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“Restoring Trust” or Losing Perspective?

Much press has already been generated by the “Report on Corporate Governance for the Future of MCI” prepared by Richard Breeden, the court-appointed “Corporate Monitor” for the bankrupt WorldCom/MCI, in which Breeden grandiosely proposes not only to reform scandal-plagued WorldCom/MCI, but to provide a “blueprint for a system of corporate governance” that Breeden apparently believes is applicable to all public companies. His report, entitled “Restoring Trust,” contains 78 specific recommendations intended to address WorldCom’s egregious governance and management failures, as well as other musings on topics ranging from the proper size of employee retention programs to the future of corporate financing techniques such as tracking stocks.

WorldCom/MCI is, of course, the poster child for the many corporate scandals of the late 1990s and early 2000s, and a case of unprecedented financial fraud that warrants very strong responsive measures. But removed from the WorldCom situation, Breeden’s report is not really a “blueprint” so much as an unfiltered laundry list of virtually all of the various types of reforms already considered at great length by everyone from Congress and the SEC to the stock exchanges. Individually, many of the recommendations make sense, and some have been endorsed or adopted in the Sarbanes-Oxley Act and its implementing SEC regulations, the proposed stock exchange rules and numerous other best practices recommendations from many quarters. But many others of Breeden’s recommendations have long since been rejected by the regulators and lawmakers who have spent much time and effort considering these matters. And for good reason: Taken as a whole, Breeden’s recommendations would straight-jacket and enfeeble boards of directors and undermine their ability to effectively guide their corporations — the exact opposite of what Breeden says he intends, and the exact opposite of what is needed in the current environment.

In short, calls to use the WorldCom report as a blueprint for further governance reforms must be resisted. Wanton piling-on of further new rules and restrictions will be counterproductive. We discuss below some major areas of concern.

Shareholder Control of Nominating Process. The report would require corporate governance committees to organize and recognize a “shareholder committee” comprised generally of representatives of the company’s 10 largest shareholders to participate in the director nomination process. If this shareholder committee does not agree with the recommendations of the governance committee (already composed solely of independent directors), then the shareholder committee would be entitled to include in the company’s proxy statement one nominee for each vacancy in that year.

As we pointed out in our memorandum of August 15, 2003 (which urges rejection of the SEC proposal to grant proxy statement access to activist shareholders who want to elect their own director), it would be a serious mistake to allow this level of shareholder control over board nominations. Companies that follow Breeden’s recommendation would, among other things, risk severely disrupting the proper functioning of the board by introducing special interest

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directors. Special interest directors frequently have agendas that are distinct from — and indeed may be contrary to — the interests of the corporation as a whole or of the corporation's shareholders other than those who nominated them.

Over-engineering of Board Composition and Board Functioning. The report requires: (1) that the entire board, other than the CEO, be independent (in contrast to the judgment of the NYSE and almost all others who have considered the question that a majority be independent); (2) that the company adopt detailed qualification requirements and limitations for board members, including as to the variety of experiences among the directors and the amount of prior public company board service, additional qualification standards for membership in each board committee (financial experience for the audit committee, compensation experience for the compensation committee, risk management experience for the risk management committee, etc.), and even more extensive experience requirements for the non-executive chairman; and (3) that at least one new director be added, and one director removed to make space, each year.

There is no formula for the perfect board. Strong, independent directors are essential to proper board functioning, but so too are elusive qualities such as collegiality, sense of common purpose, energy, industry knowledge, business sense and trust. Each company, through its independent nominating committee, must have the flexibility to determine the mix of qualifications and attributes that is best suited to the specific needs of the corporation. For example, business realities and the best interests of the corporation often make it advisable for the board to include members of management other than the CEO, or to include former executives or advisors to the corporation who do not meet the strict definition of independence. Excluding these categories of individuals entirely — as Breeden proposes — makes no sense. Indeed, if we consider all of the limitations and requirements that Breeden seeks to impose on committee members and the board as a whole — three directors with financial experience for the audit committee, three with compensation experience for the compensation committee, three with governance experience for the governance committee, three with risk management experience for the risk management committee, and most with extensive prior service on public company boards — it is not clear that it would even be possible for most companies to assemble such a board, let alone consider such other subjective qualities and attributes that might make for strong and valuable directors.

Overly Burdensome, Unduly Limiting "Reforms". The report proposes several requirements that would disrupt the operations of the company and limit the ability of directors to fulfill their fiduciary duties, without significantly contributing to the goal of improving corporate governance. Examples of this include: (1) a requirement that the company establish a permanent electronic "town hall" on its website where shareholders can post proposals for corporate action, and a requirement that any resolution supported on the website by more than some minimum number of shareholders (the report mentions 20%) be included in the company's proxy statement for its next annual meeting; (2) highly detailed requirements regarding day-to-day management (such as detailed disclosure practices and enhanced reports of cash flows); (3) a requirement that most of the key proposals be included in the articles of incorporation, which cannot be amended without a shareholder vote; (4) strict, numerical limitations on executive compensation and executive retention decisions; and (5) prohibition against the use of effective takeover defenses (including standard shareholder rights plans and staggered boards), thereby

depriving the company's board of the essential tools needed to ensure shareholders are treated fairly and equally in the takeover context.

These proposals would impose severe and unnecessary administrative burdens, threaten to divert the attention of the board and management away from the business of the corporation and suggest an environment of governance by "checklists" rather than true good governance. Moreover, Breeden's recommendations would interfere with the board's ability to make the key policy and strategy decisions that the board is legally empowered and required to make.

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Breeden's report is a case-specific set of recommendations seeking to right the wrongs committed by a most extreme example of corporate wrongdoing. The report should not be considered a model, or even an appropriate proposal, for corporate governance of a public corporation. We have witnessed sweeping reforms in this area in the recent past, and we must now focus our attention on implementing those reforms — on complying with their spirit as well as their letter and, most importantly, on getting back to business.

Martin Lipton
Mark Gordon
Laura Muñoz