



Never before has corporate board performance come under such public scrutiny. The pressure is on; not just to perform, but to perform admirably. To keep corporate leaders walking the straight-and-narrow, we have a plethora of new governance watchdogs. The federal government stepped in with Sarbanes-Oxley last summer, followed by the creation of the SEC’s Public Oversight Accounting Board and multiple regulations now being considered or enforced by the individual stock exchanges.

We’ve read the rules. We’re making changes. But are we making progress?

BOARDROOM CONSULTANTS

TOPIC # 33

Corporate Governance: Are We Making Progress?

Boardroom Consultants, a leading firm specializing in governance consulting, succession planning, and director selection, in collaboration with Hogan & Hartson, a major international law firm, recently held its thirty-third roundtable on issues facing boards. In a discussion led by former Texaco Chair and CEO Alfred C. DeCrane, Jr., a group of directors shared their thoughts on actions corporate America is taking to ensure good governance, and if those actions are truly moving us ahead of where we were a year ago. Mr. DeCrane brings a unique perspective as a current director of Corn Products International, the Harris Corporation and U.S. Global Leaders Growth Fund. He is also a member of the Morgan Stanley European Advisory Board and a co-chair of the US-Saudi Arabian Business Council.

GOOD GOVERNANCE: WHAT IS IT?

The onslaught of the new regulations designed to enforce “good governance practices” may lead casual observers, or even well-meaning executives, to believe that corporate governance can be enforced and deemed effective simply by adhering to a check list or matrix of standards.

Did we appoint a Governance Chair? Check. Are our auditors independent? Check. Have we written down our governance guidelines? Check.

“But what happens to those elements that have traditionally pushed companies into the *Fortune* 500 such as financial soundness, management strength, product quality, long-term investment value, and social responsibility?” asks Alfred C. DeCrane, Jr., former Chairman and CEO of Texaco, Inc.

Just what kind of governance are we looking for? What are the key aspects of governance that we can identify and use to help us judge whether or not we’re moving forward?

Before opening up the floor for discussion, DeCrane speculated on the pure power of the market. “Perhaps we can say we’ve made progress as soon as the market recovers. After all, as the media would have us believe, it’s a lack of confidence on investors’ part, to some extent, that is holding the market back.

DOING THE RIGHT THING

A lot of governance is just doing the right thing. By putting governance guidelines and codes of conduct in writing we have one way to benchmark our success. If we don’t put them in writing then how can we be sure our stockholders know what we think our responsibilities are?

Most roundtable participants agree that while publishing such guidelines and making them available to everyone in an organization is a valuable first step, it is not enough.

“Such standards must become a part of the corporate fiber, not just part of the corporate library,” comments one director. “When it comes to publishing, we are making progress. But when it comes to publicizing—explaining it to new directors and every employee at every level—then we are not.”

Several participants observed that the practices of good governance are driven by the tone at the top. “Ethics and corporate values must become a routine part of running a company. Only then will these practices filter down through the layers of the organization so you see your plant managers living by them, your supervisors living by them, and your entire workforce really believing them.”

“The moment of truth comes every day in the hundreds of little decisions people make at all levels of the organization,” adds another participant. “These judgment calls have a much greater bearing on the perception of the company’s values – internally and externally – than any published code of ethics or governance standards.”

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Roundtable participants cited many examples of companies now asking directors and employees to sign codes of ethics or governance compliance standards. But the truth is, if someone is intentionally planning to defraud the company, that person is going to sign it anyway.

A signed document, however, would strengthen the company’s legal recourse, others concur. “This is a situation we have not seen enough of,” remarks DeCrane. “The board’s position should be clear: ‘You were aware of the rules. You defrauded the company. Now we want the money back.’”

Meeting the high, exacting standards of good governance is a complex issue that will take time to achieve, especially in companies with multiple divisions or international locations. Yet, the directors were careful to distinguish between broad ethical standards of business practice and financial or audit fraud. “It’s important to keep in mind that, overall, ethical standards today are superior to where they were 30 years ago,” notes one director from the manufacturing industry. “Any black spot on the record these days appears to be concentrated in financial fraud, which has grown more complex and sophisticated.”

FEAR FACTOR

Perhaps the sheer complexity of business today presents one of the largest hurdles to clear in the quest toward progress.

“Sometimes the board’s biggest problem is that no one knows what is going on,” confesses one participant. “We’re often afraid to admit that. But now the importance of the Audit Committee’s role is emerging and directors need to understand how revenues are generated and how things are accounted for. It forces committed directors to learn how the business is really run. For instance, if you’re on the board of a healthcare company, you better understand how Medicare is billed.”

While business has grown more complex, the root of financial fraud and other corporate misconduct remains strikingly simple—moral character. “We must ask ourselves about the character of the people we choose as CEO, chairman or director,” cautions another participant. “We must pay careful attention to who is filling these key roles.”

DeCrane emphasizes that succession planning for *directors* is one of the most overlooked responsibilities of the board. “We’re quick to say that one of our most important jobs, from a governance point of view, is the selection of the CEO. But the selection of a director has great significance.”

If there is one clear indication that boards are making progress, roundtable participants agree that this is it: “We are now seeking people with the right competencies and skill sets and we’re appointing them to the appropriate committees. It’s a very valuable and important step in the right direction.”

Anyone charged with running a company who is still not clear on the difference between good governance and poor governance need only ask himself two questions: Is it legal? Can I stand to see it on the front page of the *New York Times*? “The two most powerful forces in human nature are greed and fear,” asserts one director. “For a long time greed was the operative force. Now, fear is driving the debate. The realization that a huge malfeasance could occur on an Audit Committee under your watch is in and of itself a powerfully motivating factor.”

IT’S A DIFFERENT WORLD NOW

“Until recently, the average director on the average Audit Committee didn’t care that much about the company’s outside auditors, and didn’t pay attention to the accounting details,” explains one former Audit Committee member. “As a group we failed miserably in trying to understand what the auditor was doing, and what relationship the auditor had with management. In fact, we were most concerned with cutting the audit fees for the year.”

“Well, the world has changed, and most directors take this role very seriously today. Accounting firms take their role seriously, and I believe this provides a very good foundation for improved governance. Are we making progress? In this regard, yes.”

“Until we get independent directors who fully understand accounting and can relate it back to the actual operations of the company, we won’t get good governance,” counters another director. “And that is still a huge problem.”

The problem is compounded again, according to the roundtable participants, by the complexities of business. “If your company has been busy acquiring others, you have several issues to contend with,” remarks a director. “With all the different management incentives and pay-outs, how can a board be sure that the enterprise is as risk controlled as possible?”

This underscores the importance of an emerging concept – enterprise risk management. “No matter what terms you use to describe it, enterprise risk management is absolutely critical to the process of good governance. It is clearly the board’s responsibility to avoid future problems, rather than simply uncover problems of the past,” remarks DeCrane.

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THE FIRST STEPS OF A LONG JOURNEY

How does this group of directors define governance? Given today’s business environment, the participants concede that oversight and control are a large part of the board’s responsibility, but not the only part. “We are responsible for the successful continuation of the business. This includes succession planning for the CEO and directors, brand equity, competitive advantage and a whole lot more.”

As a result of new regulations in the last year, participants agree that they have seen more attention being paid to all aspects of board-level responsibilities. Are we making progress? Here’s what the roundtable participants say they see as positive indicators of change:

The One Strike Rule—If taken seriously, even check-lists can begin to add up to positive reinforcement. But people must be held accountable. “You shouldn’t just obey the

law; you should perform well above it. Once certain rules and guidelines are established, I don't care how great a person you are, or how much money you brought in yesterday, if you violate the code, you're gone."

Knowledge Quest—"One thing that has happened since the catastrophes of the last couple of years is not so much that the law has changed director responsibilities, but that it has changed much of the process," remarks one board advisor who serves as legal counsel. "We are seeing for the first time that directors are actually reading the documents being put in front of them. Sure, lawyers are drafting them, but this is the first time in 20 years I'm getting questions from directors about the contents. They're getting involved."

Moving Beyond the Boilerplate—"When we talk about getting rules and guidelines down on paper, I've seen companies just copy the legal information into their charters. It's boilerplate. But the intent behind many of the new regulations is to use them as a platform for discussion. The better boards are doing that. They're discussing how they can improve, how to work the regulations into practice, and what the real issues are."

Revisiting the Mission—As the board reexamines its responsibilities, more directors are going back to the mission to consider what the corporation is there for. The ethics statement is just a list of things we will or will not do to fulfill our mission. But it's not a question of ethics. It's a business question: Are we making money for our shareholders? "I think we agree that we want to achieve this in an appropriate fashion, which is both ethical and legal. We must weed out those who don't want to play by the rules. We must show the rest of the organization that there is a price to pay if you do violate these rules."

Finally, DeCrane spoke of the group's shared determination. "We've taken some steps, we've made some changes, but there is a lot more to do. We can say we're making

progress, but the goal is constantly shifting. The closer we get the further out it moves. We must bear in mind that the pursuit of good corporate governance is much like the pursuit of quality: There is always room for improvement."

NOTES FROM BOARDROOM CONSULTANTS

The very fact that we are having this debate says a lot about the fact that we *are* making progress.

This roundtable discussion revealed two distinct areas of progress: scrutiny and transparency.

First, companies are even more discriminating in the selection of directors and other corporate officers. The best board candidates need to have specific business skills that are relevant to governance needs. Audit Committee candidates absolutely must have strong financial credentials. Those who don't, need not apply.

Then, there is the question of character. We cannot legislate moral fiber. We can't write it into a charter. But we can look to hire directors and CEOs with unblemished track records and a history of making sound, ethical decisions.

We are certainly seeing changes in behavior as a result of federal and regulatory guidelines, and that's good. We'll see the frustration levels drop for those directors who, over the last 20 years, felt unable to make an impact, especially when it comes time to approve the sometimes outrageous management compensation packages. There was often a great deal of tension.

Second, we are seeing companies publish, and *publicize*, with more frequency. Codes of ethics are now being circulated for signatures. Corporate governance guidelines are being reviewed, revised and redistributed to direc-

tors and others. Some directors are calling for governance guidelines to be published in the annual proxy and it may soon become a requirement.

It's important to have reference points. Whether the lawyers or committee members write the rules and regulations, such guidelines give us a basis for review. They can also provide a board with valuable documentation should there ever be a need to seek legal recourse.

As shareholders, the investment community and the general public begin to see greater effort to adopt solid corporate governance measures, we may even see less regulation. In fact, new regulations and guidelines for listed companies could be a lot less onerous if current corporate governance activities were more transparent. In the end, transparency may be the best answer we have – not only against legal challenges but in protecting a company's ability to remain innovative and competitive.

ABOUT BOARDROOM CONSULTANTS

Founded in 1974, Boardroom Consultants was the first firm to specialize in governance consulting and director selection. Since that time, the firm has also become a recognized leader in succession planning and top-level management recruiting as well. Because we believe that the best and worst things that happen to a company start with the board of directors, our mission is to help companies improve

their corporate governance. Services include counseling with chief executives and boards on such issues as board structure, committee charters and best practices; benchmarking for succession planning purposes; and providing in-depth governance reviews involving top management and the entire board. The firm's Advisory Directors, sixteen former chief executives of major corporations, are an exceptionally valuable consultative and due diligence resource.

ABOUT HOGAN & HARTSON'S DIRECTORS ADVISORY SERVICES

Hogan & Hartson offers an interdisciplinary response to the questions and uncertainties of boards and individual directors as they adjust to today's spotlight. Our attorneys include some of the nation's most experienced corporate advisors including former U.S. Attorneys, Assistant U.S. Attorneys and attorneys who once served in top positions at the SEC and other federal and state agencies. With an extensive knowledge base and a focused perspective, we provide practical solutions to the many questions facing boards today. Founded in Washington, D.C. in 1904, Hogan & Hartson now has 19 offices throughout the U.S., Europe and Asia with more than 900 attorneys contributing to a broad-based national and international practice that cuts across virtually all legal disciplines and industries. Further information is available at www.hhlaw.com.



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