CORPORATIONS

6TH ANNUAL CORPORATE GOVERNANCE CONFERENCE
CURRENT CORPORATE GOVERNANCE LESSONS*

Professor Charles M. Elson, *University of Delaware Center for Corporate Governance*
Mr. Terence J. Gallagher, *Chief Executive Officer, Corporate Governance Associates, LLC, and former Vice President for Corporate Governance, Pfizer*
Ms. Holly J. Gregory, *Partner, Weil, Gotshal & Manges, LLP*
Ms. Ann Yerger, *Director of Research, Council of Institutional Investors*
Hon. Philip R. Lochner, Jr. *Member of the Board of Directors, Aprea Healthcare Inc., American Stock Exchange, Clarcor Inc., and Gtech Holdings, Inc., and former SEC Commissioner, moderator*

MR. LOCHNER: Our idea for this panel is, rather than have individuals each give 5-minute or 10-minute presentations as is usually the practice, that I would simply pose some questions and issues and have everyone respond.

We would also like your participation and questions as they come up. Obviously, we'd like to let the panelists talk as well, but if you have questions or comments you want to make as we go along, that would be terrific.

I think probably everybody knows our panelists, but just for formalities, from my far right — where I don't think he belongs — Charles Elson, who's the Edgar S. Woolard Professor of Corporate Governance and the Director of the Center for Corporate Governance at the University of Delaware.

Next, we have Holly Gregory, who is a partner at Weil, Gotshal and Manges and has been practicing in the area of corporate governance for quite some time.

To my left, where he doesn't belong either, Terry Gallagher, who is the former Vice President for Corporate Governance at Pfizer and really was instrumental in creating the Pfizer model of corporate governance. Terry is now CEO of Corporate Governance Associates, LLC, which is a consulting firm in this area.

And to the far left, Ann Yerger, who's the Director of Research for the Council of Institutional Investors, which represents — how much are we talking about in assets these days, Ann?

MS. YERGER: More than two-and-a-half trillion dollars.

MR. LOCHNER: More than two-and-a-half trillion dollars of institutional money.

I guess where I'd like to start today is with the question of independence. We keep on hearing about how directors need to be independent. My first question for the panel is what do we mean? After all, directors are paid by companies. Are they all not independent simply on that basis?

Charles, do you want to start?

PROFESSOR ELSON: Sure. I think independence is really a pretty simple concept. I think it means just in its essence no relationship, no financial relationship, to the company or company management other than long-term equity ownership. The theory behind it is that the view is — actually sort of two ways. Number one, independence as a director gives you objectivity in evaluating what the company management is doing. That's your job; you're to hire and fire managers and monitor in between. The only good way to monitor is if you aren't connected to the folks you're monitoring, through some relationship that may compromise your objectivity.

Secondly, independence is important because those within the organization view you as a counter-weight to management, if you will, sometimes. If a problem develops and management doesn't view you as classically independent, then nothing will ever bubble to the top. And I think some of the controversies, some of the failures that we're talking about today — we won't name them, obviously, but we know what they are — came about, at least in part, because of independence issues. Some folks will look not independent, but they might say, "Well, I may take consulting fees, but I'm an independent minded person."

Well, that may be true, but it's very tough to separate out or to compartmentalize all those relationships. And at some point, something from the back of your mind is going to leach its way into the front of your mind, and also, within the organization itself, people will not view you as independent because of those relationships. And you'll never learn all the good stuff.

MR. LOCHNER: Holly?

MS. GREGORY: Well, I'm not going to disagree with anything Charles said, because I think he's right on. It's about the ability to bring objective judgment to the table. The CEO and management need someone who can say that the emperor has no clothes. And while there may be people who have the kind of integrity that, even with significant financial and family ties to the CEO, they can really tell management the honest truth in all situations, the best we have to judge by as outsiders are these objective criteria about director relationships. And so a lot of the definitions of independence are aimed at trying to describe relationships that outsiders can look at and say, "Yes. We think the absence of those kinds of relationships makes it more likely than not that the person could bring objective judgment to the table."

MR. LOCHNER: Well, I've got to congratulate both of you on not really answering my question.

MS. GREGORY: We're lawyers, what do you want?

MR. LOCHNER: Maybe I can pose it again, and maybe a hypothetical would help. Many boards have academics as board members. If directors' fees are a significant portion of a director's total compensation, and that director does not have huge resources, family wealth, or something like that to help him along, isn't that director more likely just to kind of go along with whatever management wants for fear of losing that stream of income? And isn't that a legitimate question to raise about independence? Ann or Terry?

MR. GALLAGHER: Well, I think one of the sort of balancing factors that would off-set that kind of analysis would be the reputation of the individual. One of the reasons people join boards of significant public companies, I think, is because it's a boost to their reputation in the community, and if they are influenced simply by their director's fees to vote a certain way, I think they are in danger of ruining that reputation. And that's a very important thing. Many of the directors who are not academics, poor academics like Charles, would feel that the director's fee was minimal compared to their net worth or their present income from their primary function as a corporate officer of another company or something. So I think that counter balances the possible implication that just the director's fees would make them non-independent.

When we were setting up our first set of corporate governance principles at Pfizer many years ago, probably 11 years ago now, I discussed with our chairman what constituted independence, and we thought about putting a definition of independence into our principles. We didn't do it because we had a lot of questions about what constituted independence. We certainly were interested in all of the objective standards that people would look at in terms of independence. And by the way, we had at least one academic on the board at that time, and we did not consider that the director's fees alone would affect the independence of that director.

But after looking at all the objective criteria, the chairman really said that the independent director, as far as he's concerned, is the person who is willing to basically put his position on the line by questioning management and identifying problems with or raising questions about what management proposes. And that's the real test of independence.

And as he put it, like any good CEO, he said, I want guys who have guts. So that's another way of viewing independence. That's non-objective, and it's a tough way to try to judge independence. But as we went through the years with evaluations of the board, I think the other directors sense that in determining whether or not a director was effective, one of the things they were looking at was that kind of independence of the director.

MS. YERGER: That's interesting. I think independence is probably the most simple concept, but it's the most difficult for us to apply, because the fact is independence ultimately is a state of mind, and no definition can get at that. We at the Council have a very rigid approach to looking at the independence of directors. We look at financial relationships; we look at personal and family relationships. I think that right now there's a significant gap in disclosure. It's very difficult for shareholders to get a clear understanding of various relationships between company directors, the company and company executives. I think that is a problem. We have been asking for four years for reforms to the disclosure rules so that folks have a better understanding of what some of the links are.

Regarding compensation, we don't per se eliminate a director as independent because of compensation issues. I think last week our members met with three of the five chancellors or judges in Delaware, and they encouraged us, frankly, to broaden our consideration, to look at compensation issues for directors. I don't think there's an easy answer to that. I think it's a very interesting question. It's something that the institutional side hasn't really focused on.

Certainly some of the pay packages are extraordinary for directors. And when you're talking about folks who might not make that much in their day-to-day profession, I think it's something to think about. But at this point we haven't made one assessment or another.

MS. GREGORY: May I comment?

MR. LOCHNER: Yes, sure.

MS. GREGORY: Your question assumes that the chairman/CEO or management somehow controls who sits on the board and their ability to stay on the board. And so, if you have a really independent nominating process and you've taken control of board member selection away from the chairman and the CEO, that's another way to support independence. To me, it is a counterweight to the compensation issue.

MR. LOCHNER: Yes, Charles.

PROFESSOR ELSON: Also, too, that explains that a lot of these are pushed towards equity-based compensation for directors. The theory is that the more equity you've got, your interest is aligned with the company rather than appointing management. But of course at any level when compensation reaches such a level that a director fears losing this income stream, even an equity stream, you've got to re-think it.

But that's true of any salary range. When does salary go from being compensation to a bribe? But again, if it's equity, theoretically you've got a lot more wiggle room because your ownership interest in the company and your wealth is tied up, not in the relationship of the CEO, but in the relationship with the company itself. So if he does a lousy job, your wealth goes down. I've discovered that on a couple of occasions.

MR. LOCHNER: We have a question back here.

AUDIENCE PARTICIPANT: Well, at one of these conferences a few weeks ago at Columbia Law School, former Chairman Levitt described something that he said was a culture of seduction. Maybe the panel can comment on this, not only with respect to directors but also with respect to corporate officers. This whole notion of incentivizing through equity somehow or other became the tail wagging the dog, when you've got the various derivative devices created. It was almost a built-in disincentive to look at long-term decisions, and a roping in of the directors and officers into a kind of, to use a phrase from the 1960s, go-go mentality. A company would be growing by making perhaps imprudent acquisitions or becoming a serially acquiring company, rather than concentrating on building a better widget and developing new technologies. How do we get out of this box, if we are in it?

MR. LOCHNER: That's only if an officer or director can sell his equity. I mean, that's the whole point. In other words, the problem comes up if you use short-term informational advantages; that's really what all the controversies lately have been about — people hyped the stock, knew things were terrible, sold it, and said, "Good-bye and gee, it's not my fault." But I think that a lot of people have misread options and misread the use of equity.

Certainly options have been abused. They've become highly dilutive, and the question is how incentivizing are they? But the problem is executives who exercise options and sell the stock, or who take the stock and sell it, or directors who take the stock and sell it. At that point you're right, there is no long-term incentive. And really what that person is saying is, I found a better investment for my money, which isn't a good thing; and perhaps I have an informational advantage that you don't have and I'm trading on it. That's problematic too.

So, I think the chairman is right, it did create problems. But I think he was a little off in the sense that you can clear that up by restricting the re-sale of stock or making it tougher to sell. And I think that then the incentive is realized.

Because I think if you said, we're just going to give you cash, forget about the company's long-term health, I think that's equally problematic. Because paying everyone cash years ago got us into a malaise that led us to the whole governance revolution.

MS. YERGER: If I could make a comments on this, too. I personally believe that executive compensation is just completely out of control. It's been 10 years since the disclosure rules were changed, and you, shareholders, everyone could get a very clear idea of what executives were taking home. And we've had compensation consultants say to us, that's contributed to the escalation, because everyone starts looking at those numbers and saying, well, gosh, my peers are making more.

But 10 years ago, if an executive got an option for 200,000 shares, that was huge. You thought of him as piggy. I think it was O'Reilly at Heinz who got an option for about 200,000 shares and people were complaining about it. That is chump change today. The size of these packages is just extraordinary. And I think it has really shifted focus on the short-term side.

And frankly, I think our members are equally responsible, because institutional investors, I think, have been putting too much pressure on companies for their short-term quarterly results. And so they've been playing into one another. I personally think that the best discipline for options is to require expensing of them. Right now, companies do not have to record them on their income statements. This is very controversial. But the simple fact is, I think, there are directors who think, and we even heard this from Ruben Mark last fall speaking to our members, that these things are free, and they're not. They're very deluded investors, and I think compounding that problem is the fact that shareholder oversight of these plans has decreased a bit as companies are figuring out ways to adopt programs without any shareholder oversight.

So I think there are a number of factors that could be reformed that might help the situation.

MR. LOCHNER: Let's assume for the moment that options won't be expensed, which is what I read in the newspapers is coming out of Washington, at least in the short-run.

Then what's the sort of ideal package for director compensation? All stock? All cash? I mean, you could make the argument that options, whether they're a great number or a small number, can distort director behavior just like anything else, any other instrument. Is there an ideal package? Does it matter?

PROFESSOR ELSON: The NACD recommends the stock-cash blend with a bias toward stock — 75 percent stock, 25 percent cash — to give you the ability to pay the tax due on the stock and to align your interest appropriately. I don't think that's at all problematic, and I don't think anyone has a real beef with that.

If you go back to an all cash system, you're back to where you were to begin with, which was the problem of alignment. Management appoints you, it pays you cash, you're probably going to be aligned with management. Management appoints you but you are linked to the company in stock, you're probably going to look a little closer — long-term, but the key is you can't sell it. You've got to hold it while you're a director.

MR. LOCHNER: So, Charles, their recommendation — you said the NACD's recommendation was not grants of stock options —

PROFESSOR ELSON: No, no.

MR. LOCHNER: — but grants of stocks.

PROFESSOR ELSON: Straight stock.

MR. LOCHNER: And you're expected to hold on to that until you resign from the board or whatever.

PROFESSOR ELSON: Yes.

MR. LOCHNER: Ann, what do you think of that? What's your ideal compensation package?

MS. YERGER: It's actually very similar to where the Council is. We don't specify whether it should be options or restricted stock or whatever, but there should be a component of cash and equity in a director compensation package.

And we also believe that directors should own a meaningful stake in the company. And obviously, we don't define meaningful, because that will vary based on the resources of each individual director.

MS. GREGORY: I would go further and extend it to executive compensation as well. Why not require executives and directors to hold stock for their tenure? Stock-based compensation is designed to be a long-term incentive. It's something that you can look forward to down the road when you retire and go on to other things — to be your long-term wealth driver. A holding requirement would take away the personal incentive to focus on short-term stock price changes.

MR. LOCHNER: Terry?

MR. GALLAGHER: In the case of Pfizer, we did something slightly different in that we did phantom stock for the directors, which they could not use or do anything with until they retired. So it did align their interests with the long-term interest of the company. It was a little different from actually giving them shares.

As far as the officers are concerned, I think Holly's thought may be a good one, but in my experience, we came up with a lot of reasons why officers had to sell some stock throughout their term. There were family matters, purchase of a home, moves —

MR. LOCHNER: To buy that condo if the company won't.

MR. GALLAGHER: Right. And so there are always things in the officer category that indicated that there was a reasonable argument for selling some of the options. But absent those kind of reasons, I guess it wouldn't be bad to try to design a program that would incentivize the officer group to hold on to its stock.

MS. GREGORY: I don't buy it.

MR. GALLAGHER: You don't buy it.

MS. GREGORY: I don't buy it, because I think we should be able to compensate our senior executives well enough that they can afford the family home and their children's education without having to sell stock.

MS. YERGER: I would agree with that. We're talking here in the executive officer category about very highly compensated individuals. I have strong personal feelings that there should be very strict, if any, allowances of sale of equity.

MR. GALLAGHER: Well, the argument that was made and the situation of many officers was that the expenses increased to meet the income. And when they began to get more pay, their wives wanted membership in clubs; they wanted a yacht; they wanted their vacations in Tahiti. So there were a lot of expenses that came up that the cash compensation, private schools for children, whatever, did not cover.

MS. YERGER: These people are making millions of dollars —

MR. GALLAGHER: Well, no, no, no.

MS. YERGER: — millions of dollars. In many cases they are.

MR. GALLAGHER: Okay.

MS. YERGER: And I think we also are realizing that companies are paying for increasing portions of executives' lifestyles, country clubs, financial planning, the list goes on. And now obviously after TYCO, we learn about the apartments. They're not even paying for their living spaces in some cases. They're getting interest-free loans to buy — I'm hard pressed as a person working for a non-profit obviously not falling in the highly compensated category and managing to cover my expenses, to have a lot of sympathy ultimately.

MS. GREGORY: I'm with Ann.

MR. GALLAGHER: Well, there are exceptions and there are bad cases, but I still believe that overall the American enterprise community and the officers of those corporations are reasonable people, and people who are not getting into that kinds of excessive compensation. Certainly my experience at the company I was at, Pfizer, was that the company didn't provide anybody a home; we didn't have any country club memberships; we didn't have any apartments. We didn't have any of those kind of excessive compensation arrangements.

Our senior executives were paid well. But at times they also felt they had to exercise options in order to cover extraordinary expenses.

MR. LOCHNER: Terry, can I ask you a question and go back to something you said? You mentioned that you had adopted a phantom stock plan for directors. Why phantom stock rather than options? Or a direct grant of stock?

MR. GALLAGHER: It was just an easier way to compensate the directors, and it was tied into the stock of the company, but wasn't a straight option plan. It was just phantom stock grants that they had to hold on to until they retired. And we felt it was a better way to tie them in. We felt it was a possibility if you gave options — well, I guess you could give options and then require them to hold the stock if they exercise the option. But here they received their phantom stock grant, and they could do nothing with it until they retired.

PROFESSOR ELSON: It's also tax effective too; they didn't have to pay tax on it. It wasn't ordinary income until they retired, which makes sense, because when they retire, their income bracket was lower.

MR. LOCHNER: Yes.

AUDIENCE PARTICIPANT: Related topic, corporate charity. Should corporations make charitable donations to charities with which directors are affiliated? It was an issue with at least two of the Enron directors.

MR. LOCHNER: My guess is you're not going to find much disagreement on that subject, but Ann?

MS. YERGER: Well, personally I would say no. The way the Council's guidelines are set up essentially is that we consider that kind of relationship would make that director non-independent. We've never said that companies can't make charitable contributions. I have personal views about it, but the Council's position isn't one that restricts that.

AUDIENCE PARTICIPANT: How do you define affiliation though?

MS. YERGER: If the company made a contribution of more than, I think, 100,000 dollars or a contribution worth more than one percent of the charity's revenues, then that director would not be considered independent.

I'm sorry, let me explain. The director would have to be an officer of the charity, not simply a director of that charity.

MR. LOCHNER: Ann, going back to something you mentioned earlier, you said that the Council had gone to the SEC and asked for more disclosure which would help you determine whether directors were indeed independent. Inform us what sorts of additional items of disclosure you're looking for.

MS. YERGER: Well, initially we asked for disclosure of professional, familial, and personal relationships between directors, companies, and company officers. We had several discussions with the SEC staff, who at that time were interested in the rulemaking petition. And they said the personal is too difficult to define. I do think it's significant if the CEO's college roommate is on the board. But the fact is, I think there was a lot of debate about that. We withdrew that and amended our petition to ask for details on essentially professional and familial relationships.

For professional relationships we want greater disclosure. It's very difficult to uncover some of these relationships. And so we painted a very broad brush in terms of the kinds of information we wanted. The petition has gone nowhere. The AFL-CIO submitted a similar one in December. We haven't heard a word from the SEC on it.

MR. LOCHNER: Yes.

AUDIENCE PARTICIPANT: The New York Stock Exchange has proposed within a couple of years that listed companies, to retain their listing, must have a majority of independent directors. I was wondering, should that apply to the board of directors of the New York Stock Exchange? Aren't most of the directors on it currently with companies that have a listing on the New York Stock Exchange? I'd be interested in knowing — is that common?

MR. LOCHNER: Yes, they're not a public company yet, at any rate, but yes, my understanding is a majority of that board is made up of CEOs of companies that are listed and pay listing fees and all the rest of it.

MR. GALLAGHER: I've experienced something since I retired, and as Phil mentioned, I started doing a little bit of consulting. One of my clients is a major railroad. They operate in a good part of the country. One of their problems in finding independent directors is that just about every business in their operating area uses the railroad in some way or another, and probably to an extent that they would not normally be considered independent.

So I can see the Stock Exchange problem in that most of its universe of people who are involved in the broker's business are in some way connected with the Exchange. So if they did become a public company and needed independent directors, I'm not sure where they'd find them.

MR. LOCHNER: The other exchanges have the same problem. My recollection is that they have defined a category of so-called public directors, but I'm not sure they make up a majority of any of the exchange boards.

Let me go on to a slightly different subject. You know the press is just full of criticism in general of directors these days. I guess my question is, are we setting our sights too high? Do we have unrealistic expectations of what directors can actually do? You know the press pieces say directors are asleep at the switch, not paying attention — what's realistic? One would like to think that the Enron board, if it had been somewhat differently situated, might have asked tougher questions. But do we really know? I don't mean to focus on Enron, but — Ann, are we being realistic?

MS. YERGER: Well, I think we have very high expectations for directors. One thing that's come out of all of these blow ups, and there have been so many, I think is a realization that directors from the shareholder perspective probably aren't doing the jobs that we think they are doing.

Do I believe that directors can necessarily avoid or prevent financial fraud? I think that's very difficult frankly, and I don't think that shareholders necessarily expect that. I do think that they expect that independent directors and, an independent audit committee are going to be doing a careful job and asking enough questions that we should feel comfortable with the financials that are coming out.

I don't know what more to say. I don't want us to put too high of an expectation on the board of directors. And I think we all realize there are limitations. But at the same time, they have an important position in the whole process, and we're counting on them to do their diligence and be careful for the shareholders.

MR. LOCHNER: Charles?

PROFESSOR ELSON: I think that unfortunately a director is captive to the information the director receives. And the information the director receives comes from management or from the independent auditors or the internal audit staff. I think that the key is motivating them, once they receive information that troubles them, to act.

Can they go around ferreting out information? Probably not; it's not in their job description. And frankly, if they get too involved in the process, they're no longer monitors but they become managers, and that's sort of a mistake, too.

I think the task is how do you get good information to the board. I think, oddly enough, that's where independence comes in. Because I think that information, bad information, has a strange way of filtering up to people, those within the group feel would side with them.

There's a great story that Nell Minnow always tells. Do you remember this? You probably remember about the Sears Tower and Bob Monks. Bob Monks and Nell Minnow launched a proxy fight at Sears. They were trying to replace the board. The head of Sears agreed to meet with Bob Monks and talk about it. Anyway, he goes to the Sears building, and he and the Sears general counsel get in the elevator. They're going up, and the general counsel is taking him up to see the CEO. Anyway, they're going up, and finally the general counsel turns and says, "Wow, that's amazing." Mr. Monks said, "What?" And the general counsel said, "I just can't believe it; we're at the 85th floor." Mr. Monks said, "So, this elevator goes up by there every day." The general counsel said, "Yes, this is the first time bad news ever got by the 85th floor."

I think the point was that bad news isn't going to filter to you unless people view you as independent.

MR. LOCHNER: Yes, I think that's true. Just going back to one thing you said; you said that if the board receives or a member of the board receives troublesome information, then it's pretty clear about the need to pursue things.

PROFESSOR ELSON: Yes.

MR. LOCHNER: But those sort of red flags, however, don't happen every day.

PROFESSOR ELSON: No.

MR. LOCHNER: They appear to have happened at some companies we could all think of recently, but probably in the vast majority of companies, not. If there are no red flags, is it reasonable to expect directors to be able to really verify the annual audit?

PROFESSOR ELSON: No, that's why you have independent advisors. Your job as a director is to assure yourself that the auditor is capable, competent, and independent. That's the whole point. And I think that's what all these reforms center around.

Now the question is, if there are no red flags, if they don't bring you a red flag, what do you do? Well, you're human, and there's not much you can do, unless something does come up, and then you have to respond to it. The key is, once you do get that flag, how quickly you respond to it.

But again, you need to be, as a director I think, kind of a sponge for information. You ought to be constantly listening, reading, thinking about the thing. Information comes to you from funny sources. It can come from the newspaper, from an analyst report, from overhearing a conversation in the subway. And you have to be receptive and open to it.

MR. LOCHNER: Yes, we had a question in the back.

AUDIENCE PARTICIPANT: One of the issues relates to hiring the auditors. If you have management hiring those people, then the accounting partners are going to be more concerned about what the CFO thinks about his last bill, or what the CEO thinks about what he's actually going to save, than about the audit committee. It seems maybe part of the solution is to have some independent directors, and they are the ones who ought to be hiring the independent advisors. I think to a large extent that that's probably not happening today, and that's a good part of the problem.

MR. LOCHNER: I agree with your point that it ought to be the audit committee that hires and fires, or the board as a whole that hires and fires the auditor. My impression is, and the panel may have different views, that is more and more the practice and has been over the last couple of years.

MR. GALLAGHER: And the proposed New York Stock Exchange rules that came out last week mandate that the audit committee hire and fire the auditors, so that will come about, I think.

MR. LOCHNER: Yes?

AUDIENCE PARTICIPANT: Professor Elson mentioned monitoring, and isn't that really part of the issue here, whether the corporations have had autonomous committees that have sufficiently discharged their duties to monitor?

MR. LOCHNER: Go ahead, Holly.

MS. GREGORY: When we talk about the expectations placed on the board in this monitoring function, there is an awful lot that boards can be doing to ensure that Caremark-type compliance procedures are in place. The other thing that we can expect boards to do, which they are fully capable of doing, is to judge the credibility of members of management and the internal audit staff and outside auditors.

We can also expect directors to ask really good questions, to ask the CFO or the outside auditor, "What do these footnotes mean? Do these financials really give a clear picture?" And they can ask themselves, "Do I understand what these financials mean?" They can ask these kinds of questions.

I agree with Charles that the audit committee doesn't create the numbers. And there are issues about just what information they really have access to. Too often boards get fed information. A management team works very closely a few weeks ahead of a board meeting trying to determine what information goes to the board. Too rarely do boards really get involved in telling the management team what the information is that they expect.

MR. LOCHNER: Yes.

MS. GREGORY: That should be a regular part of the board and management dialogue. At every meeting they should be talking about what information they expect.

MR. LOCHNER: Yes?

AUDIENCE PARTICIPANT: Just a comment — I've sat on boards on and off for about 16 or 17 years in troubled and untroubled situations. I think the best defense the board has, whether it's an academic or a medical practitioner coming in from left field, is to institute processes that guarantee the kinds of questions an individual who is unsophisticated in the area can easily raise. So, the former president of the YWCA can be on a board and ask — as we all know, there's no such thing as a stupid question, and there really isn't — the key questions and feel comfortable in the environment, and set up processes whereby that comfort level is available.

To answer another question that was raised just now, I'm quoting Warren Buffet, when I was first put on the audit committee of X, I called in a court reporter to the audit committee and the lead relationship partner from the accounting firm. And I asked him on the record, with full knowledge that his answer would be filed with the minutes of the corporation, if he were in charge of running the books of this corporation, would you be doing them the way they are now being done, or would he have some suggested changes.

MR. LOCHNER: Let me ask the panel. Two specifics — I guess the question would be, are the directors adequately doing their monitoring job? That is, are they keeping their antenna up for hearing about bad news, if the company does not have a 1-800 anonymous call-in number for employee complaints, concerns, whatever, or if the company does not publish the email addresses of the directors to its employees? What do you think? Ann, are those minimums? Are those required to be really doing your job?

MS. YERGER: I don't know. We believe it's very important that there be a mechanism for shareholders, and I think probably also for employees, to contact directors. It's a huge problem that we can't fix at this point. So I don't think right now it's easy at all for folks to contact independent directors, give them feedback, whether it's anonymous or whatever, or for shareholders to contact them to talk about substantive issues, governance issues, governance concerns. So it is a problem.

MR. LOCHNER: I guess an alternative would be simply publishing in the annual report or something like that the mailing address of the directors. Terry?

MR. GALLAGHER: I'd be surprised if most corporations didn't now have a compliance officer or some sort of compliance mechanism and a mode for employees to contact that compliance officer with questions, problems, things that they see that they think are wrong. I think that accomplishes what you're after.

As far as the independent directors are concerned, it's more problematic. But one of the methods that we used was my own position as Vice President for Corporate Governance. I went out proactively to the institutions, and also the religious shareholders, the ones of both sets who were active in making their views known to the corporation. I assured them that if they told me something that bothered them — some program that they thought was wrong at Pfizer or whatever kind of information they wanted — that that information would be conveyed to the senior management and to the board.

We had a corporate governance committee of the board that we used as a mechanism. I would meet with the corporate governance committee and the board, and they met six times a year, and I would advise them of what I was hearing in the field from the institutions. I think that's a good compromise way to get through to the board whatever the concerns of the shareholders are. It worked fairly well, I think. I think the major institutional shareholders were satisfied that their concerns were getting through to the Pfizer board.

Now, the New York Stock Exchange proposals of last week mandate that a company have a nominating/corporate governance committee of the board made up of independent directors, so the mechanism will be there. What I would suggest or urge is that every corporation have somebody in its corporate setup who is designated as the corporate governance officer and will be the contact point with the institutional and other shareholders who want to say something to the board. And that person should have the mandate to convey those concerns to the corporate governance committee of the board, and through them to the board.

MR. LOCHNER: Terry, what you suggest, I think, makes a lot of sense. That is, having somebody proactively out there talking to the major shareholders. But how about the whistle-blower or the potential whistle-blower? Employees are naturally concerned about confidentiality, exposing themselves, getting fired, but may be seriously concerned about something not being right. What's the right mechanism for discovering that?

MR. GALLAGHER: Well, I think that's the compliance officer set up. I'd be surprised if most companies didn't now have some sort of set up in order to be concerned about whistle-blower situations where an employee could contact an officer of the corporation who was designated as the compliance officer. My experience has been that the person designated as compliance officer is very sensitive to receiving that kind of communication, absent a fraudulent situation such as we've had recently.

But in the normal run of the corporation's business, a compliance officer who receives that kind of letter, complaint, phone call, what have you, acts on it. He starts an investigation. He tries to find out what the situation is. He may call in an independent outside counsel to do the investigation, or he may call in an outside auditing firm to take a look if it's in the financial area.

Those kinds of things get paid attention to and I think are raised to a level at least of the senior officers of the company, if not to the board itself.

MR. LOCHNER: Holly?

MS. GREGORY: I would add to that. I think that the board needs to have a relationship with that compliance officer. There need to be regular — meaning at least annual — presentations by that compliance officer, maybe without other members of senior management present, where the board can freely ask the compliance officer about the nature of some of the kinds of issues that were investigated and weren't investigated. And, why weren't things investigated?

The other thing that the board can do in this field relates to employee whistle-blowing issues. The board should develop relationships with senior members of management who are not on the board, so that a channel of communication is developed. That's why it is so important for managers to be in board meetings and to make regular presentations, so that the human relationships develop that allow information to come to board members through informal channels in a time of crisis.

MR. LOCHNER: Yes?

AUDIENCE PARTICIPANT: I think the problem that directors have in looking over the millions and billions of dollars of affairs of a corporation is that it's a very part-time position. I always thought that it's sort of pennywise and pound foolish that directors don't, as you were saying, have a good source of information about what is going on. I assume that it would be useful for corporations to give each director some kind of a research assistant, because one of the things that happens is that you're just inundated with a tremendous amount of information — either too much stuff or not enough stuff. So that person could be like a full-time helper. I think that would be very, very helpful.

MR. LOCHNER: Go ahead.

MR. GALLAGHER: My experience was that since most of our directors were involved in other corporations, their research assistants were their own staff at their corporation. We sent out a board package, and it was basically a mini annual report every month that we had a meeting, and we sent it out a week before the meeting. Our directors would either go through it themselves, or more likely, their general counsel, their CFO, their personnel person, would go through it. I would get calls from those people saying, well what do you mean by this? Where are you going with that? So there certainly were the resources available to those directors.

Now in the case of directors who were not officers of a major corporation, they had to do it themselves. Or at least in one case we had a president of a major university, and I would get calls from his staff at the university, so he had the resources as well. So there were very few who did not have the resources to analyze and question issues that were going to come before the board.

MR. LOCHNER: Ann?

MS. YERGER: We don't really think of it as staff, but we have always felt that directors and the committee members should be able to hire their own advisors. I think that sort of a relationship can solve that issue. If you hire an expert to look at the financials or whatever, I think that can be a big help.

MR. LOCHNER: Yes, Charles.

PROFESSOR ELSON: I would kind of caution, though, against having board staff. You know there was, I guess, a proposal — I think it started with Arthur Goldberg, I guess this is probably 30 years ago now — that you have like sort of a professional staff assigned to the board, sort of a directorate group. I think the problem with that — while in some respects it's an appealing idea — is you don't want a director to become full time. You don't want a director to think of him or herself as full time, because then they become management, then they lose the monitoring.

Good directoring, I've always thought, is nuance. It's appreciating nuance; listening to the explanation that just doesn't sound quite right; or the number that you recall from an earlier meeting that suddenly disappeared from the balance sheet. That in and of itself is really what makes an effective monitor.

I think if you begin to create staffs and whatnot, you begin to lose a little bit of what you're really looking for. You need as much information as you can. But again, remember, it's nuance. And the nuance is, when do I get a funny feeling when I keep getting a strange response to this question? And that then means you just call another director and ask him, gee, what did you think about this?

Phil, you've been on a couple boards. I think you've sort of experienced that as well.

MR. LOCHNER: Yes, I don't disagree at all, Charles.

Yes, Holly?

MS. GREGORY: I don't disagree either. But I do think that there is another board role that is important to think about. There is this important role in monitoring and understanding nuances and judging credibility, but it is not supposed to be an adversarial relationship. The management benefits from having a tough board as a real resource and as a sounding board.

The board should be a place where management can test out and hone and shape an idea so that when they roll it out more publicly, the idea is well firmed up. We shouldn't lose focus on this other important role in all the talk about monitoring.

I don't know that staff could add to that aspect of what boards do. You really want those smart directors in the room largely for the judgment that they bring to bear. To have a separate staff out there ferreting out information rather than having the directors talking honestly to management about the kinds of information they'd like and the kind of support that they'd like, I think, places the wrong emphasis in what the relationship is.

MR. LOCHNER: Yes?

AUDIENCE PARTICIPANT: Holly, I agree with you in part. It seems to me that if you're in a situation where the company is doing well and it's prospering and management seems to be doing a good job, then being more collegial is appropriate. But if you're in an environment where things are troubled and there are problems cropping up and maybe issues that suggest that there might be something disturbing lurking under the surface, then you have to be even more aggressive, more hard-nosed, and frankly, less collegial. In this kind of relationship, it's a difficult balance.

MS. GREGORY: I wasn't meaning to suggest that collegiality means that at appropriate times the board isn't hard-nosed. A board really needs to be tough-minded in acting as a monitor and as a sounding board, specifically in the boom times.

Retrospectively, one of the things that we can see happened in the 1990s relates to this great boom. There's a kind of psychosis that goes with a boom. But the board is supposed to be the entity that questions whether the emperor has clothes, and it should be asking in boom times, "Are these results really based on fundamental good business or on something else?" I think that the challenge for boards is to be really tough in the good times. It's kind of easy to be tough when the red flags have all gone up. But how do we maintain that tough-mindedness in what appear to be really good times?

MR. LOCHNER: Yes, we had a question.

AUDIENCE PARTICIPANT: That's a good point, because in one example, they had to restate back to 1997. For a number of years, at least five years, there was this appearance that times were good and everything. We were all led to believe things were good, and that's really a picture often on financial statements and things like this. You swallow the propaganda that is spun by the White House or whoever's propaganda you're swallowing. And without really posing the hard questions, and Joe Mogul made a great point, I think — well, it's difficult to put this into accounting standards or in governance standards — but really is an issue.

MR. LOCHNER: Well, can I go back to something Charles raised, which is an important point? You said, gee, if you are at a board meeting and something doesn't quite look right and you read about it later on in some report you get, you call up another director, and say, gee, how did you react to this? And maybe that process raises the question which has been debated seemingly endlessly about the non-executive chairman, the lead director, and now what the New York Stock Exchange proposes, which is when the directors meet independently, somebody's in charge of the meeting.

Can I get the panel's reaction? Ann, do you think it's a good idea, and if so, would you prefer a full-time non-executive chairman or just a lead director or something else?

MS. YERGER: We actually don't advocate splitting the chairman and CEO roles. This is an issue that's actually controversial within our membership. We have some folks and institutions that feel strongly they should be separated, and others that do not. We do believe that it's important that there be a contact director — we didn't even call him a lead director — but an independent director essentially who would call and organize executive sessions of the independent directors and be the person that other directors would call and say, I think there's an issue, we need to talk about this.

PROFESSOR ELSON: See, I guess I agree with the percent of your membership who doesn't like splitting. I never thought they should be split. Put it this way. Sometimes there's a good argument for splitting them, but generally I've always seen them really not work. You create two sources of authority within the organization, and it makes for a mess.

I think also what happens is, unfortunately, it causes the other directors to sort of shirk on their duties a little bit, because they feel, oh, well, so-and-so's the lead director or the head of the board, let him worry about it. That's not very good either, because every director ought to be thinking and ferreting, if you will.

If you have a lead, there's a natural tendency amongst people that if someone else is doing it, they'll let him do it. Even though their legal duties are in fact the same.

I'm delighted with the Stock Exchange proposal on executive sessions. I think that's terrific; that's very important. But I'm not so wild about the lead director concept just for that reason.

MR. LOCHNER: Holly?

MS. GREGORY: I think the New York Stock Exchange hit just the right tone. They don't call for a lead director. They simply call for executive sessions of the non-management directors, and then recognize that somebody needs to be responsible for convening and chairing those sessions. And so they call for disclosure of a presiding director. It's a fine balance.

The lead director concept is very problematic if, as Charles points out, you give that person the authority or perceived authority as some sort of super director. There shouldn't be a super director, but certainly somebody needs to take on the responsibility for convening the outside directors so that in times of crises there is a way to get together and take action.

MR. LOCHNER: Terry, did Pfizer have a lead director?

MR. GALLAGHER: We didn't have a lead director. One of the things I discussed with the institutions over a period of time when they were pushing for lead directors was basically our program. At Pfizer, it was understood within the board when there was a need for an executive session of the board, and we had one standard executive session of the board each year without any management directors present, including the chairman. So there was that standard meeting. But if there was need for another meeting, it would be chaired by the head of one of the three committees. We only had three committees. We had the compensation committee, the audit committee, and the corporate governance committee. Whoever's jurisdiction the problem fell in would convene that meeting and would chair that meeting.

That was the understanding of the board, and that's what I told the institutions. Basically, or for the most part, they bought that as being a good program. So when I read the New York Stock Exchange proposals, I was just wondering whether you could name three people as being leaders or conveners of those meetings, depending upon what the issue was. It seemed to work at Pfizer. It seemed to be acceptable to the institutions, so we'll find out whether the Stock Exchange will buy that kind of approach.

MR. LOCHNER: Yes?

AUDIENCE PARTICIPANT: We keep circling to this proposal from the New York Stock Exchange, and the reason I'm asking this question is because of the *C.S. First Boston* case. The *C.S. First Boston* case was the first time the SEC had stated exchange rules as even a partial basis for enforcement. So my concern is, if these become rules of the New York Stock Exchange and are followed and imposed, is there any real threat that the SEC may at some point in time decide to make these rules the basis for enforcement action?

PROFESSOR ELSON: Sure, Delaware certainly will. The Delaware courts have really basically adopted most of these principals and the way they view board conduct. Effectively, they have become legal rules, I think.

MR. LOCHNER: Yes?

AUDIENCE PARTICIPANT: I think this really boils down to a fundamental issue, with all due respect to Delaware. Aren't there certain areas where corporate governance, which you've all been talking about today, is so intimately related to the nature and quality of things that governance is regulated by SEC security forms — annual reports, proxies, financial statements? Ms. Gregory's partner, Harry Olstein, has a panel about best practices. The problem I have with it, and certain former Commission officials and leaders have with it, is that we always wind up going back to the Exchanges. We have this voluntary system of, well, you know, we have to rely on the Exchanges, or that panel relied on best practices disclosure, so that these corporations will be shamed into saying something.

Since the whole concept of interstate commerce is commerce across state lines, why can we not have a corporate law that will further federalization?

MR. LOCHNER: That's a terrific question and a great lead in to the next point I had on my outline, which is we have a lot of activity going on in Congress, a variety of laws being considered. I am uncertain which ones, if any, will pass, at least in this session. But I'll state the question two different ways, and the panelists can choose how they want to respond.

Is there some law that, had it been on the books, would have prevented Enron? And secondly, is there any law, such as the one suggested just a moment ago, which ought to be on the books, whether or not it would have prevented Enron? It just is something that needs to be covered?

Charles?

PROFESSOR ELSON: I think it was Bill Carey years ago called for a federal corporation code, federalizing the corporations. I have some problems with that for a lot reasons. I'm from Delaware. I'm a taxpayer. I find a federalization of corporation law problematic for a lot of reasons, ignoring the Delaware point.

I think that there is an argument that, well, interstate commerce shouldn't this be subject to regulation. Suppose we took these corporate governance guidelines and standards, and enacted them into law. Let's just say there was a federal law that says thou shall have independent directors. Would that have necessarily stopped Enron? I don't know. I think management fraud is always going to exist, whether you have law or not.

The question is, how do you respond to it? Had the board, let's say, in Enron been independent, maybe they would have reacted sooner. Would they have stopped what happened? Maybe, maybe not. On the other hand, certainly there would be the better chance for that had you had independent directors. But again, is it best to have the law itself define independence, or is it best to have those that invest capital to define independence?

And this comes back to Ann and the Council of Institutional Investors. Really, what it comes down to is, will people contribute their capital to organizations that safeguard that capital? And those who contribute can always get, from those to whom they provide capital, assurances that it'll be protected — a la, independent boards.

I think that's why you've seen these things as listing standards as opposed to law. I sometimes find that when we codify things, we tend to create form over function to respond to law rather than to respond to the nuance of the law. What troubles me about federalizing all this stuff is that we'll end up creating a check-the-box culture that in the end does no one any good.

But I'm interested in everyone else. This is a good law school point.

MR. LOCHNER: Ann, does the Council have a view?

MS. YERGER: I'm scared because I think I'm the only non-attorney up here, so I'll give you just my practical view of this. I just think our current system is ridiculous — the state laws. We've got the listing standards; there's federal securities laws. It doesn't make any sense. And I'll tell you, the fact that the Council is holding on to the New York Stock Exchange as being the reformer in all this is extraordinary.

We have never been pleased with the job of the New York Stock Exchange in terms of protecting investor rights. It is proposing changes to rules that have been in place since the 1950s and some since the 1930s, and we have been pushing for reforms for all these years. The New York Stock Exchange brings the straight thing out. NASDAQ has nothing essentially; that's a disgrace. I don't think they're interested in the least in moving forward.

I think the New York Stock Exchange will be under terrific pressure from its vested interest groups to back off significantly. It will. And investors are left essentially with a system that does not work, and which I do not think is offering adequate protections.

But look at Congress. It's not doing anything either. We're in an election year, and I don't think anything's going to come out of that. So investors are sort of left begging for somebody to help us out here. I think, personally, it's ironic that it looks like now it's the New York Stock Exchange.

MR. LOCHNER: Holly, do you have a view about federalization?

MS. GREGORY: I have to disclaim, I'm a bit at a disadvantage because I can't talk about Enron at all. We are bankruptcy counsel. We were not counsel to them before —

MR. LOCHNER: Good disclaimer.

MS. GREGORY: But we are counsel, and so I cannot speak about Enron, nor do I want any of my remarks to be interpreted as being about Enron.

You've posed a great question. It's one that, as Charles pointed out, we've been struggling with for decades. This notion of federal chartering and federalizing corporate law comes up every 20 years or so when we get involved in a great debate. There was a great debate in the 70s. The American Law Institute's *Principles of Corporate Governance* were a reaction to the calls for federal chartering that came out of a series of bribery scandals — *Penn Central* and those cases. These were also the cases that led to the formation of audit committees, the New York Stock Exchange requirement that companies have audit committees, and the first requirements that at least some members of the board must be independent –- for audit committee purposes.

Approximately seventy-five percent of listed companies on the Stock Exchange now have a majority of independent directors, even though there is no requirement at all that they have that. This has come about through a combination of listing rules requiring independent directors on audit committees and recognition that independence helps protect boards and directors from lawsuits due to a series of cases that have come out of the Delaware courts.

It's been interesting to see it evolve. We have a very unique system. I'm somebody who thinks it works. It's interesting how it's been formed. I don't like the notion of heavy, heavy regulation in corporate governance, because I think we have different needs at different times.

Recent events show that we react to failures in some very positive ways. Look at some of the high profile corporate failures in the last nine months and think about what the reaction would be if this were in Japan or in France or in Germany. The first reaction would be denial — keeping it quiet — with the cross-relationships of companies enabling them to transfer assets to make everything look okay. And then government would come in and try to make everything look okay. And Japan is still in that mode.

Here in the United States we have a very, very different system. At the company level, we have bankruptcy, which is fairly quick. And at the system level, everybody starts to analyze how we can fix it, how we can change it. We go through this great self-study, and then we improve. And then, yes, there'll be another scandal in five years, and we'll tinker with something else. But wholesale change, I think, is overblown.

MR. GALLAGHER: I would agree with Holly in that the American enterprise system, I think, needs the freedom and the flexibility of the present system. I think a federal incorporation would mandate too much, put us into too much of a box. We really have a system that has produced the great advances in the United States economy and the productivity in the operation of businesses, and the discovery of new products. The pharmaceutical industry, with the discovery of new drugs, is really a unique United States phenomenon.

There are very few countries around the world that allow the freedom to their corporations that would produce those kinds of results. So I favor the present system as an endorsement of the American enterprise system.

MR. LOCHNER: Yes?

AUDIENCE PARTICIPANT: Many years ago in a burst of irrational exuberance as a young lawyer, I actually read the entire legislative history of the '33 and '34 acts. And I have to tell all of you that if you go back and read that history, it's really an eye-opener. The reason we have the '33 and '34 acts is that there were a series of huge scandals that rocked Wall Street prior to the enactment of those laws.

They were so serious; there were massive pyramid schemes and massive fraud everywhere. And what happened as a practical matter is the American public lost confidence in the markets and stopped investing its money. The Douglas Commission, of course, came in and recommended these reforms, which entailed enacting this legislation and the subsequent regulatory scheme, to get the public back to the markets.

We've got a hiccupping market in the midst of an economic recovery because of the current scandals. And the issue is, will the public come back to the markets?

One other point: the vote in the Congress of the United States for the '33 and '34 acts, which stunned me when I read it, was unanimous. The entire Congress unanimously voted for these regulations. The reason was Wall Street went to Washington and said, rescue us. We can't get people to put their money in the markets.

So my point is that it's the American public that's going to be the ultimate determinate of whether there is significant additional federalization and reform. If they'll come back to the markets under the current system, despite these scandals — because what's been challenged here is the notion that the independent board system and the public accountancy system are supposed to be protecting the public. If the American public has lost confidence in these major safeguards, we have a problem. And we're going to need more legislation; that's my point.

MR. LOCHNER: Yes?

AUDIENCE PARTICIPANT: Thank you, I appreciate that you've brought up that point. My experience was doing recap work on sick banks and thrifts back in the late 1980s and early 1990s. To perhaps give you background information, I think you're actually talking about a lot of the propaganda that's been disseminated. The whole repeal of Glass-Steagall came about in part because the economy pretty much cratered during the Newburg administration and the Fed was lending money to Britain.

Roosevelt had closed a significant number of banks and they selectively chose which would reopen. It really wasn't an issue that the public was afraid of what was happening in the markets. And you didn't have a great participation of the American public in the markets at that point.

And the fact that he selectively chose which would reopen really left a lot of the American public pretty much on the skids in part, because if one's banks didn't get reopened and he didn't have access to his money, it was gone.

Having said that, that meant that there still had to be a level playing field and you couldn't have insiders enriching themselves.

MR. LOCHNER: Well you've both raised a very important point, which is attracting investors into the market and driving investors to participate in the market as opposed to put their money in CDs.

A related issue is, and I've heard this everywhere — from search firms, from companies — that it is increasingly hard to find people who are willing to serve as directors. If you want the directors to be the watchdogs and the activists on behalf of the shareholders, where are those people going to come from?

Among the changes suggested probably at the moment of the highest confusion about Enron was doing away with directors and officers insurance. Surely, you would have very few directors after that move. But I guess I'd be interested in a couple of things from the panel. One: is the perception I have that it's harder and harder to find good directors, correct? And if that's true, what do you do about it? Is this a public policy issue that needs to be addressed? Is it a compensation issue; are we underpaying directors for what they're being asked to do?

Charles?

PROFESSOR ELSON: I think there is a real fear for directors, who say, "Do I really want to subject myself to these problems? Do I want to subject myself to the embarrassment? Do I want to subject myself to the financial risk of going on a board?"

The danger of being a director is not what you know, it's what you don't know. And you have no control over what you don't know, unfortunately, in many circumstances. What is going to happen is you're going to get people eventually who go on boards who have no assets to protect and no reputations to protect. And that's exactly who you don't want as a director, people who don't care about their reputations and have no assets.

MR. LOCHNER: Sounds like my dog.

PROFESSOR ELSON: But I think that that's a real problem, because I think you really want people who are talented and who value their reputations and who have been successful in life to go on these things. I think they make the best monitors. But I think you can create a climate where they say, "I can do nothing right," if you will. The two most thankless jobs in the world, in my view, are being on the board of a country club and being on an audit committee. Nobody ever says anything nice to you, and no one ever says, "gee, thanks." It's a lousy job.

I think because there's no upside. It's all depressing. No one says thanks for the good job; it's always, "Here, let me tell you what's going wrong."

MR. LOCHNER: So what can we do about that? How do we change that?

PROFESSOR ELSON: With respect to the liability system, I'm sort of more of an equity bug. I believe in private incentive rather than external incentive to act appropriately. I'd rather see a liability system that protects against self-dealing, which I think is pretty easy to stop. In other words, stealing from the company, sort of the things we've seen a lot lately, versus just plain old slothiness; how do you protect against it?

D & O doesn't protect you from self-dealing transactions anyway.

People who steal aren't protected by D & O. D & O is really just there to protect the slothy action. The question is what is slothy, what isn't, and is litigation the best way to prevent slothfulness? I've always felt it has to do with equity and retooling the duty of care to be more equity-based, a la stock base, that is.

And I think beyond that, if you don't remove the fear factor, you're going to have a tough time recruiting good folks. Now we've said that all along, and you had these big things in the 1970s and 1980s where there were a lot of suits. People said people won't serve as directors. And there was, after Van Gorkum, a bit of a falling off.

On the other hand, I do think that today the crisis is real. I think it's a very different story. You didn't have directors hauled before Congress in the same manner that you did recently. I think it's becoming sort of a dangerous job. I think you're going to prevent the really strong people from going into it.

There's no way that a former accountant will go on an audit committee these days, or at least admit that he was a financial expert, for obvious reasons.

But I don't know. Ed, what do you think?

AUDIENCE PARTICIPANT: I believe that equity is an important factor, but it can't be the only one. There are lots of people who have lots of equity who want more. And they want to get it the wrong way. I don't want to prejudge the McNulty case, but they even borrowed money to invest in their company. They borrowed without telling anybody about it in the company. But they wanted equity.

The range of directors runs from Vic Depose on the one side to Warren Buffet on the other. In between there's this huge bell curve. In that bell curve there are people who will be incentivized by equity. They'll be people who'll only not do something wrong because they will be punished for it. And you have to have sufficient safeguards and sufficient tools in place to reach out to those directors.

And particularly in the last 10 years when we've had a tremendous number of young promoters and young entrepreneurs having no real knowledge of the system in control. They have to know that if they do something wrong, bad things will happen to them, whether it's financial or criminal. But there has to be some disincentive to doing the wrong thing, and those disincentives have to be financial, and possibly criminal under certain circumstances, but certainly financial. It has worked reasonably well up until the last two years in terms of disincentive.

PROFESSOR ELSON: And I agree with you, Ed, vis-à-vis self-dealing. I totally, completely agree. But I just think care's a little tougher.

AUDIENCE PARTICIPANT: I think it's more than self-dealing. You look at the headline of who was arrested yesterday for maybe self-dealing. You also see the disregard for the importance of transparency in transactions. Even without that, you have to have a serious disincentive to people not making full disclosure of their doing.

MR. LOCHNER: Ann, does the Council have a view as to whether directors ought to be paid more in order to attract the right people; whether they ought to be subjected to greater liability than they are now? Where's the Council on these issues?

MS. YERGER: We haven't taken a position on these issues. We've never set a dollar amount that we think is appropriate that directors need to get paid. I think companies have to make that decision on a case-by-case basis. Having said that, shareholders and investors have high expectations of directors, and I think they need to be paid appropriately. I don't think a $20,000-a-year retainer is probably adequate for what we're expecting of our directors.

I think investors are pretty reasonable. I don't think they get very upset when you see director compensation packages, unless they seem to be completely out of whack.

In terms of liability, I think we don't have a formal position, but I think there's a clear sense, having read all these headlines, that people need to be liable. Someone should be liable for some of these activities.

I'm not an attorney, and I wanted to pose this question because we keep hearing directors concerned about liability. When has a director ever had to pay money out of his or her pocket? Has that ever happened?

PROFESSOR ELSON: Only if they've been stealing.

MR. GALLAGHER: Yes, Al Dunlap and Sunbeam.

MS. GREGORY: Not as a director, he was a CEO.

MR. GALLAGHER: That's right, he was CEO.

MS. YERGER: It's just rare, I think, that ultimately a director has to pay out money. What happened there was just outright fraud. Who has sympathy for someone who has to pay in those cases?

MR. LOCHNER: Terry?

MR. GALLAGHER: Does anybody think that the director education programs that are being proposed would help to solve this? My personal view is that they probably won't, that they probably won't make much difference. The New York Stock Exchange and some of the others are feeling that directors, or the people who will become directors in the future, because of having to reach out past the CEO of other companies or the CFO, need to have a director institute or a director education program.

Charles, you might have some self-interest in that.

PROFESSOR ELSON: Totally. I think it'd be great.

MR. LOCHNER: Let's hope it's more effective than continuing legal education in the legal profession.

Yes, Holly?

MS. GREGORY: The emphasis by the Stock Exchange on director education is important because it helps send the message that being a director is a real commitment. I don't know that actual director education will add a whole lot, but it's important for directors to understand that they're really taking on a commitment and there's time and effort and expertise that's involved.

Going back to the issue of the difficulty in recruiting directors, we continue to look at the same small pool of potential directors. However, there is great value to be had if we stop looking only at other CEOs as the directors everybody wants on board. This focus on other CEOs causes some of the cultural difficulty in getting boards to activate, because every CEO on the board wants to treat the CEO of the company as he wants to be treated.

In truth, we have a huge amount of untapped talent in this country and in other places, below the CEO level. Look around this room. There are a lot of people here who aren't CEOs but who would make mighty fine directors. These people are not yet really being tapped.

MS. YERGER: I agree.

MR. LOCHNER: Yes.

AUDIENCE PARTICIPANT: I've been the general counsel for 20 years and on three boards, and I can give you some observations that we're talking about 80-20. Eighty percent of boards are good, and the 20 percent that are going to steal and commit fraud are never going to get trapped anyway.

Number two, disclosure is critical because I have sat through board meetings where directors don't want to disclose something because it's embarrassing and they've changed behavior. In fact, the SEC went the other way in the last five years; they reduced the amount of filings for activities of insiders consciously. Our filing level went down. So the SEC actually reduced the burden on most insiders over the last few years. If they had escalated, I think Enron might not have been as disastrous, nor might Tyco have done what they were doing. They were selling back to the company, and they didn't have to disclose it for a year.

Number three, I think the process has to change. I think boards are intimidated by domineering CEOs and chairmen. I've watched it. I was on one board where the majority was a football team from the chairman's college. It was not disclosed because football affiliations weren't required.

MR. LOCHNER: I want to know whether the CEO was the quarterback or what?

AUDIENCE PARTICIPANT: He was the linebacker.

MR. LOCHNER: Good, good.

AUDIENCE PARTICIPANT: The chairman of the conflict committee was the quarterback. Those are all true facts.

Then I was on a board where the chairman, his brother-in-law, his son-in-law, and his brother were all on the board. Everything was disclosed; it didn't make any difference; the chairman drove the board. He dominated those people. And I watched it. Even into bankruptcy and in reorganization, he still dominated. And it didn't make any difference who the CEO was. So, I think you really need separation between the independent directors and the CEO, regardless of whether they're good people or not good people. They have to have a chance to communicate. Because the domination in that room, if they're all sitting there at the same time, is just human nature.

I've never seen most board directors raise a whole lot of questions in a group setting with the CEO sitting there. It just isn't going to happen. The third thing is, you're going to have to change some laws. Because frankly, unless you mandate certain things, they're not going to change. You need to reduce the amount of theft potential. But the reality is, it really gives everybody a little more comfort. How much control have the institutions been able to exercise over two-and-one half trillion dollars the last 10 years? About zero.

We're all victims of the situation until people decide it's gotten so bad that we're going to have to make some changes. I'm not a big believer in regulation. I don't think federalization is the solution. I think 80 percent of the time people try to do the right thing. Most directors really don't know exactly what their job is. That's what general counsels do, they educate boards, they give them a lot of material to read. Directors try to read it, and they try to be conscientious. So 80 percent of them aren't doing a bad job. Incompetence is happening. Companies fail because they're just bad companies.

What we've seen a lot of lately is companies failing because they're crooks. That doesn't get you to the real problem with corporate governance, where you need some independence on boards. Board members need to have the feeling they can talk among themselves. It's process and disclosure.

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