAQ Stock Market are proud to present commentary from a group of renowned experts in corporate governance trends in volume 8 of our director education resource, the Board Governance Series. These special supplements complement our online webcasts, which are designed to inform corporate directors on the critical issues influencing the governance climate. The topics covered in this volume include director and executive compensation, electronic discovery and the associated risks for boards, how boards should deal with bad news, and the role of the lead director.

Since its inception four years ago, the series has continued to be regarded as a premier resource for corporate boards and governance experts across the country. We invite you to visit the websites of our prestigious contributors and to access online the specific webcasts featured in this special publication to *Corporate Board Member* as part of your continuing education.



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CONTENTS

Keys to Effective Audit Committee Meetings

Catherine L. Bromilow, Partner and U.S. Leader for Corporate Governance, PricewaterhouseCoopers, discusses steps that can improve the audit committee's processes as well as help the committee improve its effectiveness during and after meetings.

Catherine L. Bromilow
U.S. Leader for Corporate Governance
PricewaterhouseCoopers LLP

In a previous webcast, I provided some ideas for audit committees that want to focus on their efficiency, particularly as it relates to meeting preparation. In this session, I would like to discuss four key steps audit committees can take to ensure that what happens during and after their meetings promotes effectiveness.

Let's start with what happens during audit committee meetings. There are two key issues: the agenda and meeting dynamics. First, it's vital that the audit committee has a carefully crafted agenda. These days, meeting times are expanding substantially; it's not uncommon for meetings to last three or even four hours, if not longer. And audit committee members are only human–they can sustain their attention span and energy level for only so long before their effectiveness declines. That's why it's important for audit committees to put the most important, highest priority, and highest risk issues first on their agendas. That also means, by default, the more administrative functions, such as approving draft minutes, and some of the lower risk areas, such as getting standard reports that really don't change much from meeting to meeting, are deferred until later in the meeting. This sounds like a simple idea, but relatively few audit committees think strategically about how they order items on their agenda so they can ensure they deal with the most important ones while they are mentally at their freshest.

Meeting Dynamics

Moving on to meeting dynamics, it's important that audit committees not allow presentations to take over the entire meeting and, in effect, kill discussion. Audit committee members are incredibly busy. If they attend a meeting only to have read back to them essentially verbatim what they've already read in the premeeting materials, they will cease seeing any value in spending time preparing for meetings. Some audit committees are dealing with this by setting limits, such as allowing no more than two to three slides per presenter, just enough to refresh the directors on the issues they've already read about, and thereby setting the stage for further discussion. This results in far more robust discussions. Another approach some committees use is to focus on the quality of the presenters who appear before the committee. If a presenter goes into too much detail for the committee, or if he or she is just not communicating the key issues effectively, the committee may ask management to get that person coaching to improve his or her communication skills, making future appearances more effective.

The bottom line is that if you, as an audit committee member, are not satisfied with either the order in which you're covering things or the balance between discussion and presentation, you need to drive the changes that will make meetings work for you.

Post-Meeting Issues

Once the audit committee meeting is over, that doesn't mean the work is finished. There are two issues directors should consider: follow-up on unresolved issues and how the minutes are handled.

Let's talk first about unresolved issues. The audit committee needs to be comfortable that questions management didn't have an answer for during the meeting, or requests that require management to do more work and report back, aren't simply lost after the meeting. That means having a mechanism in place whereby management can track the issues, work to resolve them, and then communicate to the committee how they ultimately were resolved. One committee does this by designating a separate place in its minutes to capture outstanding issues that weren't dealt with in the current meeting. It then uses that portion of the minutes also to report how outstanding items from previous meetings were resolved or are being tracked until they're resolved.

Committee Minutes

That brings us to the topic of minutes. Minutes can either save a committee or hang it. There has been a lot of talk over the past few years about what needs to go into minutes. Although I'm not going to discuss minute contents–which is a major topic in itself–I do want to look at the process. It's important for audit committee members to see the draft minutes soon after the meeting is over–ideally within a week or two. I understand this time frame differs from the current practice, where it's more common for audit committees to receive the draft minutes a week or two before their next meeting. The problem with that time lag is by the time they receive the draft minutes, audit committee members aren't as fluent with the focus of the discussions, since memories may have faded. Distributing the minutes in short order allows committee members to review them while the discussion is still fresh and to request revisions if they don't think what's captured in the minutes properly reflects what went on in the meeting.

In conclusion, audit committees can take important steps to control their agendas and to ensure there is an appropriate mix in their meetings between discussion and presentation, to make sure that issues not addressed during the meeting are followed up on, and, through timely review, that the minutes properly reflect what happened in the meeting. These steps can improve the processes the committee has in place, both during and after meetings, as well as help the committee improve both its effectiveness and efficiency.

"…it's important that audit committees not allow presentations to take over the entire meeting and, in effect, kill discussion."

Top Legal Risks Facing Boards

Mike Pace, senior managing director, FTI Consulting, reviews the legal risks facing directors, particularly those stemming from investigative and due diligence work around an acquisition target or a potential joint venture partner's business practices.

Mike Pace
Senior Managing Director
FTI Consulting

Every year *Corporate Board Member* joins forces with FTI Consulting to survey directors and general counsel on important legal issues. On our last survey, we asked general counsel, "What are the top three legal issues that companies and boards will face in 2006?" Interestingly, M&A was the number one issue they felt would be addressed in the boardroom, followed by issues related to the SEC and the Sarbanes-Oxley Act, followed by compliance. Does this list mirror your experiences in the boardroom these days?

It's very consistent with what we're seeing and being asked to do at the board level and also at the senior management level. Since Sarbanes-Oxley was enacted in a post-Enron world, the investigative due diligence assignments have really expanded in terms of what we and others are being asked to do. One of the key components of an investigative due diligence assignment continues to be background investigations on the management team, on the proposed management team, or on the acquisition target–to determine if something in their backgrounds could affect the company's willingness to enter into the transaction or develop the relationship.

But there are at least two other areas that have really expanded in the last few years. One is investigative and due diligence work around the business practices an acquisition target or a potential joint venture partner might engage in. We're being asked to evaluate the business practices that a target company and its management team might be engaged in, especially from the international perspective. One needs to evaluate everything from whether there might be Foreign Corrupt Practices Act violations or exposures that might present problems to a U.S.-based multinational company, to whether there are other business practices–fully lawful and suitable in a particular country or jurisdiction–that might cause issues or even exposure for a U.S. company thinking about acquiring or partnering with that international business.

The other area where there has really been substantial growth from a due diligence perspective has been in the area of compliance programs. If a potential acquisition target has a compliance program, we are regularly asked to evaluate whether it's effective, and to evaluate whether there is a culture of compliance within the target organization. So the notion of what constitutes due diligence and sufficient due diligence has really been expanded over the last few years.

In today's environment, there are additional dimensions to due diligence that, for the most part, didn't exist before Sarbanes-Oxley and the business failures of a few years ago. These days, investigative due diligence teams take their seat at the table alongside lawyers who are performing the legal due diligence and accountants who are performing the books and records due diligence. It's been increasingly important to have a multidisciplinary approach and a multidisciplinary team as it relates to evaluating potential partners and acquisition targets.

Another finding in the survey was that directors hoped they would be spending more time on company growth issues and less time on compliance. What are

some key points or best practices directors should know about to help them mitigate the risk associated with increased M&A activity or company growth, both in this country and internationally?

What I thought was particularly interesting in the *Corporate Board Member* and FTI survey was that 63% of the board members surveyed planned on spending more time on growth and expansion issues in the coming year as compared to previous periods. There are three primary risks board members should keep in mind as they think about acquisition or expansion, particularly internationally. The first is integrity risk, the second financial risk, and the third compatibility or integration risk.

Integrity risk focuses on the business practices, the suitability of a management team, and whether its members have reputations that can be trusted in their particular business or their particular geography. Financial risk is essentially what it sounds like. It is asking whether the potential target's or joint venture partner's books and records are a fair representation of what they purport to be. Is the valuation of the company what it purports to be? The compatibility or integration risk relates to whether this potential target can actually and fully be integrated to the appropriate degree in the acquiring company's portfolio.

It's awfully important to be asking the questions related to who is performing the due diligence investigation and the analysis on behalf of the acquiring company. We've found that it is critical for a board to employ a multidisciplinary set of professionals–whether they come from within the company or are outside professionals.

Can you summarize your take from the survey and where we're headed with all this?

Companies are becoming more international and global. They have been for some time, but U.S. multinationals are increasingly moving into places and areas they haven't been in before–whether it is China, India, or Latin America–and the need for a due diligence investigation or an expansive overall review of a potential acquisition target or joint-venture partner is more complex today than ever before. The need and the regulatory climate requires added due diligence–whether it be to address financial issues, controls issues, or integrity issues. And the places where companies are looking to do more business and make more acquisitions–whether they are in Asia or Latin America–are places where the business practices are different and the access to information about the business practices historically has been more complex. It's going to be a challenging environment for any U.S.-based company planning to acquire or partner with someone on a global context.

"These days, investigative due diligence teams take their seat at the table alongside lawyers who are performing the legal due diligence and accountants who are performing the books and records due diligence."

When Boards Must Deal with Bad News

Ellen Odoner, head of the Public Company Advisory Group at Weil, Gotshal & Manges LLP, discusses the importance of boards creating a climate in which crises can be dealt with directly and without delay.

As we see every morning when we open the newspaper, no company is immune from bad news, and no board can be confident that its company–no matter how well run it appears to be–carries such immunity. Bad news can come in a heartbeat: in the form of an industrywide problem–perhaps regulatory or litigious in nature, or in the form of a company-specific problem–a business failure, an accounting error or, most painful and difficult to deal with, an allegation against management's credibility and integrity.

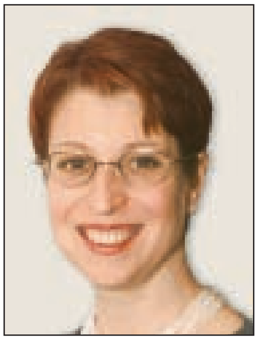
What steps should a board take to address bad news? Actually, the most important steps can and should be taken before any bad news arrives. First, the board must set a tone with management–the CEO, CFO, GC, and internal auditor–that makes it clear that when bad news–or an early warning of bad news–arrives, it should be communicated to the board directly, clearly, without sugarcoating, and without delay so the board can do its job. Second, through its normal course of operations, the board must create the climate and working relationships that will enable it to organize and galvanize itself, without too much housekeeping, to help management.

"The worst thing a director can do for himself or his company is make a statement at the outset of a crisis on the basis of imperfect information..."

Once the lead director or the audit committee chairman gets that call from the CEO with the bad news, what's the board to do? First, either the board as a whole or several members of the board should sit down with management and assess the situation: what's known about the problem, what can be known about the problem, what's the time frame for gathering information about the problem, and who should gather the information? And if management's integrity seems to be at issue, the board should play the lead role and perhaps get its own advisers to help gather the necessary information and make decisions. It's really a matter of what's at the heart of the issue, and that can change as more information is uncovered.

Boards should give thought at the outset to all the constituencies that may be affected by the bad news. Does the company have an immediate disclosure obligation? Should it cease stock buybacks or other market activities? Should it stop a public M&A transaction? Should it close the trading window for executives and perhaps shut down its equity-based employee programs? These are critical decisions that need to be made in conjunction with management on day one.

When bad news arrives, directors and managers may be sorely tempted to jump into the fray and immediately defend their company to the hilt, but that is a temptation to avoid. The worst thing a director can do for himself or his company is make a statement at the outset of a crisis on the basis of imperfect information that, in hindsight, appears misleading. At the same time, directors should help management meet the challenge of maintaining an accurate flow of information to customers, employees,



Ellen Odoner
Head of the Public Company Advisory Group
Weil, Gotshal & Manges LLP

lenders, institutional investors, rating agencies, and regulators so that the business can go on. In resolving a crisis, it's very important for the board to be perceived by regulators and outside auditors as bringing its intelligence, objectivity, and experience to bear on the problem and getting to the root cause.

When they find themselves in these situations, boards must be prepared to clear the decks and do what's necessary, though this may very well occur at the most inconvenient times. But that is when boards can make their greatest contribution to shareholders. Directors today must expect the unexpected. It's very unlikely a director will get through his or her career without experiencing a crisis of one sort or another. They can help their companies find the way through the thicket with objectivity, independence, active skepticism, and dedication.

Recent Trends in Director Compensation

Doug Friske, managing principal, Towers Perrin HR Services, spoke with *Corporate Board Member* about key shifts in director compensation, and how in some cases, those changes parallel trends in executive compensation.

Doug Friske
Managing Principal
Towers Perrin

There's no doubt we've witnessed a sea change in directors' compensation over the last few years, propelled largely by the passage of the Sarbanes-Oxley Act in 2002 and the increased focus on sound corporate governance. The role of the director has itself changed fairly dramatically over this period, especially in the audit committee, which has assumed far more responsibility for governance and sound fiscal practices than in the past. This shift in role has led to a corresponding shift in compensation, not only driving it up, but also changing the mix. In 2002, for instance, a Towers Perrin study of Fortune 500 boards showed a 19% increase in pay for directors year-over-year.

Since then, the pay trend has moderated. In our 2006 study, by contrast, the median increase for directors was 8%. As the director's role has stabilized since passage of Sarbanes-Oxley, pay practices have followed suit.

That said, there remain a number of key shifts worth noting. First are the changes in equity compensation–both in the form it takes and in the importance of stock ownership. One of the more prominent trends we're seeing is a shift from stock options to full-value shares, including restricted stock, stock grants, or deferred stock units. Looking back, again, to the 2002 time period, most companies provided equity compensation to directors in the form of stock options, much as they did with their executives. By this year, however, our data show a dramatic shift, with over three quarters of the Fortune 500 companies in our 2006 survey using full-value shares and less than half still using stock options. I think this has occurred for much the same reason we've seen a parallel trend in executive compensation. Companies have grown increasingly concerned about the evolution of stock options–especially the accounting expense now associated with them which started this year–and many now feel that options have been overused. For these reasons, I believe this transition from options to restricted stock is a trend that will continue.

The other trend in the equity arena is an increased focus on stock ownership guidelines for directors, again mirroring what we've seen with the executive population. In 2002, generally less than one in five Fortune 500 companies had explicit stock ownership guidelines for their directors. Today, our data shows a threefold increase, with more than two-thirds now setting ownership guidelines for directors.

The second area of significant change is in committee compensation. Generally, there are two schools of thought regarding committee pay. One is that all board committees do important work and there's a fair amount of rotation across committees, so they should be treated identically in terms of compensation, with the same pay provided to everyone. The other view says committees have distinct roles and responsibilities, and their pay should reflect those distinctions.

The latter view, which is already becoming more common, is likely to prevail. Over the last several years, we've seen committees, particularly committee chairs, receive compensation designed specifically for them. This is most common for audit committees, again, harkening back to Sarbanes-Oxley, largely because of their increased role and responsibilities. At this point, more than two-thirds of the Fortune 500 pay their audit committee chair more, or a premium, relative to the pay for other committee chairs. Our expectation is that as pay practices and committee roles continue to evolve, and as members take on more work, we're going to see more and more differentiation in pay across committees.

While committee compensation is a part of the total package, it is actually a very important part because it ties so closely to the time and effort committee members put into their work. While working with a client recently, we saw an example of the issues that arise when total compensation tracks competitive practice, but committee chair fees fall below market. In this case, the compensation committee had a long and healthy discussion about whether the focus should be on the total package or the competitiveness of the committee chair fees. Ignoring the chair fee issue could suggest that the additional work done by the chairs was not valued. On the other hand, ignoring the competitiveness of the total package clearly doesn't make sense either, and could create retention or other issues. These are the kinds of discussions more and more companies will have as they address this issue around the work of committees and how that work should be reflected in compensation.

The revamping of committee compensation will also take into account the role of meeting fees. Traditionally, meeting fees played a prominent role in the compensation mix for directors, and most companies provided them. While the use of meeting fees continues to be majority practice among the Fortune 500, we've started to see a move away from that philosophy, with companies either providing annual committee retainers in lieu of meeting fees, or eliminating fees altogether. Given that meetings are a function of the individual's role as a committee member and that work loads for committees have increased the number of both informal and formal meetings, it's easier to provide a retainer for members than track the number of meetings. As a result, we expect that committee meeting fees will be less and less relevant and that companies will put more emphasis on some form of committee retainer that reflects the amount of time individuals spend on committee work.

When you consider the whole picture of directors' compensation, the predominant theme is continued evolution. Board members are intended to be the shareholder's advocate within the organization. They protect shareholders' interests, and as shareholders continue to rethink what they expect from directors and the roles they want directors to play in the governance of the organization, it's clear that compensation for directors will continue to evolve as well. What's critical is that directors proactively consider current and future changes in their roles and responsibilities as they contemplate how to best pay themselves, keeping in mind their fiduciary obligations above all else.

"While committee compensation is a part of the total package, it is actually a very important part because it ties so closely to the time and effort committee members put into their work."

The Role of the Lead Director

Holly J. Gregory, partner at Weil, Gotshal & Manges LLP, spoke with *Corporate Board Member* magazine about the function of the lead director and its pivotal relationship with the chairman/CEO.

Holly J. Gregory
Partner
Weil, Gotshal & Manges LLP

Why should a board consider a lead director?

Some form of independent board leadership is necessary to help the independent directors focus on certain key issues in which management, by definition, has a conflict. The board is responsible for selecting, evaluating, compensating, and deciding when to replace the CEO, as well as for determining whether management's performance is sufficient and whether or not the board's strategy is one the directors believe will take the company in the right direction. And clearly the board also has an important role in providing oversight of financial disclosures. These are all areas in which the CEO and other members of senior management have personal interests that are in potential conflict with the best interests of the corporation and its shareholders.

While the designation of a lead independent director was developing as a best practice throughout the last decade, it gained traction with the reforms to the New York Stock Exchange (NYSE) listing rules adopted in the aftermath of the Enron and WorldCom problems. The NYSE listing rules now require that both nonmanagement and independent directors meet in executive session. They also require that a listed company disclose either who the leader–or "presiding director"–is for those sessions or disclose the method by which such leader is determined (for example, by rotation of independent committee chairs).

While the board of directors has considerable discretion to determine how to structure board leadership, a number of boards select the lead or presiding director from among the key independent committee chairs. For example, it is not uncommon for the chair of the nominating and governance committee to be designated. Another option is to choose a director who is not a committee chair to ensure that the person has the significant time available that may be entailed in serving as a lead director. The less-favored practice from a best practice standpoint is selecting a director from among committee chairs or otherwise on a rotating basis so that a different presiding director is available for each meeting. Some observers have expressed concern that rotation for every meeting does not provide an opportunity for strong leadership to develop.

Clearly, an alternative to appointing a lead or presiding director is to separate the chair and CEO roles, but that is not a favored structure in our country. For cultural reasons, we have a long history and practice of combining the positions of chair and CEO. Having a designated and empowered lead director maintains the corporate culture and tradition of combining the chair and the CEO positions, while still providing the board with independent leadership for key issues on which the CEO and other senior managers may be conflicted.

What are a lead director's duties?

In addition to presiding at the sessions of the nonmanagement and independent directors, a lead director often plays a vital role in helping to set the board's agenda and determine the kinds of information directors need to be well prepared for various board and committee decisions. This role contemplates a very close relationship between the lead director and the chair/CEO and requires regular contact and dialogue to identify the issues that are boardworthy at a particular point in time. In addition to that function, the lead director often communicates to the CEO decisions or sentiments that are expressed in executive session, and this requires a certain diplomacy from a lead director. In selecting a lead director, personality and chemistry matter. I've heard concerns expressed by some directors that in choosing a lead director, their own importance may somehow be lessened. So a lead director has to be very sensitive to how he or she interacts with all the directors and must keep the board functioning as an organ of consensus without usurping important roles or creating a bottleneck between the directors and the CEO.

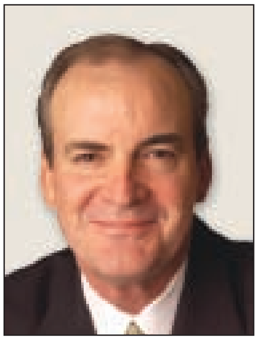
It's critically important that the lead director understand what the role is not. It is not about being a "super-director," and it's certainly not about being a shadow CEO. The lead director should not be someone who is at the company full time or even half time or close to it–unless very special circumstances (i.e., a crisis) require that. A lead director requires a certain confidence and finesse to be able to focus on helping to support the board in those areas where it may be difficult for the CEO to do so due to potential blind spots, without creating a bottleneck for information flow. A lead director needs to think in terms of facilitating the board's work, with a sensitivity to the importance of the other directors developing and maintaining strong direct relationships with the CEO and senior management team.

Lead director effectiveness is more art than science. Nonetheless, there is considerable value to be had, and most companies would be well served by designating an empowered leader of the nonmanagement and independent directors. Having a designated leader from among the independent directors not only helps position a board to address the inevitable areas of inherent management conflict, but also provides a clear mechanism for calling the board together should a crisis arise.

"…a lead director often plays a vital role in helping to set the board's agenda and determine the kinds of information directors need to be well prepared for various board and committee decisions."

How Can a Board Control Executive Compensation?

Our corporate governance experts discuss what boards of directors can do to maintain a fair and effective structure for executive compensation.



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With each edition of the Board Governance Series, we ask our series partners to address a question related to a current board topic. The topic for this edition is executive compensation. According to results from a 2006 study conducted by *Corporate Board Member* magazine and PricewaterhouseCoopers, 66% of directors at public companies believe that U.S. company boards are having trouble controlling the size of CEO compensation. So we posed this question to our series partners: How can a board control executive compensation?

Catherine L. Bromilow: The bottom line is that the board needs to use its judgment to make sure it has both the right executive talent in place and an appropriate relationship between how those executives are compensated and how the company has performed. This really starts with the compensation philosophy to which the board subscribes. Does that philosophy link appropriately to the business strategy? Is the board using the right group of peer companies when comparing performance? And is it considering the company's performance from the right perspectives, both annual versus multiyear performance and how the company performed in the absolute versus how it performed in relation to its peers?

Once the board has a philosophy in place, then it needs to ensure it applies the philosophy correctly. So, if the board looks at the actual compensation it is awarding executives, is that compensation consistent with the philosophy? And, is the philosophy really achieving its goals? For example, if the directors are paying more to retain executives and yet, at the end of the day, although they've paid more, they don't have better retention rates than their peers and other companies in their marketplace, that's probably not a good use of funds. The board's ability to articulate a sound compensation philosophy, and apply that philosophy to demonstrate the pay-for-performance link, is becoming increasingly important in light of the greater transparency around executive compensation.

Doug Friske: The use of the word control in the context of executive compensation is interesting. When I think about control in this area, I think about historical examples. One is the wage controls instituted in the 1970s, which many people would say contributed to the rise of pension plans and some of the challenges companies face in the current environment. Another example relates to the change-of-control issues that came up in the 1980s when the government adopted several regulations affecting severance packages. And even in the 1990s we had government-sponsored controls on salaries–such as the million-dollar pay cap–which most parties today would agree probably did not have the intended effect. All of these examples suggest that rigid controls in the form of government regulations, caps, or formulas on pay don't always provide the intended outcome and, in fact, can produce unintended and unwelcome consequences in some cases.

There are three things boards can do to manage executive compensation more effectively, as opposed to trying to control it. One is to look at compensation on a total basis, both in terms of the various elements of compensation and how those might play out over different performance scenarios. For example, tally sheets, which many organizations now use, are a valuable tool to assess how different packages play out.

The second thing boards can do is to make sure they're managing their programs using a fair, consistent, and disciplined process. When unintended consequences occur, it's often because companies make inconsistent decisions over time or chase the latest fad in changing their incentive programs. Deciding on a program that makes sense for your organization and maintaining it over time is often noted as a best practice among high-performing companies.

The third area directors can focus on to manage pay effectively is the succession and talent management process. One of the drivers for the pay practices we see today is increased turnover among senior executives and the need to recruit externally, which in turn drives up costs. The cost of attaining talent on a spot-market basis is obviously more than it would be if that talent could be grown from within. So if companies can develop a deeper bench to bring talent up the ranks, they will clearly be better able to manage their compensation program overall, to say nothing of their succession process and their ability to transition leadership quickly and effectively.

Holly J. Gregory: Getting executive compensation right these days is a very difficult task. The starting point for the board and the compensation committee is an understanding of the full panoply of elements in the compensation package—how they support the company's strategic objectives and how they interact with one another and in various scenarios. How do the compensation elements work with unexpected levels of success and failure? How do they work with unexpected changes in control, succession, or retirement, or in different time frames? How do they link to the firm's incentive philosophy and structure? What role does culture play? What role do choices about accounting principles play? And what strategies or decisions might they cause management to support that the board might not have intended? These issues are complex. Integrity certainly plays into it. The board and the compensation committee should consider what kinds of messages compensation policies and levels send throughout the organization. They should also consider what they expect of executives by way of integrity with respect to compensation proposals. If this foundation of understanding and integrity underlies compensation decisions, and the compensation committee is delighted and attentive, the board and the committee will be positioned to make effective compensation decisions.

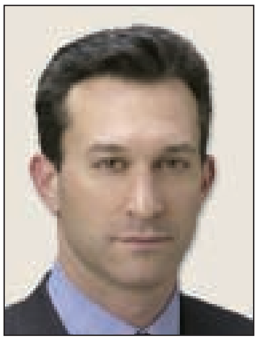
Marty Wilczynski: One thing board members can do to control executive compensation and other corporate costs is to pay attention to the SEC regulations regarding executive compensation. Since they were put out for draft, those rules have garnered a lot of attention with respect to the stock options backdating issues being faced by a lot of different corporations. The issues are especially important for board members because the early cases that are being resolved with the SEC, and the restatements that are being done as a result of the stock option cases, are demonstrating that board members have potential exposure for conduct that they may have engaged in—or that compensation committee members may have engaged in—when the options were being initially issued. As a result, board members, or compensation committee members, may be well served, even if they don't currently have exposure or even if they've not been contacted by the government, to check what types of options were issued in the relevant time frames, what sorts of potential exposure they may have had, and what types of corporate governance and oversight was being provided during those time frames. Doing so will ensure that any exposure they may have is properly evaluated and covered such that if and when the government comes calling they'll understand and know exactly what the framework looks like and what sorts of issues they may have to deal with.

"Deciding on a program that makes sense for your organization and maintaining it over time is often noted as a best practice among high-performing companies."

– Doug Friske, Towers Perrin

Why Electronic Discovery Creates New Board Risks

Adam Cohen, senior managing director, FTI Consulting, advises on the significant changes that are scheduled to take effect at the end of the year in the area of electronic discovery.



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"Electronic discovery" is a broad term. It refers to the use of electronic information in the context of legal proceedings, be those state or federal court investigations, regulatory investigations, criminal investigations, or even internal investigations. It is part of the legal process that has caught fire in recent years, with the expanding use of electronic recording and the exchange of all sorts of communications. Perhaps in the past somebody would have picked up the phone, or walked over to your office, and had a conversation with you. Now they're doing it through e-mail or an instant messenger. Also, there has been the expansion of things like complex financial databases, and there are all sorts of uses of electronic information that we didn't have 10 years ago.

Discovery refers to the part of the legal process that involves the exchange of information, typically between two adverse parties. In the old days, it used to be that discovery items were paper, and you would see lawyers sitting in warehouses surrounded by boxes and boxes of documents, spending hours and hours reviewing those documents. Well, we don't have that anymore. Now it's all electronic. This has spawned an entirely new area of law, where there are lawyers who specialize specifically in electronic discovery. It has triggered new changes in the law, particularly to the federal rules of civil procedure, which govern every single lawsuit that is filed in a federal court in this country.

Major changes are scheduled to take effect at the end of this year. They cover the range of activities involving electronic information in legal proceedings–everything from the computer forensics involved in collecting and extracting the information through the review and analysis of millions and millions of e-mail messages and all the technical methods that have been devised to help do that–and all the issues that arise when people try to introduce that electronic information as evidence in court. As we've seen from many of the cases that have been in headlines in recent years, it's often that smoking gun e-mail message that wins or loses the case.

One of the reasons prosecutors and plaintiffs' lawyers are so interested in this electronic information, and are causing large corporations such pain in their efforts to try to get to these smoking gun e-mail messages, has to do with the way people use these forms of communication. They're very casual. They often replace oral communications. People aren't careful about what they say. On top of that, they have this illusion that these kind of communications are ethereal and that they disappear once they're sent or after they delete them from their computer. Well the fact is, unless you're prepared to take a sledgehammer to your hard drive, smash it into bits and scatter it across the ocean, there is a computer forensics guy who's going to be able to recover that e-mail message. In fact, even if you've smashed your computer to bits, that information probably got transferred to a server somewhere else and even the physical smashing of the computer isn't going to help you very much. People don't understand that when you delete an e-mail message from your system, typically you are simply deleting the reference to that message in the computer's memory. A computer forensics specialist can go into the computer, look at what's called the fragments on the hard drive, and extract the deleted messages. Of course it becomes even more damning evidence if it was something that you were trying to cover up, because there is also the evidence that you tried to delete it.

Why do boards need to understand e-discovery risks?

There are several aspects to the risks associated with electronic discovery. First and foremost is cost. It is incredibly expensive to deal with the massive volume of electronic information in the course of legal proceedings, and this is not because you need to use some advanced technology to try to get at, review, or analyze this information. In fact, it's the advanced technology that helps you do so more efficiently. The expense stems purely from the volume of electronic information. Think about how many e-mail communications are sent every day. Think about how much information is stored on backup tapes at a large corporation. The problem is that once you're involved in a legal proceeding, you have to pay lawyers to review this information. You multiply that massive volume of information by those hourly legal fees, and you come up with some very big numbers.

The second risk element is the high-profile cases where major companies have been severely punished by the courts and regulators. We've seen large fines, large monetary punishments–the best example probably being the Morgan Stanley case where they suffered a $1.45 billion jury verdict because of electronic discovery issues, and only because the company didn't know what e-mails it had or didn't have or what backup tapes it had. Another prominent example is a case involving UBS Warburg in the context of an employment discrimination suit. It suffered the loss of a $29.5 million verdict, and there's a whole back story to that case involving missteps with the handling and erasure of e-mail messages that should have been retained by USB Warburg, according to the court. And then we've seen a slew of multimillion-dollar fines against parties that failed to adhere to the SEC's e-mail retention requirements. What this tells you, because these are sophisticated parties with sophisticated law firms, is that this stuff is not easy. Most of the cases do not involve situations where people went out with bad intent and tried to mess up electronic discovery or destroy electronic information that they thought was going to be harmful to their case. The fact is, it's complex. It's difficult. And dealing with it requires specialized expertise. So I don't think we're going to see much abatement in the way of those kinds of punishments and sanctions. It has to be handled very carefully.

The third risk element is the ability to effectively use information that is helpful to you in the course of defending your position against the regulators, or in a case. It's much more difficult to identify and organize the information relevant to a case now than it used to be, again, because of the massive volume of information that's out there. It's hard to marshal that information and use it effectively. All of these factors make electronic discovery a very significant risk issue for any business organization that makes serious use of computers. Of course, that's almost any business operation these days.

What should companies be doing about e-discovery risk?

We have seen from the Supreme Court opinion in the Arthur Andersen case that it's ok to have what's called a document retention policy, and it's ok for that policy to say that you don't have to keep everything. What companies need to do, to make sure that they don't get punished for destroying things the courts want them to keep, is to reevaluate their document retention policy–including their information management policies, practices, and procedure–in light of these electronic discovery risks. And, if they don't have a policy, they need to establish one.

Many companies have written document retention policies that specify retention periods for different types of documents, but quite often these haven't been updated for the electronic age. They often don't give sufficient guidance, for example, with respect to e-mail and other common forms of electronic documents that now make up the bulk of the volume of business records and thus constitute the biggest risk. So first,

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(continued from page 17)
companies need to be aware of the current environment, the current legal environment especially, and the changes in the law that are happening at the end of this year. Then they need to look at their information management policies. That involves corporate policy issues, information technology architecture, and information technology policy issues. They need to assess whether those practices, policies, and procedures are sufficient in this day and age, given the reality of electronic discovery.

One of the biggest problems we've seen in this area is that the responsible people on the board or in the general counsel's office simply aren't aware of the scope of the issues involved in electronic discovery.

With the changes in the law that are happening at the end of the year, they are no longer going to have a choice as to whether electronic discovery is something they deal with or don't. I would say that those who have not dealt with it yet and who are involved in a serious business enterprise that may require litigation have simply been very lucky up to this point. Come the end of the year, the law is going to require that you come to federal court with a plan for dealing with electronic information, and there will be serious consequences if you don't. So it's not too late. It's not a situation where people need to feel overwhelmed by this tidal wave of electronic information. There are techniques and technology for dealing with it. Focusing on the most high-risk issues involving your electronic information now, assessing your current information management policies and procedures, and bringing them in line with the current state of the law and what's expected from regulators will go a long way toward mitigating those risks we've talked about.

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