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New Evidence Puts Governance Raters under Fire

Academics, shareholders and competitors fuel growing pressure on ISS

ORPORATE GOVERNANCE RATINGS that are based on board structure are losing validity among academics, institutional investors and independent directors. Bearing the brunt of that criticism is the rater with the highest profile: Institutional Shareholder Services.

"There is no evidence that scorecards map into better corporate performance or better behavior by managers," says

Wharton professor David Larcker.

Larcker and two colleagues studied more than 2,100 public companies. They wanted to know whether the measures typically used by institutional ratings services are predictive of fewer accounting restatements, better credit ratings or fewer shareholder lawsuits. The study concluded that there's no proof of a link between such measurements and better governance.

That's significant because the costs of conforming to scorecards can be great in terms of investments of money, time and energy. Boards can spend as much as four hours on structural policy in a meeting.

"That's why it's frustrating for boards," says
Mason Carpenter, a management professor
at the University of Wisconsin–Madison
School of RATINGS (continued on page 7)

Boeing, Honeywell Detail Exec Perks

NUMBER OF COMPANIES, including Boeing, Honeywell and Winn-Dixie Stores, are now going above and beyond SEC requirements in disclosing executive perks.

Compensation committee reports now contain fuller descriptions of exactly what benefits are provided. And companies are itemizing a host of benefits they provide their executives.

Boeing for the first time has disclosed that its executives receive perquisites ranging from use of the company plane to annual physicals. Honeywell added a table to its disclosures that outlines

BENEFITS DISCLOSURE (continued on page 8)

Scrutiny Drives Growth in Emeritus Positions

N AN EFFORT to benefit from the counsel of aging directors while maintaining independent majorities, more and more boards are establishing director emeritus positions.

These honorary titles allow former board members to contribute to their boards while not counting as active members, thereby maintaining an independent majority and adhering to mandatory retirement policies some companies would rather not enforce.

According to **The Corporate Library**, the number of companies establishing emeritus positions increased nearly 20%, to 78, in 2004,

up from 64 last year. The current total is 107 if honorary directors are counted.

The majority of directors who become emeritus don't draw a salary for their services. According to The Corporate Library, only 32 out of the 78 emeritus directors currently serving on boards receive any sort of retainer. It's something that directors can use to rebut claims that the emeritus position is just another way to lard an outgoing director with extra cash.

Despite the position's in-between status and some **EMERITUS DIRECTORS** (continued on page 9)

BOARD STRUCTURE

Boards Consolidate Committee Responsibilities

INCE THE PASSAGE of the Sarbanes-Oxley Act, boards have been steadily paring down the number of their standing committees. Some are dissolving targeted committees and incorporating their responsibilities into one of the remaining "big three" committees: audit, nominating/governance and compensation. Others are putting those issues up for discussion before the full board.

In 2004, **Dimon, Revion, Starwood Hotel** & **Resorts** and **Starbucks** all dissolved standing committees. They disbanded the finance, executive, nominating and special compensation committees, respectively. And most of them decided to incorporate the duties of their disbanded committees into their audit, compensation or nominating and governance committees.

Corporate Directors. Klock expects the trend to continue when the NACD releases its next governance survey in November.

And in the past year, the number of boards with executive, finance, corporate responsibility or investment committees all declined, according to a recent survey of Fortune 1000 companies conducted by **Korn/Ferry International**.

For instance, only 30% of boards have a finance committee, down from 33% the year before, according to the latest numbers from Korn/Ferry. And 13.6% of boards surveyed by the NACD now fold the finance committee's responsibilities into the audit committee. A similar trend is occurring with boards' ethics and compliance committees.

"Many of these second-tier committees

were born in companies at a time when boards were significantly larger," says Charles King, head of Korn/Ferry's global board services practice. He thinks that as companies moved to reduce board size, the need for "ancillary" committees was reduced too.

The number of boards with ethics and compliance committees has fallen dramatically, with only 9.2% of boards designating a standing ethics committee compared to 16% in 2002. The bulk

of the work that the ethics committee did has fallen to either the nominating and governance committee or the audit committee.

Source: Korn/Ferry International

This means increasing demands on directors' time. New responsibilities for audit and compensation committees have added hours to directors' schedules both inside and outside the boardroom.

"It seems to me that most companies will be going in the direction of the big three, because there are so many responsibilities that these committees have these days," says **Denny Beresford**, a director on the boards of **Kimberly-Clark**, **Legg Mason** and **MCI**, as well as professor of accounting at the Terry College of Business at the **University of Georgia**.

Some directors are concerned about the increased workload that the remaining committees will have to shoulder, and the resulting loss of focus that could ensue. "You can give those committees [additional responsibilities], but I would be afraid that they wouldn't have time to deal with it as well as a separate committee could," says Ed Brennan, executive chairman of AMR and a director on the boards of 3M, Allstate, Exelon and McDonald's.

Other directors, like Bonnie Hill, who serves on the boards of AK Steel Holding, Albertson's, California Water Service Group and Hershey Foods, argue that companies need their specialized committees to address certain company-specific issues. Hill warns that boards shouldn't just apply one model because it's suggested.

But just because a committee is dissolved doesn't mean that its work won't get done. King says the big committees are compensating in some ways for their additional responsibilities by meeting longer and working harder. "The mere consolidation on paper, which is basically what it is, probably doesn't have any impact," King says.

Boards are also employing other strategies to ensure that proper attention is paid to important issues. Increasingly, independent directors are serving on ad hoc committees that dig more deeply into specialized concerns about technology, acquisitions, regulatory investigations or any other business issue that rises to command directors' attention.

"You've got fewer committees, but you've got special purpose committees that tend to be more involved in the things that a board has a greater concern about," says **Suzanne Hopgood**, chairman of the board at **Del Global Technologies** and a director of **AKR Realty**. Hopgood points to the rising trend in boards' establishing acquisition committees and litigation committees (see related articles) to address those needs as indicative of what the future may bring.

PREVALENCE OF STANDING BOARD COMMITTEES

	2003	2002	2001	2000
Audit	100%	100%	100%	100%
Compensation	99%	99%	99%	99%
Nominating*	87%	75%	72%	73%
Governance*	72%	54%	48%	46%
Executive	52%	55%	56%	57%
Finance	30%	33%	35%	40%
Corporate Responsibility	19%	20%	21%	22%
Investment	16%	18%	19%	21%

Then there are companies like **Ceridian**. When it disbanded its strategy review committee, rather than concentrate strategic oversight in either the audit or governance committee, Ceridian decided to have the entire board tack-

committees was provided.

le the issue.

"Between 2001 and 2003 almost every committee, except for the audit and compensation committees, has decreased in prevalence," says **Kevin Klock**, corporate governance analyst at the **National Association of**

SHAREHOLDER VOTES

Mutual Fund Voting Reveals Complicated Picture

CTIVISTS WERE HOPING that they could vilify them and boards were hoping that they could count on their support. But the largest mutual funds surprised both naysayers and boosters by charting a middle ground through a contentious proxy season.

Fidelity sided with governance advocates in the vote-no campaign against Michael Eisner at Walt Disney, but held the line with management on most votes to reduce executive compensation. However, where companies were proposing raises for executives at underperforming companies, Fidelity joined pensions in voting against those proposals.

stock price performance exceeds its peer group's performance.

By contrast, the votes at **Bear Stearns**, **Broadcom**, **Delphi** and **Union Pacific** were all proposals brought by the respective corporations for shareholder approval.

The capital accumulation plan vote at Bear Stearns would have allowed the company to award stock grants of up to 15% of the total outstanding shares to executives. During the life of the plan, stock exceeding 150% of today's total outstanding shares would be transferred to executives.

The issue for the union at Broadcom, Delphi

	Proposal	Fidelity	American Funds	Vanguard	Franklin Templeton	Putnam Fund
Allergan	Expense Options	No	Yes	Yes	Yes	No
CSX	Golden Parachute	No	N.A.	Yes	N.A.	No vote
elta	Approval for Executive Pension	No	No	No	No	N.A.
(ohl's	Institute Performance-based Pay	No	No	No	No	No
ucent.	Limit Golden Parachute	No	N.A.	Yes	No	N.A.
PeopleSoft	Expense Options	No	Yes	Yes	Yes	No
Raytheon	Expense Options	No	Yes	Yes	Yes	No
print	Institute Performance-based Pay	No	No	No	Yes	No
Bear Stearns	Capital Accumulation Plan	Yes	N.A.	No	Yes	Yes
Broadcom	Stock Incentive	No	N.A.	No	No	No
Delphi	Long-Term Incentive	No	No	No	Yes	No
Jnion Pacific	Stock Incentive	No	Yes	No	Yes	Yes

Meanwhile other funds, notably American Century and Vanguard, voted with public pension funds to curb executive pay a startling 100% and 75% of the time, respectively, according to a study put together by the AFL-CIO.

The following chart compiled by the AFL-CIO tracks the ways the five largest mutual funds voted on proposals at 12 companies. The votes all related to compensation, including proxy proposals on expensing stock options and the ratification of a particular capital accumulation plan.

Proposals at CSX, Lucent and Delta required shareholder approval for golden parachutes in executive contracts and retirement benefits. The AFL-CIO also examined mutual fund votes on attempts at Kohl's and Sprint to require that all future stock options grants be made in performance-based restricted stock. That would mean, for the union's purposes, that all option grants have value only to the extent that a company's

and Union Pacific was the potential stock dilution that would result from the proposed executive stock grants. Broadcom's stock incentive plan, which all the fund groups voted against, would have allowed repricing of options and increased the total stock dilution to 92.4%, compared to a peer group median of 25.1%. While stock dilution at Delphi increased to only 22.7% through its proposal to bump up the number of shares available under the long-term incentive plan, it would still be higher than its peer group. The median dilution for Delphi's peers is 14.5%. Almost all the fund groups voted against this plan.

The mutual fund vote on Union Pacific was split. Stock dilution there would have risen to 18.7% against a peer group median of 12.4%. The company did not disclose performance goals or holding period guidelines, and there was also a provision for immediate options vesting in the event of a change of control.

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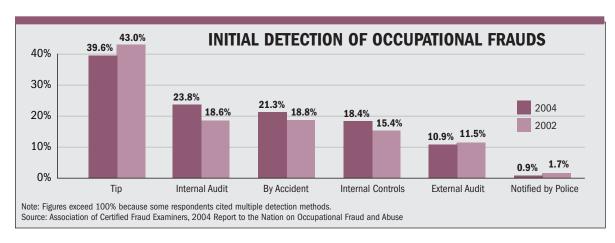
Auditors Fail to Spot Most Corporate Fraud

NTERNAL AUDIT and internal controls aren't terribly effective in ferreting out corporate fraud, and the sheer scale of fraud is getting worse. That's a big concern to audit committees, because they're responsible for ensuring that the control systems at their companies work properly. And fraud losses can be a major hit to a company's bottom line.

company will find problems that need fixing.

Indeed, the ACFE reports that internal audit's share of fraud detections in 2004 rose five percentage points from two years earlier. A somewhat smaller increase was reported for internal controls. In future years, the numbers may be even higher.

"I think you're starting to see a little improve-



Based on a survey of its members, the Association of Certified Fraud Examiners estimates that total losses due to occupational fraud in the U.S. stand at \$660 billion, up 10% from \$600 billion in 2002. About 15% of victimized companies lose \$1 million or more.

While more attention is being paid to fraud in the wake of recent corporate scandals, experts say statistics show an increase both because the economy is growing and because the increased scrutiny has brought more wrongdoing to light. However, the ACFE found that tips are the most common means of fraud detection, helping to uncover about 40% of frauds that come to light. Internal audit, by contrast, is involved in just under one fourth of fraud cases. More disturbingly, companies are more likely to uncover fraud by accident than they are through their established internal controls (see box).

Still, the focus on internal controls and the internal audit process, enshrined in Sarbanes-Oxley's section 404, will likely help bolster fraud detection. The law requires companies to review their internal controls and report on their findings. The outside auditor must then offer its assessment both of the internal controls and management's own report. While the first batch of reports won't be required until November, already auditors and audit committees have had to look at internal controls to an unprecedented level. And experts agree that virtually every

ment [in fraud detection] because of the emphasis on internal controls," says **Joseph Koletar**, a principal with **Ernst & Young**. "But, quite frankly, 404 is still a relatively new phenomenon, so I think it's going to take a while for that full impact to be felt."

Auditors have a poor track record of finding fraud because, historically, they haven't been asked to look for it. "The assessment is that, for many companies, fraud risk is not high on the priority list of what people do," says David Richards, president of the Institute of Internal Auditors.

In fact, audit experts say that until very recently, many internal auditors haven't been involved with fraud prevention work at all. If they have been, it's often been only on the most superficial level.

"Internal audit has focused for much of the past decade on seeking operational improvements and serving as internal consultants in organizations," says **Toby Bishop**, president and CEO of the ACFE. "And they execute tasks that are assigned to them by their leadership. Since no one has responsibility for fraud losses in most organizations, there's usually no one tasking them with reducing those fraud losses."

Furthermore, many companies fear that a focus on fraud detection will send a message to employees that they're not really trusted. So they don't spend (continued on next page)

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(continued from previous page) a lot of energy looking for small frauds in the field, which are the most prevalent. And when it comes to investigating fraud at the top, internal auditors often run up against political obstacles within the organization. Despite the lip service paid to auditor independence, it's an inescapable fact that auditors work for management and can be influenced.

"Politically it's a very dangerous game to be totally independent, even as an internal auditor," says **Rich Lanza**, a certified fraud examiner and internal auditor at **Toys** "R" Us. "Most internal auditors report to the CFO, even though they have a dotted line to the audit committee. You see [the committee members] five, six times a year. Let's be honest: Who's really your boss? Who pays the bills, and who can get you fired tomorrow if they wanted to?"

When it comes to internal controls, the situation is equally difficult. Most such processes are set up to guard against employee errors rather than large-scale corporate looting. Even if internal controls are put in place with an eye to **Enron**-scale shenanigans, such mammoth fraud cases usually involve management's overriding

EXPERT'S VIEW

MORE PUBLICITY FOR THE HOTLINE EQUALS LESS FRAUD

One easy step audit committees can take to boost their fraud detection success is to better publicize the whistle-blowing mechanism mandated by Sarbanes-Oxley to outsiders. Most companies have told their employees about it and written about it in their proxy statements, but that's about it. **Toby Bishop**, president and CEO of the **Association of Certified Fraud Examiners**, says companies should promote their fraud hotlines to customers and suppliers as well.



TOBY BISHOP, CEO, Association of Certified Fraud Examiners

That can be valuable because outsiders are often the first people to notice financial improprieties.

Already, suppliers and clients account for about 35% of all tips that lead to fraud disclosure, the ACFE finds. "Customers and vendors are a tremendous source of information about potential frauds since they deal extensively with a company's employees," Bishop says.

What's more, such reform wouldn't require any major changes. "It's easy to do," Bishop notes. "You can put the hotline number on every invoice that you issue and on every purchase order that you issue, as well as your website."

of all internal controls. "There are very few remaining control measures that can be effective in preventing those major frauds like Enron or WorldCom," Bishop laments. ■

BOARD STRUCTURE

More Boards Form Special Investigative Committees

NCREASED RISKS to company valuation by even the threat of a lawsuit or government investigation are leading boards to form special investigative or litigation committees more regularly now than in the past.

Potential lawsuits are "becoming a key component of market value," according to Bill Ide, a former senior vice president, general counsel and secretary of Monsanto, who sits on the board of AFC. That's because of the larger threat to a company's reputation in today's environment of increased scrutiny. Analysts and investors are paying more attention to whether a company has any suits outstanding and what's been done to address the claims.

"Boards are more frequently creating independent committees" to oversee investigations into malfeasance or allegations of impropriety, says Joe Grundfest, a law professor at Stanford Law School and former SEC commissioner. In fact, a search of SEC filings reveals that 38 special litigation committees were created this year, up 27% from 2003. Lawyers and academics think those numbers can only increase.

Grundfest says that one of the factors motivating boards to create these committees is the increasing need for them to prove their independence to the SEC. Independent committees let the SEC know that the board is in charge of the situation, rather than management, and that also sends a message to investors.

"We're in a very nervous market," says Ide. "If there's a blemish, everybody thinks there's a cancer. One of the best ways to deal with that is to open the kimono" and let investors see what's really going on, he says. Establishing an independent committee to oversee an investigation can help ensure transparency and comfort investors.

That's the rationale behind the creation of the special committee at **Medtronic**. In September 2003, the **Department of Justice** began an investigation into allegations that its subsidiary dealing with spinal and cranial conditions, **Medtronic Sofamor Danek**, was giving kickbacks to doctors that used its products. At that point **Ron Lund**, the company's corporate secretary, recom
(continued on next page)

(continued from previous page) mended that Medtronic's governance committee form a special committee to investigate the allegations.

"The charges go to very fundamental principles that we adhere to strongly," says Lund. "The audit committee [had] a full plate, so we decided to split it out and give it attention in a special committee that would focus on nothing but that."

This is the first time on record that the board at Medtronic has created a special committee, though the company has faced lawsuits in the past. Now, with governance demands ratcheted up several notches, more companies will find themselves taking similar steps.

The creation of a special committee to deal with a government investigation indicates how much more seriously boards have to take accusations of impropriety. The special committee is a sign of an active board responding to allegations that could lead to an auditor reporting a material weakness in internal controls.

Committee members are receiving an additional \$2,500 per quarter for as long as the committee is convened.

Medtronic has lined up a good range of experience for the special committee. But, according to special litigation committee criteria outlined by **Debevoise & Plimpton** lawyer **Meredith Brown**, the committee's makeup could face some challenges.

Brown advises that directors for a litigation committee be "completely independent" and

cautions, "The tests for independence are particularly strict for SLC membership." Since only one of the directors on Medtronic's committee is a new director, the committee's independence might come under additional scrutiny.

To assist in the ongoing investigation, the special committee is using both in-house counsel and outside counsel retained at the suggestion of Lund. Their outside counsel, Ty Cobb of the firm Hogan & Hartson, and Lund report to the committee at every board meeting.

While the unfettered reporting relationship between the committee and its outside counsel is a best practice, Brown says that members of a special committee "should choose their own law firm to look at the merits of the claims and other considerations relating to the claims." It may not matter too much in the long run, but again, the fact that Lund recommended the committee's lawyer could be questioned.

Nonetheless, lawyers like Ide think that special committees are going to become even more common among boards. Ide points to a similar committee and investigation at Tyco as something that "cleared the air." The problems have been found and they've been fixed, he says.

But Ide warns that simply creating a committee is not a guarantee that all of a company's problems will go away. At Enron, and again at HealthSouth, special committees were formed using outside (but not independent) counsel that tried to gloss over the very real issues that the board should have been confronting.

DIRECTOR COMPENSATION

Service Firms Lead Director Pay Hikes

HE AVERAGE BOARD member's compensation continues to rise in 2004. Pay for nonemployee directors has been rising for the past couple of years as new responsibilities and greater liability concerns make the job more difficult and time-consuming.

"It's not surprising, because there's more onus on outside directors now," says **Charles Peck**, a compensation researcher for **The Conference Board**.

According to recent Conference Board statistics, directors of manufacturing companies have the highest total compensation of any directors in corporate America. Their median total pay, including grants of stock and options, rose 4% this year to \$72,750. Service company directors earn \$70,000, although their compensation rose more quickly, by about 17%.

Overall, equity grants account for about one fourth to one third of directors' total pay. The type of equity being offered is changing, though. Companies are starting to replace stock options with restricted stock or other full-value share awards to directors. The shift parallels a similar change taking place in executive pay patterns.

"Overall, of all the companies that we surveyed, 65% are granting stock options to outside directors" this year, Peck says. "And last year it was 75%." ■

MEDIAN ANNUAL COMPENSATION FOR OUTSIDE DIRECTORS BY INDUSTRY CATEGORY

Basic Compensation	2004	2003
Manufacturing	\$50,000	\$45,000
Financial	\$43,750	\$43,000
Service	\$50,000	\$40,000

Total Compensation		
Including Stock	2004	2003
Manufacturing	\$72,750	\$69,620
Financial	\$67,000	\$55,000
Service	\$70,000	\$60,000

Source: The Conference Board

Board Alert

RATINGS (continued from page 1)

Business. "There's no conclusive evidence that this matters at all."

Larcker insists on hard proof before governance changes, such as requiring directors to retire or invest money in shares, can be justified. "This may be too high a cost to pay for changes that may not lead to better long-term results. It might not even be desirable to get a higher rating," he argues.

Directors pay close attention to ratings because insurers, some investors and credit ratings agencies do. Ratings can have a real effect on the cost of capital and access to capital. As a result, some companies use the ratings as a benchmark for their governance practices.

For example, National City and Equity Residential made significant changes partly with ISS ratings in mind, including the voluntary replacement of some directors. And Gavin Anderson, the chief executive of ISS ratings rival GovernanceMetrics International, says some clients have told him they use his ratings for benchmarking as well.

The Wharton professors aren't the only academics to question the efficacy of ratings based on board structure. A working paper out of **Harvard** by governance guru **Lucian Bebchuk** and colleagues Alma Cohen and Allen Ferrell also takes on ISS and GMI, cautioning against "the kitchen sink approach" of "building ever-larger indexes of governance measures." ISS considers 61 data points; GMI has almost 500 data points.

"The paper empirically demonstrates that in this area more can actually be less. You can lose something substantial by adding various provisions that do not matter," says Bebchuk.

He specifically mentions ISS. "Shareholder advisory firms, including industry leader ISS, have put forward indexes of good corporate governance based on a massive number of revisions.... A governance rating system based on a much larger set can push firms in directions that are counterproductive or at least wasteful, and provides a noisier measure of governance quality."

ISS has defended its ratings as necessarily allencompassing. Such broad analysis gives insights into all the relevant characteristics of a company's board, and thus its leadership, it says.

But some directors, angered by what they see as the check-the-box mentality of ISS and its recommendation against **Warren Buffett** as a director, are already starting to reconsider how they use ratings.

Not content to reform their ways across the

board, directors are being more selective about what changes they make in order to improve their boards' governance. Many boards have already adopted reforms. Going forward, "boards are learning what is important and making judgments about what is important [and therefore] becoming smarter consumers," says Carpenter, who is studying the ratings.

"Directors are starting to become more savvy

consumers of the ratings and the information provided by services," Carpenter says.

Carpenter knows firsthand that institutional investors, too, are questioning how effective these ratings are and which ones are the most predictive.

The State of Wisconsin **Investment Board** recently opened up its proxy advisory work, including governance ratings, to multiple bidders after using ISS exclusively for the past five years. SWIB has funded research that Carpenter is leading to evaluate the ratings of The Corporate Library, ISS, GMI and the **Investor** Responsibility Research Center. Results will be ready in November, at which point SWIB will make its decision.

"There's been more academic research on governance matters lately given all the changes in Sarbanes-Oxley, and particularly with the influence of the governance ratings of GMI and ISS," says **Keith Johnson**, chief legal counsel for SWIB. "It's due time that institutional investors focus more on the research that evaluates governance ratings, since those ratings are taken into consideration in making decisions on corporate governance issues."

Studies such as the one SWIB has commissioned may affect which rating service gains the most legitimacy, thus influencing future director decisions. Research could also affect the factors rating services include to arrive at their ratings. At the moment, ISS is attracting the most criticism from directors and academics alike.

As a result, experts predict that boards will lean toward data sources that don't focus on board structure. So far, ratings from The (continued on page 14)

PROXY FIRM TEAMS UP WITH ACADEMIA

Glass Lewis recently announced a good-governance index of S&P 500 stocks based on the recent findings of Harvard professor Lucian Bebchuk. Bebchuk's analysis of the return of a large number of companies over the period 1990–2003 indicates that those with poison pills, staggered boards and four other indicators of what he calls "entrenchment" performed substantially worse on a riskadjusted basis than firms with lower entrenchment scores. The companies considered in the research account for more than 90% of total U.S. equity market capitalization

The new index weighs the stocks in the S&P 500 differently depending on Bebchuk's entrenchment indicators. Glass Lewis plans to market the index to plan sponsors and other institutional investors. **Standard & Poor's** will calculate the new index.

BENEFITS DISCLOSURE (continued from page 1)

the costs of 10 perks its executives receive. And Winn-Dixie informed its shareholders that management is provided with personal security.

The changes come in an effort to improve transparency in an era of intense scrutiny of executive benefits from shareholders, the press and regulators. Governance activists speculate that fuller disclosure might serve to blunt shareholder objections, contrasting it with the firestorm resulting from the revelations of former GE CEO Jack Welch's benefits.

"It tends to mitigate criticism since at least people know. In Welch's case no one knew, and people's reaction was 'Good grief!'" says Paul Hodgson, analyst for The Corporate Library.

Meanwhile, the SEC is seriously considering completely revamping the way executive benefits are disclosed. The SEC even chimed in on the Jack Welch benefits package. In a September press release, the SEC upbraided GE for not fully describing the benefits it provided Welch.

DISCLOSURE OF EXECUTIVE PERKS IN 2004 PROXIES

Boeing

"In 2003, executive officers received the following perquisites: access to the company's plane for business purposes and, in some cases, personal usage; company-provided leased vehicles, first-class air travel, financial services allowance and an annual physical exam. The committee reviewed the competitiveness and appropriateness of these offerings, in consultation with the independent consultant, and determined this package of benefits and perquisites is consistent with Boeing's executive compensation policy and market practices."

► Honeywell

A table that itemizes the costs of legal fees, personal use of aircraft, personal financial planning, cash flexible perquisite payments, temporary housing, excess liability insurance, personal use of company car, executive auto insurance, security and tax reimbursement payments. Costs are provided for the last three years for the top five executives.

North Fork Bancorp

"The individualized benefits include travel and transportation arrangements, social group allowances (clubs, etc.), professional association fees, key personnel insurance, individual security measures and assistance in personal asset management."

► Winn-Dixie Stores

"Our executive compensation program also includes various employee benefits. They are similar to the benefits offered to our other employees but, in some cases, include variations which are intended to enhance the tax efficiency of the benefit to the recipient or serve as a substitute for benefit opportunities lost due to regulatory contribution limits or changes in company policies. Specifically, among other such benefits, the Company offers a Supplemental Retirement Plan and a Senior Corporate Officer Management Security Plan, which is a contributory defined benefit program available to officers."

In the past, there was only vague disclosure of executive benefits, if any at all. What GE stated before the storm of criticism was that Welch would receive "continued lifetime access to Company facilities and services comparable to those that are currently made available to him by the Company."

By contrast, the SEC says GE should have listed the specific rental value of his apartment, a leased Mercedes, security and a book tour, among other things. The big difference in these new disclosures is the level of specificity.

While Honeywell did not disclose executive benefits two years ago, now the company's level of disclosure sets an exemplary standard. Honeywell itemized the costs of 10 perks for five top executives, including personal use of company aircraft, personal financial planning and security, in tabular form. For CEO **David Cotes** they add up to close to \$600,000. Only costs that make up more than a quarter of the total are required to be itemized, but Honeywell discloses each and every one.

In fact, companies are required to disclose only perks and other personal benefits above \$50,000 or 10% of the total salary and bonus. The cost of personal financial planning for the CEO does not reach this threshold, for example, but Honeywell nevertheless discloses it.

According to corporate secretary **Tom Larkins**, Honeywell made the decision to go beyond SEC requirements last year in connection with implementing Sarbanes-Oxley. He says implementation made the firm consider fresh opportunities for more transparency. He says the recommendation to put the information in tabular rather than narrative form came from senior management and was approved by the compensation committee. The idea was to improve clarity as well as transparency.

Governance watchdogs give Honeywell high marks and consider it a model of transparency. "It shows the company feels that these are justifiable benefits. It's up to shareholders to object," says Hodgson.

Other companies have also moved toward fuller disclosure. Winn-Dixie added a line in its 2004 proxy indicating that management gets security and a supplemental retirement plan. Boeing also included details about perks for the first time in this year's proxy (see box).

The risk of fuller disclosure is attracting shareholder ire in an era of lower tolerance for executive perks. Most companies are therefore waiting to see what new rules the SEC announces before opening themselves up to potential criticism.

EMERITUS DIRECTORS (continued from page 1)

vagaries about what it actually entails, both governance advocates and directors expect that the numbers of emeritus directors should continue to rise.

Boards that recently created the emeritus position include Gerber Scientific, Jo-Ann Stores, Devon Energy, Krispy Kreme Doughnuts, Pep Boys, CDW, Express Scripts and Williams-Sonoma. At Gerber, director Stanley Simon was named an emeritus director for his 30 years of service on the board. And none of the emeritus directors at Devon Energy, Pep Boys, Express Scripts or Williams-Sonoma is younger than 77 years old.

It was the independence requirements coming out of the **New York Stock Exchange** that caused Jo-Ann Stores to rethink the responsibilities and position of its two founders in the boardroom.

"We benefit from the perspective and insights of the two founders," says **Gregg Searle**, president and CEO of **Ross Environmental Services** and a member of Jo-Ann Stores' governance committee. "At the same time, we recognized and they recognized that, from an independence standpoint, Sarbanes-Oxley and good governance practices would suggest that what we wanted to do was bring in more outside directors to improve the independence of the board," he says.

As directors emeritus, neither of the founders receives a retainer or is allowed to sit in on executive sessions of the independent membership of Jo-Ann Stores' board. They attend only the general board meetings and may participate but cannot vote.

At Express Scripts, it was a mandatory retirement age that had already been raised once that forced the company to institute its own director emeritus position. "We established the position in the past 12 months," says Seymour Sternberg, a director on both the Express Scripts and New York Life boards. Sternberg says the emeritus position responds to governance ratings agencies' demand for a mandatory retirement age. The directors on the Express Scripts board created the position to keep the input of Norm Zachary.

However, Zachary's service at Express Scripts is not restricted, and Zachary is paid. Sternberg says Zachary receives a per diem for work done at the request of the board and that "he may be used for some service that may not be associated with the board meeting."

The different ways Express Scripts and Jo-Ann

Stores have defined the director emeritus position reveal some of the issues raised by the position. Since the emeritus position lacks firm precedent or legal standing in state law, most boards that do create the title are flying blind.

Some governance consultants see the potential for confidentiality problems. "If somebody is a director emeritus and doesn't get paid and doesn't attend board meetings, the question is: What kind of information should this emeritus director receive?" says **Stephanie Joseph**, president of the **Directors' Network**,

a New York-based consulting firm.

The issue of whether to pay the emeritus director a per diem fee, an annual retainer or no fee at all is another issue boards should discuss, Joseph says. The governance charter, in her opinion, should also spell out exactly what the obligations, terms of service and criteria are for being an emeritus director.

Perhaps the most ticklish question for boards is how to count the emeritus director when determining whether the board has an independent

attended.

majority. "If [a board] made them into emeritus directors and let them participate, that's something that's probably going to be looked at harshly," says Joseph. "It doesn't really look good, and you're not going to fool anybody."

That was the criticism leveled at Krispy Kreme when it announced that three of its franchisees would become emeritus directors. The board gave them an annual retainer of \$26,000 and additional fees of \$300 per quarter for miscellaneous expenses. The compensation arrangement is anomalous among emeritus directors. Normally, they're paid per diem or per meeting

Predictably, the disclosure brought howls from some corners of the governance community and an interrogation of what exactly those affiliated directors would do on the board.

Governance watchdogs are already viewing the position warily. "It's a label that says we really need to get rid of this guy and we just don't want to push him out the door," says Paul Hodgson, a senior analyst with The Corporate Library. Either that or it's a way for the board to give an honorary title to a "big name" who once served on the board to attract interest or investors but is now a liability in the new era of accountability.

We benefit from the perspective and insights of the two founders. At the same time... we wanted to bring in more outside directors to improve the independence of the board."

GREGG SEARLE, Director, Jo-Ann Stores

COMPENSATION COMMITTEES

Execs at Troubled Firms Expected to Return Pay

HAREHOLDERS AND BOARDS are gaining more leverage to take back executive compensation that's already been granted. So far, directors haven't moved to take advantage of that increased power. But, experts say, they soon will if they want to avoid being sued.

The Sarbanes-Oxley Act specifies that companies must revoke performance-based compensation paid to the CEO and CFO if the company restates its performance due to "misconduct." But recent legal proceedings are establishing a precedent that goes far beyond that. And as the threat of compensation-related lawsuits rises, experts say it's becoming increasingly important for boards to leave themselves a way to take back money they've already paid out.

In virtually every shareholder derivative suit, directors end up named as defendants. So they're putting their own assets and reputation at risk if they don't make serious efforts to recover compensation that was inappropriately granted.

"If the boards don't do it, the shareholders are going to sue," says **Jameson Baxter**, a director of **Ryerson Tull** and **Banta Corp**.

Mike Kesner, the partner in charge of Deloitte & Touche's executive compensation practice, agrees. "It's the litigation risk that's causing the board to wake up and deal with this stuff," he says. "If bonuses are paid, if option gains are realized, and then there's a material misstatement and the stock price drops, you've got plaintiff's lawsuits all over the place."

Until recently, it was rare for executives to surrender compensation they'd already received unless forced to by a court of law. But that may be changing. In August, as part of a settlement of shareholder litigation at utility firm FPL Group, CEO Lewis Hay III and seven other current and former officers agreed to return \$22.25 million. They had received accelerated payouts of \$62 million in 2000 after shareholders approved a merger with Entergy, but the merger was never consummated.

The FPL payouts came because change-of-control language in the executives' long-term incentive plan defined shareholder approval of a merger, rather than its actual completion, as the triggering event. No financial restatements occurred, so there was no legal mandate for returning the compensation.

That case stands in contrast to that of former **Sprint** CEO **William Esrey** and president **Ronald LeMay** in 2000. Both Sprint executives kept large grants of options and stock following shareholder approval of a merger with **World-Com**, even though regulators killed the deal. The ability of FPL shareholders to recover funds in the same scenario shows how the balance of power between investors, boards and executives has changed as a result of the increased attention to compensation practices.

Shareholders are exercising their newfound leverage at Computer Associates as well. Last month, the firm's former CEO, Sanjay Kumar, was indicted for allegedly inflating company revenues. This summer, Amalgamated Bank's LongView fund submitted a shareholder proposal that would require the company to take back any executive bonuses if a restatement occurs and performance targets were not in fact achieved. While it was defeated, it may presage further such attempts. And investor Sam Wyly is suing for the return of over \$1 billion in compensation already awarded to Kumar and others.

So far, shareholders have initiated almost all attempts to recover previously paid compensation. But directors and other experts say boards will have to take such actions in the future in order to stanch shareholder anger.

"The ability [for boards] to say, 'We've cleaned house' is very important," says Yale Tauber, principal with Independent Compensation Committee Adviser. "And it doesn't stop where Sarbanes-Oxley drew the line."

Compensation committees do have a few tools at their disposal to make it easier to take back pay if they need to. In the first place, they can add language to their incentive plans stating that execs must repay their bonus if there's any financial restatement at all. Very few firms do that now. "We need this to be institutionalized in documents," says Kesner.

Another step boards may take is the establishment of a so-called "bonus bank." Under such a system, the company retains a certain percentage of executives' bonuses and holds the funds in a deferred account. That type of provision is quite uncommon, partly because it irritates executives who don't have instant access to all their earned compensation. But **Doug Friske**, a managing principal at comp consultancy **Towers Perrin**, suggests that boards may revisit the concept in the future.

"Given the increase in the number of restatements, we may see that as a tool to get at this rather than going back and trying to have executives write a check," he says.

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If the boards don't do it, the shareholders are going to sue."

JAMESON BAXTER, Director, Ryerson Tull, Banta Corp.

LIABILITY COVERAGE

Double-Digit Rate Drops Hit D&O Insurance

OMPANIES HAVE SEEN double-digit declines in their D&O premiums in 2004. Many insurance experts worry that the pricing trend is unsustainable given current claims activity. But so far, only one insurer seems to be making any effort at all to push pricing back up.

Ann Longmore, senior VP and product leader with brokerage Willis Executive Risks, says public companies that aren't huge or in troubled industries may be enjoying decreases of 10% to 20% in their premiums. What's more, she claims, the decreases are magnified because companies generally purchase several policies to cover themselves fully. Once the primary policy is exhausted, each additional policy kicks in according to its place in the sequence. The excess policy is often priced as a percentage of the layer beneath it.

Last year, Longmore says, the price of an excess layer of coverage was generally 85% to 90% of the cost for the policy preceding it in the tier. Now the figure is more like 75%. "If you start by dropping the primary by 10%, you see how the decreases snowball as you move up the program," she says.

Recent statistics from the **Council of Insurance Agents** and **Brokers** show that the shift really began in earnest during the spring. In the first quarter of 2004, one fourth of brokers surveyed said overall D&O premiums went up 10% to 20%, with 9% saying prices were rising more than that. The percentage reporting a decrease stood at just 12%. But in the second quarter, 24% of respondents reported that D&O premiums were falling, and only 7% reported price hikes of more than 10%.

D&O premiums started to moderate about a year ago. They had soared during 2001 and 2002, when scandals at **Enron**, **WorldCom** and other companies led to enormous legal bills and major insurance claims. Some companies in troubled sectors, such as telecoms or energy, saw their D&O premiums double or even triple. At the same time, insurance carriers tightened up their terms to make it easier to deny coverage.

The reason insurers had to increase their pricing so substantially, in turn, was because throughout the late 1990s they had been offering substantially lower rates in a frenzied race to sign new business. Many experts suggest that the insurance companies may now be starting to repeat their mistakes of the last decade, and that they'll soon see a reversal as more claims hit their books.

"These insurance markets going up and down, it's a never-ending cycle," says attorney **Dan Bailey** of **Bailey Cavalieri**. "I think this particular cycle of the market going down is going to be a fairly short cycle."

Initially, companies judged to be good risks were the only ones to see premiums stabilize or even drop slightly. But over the past few months, insurance experts say, the

trend has accelerated notably. "It's really all industry segments, all geographies, all distribution channels," says **Donna Decina**, VP and D&O product manager at insurer **OneBeacon Professional Partners**. "There's just a wide range of decreases being granted to all organizations, and there really is no rhyme or reason to it."

Last month, OneBeacon, a relatively small carrier that entered the D&O arena only in 2002, sent a letter to brokers expressing "dismay" that premiums have fallen so far despite no letup in securities claims. The letter said that OneBeacon is going to hold the line on pricing for public company D&O policies and expects to lose business as a result.

The letter, signed by Decina and president **Matthew Dolan**, stresses that the insurer will still issue D&O policies. But, it says, "we fully expect that our pricing discipline will render us uncompetitive relative to the prevailing market conditions."

Nonetheless, other insurers seem to be battling each other more and more aggressively, thereby helping push prices down even more. Small and midsize businesses are benefiting most from the competition. "Their decrease could easily be 25 to 30%," Longmore says.

Large-cap companies historically have been viewed as the most desirable insurance clients by virtue of their size. But after the troubles at Enron and other huge companies, many insurance carriers decided to focus more on smaller clients. Those companies were viewed as better risks because, in the worst-case scenario, they would never turn into an Enron-sized black hole.

The price drops insurers are currently offering to woo clients worry many insurance experts. They note that claims activity remains high, and they fear that insurers may be setting themselves up for financial trouble with their aggressive pricing policies. "We have not seen any commensurate decrease in exposures or claims frequency," Decina says. "The pipeline of claims is still extremely large."

In fact, Cornerstone Research and the Stanford Securities Class Action Clearinghouse claim that the number of federal securities class action filings this year is exceeding last year's pace. As of mid-September, there were 171 filings, compared to 216 for all of 2003. That said, average settlement size dropped 14% in 2003, to \$21 million. At the moment, it's not clear what direction claims activity will go over the coming months. But it's certain that if insurance carriers find themselves facing a new surge in claims, they'll pass that financial pain on to their customers.

"This market is very volatile right now," says **Michael Tomasulo**, VP of **Nasdaq Insurance Agency**, a brokerage. "I think this thing can turn right back around with the wrong kind of claim scenarios." ■

COMPENSATION

Boards Dissolve Pension Committees

ORPORATE BOARDS are dissolving the committees they had established to deal with pension and employee benefit issues.

This year a number of companies, including Schering-Plough, VF Corporation and Warnaco, disbanded their pension committees, placing pension management oversight responsibilities in the hands of either the audit or compensation committee.

"We have a small board, and we decided that it made more sense for the functions of that committee to be included within the compensation committee," says Candace Cummings, corporate secretary for VF Corporation. "We thought that what we were doing was also consistent with current board practices," she says.

She's right. The number of boards with standing committees for tackling employee benefits issues dropped to 9% in 2004 from 14% in 2003. Corporate secretaries say that coupling pension committee responsibilities with those of another committee only improves the efficiency of the board. They argue that cutting the committee streamlines the board and lets directors put pension issues in a broader context.

Cummings says the changes at VF make the board "aware of the total compensation plans available to our employees." She says this enables the board "to take that into account when looking at our compensation plans going forward."

But some lawyers say that the Employee Retirement Income Securities Act of 1974 might figure in VF's decision. "The concern is ERISA fiduciary liability," says **Susan Serota**, head of the executive compensation and benefits practice at the law firm **Pillsbury Winthrop**. "The directors on that [pension] committee may be a fiduciary with respect to the underlying ERISA plans," Serota says. That's something that could be a concern because courts are now holding directors and officers as fiduciaries of corporate pension plans in some cases.

Like so many other changes in governance, this new wrinkle on fiduciary responsibility comes back to Enron. Before Enron's pensioners pled their case, individuals normally weren't held personally liable for the decisions they made on behalf of their company as plan managers or fiduciaries. But a ruling by the U.S. District Court for the Southern District of Texas last October changed that interpretation.

The court ruled that individual officers and directors who oversee the benefit plan on behalf of a corporate fiduciary are ERISA fiduciaries themselves. As ERISA fiduciaries those officers and directors can be held personally liable for their lapses in executing their fiduciary duties.

Cummings says the pension advisory committee was carefully structured at the time that it was established so that it wouldn't be a plan fiduciary. But these changes in the ways courts are determining who is and who isn't a fiduciary may have played a role in the latest reconfiguration of the board. And ultimately, the board has to answer for the people it appoints as the direct fiduciaries of the plan.

Over at Gillette, where the compensation committee has historically had oversight responsibility for the pension, corporate secretary Bill Mostyn says that the board is already examining pension issues more closely. Mostyn says the board's newfound interest is partly a response to the collapse of companies like Enron and the lawsuits thus engendered. "There is a heightened sensitivity at the board level about the performance of the funds," he says.

Gillette's board periodically reviews or has management present a review of the performance of optional funds within the plans. "It's an oversight and a post-audit function," Mostyn says. "We do have management committees that basically manage the funds, but we have asked for annual reports to the compensation committee on the performance of the funds."

If an annual review constitutes increased oversight, it may not be enough, say lawyers like **George Kraw**. Kraw serves on the advisory committee of the **Pension Benefit Guaranty Corporation**, the government entity charged with oversight of employers' defined benefit plans. "Regular monitoring is certainly called for," says Kraw. And, he adds, if the board isn't directly monitoring the pension funds, it should receive updates "no less than annually and quite likely more frequently."

Kraw's point highlights the risk of dissolving pension committees. In the event of a lawsuit, directors need to show that they exercised the appropriate oversight to get a case thrown out. With so many other issues to distract them, pensions can get lost in the shuffle. "Pension plan issues are not top-tier issues for most companies until the plan becomes a problem," Kraw says.

The Decline of the Benefits Committee

Percentage of companies with standing benefits committees

1997: 25% 2000: 23% 2002: 14% 2004: 8.9%

Source: NACD

New COSO Report Defines Risk Responsibilities for Directors

IRECTORS CAN LOOK FORWARD to even more responsibilities piling on their shoulders now that the Committee of Sponsoring Organizations of the Treadway Commission (COSO) has released its new report on enterprise risk management.

The report attempts to clarify enterprise risk management in the same way that an earlier report from COSO addressed the subject of internal controls. With its emphasis on incorporating risk response into all aspects of corporate strategy, the report includes a number of new duties for directors.

These range from working with the CEO to set the amount of risk a company is willing to assume to establishing and overseeing the system put in place to manage a company's response to risk.

"It's being tagged to the board," says Mark Beasley, professor of accounting at North Carolina State University and COSO advisor.

"Enterprise risk is meant to be a process that's board-driven and management-focused on

to have an enterprise risk management system implemented within three years. That means boards must do a lot to get up to speed on risk management, especially since no single definition of risk management exists, other than the COSO document coming out now.

While COSO has no regulatory authority and does not set standards, many executives and directors look to its publications as a resource on best practices. COSO, which includes representatives from academia, business and professional auditing organizations, created the framework for internal controls adopted in the Sarbanes-Oxley Act.

COSO breaks down a board's responsibilities for risk management into four key areas. The first is identifying a company's risk appetite.

FIVE ELEMENTS OF A RISK MANAGEMENT SYSTEM

1. Risk Assessment:
Determining both the inherent risk that a company faces in the absence of management response and the residual risk that remains after a management response

Risk Response:
Identifying whether to accept, avoid, share or mitigate the risk the company faces, then determining what kind of resources and oversight are necessary to ensure success

Control Activities:

Creating policies
and procedures throughout the organization,
including technology
infrastructure, that
ensures that risk responses are carried out

Information and Communication:
Ensuring that information is communicated to all levels of an organization to properly identify, assess and respond to risks

Monitoring:
Providing ongoing oversight capabilities to ensure the effectiveness of each element of the risk management system

Source: Mark Beasley, professor, North Carolina State University

identifying risks that could affect management's ability to achieve strategic objectives, and then assessing the probability and impact of those events' occurring to make sure they're within a company's risk appetite," Beasley says.

The report arrives at a time when many boards are beginning to struggle with how to tackle a broad array of risks, including geographic, brand-reputation, physical and investment risks.

For instance, a 2004 global survey of CEOs from **PricewaterhouseCoopers** reveals that only 29% of U.S. CEOs believe that they have an effective and efficient enterprise risk management system in place at their companies. However, another 46% of U.S. CEOs surveyed expect

In order to do that, **John Flaherty**, COSO's chairman, suggests that a board ensure that people are educated about risk and talk about it throughout the company.

COSO's report argues that it doesn't do any good for the board and senior management to identify risks if they're doing it in a closed loop. The new ways of identifying and mitigating risk need to be understood at every level of the organization so that the different types of risks and response mechanisms a company has can be effective.

Next, the company board needs to make sure that the strategy in place aligns with the risk threshold established. Basically, that's just reviewing company (continued on next page)

(continued from previous page) operations with an eye toward their differing potential risks. Sometimes, Flaherty thinks, companies are surprised by the levels of risk that they've assumed.

COSO's report asserts that boards then need to oversee the framework that their companies would put in place to ensure that their strategies are being executed effectively.

Finally, boards need to ensure that risk response does not remain isolated within particular business units. The value of the COSO framework and approach to risk management hinges on its adoption throughout the entire organization. Its proponents say that enables a company to mobilize itself more effectively to respond to the risks it faces.

But with all of the work directors are doing to comply with the existing regulations, the question is: Who can take on these new demands on directors' time?

Different members of COSO answer the question differently. Audit committees, which seem to be a fairly logical place to locate risk responsibilities, are already swamped with their internal control oversight work. And while risk management and internal controls are related, they're not the same thing.

"Given the demands on boards right now, a risk committee or comparable type of committee can play a valuable role in understanding the risks and how they're being managed," says Miles Everson, engagement partner for PricewaterhouseCoopers on the COSO report.

Everson goes on to say that the board as a

whole bears the responsibility for determining the risk appetite of a company and its strategic response to risk, but that a dedicated committee might help to take care of the oversight functions once a company-wide risk management system is in place.

Meanwhile Flaherty, the committee chairman, thinks the governance committee should be responsible. "I'm not one for having the board fractured into a lot of committees," Flaherty says.

Finally, Beasley suggests the board establish a risk committee, add a chief risk officer, or do both. That way the board as a whole, and in executive session, can receive the reports it needs to assure everything is working properly and can avoid weighing already overtaxed directors down with yet another responsibility.

Flaherty points to Ford Motor Company to show what extra oversight could accomplish. In the 1990s the automotive industry was worried about the cost and availability of metals needed to manufacture catalytic converters. By 2001 the problem had been resolved, but Ford had been acquiring surpluses of the metals and was forced to sell them on the market. The resulting sale led to a billion-dollar write-down.

With a more holistic approach to risk management, Flaherty argues, Ford could have realized that R&D was solving the problem. He says the risk management program COSO presents breaks down the communication barriers that led Ford to tackle the problem in two opposite ways.

RATINGS (continued from page 7)

Corporate Library have escaped much criticism for that reason.

ISS and GMI rely on structural board elements such as whether there is a lead director, whether the CEO and chair positions are separated, and the number of insiders on the board.

In addition to board structure, GMI also looks at regulatory issues and culture. To look at a company's culture, GMI looks at the company's litigation history and history of regulatory infringements, among other things.

The Corporate Library doesn't consider whether boards have independent chairmen, a lead director, formal governance policies or annual elections. All of these are considered by ISS.

"The only way to rate is not on what boards say they do, but on decisions they really make," says **Nell Minow**, editor of The Corporate Library. "These include how revealing the accounting is—we consider various techniques

for managing earnings; how many boards a director sits on, since that indicates a board saying no to directors; and whether compensation is tied to performance, since that shows that the board can say no to the CEO."

The jury is still out on how much better The Corporate Library's ratings are, however. An unpublished study of its ratings by professors at the University of Wisconsin and the University of Iowa found no relationship between its metric and credit ratings, according to Carpenter, who saw a copy of the study.

Despite all the criticism, ratings still play an important role, says Carpenter. "It's to the credit of ISS and GMI that they have really increased the awareness of the dimensions of governance and how they are related," he says.

GMI CEO Anderson says that most of the ratings studies are inconclusive.

"I think the jury is out, to be honest," he says.

"None of the ratings firms have been doing this long enough to have a database that has 10 years of data to test."

■ M&A

Oracle Gives Acquisition Committee Greater Role in M&A

N A MOVE showing an increasing aggressiveness of directors in influencing corporate strategy, **Oracle**'s board has expanded the responsibilities of its acquisition committee.

Rather than tackle problems solely related to **PeopleSoft**, the committee will be looking at potential acquisition targets on its own.

Initially, the committee worked within the framework followed by most companies. Oracle had very publicly identified a target company, PeopleSoft, and was using the acquisition committee to vet that target.

However, the hostile takeover at PeopleSoft has become stickier and stickier. Even with a recent court ruling that this acquisition wouldn't create a monopoly in the software industry, there remain a slew of roadblocks to the completion of the deal, and both companies have filed a battery of lawsuits and countersuits.

Given the appetite at Oracle for more consolidation even if the PeopleSoft deal goes through, creating the acquisition committee to vet the process of buying companies makes sense.

Having a group of directors who can work on deals on an ongoing basis is a good way to ensure that boards are up-to-date and can act in a timely manner to approve a deal, according to **Paul Healy**, professor of business administration at **Harvard University**.

At Oracle, the committee isn't just vetting targets that management selects. They're actively engaged in the selection and rejection of targets. "We have a very active and vigorous and independent committee," says **Joe Grundfest**, a member of both Oracle's acquisition and special litigation committees.

The evolution of the committee into its current, more active, state is significant because it puts the board (or a committee of the board) on a more equal footing with management. Directors, in a very real sense, are partnering with management in a way they had not done before.

The committee receives information about deals on an ongoing basis. It held six committee meetings in the past fiscal year, and since the committee members are local, the membership confers more frequently than the meetings

would suggest.

"We have a screen of targets, and that screen is shared with the committee and the board," says **Daniel Cooperman**, senior VP, general counsel and secretary. It's the board's responsibility to set strategy, he says. "The acquisition committee," on the other hand, "would actually review specific targets."

In the eyes of both Oracle's corporate secretary and the committee membership, the subcommittee also helps increase the flow of information between the board and management. "It made sense that the board should establish a [committee] that could specialize and evaluate these transactions on an ongoing basis," says Grundfest, former commissioner of the SEC.

"They wanted to be involved every step of the way with the negotiation process," says Cooperman. "[The acquisition committee] allows the people who really are able to spend the time to do so, so that presentations to the board are better informed by the board's views."

And while it's important to note that Oracle hasn't made the committee a standing board committee yet, it's considering taking that step. "It depends on how regularized the acquisition [process] becomes," according to Cooperman.

There are risks to giving the committee so much responsibility. Healy wonders whether it might be piling too much of a workload on already busy directors. "It's imposing a lot more time requirements on a subset of directors," he says. Not only that, but if the deal flow a company expects doesn't materialize, then "you're appointing a committee for the sake of appointing a committee," says Healy.

If Oracle did decide to make the committee a standing board committee, it wouldn't be the first company to take that step. Cisco Systems has had an acquisitions committee since 1994, in part to address the significant deal flow that the board sees. Cisco's growth strategy has had a significant acquisition component for years, so setting up a standing committee to vet all the deals makes sense.

Cisco's acquisition committee includes CEO **John Chambers**, while the committee at Oracle is wholly independent. That may not seem like much of an issue, but in an era where every board committee making significant decisions seems to need some sort of independent oversight, the idea of manning a committee evaluating strategic decisions with independent directors seems smart.

"There are many legitimate ways to structure an acquisition committee," says Oracle's Grundfest, but "having a critical mass of independent directors is key." ■

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It made sense that the board should establish a [committee] that could specialize and evaluate these transactions on an ongoing basis."

JOE GRUNDFEST, Director, Oracle



A CLOSER LOOK

Paychex Boosts Director Pay with More Cash

N A MOVE similar to that of many boards, **Paychex**, the Rochester, N.Y., payroll outsourcing company, raised its independent directors' annual retainers by increasing their cash compensation.

The increasing demands on directors' time are driving up cash retainers at most firms. But at Paychex, these demands were coupled with annual director compensation that was among the lowest for its peer group. That led to Paychex's board more than doubling its directors' annual retainers.

"As we have added more overall attention to process, and particularly compensation processes in this more sensitive governance environment, we've been using outside resources increasingly to review all of our compensation practices," says **Betsy Atkins**, who stepped down from the Paychex board this year.

The Paychex board took to heart the advice from the **National Association of Corporate Directors**' blue-ribbon panel on compensation, which advised that independent compensation consultants be brought in.

"It really was that, in this more aware and sensitized post-Sarbanes-Oxley environment, we are using outside compensation consultants more," says Atkins, who currently serves on the boards of **Polycom** and **UTStarcom**. She says that 2003 was the first time that Paychex had ever used a comp consultant. And the board was astonished by the results of the compensation review.

Historically, the company has been among the lowest-paying in its peer group in terms of annual director compensation. Competitors **Automatic Data Processing** and **Ceridian** paid annual retainers of \$55,000 and \$52,000 respectively last year (although ADP did change its compensation so that the large majority of directors' pay was in restricted stock, bucking the larger cash trend).

Directors at Paychex received a much more humble \$12,000 annually. Prior to this year, that was coupled with option grants of 10,000 shares. The shares had an exercise price of \$29.55 per share, and given the company's

current closing price of around \$30, directors at Paychex were basically receiving cash comp and little else.

"We've been among the lowest-paying for board fees," says **John Morphy**, Paychex's corporate secretary. Morphy recognizes that as the market for quality directors gets tighter, compensation is going to be a factor in determining where a potential director candidate will go. While it's not looking for new directors now, Morphy does say that the need to attract talent "over time" played at least some part in the decision to grant a raise at Paychex.

For companies like Paychex and **Intuit**, another peer, paying an annual retainer is fairly novel in and of itself. Until recently, the companies relied mainly on option grants rather than cash or restricted stock.

Atkins says that in the years before the tech market bubble burst, the stock grants performed so well that the company felt it didn't need additional compensation. But that all

s start issuing cash comp. "The powers that be on these governance issues decided that increasing stock options was viewed as dilutive, and they were going to make it a difficult

thing to do," he says.

The board at Intuit, like Paychex, had to give its directors a raise. "The workload of audit committees and compensation committees was increasing dramatically," says Hallman. "We had to increase the compensation of directors if we were going to attract and retain the quality of directors that we wanted."

As workloads become more onerous and legal risks increase, most directors feel they need more compensation for the work they're doing.

According to an August study from **Mercer Human Resource Consulting**, boards are responding to their members. Median total direct compensation at 350 large publicly traded U.S. firms was up 15% in 2003, to \$68,250, from \$59,100 the year before.

The study also indicated that in 2003 directors received 49% of their total compensation in cash; that's up from 41% in 2001. Consultants say that market performance is partly behind the shift toward a greater parity between cash and stock in compensation. But the stock market isn't the only factor. As directors' workloads are increasing, so too are their cash retainers.

"The best way to pay people for their additional work has been, and continues to be, to pay them more in cash," says **Peter Oppermann**, senior executive compensation consultant with Mercer Human Resource Consulting. "[Directors] are being paid for overseeing an organization," Oppermann says. "It certainly makes a lot more sense to pay people more in cash for doing that." Besides, he says, the stock options directors receive are negligible and the restrictions on their liquidity mean that the compensation isn't directly theirs. For a workload that's increasing now, he

thinks, directors should get paid now.

MEDIAN DIRECTOR COMPENSATION

	2003	2002	
Board Meeting Fee	\$1,500	\$1,500	
Committee Meeting Fee	\$1,200	\$1,000	
Cash Retainer	\$35,000	\$30,000	
Stock Retainer	\$29,925	\$25,000	
Source: Mercer Human Resource Consulting			

changed with the downturn in the market.

At Intuit, the compensation committee thought that the options package was sufficient to compensate directors. "When we were on a full equity plan, stock options, particularly for directors, ensured that the directors were more aligned with shareholders than if they were strictly paid on a cash basis," says **Mike Hallman**, a member of Intuit's compensation and audit committees.

But as the compensation committee looked at where governance trends were heading, Hallman says the board had no choice but to