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Finding Competitive Advantages in Corporate Governance PART I

BY RICHARD L. WISE, ATTORNEY, ECKERT SEAMANS CHERIN & MELLOTT LLC AND JOHN J. WHYTE, PRESIDENT, WHYTE WORLDWIDE PCE

Editor's Note: This first installment of a two-part series introduces the basic history, concepts, and principles of good (best practice) corporate governance and summarizes how its implementation is a value-added proposition for both public and private companies in the midst of corporate renewal. The second part, which will appear in the August issue of The Journal of Corporate Renewal, *outlines the keys to implementing those principles.*

Last year's adoption of the Sarbanes-Oxley Act and the plethora of regulations seeking to implement it may at first blush appear to have little bearing on the work of turnaround professionals, except as they may deal with public companies. However, for those who work in the corporate sector and are informed enough to recognize it, these changes mark the beginning of a significant and permanent change in the corporate landscape.

For those involved in developing new and pragmatic tools to help revitalize stagnant businesses, the new laws and regulations are only a part of a continuum of thought and research stretching back to the 1940s in both the United States and the United Kingdom. Nonetheless, while "good corporate governance," as it is now commonly called, is currently trendy in both the business and legal press, few understand its true nature or purpose, and fewer still are aware of its power to add value to businesses in the midst of corporate renewal.

Sounding the Alarm

One of the great strengths of American corporations has been their military-style command-and-control operational structure, which enables powerful and creative executives to implement strategies efficiently and effectively and to respond quickly to needs and changes in the marketplace. This structure is both a reflection of the essence of American entrepreneurship and the source of problems that subsequently required governmental intervention to conform the unbridled growth of corporate power to public needs.

Dictatorial control of operations is well suited for effective management. Logically, however, it has nothing to do with a system of governance oversight, which objectively constrains excessive financial decisions, reviews financial reporting, and grades the accomplishments of management. With the growth in the number of publicly traded companies and the increasing importance of public exchanges, corporations gave formal acknowledgment to the concept of "independent oversight" by establishing audit committees for publicly traded corporations in the 1940s.

For the most part, however, financial reporting has been the "tail" that is subservient to the business "dog," and American business schools have trained future CEOs and CFOs to find loopholes in the technical requirements of accounting, reporting, and tax laws. For example, in November 1980, Richard Greene glibly began his article "The Joys of Leasing" in *Forbes Magazine* with the remark that the "basic drives of a man are few: to get enough food, to find shelter, and to keep debt off of the balance sheet."

Sensing that something might be wrong with this approach, Congress in the late

1980s established the Treadway Commission to study issues related to corporate fraud in America. The commission's recommendations and analyses included criticism of a system in which responsibility for preparation of financial statements was generally under the exclusive control of the chief executives of corporations.

In Britain, bankruptcies and failures during the recession of 1990 led to the exposure of corruption and abuse of power by corporate executives, particularly involving the concealment of essential information in financial data released to the public. In response and in an effort to restore eroded investor confidence, Britain's Stock Act Exchange and Financial Reporting Counsel established a committee of enquiry called the Cadbury Committee, which issued a detailed report on corporate governance in 1992. This was followed by the Greenbury Report in 1995, the Hampel Report in 1998, and the Turnbull Report in 1999.

American businesses ignored all of these cautionary reports.

In September 1998, Arthur Leavitt, then chairman of the Securities and Exchange Commission, issued a Cassandra-like warning about the failures of the American corporate oversight process. In a speech at New York University Center of Law and Business, he excoriated a process that he said had become a game of "nods and winks" involving analysts, auditors, and corporate management.

Lamenting that "integrity may be losing out to illusion," Leavitt presciently warned, "If a company fails to provide meaningful disclosure to investors about where it has been and where it is going, a damaging pattern ensues. The bond between shareholders of the company is shaken…(T)he trust that is the bedrock of our capital markets is severely tested."

In a response to this call to arms, the New York Stock Exchange and the National Association of Securities Dealers established a blue-ribbon committee to improve the effectiveness of corporate audit committee members. After conducting meetings and research, the committee released a 71-page report that set forth 10 far-reaching recommendations regarding the conduct of audit committees and five guiding principles for audit committee best practices.

Diligent corporate lawyers advised their clients about the technical requirements of these recommendations and, by and large, most reporting companies complied with most of the basic requirements. Not surprisingly, the spirit of these recommendations was largely ignored. In the aftermath of Enron and WorldCom, Leavitt's predictions came true.

Crisis in Confidence

The New York Stock Exchange and NASDAQ responded to the current crisis with detailed new requirements for their listed members. On a regular basis, many of the largest accounting firms and law firms publish memoranda summarizing these new rules and regulations to advise their clients how they could comply with them. However, it is the basic approach of mere compliance in these memoranda that completely misses the mark with respect to the fundamental nature of the current crisis in investor confidence and perpetuates the problems of corporate governance.

Many private companies view Sarbanes-Oxley and the discussions that it has generated as something that, thankfully, has no application to them. Public companies, on the other hand, view the new laws as a cost that they must bear both because of mistakes by other businesses and, in their traditional hostility to public regulation, because of their need to obtain money from the public sector.

In both cases, the result is that businesses focus only on doing what is required to get on with their real business. They do not view the new requirements and regulations as responses to a broader problem that they need to think through to solve. Putting it another way, businesses are ignoring the loud demands of corporate stakeholders by focusing only on compliance. Yet, will not a company that meets a demand have a competitive advantage over others in the same business that do not?

These questions may be restated in a somewhat different format. Today there is a debate over a shift in general accounting principles from a "rules-based" system of accounting to a "principles-based" method. Similarly, good corporate governance requires a company to focus on compliance with principles rather than compliance with rules. Mere compliance with rules, therefore, is a governor on the engine of corporate creativity and does nothing but limit the ability of corporate executives and turnaround professionals to respond to an unfulfilled need of a corporation's stakeholders.

The import of this last statement is magnified for those involved in corporate renewal. While strong, profitable companies tend to think primarily in terms of returns to their stockholders, a company in the process of a turnaround has different priorities. If it is insolvent, the interests of creditors become paramount. If it is in a bankruptcy proceeding, it must also have the confidence of the bankruptcy court.

Under such extreme conditions, the interests of management truly take on more of an enterprise theory of "stakeholder capitalism" rather than one entailing only a singular obligation to stockholders alone. The confidence of shareholders, employees, vendors, customers, lenders, public debt holders, and the like all become paramount. This is true whether the company is public or private.

How is it then that a turnaround professional may assure these diverse parties that they may have faith in the integrity of the enterprise? Even in the case of a company that is not under this extreme pressure, particularly given today's lack of investor confidence, would a company that has certifiable best practice corporate governance not be a less risky investment — both to the public and to a lender — than one that did not? And would that reduction in risk not be reflected both in a lower cost of funds and in a lower cost of capital?

For a turnaround professional, that is both the opportunity and the challenge. With this in mind, a brief analysis of how good corporate governance may play an integral role in the turnaround process is in order. First, however, a brief explanation of the qualitative attributes of good corporate governance is required.

Operations vs. Oversight

Corporate governance reflects the procedural protocols that define relationships among individuals and among groups of individuals within a business entity. It sets forth the requirements and manner in which decisions are made and performance is evaluated. As a consequence, an important attribute in all corporate governance models involves the power dynamics among various individuals and groups that play roles in the corporate organism.

Corporate governance, therefore, has two main components: governance related to operations and governance related to the clear and proper reporting of an operation's decisions and results and to the manner in which differences between competing groups are resolved. This latter subject is usually referred to as "oversight."

In some systems, such as Germany's, these two functions are separate and distinct. German corporations have two boards of directors. A lower board is solely responsible for operations, and an upper board is solely responsible for oversight. Directors of the

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lower board are forbidden by law to be members of the upper board. Indeed, although true primarily by custom, they may not even "campaign" for or against directors on the upper board.

The Anglo-American system, on the other hand, uses a unitary board approach; that is, both functions are combined in one board. A simple reality that has escaped most observers is that while it is easy in the two-tier German system to envision one form of corporate governance for operations and another for oversight, when these two functions come together in a unitary board, it is not as easy to see the functions as separate. The potential for two types of governance, depending on which function is being addressed, is therefore overlooked.

Because the military-style, command-and-control form of corporate governance for operations has proved to be so successful from an economic standpoint, it has naturally carried over to the board of directors and has crowded out more parliamentary forms of governance when oversight is at issue. Therefore, to deal with the issues of corporate oversight, a different corporate culture, a different balance of power dynamics, and a more collegial approach to dealing with fellow members and dissident views must be instilled.

This raises the question of why one would want different systems for oversight governance and operational governance. There are several answers. An obvious one, which relates only to public companies and is not particularly intellectually satisfying, is that Congress and the Securities and Exchange Commission have demanded it. Slightly more satisfying is that investors are now insisting on it. Indeed, since people invest in private companies as well, through loans, equity positions, and the purchase of commercial paper, this reason also applies to private companies.

There is an inherent conflict of interest in allowing a management person or group whose performance is to be evaluated to be in control of the collection and presentation of the data on which that evaluation is to be made. Those who play tennis prefer to serve because it enables them to control the tempo of the game. Similarly, if management is in control of the selection and presentation of the data, it also has significant control over the outcome of the evaluation process. If management has too much control, it can hide and obfuscate data and results altogether.

Fundamental Issues

In summary, if the model of corporate governance in the oversight context is dictatorial in form, two fundamental flaws are created. First, proper oversight becomes dependent on those in control being "benign dictators" rather than rulers who use power for their own ends. Second, because the structure is a dictatorship, rules and decisions ultimately are controlled by the naked preferences of those in charge.

Presumably such leaders would act logically and have valid reasons for everything they did. But ultimately, in choosing between alternatives, their preferences would be determinative rather than a balancing of interests or the supremacy of reason through collegial debate and compromise.

Under a democratic structure, decisions are reached through reason and compromise. The effectiveness of this approach requires a full airing of all information, open and frank discussions of competing views and reasons, and a culture that respects and yields to legitimate opposing thoughts and needs of those involved in the process. This form, much like constitutional government, is one that is transparent, institutionalized, and reliable. While it is also more cumbersome and time-consuming, those concerns are less important when one is dealing with oversight.

One final point that by now should be obvious is that corporate governance systems have absolutely nothing to do with compliance. Thus, if a corporation is only interested in being able to check off that it has met all of the requirements of Sarbanes-Oxley or the new regulations of the Securities and Exchange Commission or NASDAQ and the New York Stock Exchange, it will never address the fundamental philosophical issues that determine the form of corporate governance it should have and the ways to implement, institutionalize, and protect that choice.

Richard L. Wise is an Attorney with Eckert Seamans Cherin & Mellott LLC and is based in the firm's Boston office. Wise concentrates his practice in advising companies on complex business transactions and strategies, including plans involving reorganization and corporate renewal. He also advises companies and investor groups and has lectured and written extensively on best practice corporate governance. He can be reached at Richard.wise@escm.com.

John J. Whyte is President of Whyte Worldwide PCE and provides professional corporate executive services to companies in transition. Whyte has held senior executive, director, and advisory positions for public and private companies, both domestic and international. He was also partner-in-charge of operations and consulting of a regional CPA firm. He is currently audit committee chair for Commonwealth Telephone Enterprises (CTCO), a CLEC/ILEC/ISP. He can be reached at whytewpce@cs.com.

Finding Competitive Advantages in Corporate Governance PART II

BY RICHARD L. WISE, ATTORNEY, ECKERT SEAMANS CHERIN & MELLOTT LLC AND JOHN J. WHYTE, PRESIDENT, WHYTE WORLDWIDE PCE

Editor's Note: Part I of this two-part series appeared in the July issue of The Journal of Corporate Renewal. *It reviewed the basic concepts of good (best practice) corporate governance and how that is affected by passage of the Sarbanes-Oxley Act. It also discussed how the implementation of good corporate governance is a value-added proposition for both public and private companies in the midst of corporate renewal. Part II outlines how corporate governance may be used most effectively in the turnaround process to reinvigorate companies.*

Corporate governance should play a pivotal role in all stages of a turnaround. At the outset of an engagement, a turnaround professional has two primary tasks:

- To assess the current position of the business by determining what the company has been doing, flushing out problems, and formulating a plan to turn it around and return it to profitability
- To win the confidence and loyalty of shareholders, employees, vendors, customers, and financial institutions

Because of the dynamic and often precarious situation in which a turnaround candidate finds itself, principles of stakeholder capitalism dominate all aspects of a turnaround professional's efforts. Even a perfect plan is doomed to failure if it lacks stakeholder support. A company that is in Chapter 11 reorganization must also win the confidence of the U.S. Bankruptcy Court.

In trying to hide its problems, a company's management may have resorted to misstating its operating results. Large creditors are likely to harbor ill will about being misled. Instituting principles of good corporate governance — independent, transparent, and collegial review and analysis of a corporation's business and affairs for purposes of oversight — assists in restating financial data accurately and provides a turnaround professional and other stakeholders with numbers they can trust.

The implementation of good corporate governance requires the building of a financial team that is competent, independent, and confident in the accuracy of its presentations to various parties. The strength and transparency of accounting principles and financial reporting enable a turnaround professional to demonstrate to essential stakeholders the company's commitment to analysis and reasoned decisions — the hallmarks of good corporate governance — and help to restore credibility.

Minimizing Risk

Midstream in a turnaround, good corporate governance has two salutary effects, one that is economic and a second that enhances performance.

Assuming that the turnaround professional has designed a proper turnaround plan, various stakeholders will find their renewed confidence in the company to have been well founded. Even in the majority of cases that require fine-tuning midway through the turnaround, the timing of announcements of adjustments or explanations of variances and the clarity and reliability of the reasons for them should further solidify stakeholders' confidence in the information that is presented to them.

All businesses entail risk. Shareholders, lenders, employees, vendors, and customers, to some degree, calculate their risks when they decide whether to do business with a company. Particularly in the current economic environment, characterized as it is by a crisis of investor confidence, one important element of this risk — commonly called "beta" by financial analysts — is the reliability of the information upon which the assessment is based.

Best practice corporate governance increases the reliability of the data used to evaluate an investment in a company. Because that part of the risk has been minimized, the company's beta factor will be less, as will the cost of borrowing money. This is reflected today in the cases of WorldCom and Enron. Similarly, entities seeking equity investment will be better able both to encourage such investment and to command a higher price per share. Good corporate governance can help lower the cost of funds and capital, thereby increasing profitability and the chances for the troubled company to succeed.

Good corporate governance involves balancing power within a company and creating areas of expertise in separate groups within the entity. From an organizational standpoint, institutionalization of best practice corporate governance allows the turnaround professional to leverage his or her effectiveness by sharing turnaround responsibilities with an expanded team. Because the procedures instituted require full transparency and reportability of areas assigned to other team members, a turnaround professional can be confident that the delegation of responsibility will not turn into abdication of responsibility.

A turnaround professional's ultimate goal is to move on to the next turnaround. To do so, the professional must get a company to the point that it no longer depends on his or her day-to-day professional advice to succeed. To reach that end, sound systemic protocols must be implemented; otherwise, a lasting renewal is impossible. If a company is successful only as long as the turnaround professional is there, the consultant has not done the job properly.

In summary, therefore, institutionalization of best practice corporate governance helps build confidence among all stakeholders in the early phases of a turnaround. It also increases the reliability of fundamental data, without which a turnaround professional cannot reliably plan a restructuring. Midstream in the process, it contributes to a lower cost of funds and capital and multiplies the turnaround professional's effectiveness through a sharing of responsibilities. Ultimately, the institutionalization of the benefits of the turnaround is assured so that the professional may move on to the next case.

Universal Elements

Any discussion of the benefits of good

corporate governance for turnaround professionals would be incomplete without addressing the nature of the elements involved. Again, best practice corporate governance goes beyond mere compliance with laws and regulations through a series of processes and checklists; rather, it requires developing procedures designed to implement principles and alter the character of an organization.

Basic requirements for the audit committee include control of the outside auditor, oversight of internal financial control and responsibility for final approval of the financial content of SEC filings, press and earnings releases, responsibility for confidentiality of stakeholder complaints, and approval of related party transactions. For the compensation committee, basic requirements include control over executive compensation, review of accounting policies and financial estimates, and review of ethical codes for executives and directors.

A more complete form of best practice corporate governance must be customized to each company. Nonetheless, certain elements are fairly universal. These include:

- ***A strong and mostly independent board of directors or board of advisors.*** The key is independence. Selecting like-minded individuals or friends or relatives of the chief executive or senior shareholders to serve as directors or advisors does not permit the "cross-pollination" that is necessary to keep a company strong. There is great truth to the adage "in diversity there is strength."
- ***Strong and fully independent governance committees with their own separately established power bases.*** The primary governance committees are nominations, compensation, and audit. Some companies add a fourth committee to deal with ethical issues. A company must make certain that each committee has the authority and financial support to do its job independently of the others.

  Decisions of these committees should be accepted by the full board of directors, absent clear and convincing reasons otherwise. To give members adequate time to perform their duties, committee meetings should not be held in conjunction with regular board meetings. Committees should have their own budgets, counsel, and access to experts, in addition to their own detailed charters and protocols for administering meetings and reaching decisions.

  These committees should address only corporate oversight issues. Operational issues should be left to the military-style, command-and-control form of governance, with operational advice provided by the full board.
- ***Independent accounting practices; internal financial controls; and "whistleblower" protection for employees, all levels of management, and well-informed outsiders.*** In publicly traded companies, audit committees are required by law to see that these elements are in place. Ideally, it would also be required for private companies. An audit committee should appoint an outsider, such as its independent counsel, to receive complaints and to protect the confidentiality of individuals who report problems. These channels should be established outside of management's normal chains of communication or control.
- ***Principle-oriented, as opposed to rule-oriented, charters for independent governance committees.*** Charters should state conceptually the purpose of each committee and describe the methodology that it will follow. The statement should direct a committee's focus away from formal compliance and toward discovering new approaches to conforming more effectively to underlying principles. Such an approach also helps create a corporate culture that is comfortable with challenges to established ideas.
- ***Institutionalization of programs, processes, and procedures.*** To accomplish this, each independent governance committee must develop detailed process flow charts, work lists, and procedures to aid committee productivity and efficient administration. The availability and transparency of these procedures to board members is important so that all participants understand how decisions are made and can ascertain whether the procedures that have been adopted are designed to yield informed and fully thought-out decisions.
- ***Detailed orientations for all new board members regarding the basic business of the company and the procedures and protocols of the various committees.*** Knowledge is essential for effective decision making. Members of independent governance committees must receive both committee-specific orientations and continuing education on changes in the industry, accounting pronouncements, changes in laws and regulations, and new approaches in good governance in their areas of responsibility.

  While the board of directors should defer to decisions of independent governance committees, it is understood that this is based on the expertise of committee members. Expertise is a dynamic, rather than static, attribute that must be constantly refreshed.
- ***A change in corporate culture from one of blind loyalty and obeisance to one of reasoned discourse.*** Each of these universal elements is designed, in part, to promote such a change. Those with differing views must be regarded as the loyal opposition rather than as threats to the status quo. Clashes in approach are best resolved not through power struggles but by the "new diplomacy" of corporate relations.

  From a process standpoint, practitioners of this new diplomacy seek to institute change not through spectacular achievements, but by meticulously laying a sound foundation in an unspectacular fashion. In practice, the new diplomacy is characterized by an overriding sense of civility, the paramount role of institutions, and the overriding importance of common norms to which corporate conduct must conform.

  A business's unique culture is to be subservient to those institutions and norms. It requires board members to use their acumen and talents to communicate rather than to obfuscate and to address and understand the interests of the parties involved rather than to focus on their own positions and construct myriad arguments to support those positions.

  It views negotiations and relations with other parties as an integrative process, rather than as a distributive one. It is the hallmark of a company confident enough in its conclusions and procedures to withstand all of the unexpected challenges and developments that appear every business day.

Implementing these seven elements requires effort, commitment, and meticulous planning. Most important, as one CEO admitted with dismay, "You really have to want to do this for it to work." Although winning this commitment may be the most difficult part of an engagement, the benefits to a business in transition can be both immediate and profound. CR