

Board Governance Series

VOLUME X 2007

A KEY EDUCATIONAL RESOURCE FOR TODAY'S BOARDS OF DIRECTORS



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Boards Need to Address?

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CORPORATE 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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CORPORATE BOARD MEMBER.[®] MAGAZINE

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Dear Corporate Director,

Today it's critical that boards of directors not only focus on meeting acceptable standards of good corporate governance, but take steps to raise the bar even higher. Directors face mounting challenges in the oversight of risk management as their boards strive to promote growth strategies, increase stock value, and move ahead of competitors in a challenging economic environment. Furthermore, several prominent court decisions have placed directors squarely in the limelight with regard to their fiduciary duties, illustrating the punitive consequences of lax governance standards. Thus, whether a board is considering an M&A transaction, examining its compensation program, or investing in a foreign market, minimizing liability and risk must be brought to the forefront of their agendas.

To aid in this endeavor, *Corporate Board Member* magazine and The NASDAQ Stock Market proudly present volume 10 of the Board Governance Series—a collection of informative commentary from leading experts in corporate governance. Inside the pages of this special supplement you'll find discussions on best practices and topics of utmost interest to corporate directors, including how the business judgment rule relates to director compensation practices, how to increase the quality of the audit committee's performance, and how to minimize director risk.

We invite you to visit our series contributors' websites as well as view online the webcasts highlighted in this printed publication as part of your continuing education efforts to stay apprised of the corporate governance issues facing today's directors.



A handwritten signature in black ink that reads "TK Kerstetter".

TK KERSTETTER
President and CEO
Corporate Board Member



A handwritten signature in black ink that reads "Robert Greifeld".

ROBERT GREIFELD
President and CEO
The NASDAQ Stock Market

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Director Compensation: Past, Present, and Future

Hewitt Associates' principal and senior executive compensation consultant Robert A. Romanchek presents an overview of the most critical developments surrounding director compensation.



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Historically, outside director pay has not been a topic boards have entertained very often. Years ago, it was considered frequent if a board of directors addressed the issue of outside director pay every three to five years. Serving on a board was really at the pleasure of shareholders and was an opportunity for retired CEOs to get together and use their experience for the good of other corporations. Compensation was not a material reason individuals served on boards, although there have been significant changes in this area.

In the 1970s, compensation was almost entirely cash; equity was rarely used. It was the age of ERISA and pension plans, so most outside directors also had some type of retirement program. In the 1980s that changed a bit when the stock market started to increase, inflation decreased, and employment went up. Once the stock market really picked up, stock options, both nonqualified and incentive, started to be used much more frequently. Also at the beginning of that era, due to high tax rates, deferred compensation programs started to kick in, for executives as well as outside directors.

In the 1990s, the stock market started going up, and with the bull market, everyone had stock options, including outside directors. As a matter of fact, they kept their full-value shares, so most outside directors of big-name companies had three different equity-based, long-term incentives in place simultaneously. That situation is now an unusual occurrence, given that there are different goals for outside directors than there are for executives. But in the 1990s, directors had a full bevy of compensation and benefit programs: cash retainers, meeting fees, stock options, full-value shares, and deferred

shares, as well as benefits. In addition to deferred compensation programs, some directors enjoyed retiree medical insurance and charitable gift programs. So they were loaded to the hilt with compensation and benefit programs.

In the early 2000s, the age of irrational exuberance peaked and then ended when the market came under closer scrutiny. Director compensation fell under that watch and certain benefits started disappearing very rapidly. More specifically, pension plans and SERPs disappeared entirely. In the mid-1990s, about 65% of named corporations had pension plans for outside directors, but by 2000 virtually no corporation in the Fortune 250 had a SERP or retirement program for outside directors. And some of the other benefits started to diminish, eventually falling to today's level.

Everyone knows there's been a significant movement away from stock options to full-value shares in the equity component of the retainer. By and large, the entire compensation package is going up, however it's my strong belief outside director pay is still disproportionately low compared with executive compensation. For companies in the Fortune 1000, total compensation for an outside director ranges between 2% and 4% of the CEO's annual compensation. So when you think about it, are you saying your outside directors are each worth about 3% of your CEO's annual pay? It's no wonder, then, with all the market constraints and lack of good candidates due to restrictions on CEOs serving on boards, etc., along with the disproportionate pay, that there is a shrinking director talent pool. Although we've seen some pretty significant changes, particularly in value, even the 20% increase many surveys are showing over the last couple

of years still results in a low number incrementally. So we have a ways to go and we're going to continue to see some significant increases.

That said, looking forward, I think a couple of things will happen. Right now there are some mixed messages related to director compensation.

Consider equity-based compensation, for example. On the one hand you have a direct alliance with shareholders, which is a good thing, particularly given outside directors' fiduciary duty. Yet this creates a potential conflict, particularly when using a vehicle such as stock options where short-term decisions at the director level could directly impact short-term stock price. Second, it's fair pay for fair work at some organizations when looking at meeting fees and retainers for committee chair heads. The director's job has grown larger, so raising fees and retainers is now clearly supportable

compensation similar to executive compensation programs. But therein lies the potential for conflicted independence and also some micromanagement on the part of directors, because they may be incented to make short-term decisions with short-term financial goals.

So there are some mixed messages about the way things are going. In general, if you look at the last few proxy statements of some of the major organizations, for example, GE and Schering-Plough, they made significant changes that I believe are indicative of where most companies are headed—toward simplicity and fairness in pay. They have specifically stated that their goal is to pay fairly for the job being done. And now that greater effort is required, there will be higher compensation. Second, they want alignment with shareholders, which again is very much in line with

The stock can be deferred or it can be an immediate full-value share; granted and taxed at the volition of the outside directors themselves, based on their own circumstances. This creates an immediate, full-shareholder interest, dividend payable, and possibly votable, which again aligns with their fiduciary duties and eliminates potential gimmicks, conflicts, and short-term micromanagement on the directors' part, and provides fair compensation.

We perceive pay going in this direction for all outside directors; total value will increase from 2% to 3% to 5% to 10% of total CEO compensation on an annual basis, and the form will be straightforward—cash retainer and full-value shares.

In summary, I perceive a couple of changes will continue with regard to outside director compensation. First, the total value will increase until it is

“By and large, the entire compensation package is going up, however it's my strong belief outside director pay is still disproportionately low compared with executive compensation.”

from that perspective. Yet there is some suggestion that doing so creates heightened legal liability; that is, if you're getting paid more for a particular job, you will be held more accountable, and in a liability situation you will be the first one scrutinized if that additional cash compensation was for those specific duties and responsibilities. Finally, some organizations are looking at or have put into place performance-based plans. Boards or organizations are aligning their interests with that of shareholders and making board

the fiduciary duty of serving on a board of directors and being elected by the shareholders to represent them. And third, it's simplicity and transparency—making it easy for shareholders to understand both executive and outside director compensation. In the case of both companies, the organizations have moved to a two-phased compensation program where one part is the cash retainer and the second is equity, full-value shares, no stock options, and no meeting fees. So it's very simple.

more relative to CEO compensation, perhaps up to 10% of that total value. Second, pay components will be simplified and moved toward two primary components: cash retainer and full-value shares. This will give greater transparency and simplicity, eliminating any potential conflict that might exist in the pay programs.

Improving Audit Committee Performance: Factors to Consider

Catherine L. Bromilow, partner and U.S. leader for corporate governance at PricewaterhouseCoopers LLP, explains how the board can use its evaluations to improve their audit committee's performance.

In a previous webcast, I discussed audit committee evaluations from the perspective of how committees could do their evaluations. In this session I would like to talk about the factors audit committees may consider when doing evaluations. Before I do that, here are two underlying principles to keep in mind.

Principles underlying performance improvement

First, think of these evaluations as opportunities for continuous improvement—not just as a compliance exercise. If an audit committee is simply benchmarking its compliance against governance rules and its charter, that compliance-focused approach essentially encourages a check-the-box mentality. Conversely, if an audit committee is looking at how its practices mirror leading practices, it will be more likely to find improvement opportunities that could add value. Getting away from thinking of the evaluation as compliance, and instead considering its role in adding value, is a helpful starting point.

Second, think about using open-ended questions, not ones with yes or no answers. For example, if you're looking at committee composition, a question might be, "Do we have the skill sets we need on the committee?" It's very hard for committee members to answer no, particularly if there are good and diligent people on your committee. But if you reword that question along the lines of, "Which skill sets, experiences, and knowledge would the committee find useful that it doesn't currently have?" the answer can help identify improvement opportunities. That kind of question is more forward-looking in terms of how committee composition matches up with company strategy. It also provides flexibility to identify any

missing skills, experience, or knowledge could be addressed by bringing a new person onto the committee, by ensuring the committee gets additional training, or by engaging an adviser to provide supplemental information.

There are a number of different ways to categorize the areas you might want to cover in an evaluation. We usually classify them into three categories: the responsibilities of the committee, its relationships, and the processes that underlie everything the committee does and that support its effectiveness. I'll start with the last one, because for many audit committees, the most value comes from looking at how well the processes they have in place are working.

Analyzing processes

To illustrate one way of analyzing processes, let's look at meetings. One key to an effective meeting is the material the audit committee gets. Members should ask themselves whether they are getting the material soon enough, whether it is at the right level of detail, and whether management and the auditors have done a good job of identifying the key issues in an executive summary, so that by the time the audit committee members come to the meeting, they are fully briefed on the issues. A related topic is whether the committee is getting the training and education it needs, what education it would find valuable, which types are best handled internally, and which types, externally.

Another way to analyze supporting processes is through root cause analysis. Say you have an audit committee member who arrives unprepared for committee meetings. That's not ideal, but if you peel back the onion, you may find out why. Is that person unprepared



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because he or she is not getting the information in time? Or are the materials too voluminous to get through? Is the director too busy with other commitments and priorities? Or, does that person come to the meetings unprepared because he or she knows that everything in the materials will be presented in detail to the audit committee, and so any time spent preparing would be wasted? Getting to the underlying cause of issues can lead to the right for continuous improvement ideas in the supporting processes area.

Do they have a firm understanding of what the critical accounting policies are, what those mean, and again, where they fall in the range between aggressive and conservative? And considering how challenging it is to understand complex accounting issues, is the audit committee overrelying on the audit committee financial expert? Similar kinds of questions can be applied to other areas allowing you to drill down into how well your audit committee is addressing its responsibilities.

useful to consider two key additional questions: Which areas are we not involved in right now that we really should be? And what areas are we presently involved in that we really don't need to be?

If you answer those questions and do a thoughtful evaluation, I'm confident you will find some good ideas to improve your committee's performance.

“Think of these evaluations as opportunities for continuous improvement, not just a compliance exercise.”

Assessing responsibilities

The second area, responsibilities, deals with how well the audit committee is discharging its oversight responsibilities for financial reporting, internal control and risk management, and compliance with laws and regulations. What types of questions might an audit committee ask about financial statements and financial reporting? Committee members may want to ask themselves whether they are really comfortable that they understand the financial statements, especially in areas requiring estimates or judgments. Do they know how aggressive or conservative management is in making those judgments? Do they understand what incentives and pressures management has both regarding their compensation and pressures from analysts, ratings agencies, and shareholders to achieve certain results? Do they understand where there is greater risk for fraudulent financial reporting?

Examining relationships

The third key area is that of relationships. At the core is the question of whether the audit committee has a robust relationship with management and with the auditors to make sure issues will surface. Does the committee have enough contact with management and both the internal and external auditors to be able to evaluate their performance? It's often useful, particularly for the nonchair members on the committee, to understand what kind of interaction and ongoing dialogue the chair has with other individuals between meetings; sometimes that's not particularly evident to the other members of the committee.

Summing it all up, after audit committees think through how well they are carrying out their responsibilities, building their relationships, and improving their supporting processes, they will find it

Keys to Minimizing Director Liability

Steven E. Bochner, a partner at Wilson Sonsini Goodrich & Rosati, outlines the principal steps directors should use as guidance to avoid or mitigate legal liability.

In examining the subject of board liability, a good first step is to look at its origins. Generally speaking, there are two types of situations in which directors are sued. One is a lawsuit involving an alleged breach of fiduciary duty, which often occurs during M&A transactions. We also recently saw this with regard to compensation decisions in the *Disney* case. This also occurs in other situations alleging that directors didn't exercise proper care or oversight. The other primary area of liability is securities litigation, alleging disclosure and/or trading violations. These types of cases are frequently brought as private securities class-action lawsuits, alleging that the company, and often its directors, members of management, and others, made misleading disclosures or traded in the company's stock at a time when they were in possession of material, nonpublic information. However, lawsuits alleging improper disclosure or trading can also be brought by the SEC, federal prosecutors, and other governmental bodies.

The question is, what techniques, strategies, or approaches can directors use to reduce the likelihood of liability? With respect to a claim of breach of fiduciary duty, the key focus should be on building a record illustrating a thorough board decision-making process, as well as a record that the board exercised appropriate oversight. The type of record required will differ depending upon the situation, but a sure way to have an indefensible position is to have a poor record of board oversight in areas of corporate risk and legal compliance. Conversely, boards that are well positioned to defend against this type of claim will have developed a sound record on which to base the business judgment rule defense.

Another important question, given the importance of establishing a record of board involvement and oversight, is what type of records regarding board deliberation should be kept? Board packages and minutes are often discoverable in litigation. There's probably not a one-size-fits-all solution, but at the end of the day, and assuming the board is engaged and exercising proper oversight, the minutes reflecting the board's deliberation should accurately and fully summarize this work. Boards would be well served to carefully document areas of decision making involving greater risk—a capital-raising event, mergers and acquisitions, or a decision on a pay package that's a bit unusual. Courts will take notice of the primary contemporaneous documentation evidencing board decision making, that is, the board's minutes as well as the other information received by the board in connection with its consideration of these issues. I am not saying that the minutes should be extremely detailed or convey actual board conversations. Rather, someone reviewing the minutes should come away with the sense that this is a board that is receiving adequate information and exercising appropriate deliberation and diligence.

As I mentioned, another area of legal risk involves disclosure and trading, and there are a couple of points I'd like to make on that topic. First, directors should be sensitive to differences between internal and external disclosure. What is a company saying externally about how it is doing and what is the board hearing at board meetings and learning in board materials about these same issues? Directors should make sure they understand why something hasn't been disclosed if it sounds important. If there has been a material development,



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that does not necessarily mean disclosure is automatically required, but the board should be receiving legal advice on this topic.

Another area of great risk for directors and management is trading in the company's securities. Trading at times when it appears, with the benefit of hindsight, that material news may have been known by the trader raises the risk of an SEC enforcement action. Further, such trading raises the risk dramatically of a securities class-action lawsuit because it helps the plaintiffs satisfy their burdens of alleging fraud and

discretion of the insider. Directors arguably always have access to important information, and determining what might or might not be material with the benefit of hindsight is a hazardous activity.

So to conclude, directors should be concerned about establishing a good record of deliberation and oversight and ensuring the minutes reflect this appropriately. Directors should think about the differences between internal and external disclosure, and they should gain a better understanding of when the company is obligated to disclose

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scienter. The situation is even more precarious now with the increasing number of 8-K reports released to the public as a result of new SEC rules promulgated in response to the Sarbanes-Oxley legislation. We're seeing companies having to report information much more frequently, providing plaintiffs and regulators the ability to argue that perhaps the director knew certain information was coming out when he or she traded.

Because it's so risky to trade in a company's stock in this day and age, I would recommend directors adopt trading plans, known as 10b5-1 plans after an SEC rule providing protection against allegations of insider trading, for properly constructed and implemented plans. The automatic trading plans set up trading where the timing and amounts are not within the

information as that information evolves during a given quarter and becomes material. They should think about how to insulate themselves from allegations of insider trading, either by being very cautious about when they decide to trade in company stock, or, better yet, by establishing a trading plan in accordance with the requirements of Rule 10b5-1.

Board Concerns for Investing in Emerging Markets

Understanding the implications of investing in international markets often takes a broad base of experience. The risks and rewards can both be high, explains Frank Holder, senior managing director at FTI Consulting.



FRANK HOLDER
Senior Managing Director
FTI Consulting

More and more U.S. and multinational companies are investing in emerging markets; however, they face many risks and challenges while trying to move into those markets with their investments. I'd like to review some of those risks, as well as some of the mitigating factors that can be applied to try to limit them.

The first risk I would like to discuss is probably the most widespread and significant one in emerging markets—corruption and fraud. Many corporations that invest in emerging markets suffer from debilitating corruption related to spurious litigation brought against them by locals who have the necessary connections to win large judgments, freeze assets, and take their money. They also may be subject to smaller corruption due to what we call the democratization of corruption, which is often found at firms with long histories of getting clientelism and favors paid for with other favors that have monetary and pecuniary advantage. So corruption is a major issue that can happen both with your own people whom you've come to work with via acquisition or with whom you're working in the region, or as a result of third parties who are trying to gain from the supposed deep pockets of these multinational corporations.

In terms of fraud, it's a similar issue of a nongovernment-related form of corruption. Many times in such regions, you'll see collusion between vendors and employees who have the kind of access needed to defraud the company. And because controls and compliance issues are so weak, both historically and in real terms, it is difficult to rely on traditional fraud prevention methods—analyzing books, records, systems, and the information that comes

to headquarters in a digital manner—to mitigate potential fraud or corruption.

The next issue companies face when investing in emerging markets is public insecurity. This is a very significant problem because it creates all sorts of issues, not only with your people but also with the movement and production of your products. Therefore, you have issues such as kidnappings, terrorist violence, local upheavals, politically motivated violence, and crime in general, which is much more severe in the emerging markets than in developed markets. People often think only about how these factors would affect them personally, but you must consider the cost of doing business in such an environment. In some cases, it can add several percentage points to your expense line and cause a significant hit on your profit margins, in addition to creating problems for some of your people. No board of directors will want to do business in a place where it may have to deal with kidnapped executives or major business interruptions because its product is getting stolen off ships or trucks as it's being brought to market.

An additional issue is related to infrastructure. Because commodities prices have been rising rather sharply in the last couple of years and that trend appears to be continuing, economies in the emerging markets have grown fairly strongly. That's put an incredible burden on the infrastructure—seaports, airports, electricity grids, etc.—to such a point that in many emerging markets, for example, Latin America and Africa, there isn't enough electricity or it's being cut off at the worst times at complex production facilities. Furthermore, companies can't get their employees from one place to another because the airports are overcrowded and

there are massive, chronic delays. The seaports are equally overcrowded, which creates problems in terms of business interruption issues. Asia is a bit different in that it has a much more modern infrastructure and a lot more money has been invested into it, but there are also issues there. In China, for example, there are quality-control issues because there's not a culture of compliance and because it is a major exporter. The rest of the world is suddenly finding out they no longer know what their products manufactured in China contain. This causes its own infrastructure issue because Chinese manufacturers need to create a level of quality control and verification that doesn't currently exist, and this will be very costly as well as take years to implement.

other types of escalation policy issues, ends up at the board level, in front of the audit committee, another committee, or the board as a whole.

In terms of what can be done, the first thing I would say is, spend a lot of time trying to know who you're doing business with, whether it's a company you're acquiring, one with which you're doing a joint venture, or one that concerns your own employees in your organic growth infrastructure in these emerging markets. Know who they are, and don't just look at the traditional things, such as books and records or legal issues. You need reputational and other types of subjective, qualitative analysis to know who these people are in order to avoid some of these problems.

unacceptable in today's compliance environment. Awareness briefings, training, and education are the only ways to avoid that.

I hope no board members will have to deal with these potential risks. These pointers and mitigating possibilities will help, however, should you ever have to face any of these issues.

“You need reputational and other types of subjective, qualitative analysis to know who these people are in order to avoid some of these problems.”

Now I'd like to talk a little bit about why this is important to directors, as well as what they can do to help mitigate some of these risks. In terms of why it's important, there are two principal reasons. The first one is that today's compliance environment is very different than it was even a decade ago. With the Patriot Act, Sarbanes-Oxley, and a number of other related issues that require increased scrutiny, such as FCPA (Foreign Corrupt Practices Act) and stock options backdating, boards of directors have become progressively more responsible for what their companies do. So something that once would have been handled by the CEO or a regional manager, in many cases, due to whistle-blower complaints or

The second point is to make sure you put your compliance assets where your risk is located. This is a very big issue. I usually see most of a company's compliance assets in places where the company faces the lowest risk. You need to invert that pyramid and apply it correctly so you can avoid some of these problems.

The last issue is education and awareness. The people you conduct business with, as well as your employees and partners, need to understand the FCPA and what these issues mean culturally to your firm, because the cultures and traditions found in many emerging markets allow them to do things that are

Creating a Special Investigative Committee

Wilson Sonsini Goodrich & Rosati partner Glenn C. Colton advises boards on how a special investigative committee can help navigate the best course if a company faces accusations of wrongdoing.

Special investigative committees. Those three words can strike fear in the hearts of directors, management, and employees. When you combine those three words with three letters such as SEC, or worse, DOJ, the fear becomes palpable. It would be nice to go through one's entire career without ever facing the issues raised by special investigative committees, but the world is not like that. There has been a proliferation of special investigative committees caused by whistle-blowers, articles in the press, and government inquiries. It is important to understand that the decisions made at the beginning of the process will affect not only the investigation's effectiveness and efficiency, but also may affect the company's future. During this segment, we will focus on three critical initial decisions that will dictate the process's future.

The first critical decision pertains to the special investigative committee's composition. Too often, there is a knee-jerk reaction to find the most famous or most publicly clean personalities so you can get public acceptance of the committee's results. Of course, public acceptance is important, but the key is balance—balancing the professional knowledge of your committee members with their operational knowledge. Both types of knowledge are critical to the process. After all, the people chosen for this special committee will have significant power and will also be members of the board of directors, which means they must also be able to fulfill the functions of strategic guidance, business planning, and advice. If you combine professional knowledge and investigative know-how with operational know-how of the particular company involved, you've achieved a balance that gives a much

greater likelihood of success. Without such a balance, you could create divisiveness in the boardroom, and in our experience, that is very costly to the company.

The second key decision relates to the committee's charter, and, once again, here's that word—balance. It's very important that the committee have both the mandate and tools to complete an effective and trustworthy investigation. But it should not be an investigation open to every subject in every area. It is easy to write a committee charter that says, "Investigate allegations of wrongdoing," but that opens a Pandora's box of problems and keeps the investigation going for years on end. We have seen investigations continue for long periods of time. We represent the chairman of the board for a company under investigation where the company has professionals who have worked 23,000 billable hours, and the investigation still isn't done. A specific and limited charter is critical. This allows the special committee to investigate concrete allegations, and, if it finds other possible wrongdoing, to come back to the rest of the board for a fulsome debate on whether to expand the scope of the investigation. It also creates cohesiveness and leads to the process that will most likely lead to proper results in an efficient, effective, and timely manner.

The third big decision involves the selection of committee professionals. Again, balance is the key. The critical task is to find someone who has had success in navigating the challenges of a full investigation while respecting the need for the company to continue its current business and business planning, and in the fulfillment of its regulatory obligations. One consideration that is



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often lost is the internal knowledge of someone who has previously worked in your target audience. If the investigation is being run by the SEC Enforcement Division or by the U.S. Attorney's Office in a particular district, people who have previously served in those offices are knowledgeable of behind-the-scenes processes. They understand the culture and mores of the particular office and are better able to provide both the special committee and the board with critical decision points and data. This helps the committee complete its investigation, satisfy its target audience, and help steer the company through troubled waters and toward prosperity.

It is my sincere hope that directors reading this are never faced with the need for a special investigative committee or the need to interact with the SEC or DOJ over allegations of wrongdoing at their company. But if they are, they should consider these three critical initial decisions. Achieving the balance that's required in those decisions will help maximize the chances of a positive result and will allow their company to get back to focusing on its business as soon as possible.

"It's very important that the committee have both the mandate and tools to complete an effective and trustworthy investigation."

Why is all this important? There has been a proliferation of investigations since 2001. The types of investigations we've seen relate to stock options backdating and accounting and revenue recognition issues—where there are allegations such as channel stuffing, which involves shipping product earlier than the customer needs it—as well as accusations involving round-trip transactions, acquirers making big sales to acquirees where the revenue isn't real, and side letters, where at the end of a quarter or fiscal year, a company signs a contract with a customer but the salesman has a letter saying the contract can be renegotiated, thereby rendering the alleged revenue fictitious. We see these types of investigations over and over again.

What Compensation Committees Must Know about the Business Judgment Rule

Robert A. Romanchek, principal and senior executive compensation consultant at Hewitt Associates, explains the nuances of the business judgment rule and how it applies to the compensation committee's responsibilities.

Not all directors are familiar with the business judgment rule as a doctrine and why it's important in Delaware law. Could you take a moment to discuss the rule and its importance to today's compensation committees?

The business judgment rule is a legal doctrine that has been developing since the 1940s. Because it is a doctrine driven by case law, it is fact—and circumstance—related, yet it has been accepted by virtually every jurisdiction in the nation. There is a very specific test outside directors can take in order to meet the business judgment standard. If they fulfill the standard, it's a perfect defense to derivative lawsuits, such as waste of corporate assets and management entrenchment. So it is a doctrine that compensation committee members, in particular, should be paying attention to when making executive compensation decisions, because they are a matter of business judgment.

The business judgment rule, as it historically has developed, has a couple of different components that boil down to this—outside directors need to make informed decisions that are not self-serving. The “not self-serving” piece of this is the easy one to fulfill as long as you're not participating in plans and programs and you are independent from other standards. The “informed” piece is one that is much more difficult to fulfill and is the component that was tested in a recent, high-profile situation. Making an informed decision means the committee not only had materials ahead of time, had proper deliberation, and spent the right amount of time doing so, but has also considered such things as relevant external market data and cost. Some observers say you don't

necessarily want to follow the data, as it can lead to spirals. I think directors need to understand not only what is happening externally, but also what the trends are and why they are happening so they can make informed decisions. It goes beyond just having the data. It's understanding the cost implications from an accounting perspective and from a tax perspective—when it comes to some of the executive compensation decisions. So you put all this together in making an informed decision that's not self-serving. Those are the two main prongs of the business judgment rule test.

Theoretically there is a third prong in heightened scrutiny situations. This test asks whether the board's decision was “reasonable,” and thereby questions the wisdom of the decision. In most cases, the court will not second-guess an outside director's business judgment if the proper process was followed to become informed and not conflicted. In this case, the board is in a much better decision-making capacity than the court of law. So the court will defer to the wisdom of the outside directors, assuming they have fulfilled this proper standard and doctrine regarding making an informed business judgment that is not self-serving.

A “heightened scrutiny” situation can exist where there's the potential for a merger, acquisition, or buyout. In these cases, the standard of care that is dictated for outside directors will be heightened. In those situations, the court may go beyond just testing the process of whether directors are informed and their decision is not self-serving. In those cases, the court may start to question the decision's reasonableness. But if you're not in a heightened risk situation, that typically



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won't happen, and thus following the right procedures will give outside directors a strong defense to all of these derivative lawsuits.

What should boards be doing to comply with the current business judgment standard?

To ensure they have the business judgment doctrine's protection against these derivative lawsuits, boards should be collecting as much information as far in advance as possible. Being passive is

The Delaware Supreme Court recently added to these best practices through dictum of a briefing it issued. So although this is not part of the legal standard, the court is trying to give some additional input and nudge us in a certain direction. In the event of a severance situation, for example, where you are putting in a severance contract, change of control, or general severance, and a tally sheet is used (where an independent party who is an expert in the area outlines the total cost of the severance package, including the

universally, compensation committees fully understand the reason or rationale behind why they need to investigate issues further, and consider data, trends, costs, and tally sheets. While it's a good corporate governance practice to get more information, to have deliberations, and to properly vet issues for executive compensation, it really goes beyond that to the legal standard and this doctrine of business judgment protection. Committee members need to be more direct about making sure the standard's specifics are being fulfilled

“Committee members need to be more direct about making sure the standard's specifics are being fulfilled and that there's never a surprise or passiveness on any of the executive compensation issues.”

no longer acceptable—not that it ever was—and will not give you the protection you need. Specifically, boards should collect information on typical compensation practices, understand the cost of making these types of decisions, and have time to deliberate major executive compensation decisions. Undergoing a two-meeting process, where the issue is deliberated and information is presented at one meeting, and then, after having time to contemplate the information, action is taken at a second meeting, would be appropriate. You want to make sure all parties and directors have gathered collectively and have had not just the time, but also the opportunity to deliberate—both together and individually. Bringing in experts, again, when dealing with a significant, material issue, would also add credibility. So it's about collecting data, having enough time to deliberate, and making informed decisions.

benefits and values that would be paid in different termination situations), materials are premailed, and an independent expert presents the data and is available to answer questions—that is prima facie evidence the directors were informed, thereby securing business judgment protection.

Are compensation committees responding to the directives that have been highlighted in some of the featured court cases, or do we still see a gap in what directors are doing versus what they should be doing on compensation committees?

The recent Supreme Court case in Delaware, which is an important state for corporate law purposes, created some very good publicity for the business judgment rule, for a time. So although the business judgment rule is very well accepted, I'm still not sure that

and that there's never a surprise or passiveness on any of the executive compensation issues. It goes beyond just simple good corporate governance to making sure the business judgment doctrine is fulfilled for directors' own purposes as well the good of the company.

What Is the Next Big Challenge Boards Need to Address?

Our esteemed panel of governance experts offered opinions on the most critical challenges facing boards in the near term.



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Steven E. Bochner: I think one of the biggest challenges for boards in the post-Sarbanes-Oxley environment is managing the various constituencies and competing interests in today's boardroom. We now have more independent directors on corporate boards due to enhanced listing standards and other legal requirements, and stockholder activists and stockholder advisory groups are putting more pressure on boards in unprecedented ways. I hear a lot of directors expressing concern over the amount of time spent on governance protocol rather than on overseeing the business. So an important task for boards in the new environment will be finding the proper balance between risk mitigation and good corporate governance on the one hand, while ensuring the proper focus on the company's core business. This balancing act will require directors to engage in more consensus building and outreach than in the past, but also to know when to push back on those who would have the board pursue a limited short-term agenda that conflicts with the company's long-term strategy.

Catherine L. Bromilow: Although it's not a new challenge, virtually every director I speak with is deeply concerned about how well his or her board is overseeing risk management. It has been five years since the New York Stock Exchange proposed that audit committees oversee policies on risk management and risk assessment. I still see a great deal of angst out there among audit committees as to how they're discharging that responsibility and how well they're doing it. Some of that uncertainty is about whether the key risks have been identified and are being overseen at the board level. The best boards we've worked with solve that issue by a formal mapping of the

key risks at the board level. But, there's a lot of concern on the part of the organizations and companies that haven't done that process.

Moreover, while many focus on risk management from the perspective of hazard, the other aspect of risk management is the opportunity side. Year after year in our *PricewaterhouseCoopers/Corporate Board Member* What Directors Think survey, we find that directors want to spend more time looking at strategy, how to grow the business, and how to increase shareholder value. And again, although it's not a particularly new challenge, I think it is an ongoing challenge we're seeing boards struggle with. There's really no easy answer other than to be thoughtful about addressing risk management, insist that the board devote the needed time to strategy, and, on the hazard side, do the blocking and tackling so at least you get comfort that key risks are being overseen.

Basil Imburgia: I think the next big challenge for boards is merger and acquisition disputes. These M&A disputes are important to boards because frequently the prices agreed upon between buyers and sellers are materially adjusted through these M&A disputes. Sellers need to understand that their agreements need to be written in a way to limit the buyer's ability to make multiple adjustments to the purchase price.

From the buyer's side of things, the buyer's board needs to make sure the appropriate due diligence is done, and the required adjustments to the purchase price are made upfront versus through lengthy disputes. I believe this is going to be a big challenge for both sellers' and buyers' boards, as there still

seems to be a lot of private equity money, and private equity firms are still looking to combine similar businesses, while sellers are still looking to shed non-core businesses to drive up overall company profitability. Therefore, boards need to stay focused on protecting price and getting what they bargained for.

is, and, if the performance is not there, tough decisions need to be made and compensation needs to be adjusted accordingly. I think too often it's the standard to look forward, and not necessarily build day-to-day performance into actual compensation. Proof of this is the reemergence of

“An important task for boards in the new environment will be finding the proper balance between risk mitigation and good corporate governance on the one hand, while ensuring the proper focus on the company's core business.”

- Steven E. Bochner, Wilson Sonsini Goodrich & Rosati

Robert A. Romanchek: I believe the next big challenge is one we're currently facing, and have been for quite a while: pay for performance. On its face it seems like a very straightforward, simple question, yet it is very complex. Right now we have an unprecedented amount of noise in the marketplace—externally, from various different corners—that is causing a lack of focus on this issue. Specifically, if you look at some of the changes that have come down in recent years, the 162(m) requirements, new proxy rules on September 1, 2007, and, again, changes in accounting for equity-based compensation, there are a range of changes where—externally, at different places in the market—they're trying to nudge us into a pay-for-performance mode, and it really isn't working. Rather, it's causing a distraction on that very issue.

restricted stock and time-based vesting, which has again become one of the predominant long-term incentive vehicles, but there really isn't much performance built into it. We may have gone backward a bit for other reasons. When you think about it, the change in the accounting rules and heavy dilution in the market have pushed a lot of organizations into using full-value shares, whereas the intent of some of the new requirements was really just the opposite. So we are somewhat losing focus on this very important issue, and I think compensation committees need to immediately get back to the details of how to provide pay for performance.

So, working through this, I think outside directors now have a critical challenge. They really need to focus on what appropriate pay for performance

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