

# Scandals Prompted Changes, But Critics Say More Are Needed To Prevent Another Enron

By CAROL HYMOWITZ  
And JOANN S. LUBLIN

**A** YEAR HAS PASSED since regulators told U.S. businesses the old style of corporate governance couldn't continue in the face of scandals at Enron, Tyco, WorldCom and elsewhere. Directors of these companies had missed or ignored the problems, some of which involved fraudulent accounting schemes.

The Sarbanes-Oxley Act, signed into law last July 30, along with rules proposed by two stock exchanges, have spawned dozens of overhauls for publicly traded companies. They include more separation of the jobs of chief executive and chairman, and the appointment of more independent directors who don't have business ties to the company. Board audit committees, which are supposed to monitor a company's books, must now have at least one financial expert—or explain why they don't. The full audit committee must review financial statements every quarter after the company's CEO and chief financial officer certify them.

## CORPORATE REFORM: THE FIRST YEAR

It is far from certain, however, how much better public companies govern themselves than they did before the reforms.

Certainly, the reforms have raised awareness of honest procedures and the criminal liabilities of not following them. The changes may finally put an end to the country-club atmosphere of boards, where members care more about their resumes and networking than about guarding against corruption. And they have shifted some power from CEOs to boards by requiring outside—or nonmanagement—directors to hold frank discussions privately.

Still, critics say the new regulations have buried directors in extra paperwork while failing to address the issues close to the heart of the average investor: overgenerous executive pay, little evaluation of directors' own performance on the board and a feeling among shareholders that they are left out of the director-selection process. And there still isn't an easy way for corporate whistleblowers to communicate directly with board members.

Some also worry that if boards and management focus primarily on compliance, companies will become risk averse. It will result in fewer strategic questions being asked, such as, "What makes your company distinct and why do you think you can achieve your strategy?" says Steven Reinemund, chairman and CEO of PepsiCo Inc.

Here are five critical areas where overhauls have been sought.

### Audit Committees

Sarbanes-Oxley has prompted greater vigilance by the audit committees that oversee a company's accounting practices. Many audit committees are spending far more time than they used to reviewing financial statements and overseeing auditors, meeting 10 or 11 times a year, up from three or four times. As a result, "they are better equipped to

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head off trouble," says Barbara Hackman Franklin, who heads the audit committees at Dow Chemical Co. and Aetna Inc., and also serves on audit committees at two other companies.

Before convening an audit-committee meeting at Dow Chemical earlier this month, she sent other members nearly 100 pages of reading material. "Does this [extra work] mean we will never have another Enron scandal? I think not," concedes Ms. Franklin, who is an international business consultant and former U.S. Commerce Secretary. "If management is being dishonest, it still will be hard to get to the bottom."

Other audit-committee heads are trying to avoid accounting problems by supervising outside audit firms more scrupulously. Sarbanes-Oxley says audit committees must change their auditors' lead audit partner every five years.

Roderick M. Hills decided to make that switch even sooner. The former Security and Exchange Commission chairman took charge of Chiquita Brands International Inc.'s audit committee when the Cincinnati food producer and distributor emerged from bankruptcy protection in March 2002.

He and committee colleagues chose Jim Havel, managing partner of Ernst & Young's St. Louis office, to be chief auditor. Mr. Havel says it was the first time in his 27-year career an audit committee—instead of management—decided whether he would lead a client's audit work.

Mr. Hills got Mr. Havel to take a fresh look at how Chiquita accounts for buying boxes of bananas. The company was using a weighted-average price per box that didn't reflect the actual cost, which var-

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ies by season. "It was a way to smooth earnings," Mr. Hills says.

In May, Chiquita said it was embracing "an actual costing method, which recognizes costs as incurred" for some expenses during interim periods.

Yet numerous audit-committee members lack sufficient knowledge to review financial statements, says Roman Weil, an accounting professor at the University of Chicago's Graduate School of Business. At recent governance seminars jointly sponsored by Chicago and two other universities, 70% of about 500 participants who took Mr. Weil's test of basic accounting principles got a failing score.

Many were top executives serving on audit committees. Most didn't understand how to question auditors. "The only thing certain on a balance sheet is the date. Everything else is a judgment," says Mr. Weil.

"Directors need enough business acumen to understand and smell the difference between right and wrong, so they perform their chief duty to be a check and balance to management," says Mr. Reinemund.

#### **Shifting Power to Boards**

Not surprisingly, many corporate boards are hiring lawyers and consultants to advise them on their expanded duties and liabilities under current and pending reforms. But they sometimes find themselves spending too much time listening to advisers, rather than attending to the company's business.

At one recent board meeting he attended as an outside director, Jeffrey Rodek, CEO of **Hyperion Solutions Corp.**, realized soon after a consultant began speaking he had heard an almost identical presentation from another consultant

at a different company's board meeting.

Nevertheless, the pending stock-exchange requirements that outside directors meet separately from management is prompting more assertiveness.

Richard Koppes, an outside director at **Peregrine Systems Inc.**, saw this change at his first board meeting in April at the San Diego software company that is in bankruptcy-court proceedings. CEO Gary Greenfield, who had joined Peregrine after it uncovered accounting fraud last year, told Mr. Koppes and three other new outside directors that he also wanted to be board chairman. Mr. Koppes, counsel to **Jones, Day, Reavis & Pogue** in Sacramento, Calif., disliked the idea—and worried he would be the only dissenter.

But when Mr. Greenfield left the room so directors could discuss the issue privately, Mr. Koppes learned he wasn't alone. "Everyone said we needed an independent chairman," he recalls. "It was an acknowledgment about the environment we're in and what was needed to avoid future problems at the company."

Mr. Greenfield was turned down.

To gather more information, separate from what they are told at board meetings, more directors are visiting company locations. Among the corporate governance changes **General Electric Co.** initiated this past November is the requirement that directors visit two GE businesses each year without the presence of corporate management.

That is a start, but likely won't yield enough information, says Paul Lapidés, head of the Corporate Governance Center at Kennesaw State University in Marietta, Ga., and a director at **Sun Communities Inc.**, Farmington Hills, Mich. He says he

would understand the real-estate investment trust company better if he visited between six and 12 of its 130 manufactured-housing communities every year. He currently visits one property a year. "You can't ask tough questions if you don't know what to ask because you don't know the people" below senior management, he says.

### Avenues for Complaint

Many companies have set up hotlines to take complaints from employees, investors and others about ethical misdeeds. But executives often screen those confidential complaints before sharing them with directors.

Few board audit committees have the procedures required by Sarbanes-Oxley to receive inside complaints about accounting problems. One exception is Pfizer Inc. Its latest proxy divulges e-mail addresses for outside directors and committee chairs. "We haven't gotten anything of significance—yet," says Robert N. Burt, Pfizer's audit committee chairman and the former CEO of FMC Corp.

### Choosing, Evaluating Directors

Seven out of 10 boards still don't evaluate the performance of individual directors, enabling those who contribute little to keep their seats.

Neither Sarbanes-Oxley nor the exchanges require any mechanism for assessing and removing weak directors. Many directors are reluctant to disturb the decorum and collegiality of the boardroom. "That is why you see only 30% of boards evaluating individual members," says B. Kenneth West, a former Harris Bank chairman and CEO who has been a Motorola Inc. director for 27 years.

Directors at some companies have

even refused to ask a failed CEO to leave the boardroom. In October, Gary Wendt abruptly resigned as chief executive of Conseco Inc. after two disastrous years at the helm. The insurance and finance company filed for bankruptcy-law protection two months later. Yet Mr. Wendt remains chairman. He stayed "to lend his help" to management's restructuring efforts, Conseco spokesman James Rosensteele says.

Mr. Wendt is expected to relinquish the chairmanship when Conseco emerges from bankruptcy, which could occur next month.

Since July 2002, the SEC has barred just two outside directors involved in business scandals from joining another public company's board.

### Executive Compensation

One big governance problem yet to be tackled is executive compensation. Though the popularity of stock-option grants has dimmed in the bear market and bonuses have shrunk, CEO candidates and incumbents still command enormous packages that reward them regardless of performance.

Christopher Galvin, Motorola's chair-

man, CEO and grandson of the founder, collected a \$1.5 million bonus during 2002 after receiving none in 2001. His salary stayed flat at \$1.275 million for the third straight year during 2002, a year in which Motorola returned to profitability but saw its stock fall by 42%.

At the company's annual meeting in May, several investors denounced Mr. Galvin's compensation package amid a depressed share price and extensive layoffs. The Motorola board's pay panel granted him a bonus last year partly because "the Company exceeded the vast majority of the financial metrics that it set out to achieve in 2002," the latest proxy statement says.



**Question of the Day:** *Has the Sarbanes-Oxley law reduced corporate mischief? Visit [WSJ.com/Question](http://WSJ.com/Question) to vote.*



**On the Air:** *CNBC will be airing special reports all week on the first anniversary of Sarbanes-Oxley, including interviews with Journal reporters.*

# Independence Of Directors Is Elusive Goal

By JOANN S. LUBLIN

**T**HE OLD-BOY NETWORK is under attack in boardrooms across the land.

The corporate-oversight law known as Sarbanes-Oxley, combined with rules proposed by two stock exchanges, require greater independence by corporate directors. The year-old law states that no members of a board's watchdog audit committee may take fees from the company other than for their board service. Two stock exchanges want boards to have a majority of independent directors, meaning they aren't affiliated with the company in any way.

As a result, many directors face criticism for activities that would have been overlooked a few years ago. A surprising number maintain business and personal links to the companies they serve. Here is a look at three such directors: former Sen. George J. Mitchell, Alabama glass contractor Larry D. Stripplin Jr. and Silicon Valley power broker Larry W. Sonsini.

## George J. Mitchell

When Maine Democrat George J. Mitchell retired as Senate majority leader in 1995, Walt Disney Co. Chief Executive Michael Eisner offered him the company's presidency. But Mr. Mitchell didn't want to relocate. He joined a Washington law firm instead.

He did, however, accept Mr. Eisner's invitation to become a board member and consultant. To earn his \$50,000-a-year consulting fee, Mr. Mitchell says he accompanied Disney's top brass on several overseas trips, and advised them "on a wide variety of subjects." Disney President Robert Iger says in a statement that Mr. Mitchell's "guidance and counsel have proven immeasurable."

Mr. Mitchell became an international peace negotiator and joined eight other corporate boards. At six of them he received consulting fees, his law firm earned legal fees or both occurred, according to proxy statements and interviews. Mr. Mitchell served as a director and consultant for FedEx Corp., Staples Inc. and Disney, all of which also used his law firm, Piper Rudnick. (Until a merger last fall, it was known as Verner, Lipfert, Bernhard, McPherson & Hand.)



George J. Mitchell

Then the former senator found himself caught in the corporate-governance firestorm. The California Public Employees' Retirement System, the biggest public-pension fund, protested his Disney ties by withholding votes for his board re-election in 2001 and 2002. Calpers also withheld its votes those years for another director with ties to Disney.

Mr. Mitchell stopped consulting for Disney "as soon as the issue was raised" by fellow directors in late 2001, says New York attorney Ira Millstein, the board's governance adviser. As part of a governance overhaul last year, Disney banned paying consulting fees to directors and limited directors who are employed elsewhere to three other public-company boards.

Mr. Mitchell was the only Disney director forced to relinquish seats. He left five company boards—a move he says he had planned to make anyway because of his busy schedule—and is a director of Disney, Staples, FedEx and Starwood Hotels & Resorts Worldwide Inc.

Disney no longer uses Mr. Mitchell's law firm, which collected \$2.6 million in Disney fees from 1995 to 2002. Mr. Mitchell still earns a combined \$175,000 annually consulting for Staples and FedEx, while Piper Rudnick still advises those two plus Starwood Hotels, the latest proxies show. "Taking consulting and legal fees is a conflict of interest and compromises his independence," contends Charles Elson, head of the University of Delaware

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business school's Weinberg Center for Corporate Governance.

"There's absolutely no legal prohibition on what I'm doing," says Mr. Mitchell, a 69-year-old partner at Piper Rudnick. "I feel completely independent. I've always told CEOs and boards precisely what I think where I have a [financial] relationship or where I do not."

Mr. Mitchell says he plays a "minimal" role in Piper Rudnick's work for Staples. He adds that the law firm billed FedEx just \$379.18 for advice in the year ended May 31 and that he isn't involved in his firm's Washington lobbying for Starwood Hotels.

Staples, however, concluded that Mr. Mitchell isn't "independent" under proposed New York Stock Exchange rules stating that a majority of board members must lack a "material relationship" with a

#### IN THE LEAD

company. Fellow board members of the Framingham, Mass.-based office-supply chain removed Mr. Mitchell from their corporate-governance committee last September. Calpers opposed his re-election at Staples's annual meeting last month; he kept his seat by 95% of votes cast, a slimmer margin than any other director.

Starwoods' corporate-governance panel, run by Mr. Mitchell, considered the question of his independence there late last year. The board of the White Plains, N.Y., company reaffirmed that its relationship with Piper Rudnick wasn't material and didn't impair Mr. Mitchell's independence. He says that he "did not participate in consideration of or voting on the matter."

Meanwhile, the Disney board has appointed Mr. Mitchell its powerful "presiding" director. He leads executive sessions of outside members, serves as an investor contact and helps set the board's agenda. Fellow Disney director Judith Estrin says the former senator is especially adept at conducting executive sessions because "he's very good at facilitating discussion without imposing his own agenda."

#### Larry D. Striplin Jr.

Last fall, HealthSouth Corp. announced the creation of a special litigation committee, composed of independent directors, to deal with a rash of shareholder suits filed after it warned its earn-

ings would fall below expectations. The Securities and Exchange Commission was probing the timing of the August warning and earlier stock trades by Richard M. Scrushy, its chairman and CEO.

But one director appointed to the committee, Larry D. Striplin Jr., had significant ties to the big operator of rehabilitation hospitals and clinics. A few weeks before the Sept. 19 announcement, Mr. Striplin's small firm landed a \$5.6 million contract to install glass at a hospital HealthSouth is building in Birmingham, Ala., its hometown. The contract is substantial for his company, Nelson-Brantley Glass Contractors Inc., which posted sales of about \$9 million in 2002.

The 73-year-old Mr. Striplin says his company submitted the lowest bid through a competitive process overseen by the general contractor. "I didn't think it was a conflict of interest," he says. "I had no earthly idea I was doing anything that would be inappropriate in any shape or form."

Mr. Scrushy, HealthSouth's founder, saw it differently. In an interview in January, he said he felt surprised and upset when Mr. Striplin disclosed his firm's winning bid at a meeting in the CEO's office. "If I had known about [the bidding] I would have stopped him," said Mr. Scrushy. "I didn't like the way it looks." The men, longtime close friends, served together on the boards of a national football foundation, a local bank and a local college, which sports a baseball field called Scrushy-Striplin Field.

Mr. Striplin's fellow litigation committee members heard about the contract during their first meeting Oct. 1 and worried about a possible outcry over his lack of independence. Two weeks later, Mr. Striplin quit the litigation panel and relinquished the chairmanship of the board's compensation committee. He left its audit committee in December.

Mr. Scrushy fared very well during the year that Mr. Striplin led the pay panel. He collected a \$3.96 million salary in 2001—more than twice what he got in



Larry D. Striplin Jr.

1999—plus a \$6.5 million bonus and 1.2 million stock options. “He earned everything that he was given,” Mr. Striplin said in January.

During that interview, Mr. Striplin didn’t see how his firm’s contract might crimp his ability to challenge Mr. Scrushy. “I am one of the few people around who can tell him when he has bad breath,” he asserted. “He has nothing I want or need. I didn’t need that [glass] job.”

This past March, the SEC in a civil suit accused HealthSouth and Mr. Scrushy of “massive accounting fraud.” Federal investigators raided corporate headquarters, the board ousted Mr. Scrushy, and 12 former executives pleaded guilty or agreed to do so for their roles in the fraud. Company auditors have identified \$2.5 billion in fraudulent or improper balance sheet accounting. Mr. Scrushy’s lawyers say he knew nothing about the fraud.

“I’m as sad and disappointed in the things that have happened as if it had been my own son,” Mr. Striplin now says. U.S. Attorney Alice H. Martin recently grilled him for several hours as part of her HealthSouth investigation. Among other things, she wanted to know how he landed the glass contract, according to Mr. Striplin.

Mr. Striplin remains a member of the compensation committee and a special board panel seeking a new CEO. Its hunt was suspended last month while interim management crafts a restructuring plan.

### Larry W. Sonsini

Attorney Larry W. Sonsini is a very busy man. He runs Wilson Sonsini Goodrich & Rosati, a prominent Silicon Valley law firm that employs about 600 lawyers. It helped launch countless technology startups, including Apple Computer Inc., and boasts numerous blue-chip clients.

Mr. Sonsini, 62, also serves on the boards of five high-tech companies that pay his law firm millions of dollars a year in total for legal services. The Palo Alto, Calif., firm acts as the primary outside counsel for four of these companies.

“They are companies I helped build” and have represented since their start-up days, Mr. Sonsini explains. “I am involved with them almost daily.” At least one partner handles those accounts “in addition to me,” Mr. Sonsini says. “I am doing not only legal work, (but also) business advice, meeting with the CEO and meeting with their management team.”

That kind of dual role bothers governance experts. They contend directors’ objectivity can be impaired when management officials, whom they oversee, retain them to provide costly services.

If an outside director is also a company’s paid outside counsel, “it’s impossible to meet the spirit as well as the specific criteria for independence,” says Roger Raber, president of the National Association of Corporate Directors in Washington.

Mr. Sonsini is aware of the possible conflict. Last year, when **Simplex Solutions Inc.** sought shareholder approval for its acquisition of Cadence Design Systems Inc., he



Larry W. Sonsini

drafted a warning about his roles as outside counsel and director of Simplex in the company’s proxy. It advised shareholders that Mr. Sonsini and a fellow law partner, who served as the company’s corporate secretary, “may have reasons” to endorse the merger “that are not the same as your interests.”

Mr. Sonsini says being an outside counsel doesn’t harm his independence as a director. “Often, my interests are aligned with the shareholders,” he says in an interview. “A lawyer serving on the board does not, in itself, compromise the concept of independence because the lawyer represents the organization and must act in the best interest of the shareholder,” he adds later in a statement.

Some clients agree. “My sense is that he’s one of our more outspoken board members,” says Ron Epstein, general counsel of **Brocade Communications Systems Inc.** The San Jose switch maker paid \$4.9 million to Wilson Sonsini, its principal outside legal counsel, during the year ended last October. Mr. Epstein isn’t concerned about Mr. Sonsini wearing two hats because “we are circumspect about making sure what role he is playing.”

A sticky situation did arise in November when Brocade agreed to acquire Rhapsody Networks for about \$173 million. Mr. Sonsini and law firm colleagues handled the transaction. He simultaneously blessed the deal as a Brocade director. Another Wilson Sonsini lawyer and Mr. Epstein presented the proposed takeover to Mr. Sonsini and other Brocade directors. “He asked a bunch of questions to make sure the board wanted to pass this,” Mr. Epstein recalls.

Mr. Sonsini says he and his associates represented Brocade in the takeover because “we do all their legal work.” There wasn’t any conflict of interest, he says, because “the long-term success of Brocade is more in the interest of my law firm than any one transaction.”

# Private Companies Also Feel Pressure to Clean Up Acts

By MATT MURRAY

**T**HE SARBANES-OXLEY Act is aimed at making publicly traded companies more accountable. But it's having a big impact on privately owned companies as well.

Dick Jackson, chief financial officer of Road & Rail Services Inc., doesn't have to file public reports on his company's operations. The logistics and transportation concern, based in Louisville, Ky., has just three owners.

But in recent months, Road & Rail, which has 400 employees and about \$25 million in annual sales, has been tweaking its corporate-governance practices. Mr. Jackson has added layers of review to the process of compiling financial results, and boosted accountability by ensuring that different managers are responsible for approving invoices and signing checks. The board is contemplating inviting one or more independent directors aboard.

Why the changes? Mr. Jackson says his company, like others, has been learning from the scandals at Enron Corp., WorldCom Inc. and elsewhere. So have a growing number of its clients—along with its banks and insurance companies—and they want to ensure Road & Rail can back up its books as well as its promises. Many of its clients are public companies that have overhauled their own governance in response to the new regulations, Mr. Jackson says.

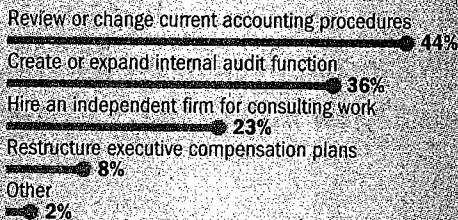
"Philosophically, as a privately held company, you don't want everything exposed to the world," he says. "On the other hand, the world is changing, and there's a lot more sharing of information between customers and suppliers and business partners. I think everything eventually is an external event."

Indeed, the Sarbanes-Oxley Act is having a ripple effect "much more far-reaching than any of us knew," Mr. Jackson says.

Among the changes, closely held companies are quietly overhauling their boards and upgrading their accounting standards. In addition to addressing their own concerns, managers are being pressured to make changes by customers, investors, accountants and venture capitalists. Many compa-

## Moved to Action

In a survey of 1,400 chief financial officers from private U.S. companies, 58% said their company has taken or plans to take steps to better control accounting practices.



Note: Multiple answers were allowed.

Source: Robert Half Management Resources

nies also are reacting to the rising cost of insurance for directors and officers.

Just last month, a federal judge in New York City ruled that directors at bankrupt Trace Interna-

tional Holdings Inc. failed in their responsibilities by allowing its chairman and controlling shareholder, Marshall Cogan, to exhaust funds through excessive compensation, dividends and loans. The decision makes it clear that "private company directors and officers are going to be held to the same standard as public company officers and directors to determine whether or not they are fulfilling their fiduciary duties," says John P. Campo, a partner at LeBoeuf, Lamb, Greene & MacRae LLP, who represents the bankruptcy trustee in that case.

To be sure, most private companies have stopped far short of the measures adopted by their public peers, and executives at many remain tight-lipped about their operations to outsiders and even employees and some investors. After all, avoiding the spotlight and the paperwork that comes with being public is part of the reason that many stay private.

"I want the right disciplines in place," says Marilyn Carlson Nelson, chairwoman

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## Private Companies Also Enact Governance Reforms

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and chief executive of Carlson Companies Inc. in Minneapolis, a family-controlled company that owns an array of hotel, marketing and travel industry chains and brands, including T.G.I. Friday's restaurants and Radisson Hotels & Resorts. She adds that she doesn't want employees or investors "worried" about governance at the company, which through its own and franchised operations oversees 198,000 workers and about \$20 billion in sales.

But at the same time, she says, "We can't become so rigid that we lose the sense of innovation and become totally risk-averse. Our intention is to be transparent in what we do, but our intention is not to make the board into managers and operators of the company." Entrepreneurs are by nature risk takers, she says, adding, "We don't claim to the board or to each other that we're never going to fail or something won't go wrong."

Of late, Carlson has been taking a more active role in monitoring external auditors and expanding internal control and disclosure requirements, such as those involving off-balance-sheet commitments, says its chief financial officer, Martyn R. Redgrave. The company's board already had independent directors and an audit committee, he notes.

"The standard I have applied is that if we find the rules relative to current practices would increase transparency or awareness, we are in favor of them," he says. But he adds that some of the new requirements are "form over substance" and says, "We're not going to sweep through our entire global system to do what is required for public companies. We're using it as a new benchmark

against which we measure ourselves, and we have a lot of it in place."

Perhaps the companies most affected in the new climate are small, entrepreneurial ventures that need venture-capital funding and have high hopes of one day going public. At Celeration Inc., a tiny medical-technology company in Minneapolis with nine employees and no revenue, Chairman and CEO Kevin Nickels last year structured his six-member board so that four directors were outsiders: two of them investors and two of them industry figures. Neither of the two insiders—Mr. Nickels and company founder and chief technology officer Eliaz Babaev—sits on

the audit or compensation committees.

Part of the motivation for such measures is pragmatic. "What you're doing is building the confidence for new investors," says Mr. Nickels. "You're not going to get financed unless money sources trust you."

But he says he also had a strong belief, as a manager, in the importance of independent outsiders on his board. "It's common sense," he says. "Rarely does an individual make it happen. It's usually a team of people, and a team is successful when you bring in all the bright ideas of a broadly experienced and deep group of people."