

BUBBLES AND THEIR AFTERMATH

ADDRESS

BY

MARTIN LIPTON

TO

THE COMMERCIAL CLUB

OF

CHICAGO, ILLINOIS

NOVEMBER 2002

BUBBLES AND THEIR AFTERMATH

South Sea Bubble – Britain 1721

- At the end of 1720 the South Sea Company collapses
- The Royal Family and a large part of the aristocracy are involved
- Parliament creates secret committee to investigate
- Robert Knight, the CFO, flees to the continent with the ledgers
- Parliament orders each of the South Sea Company directors to post £25,000 bail (5-10 million in current dollars)
- Directors are denied right to counsel by Parliament
- Personal assets of directors are confiscated by order of Parliament
- Investigation by Parliament goes on for many years, then in what has today become a typical political reaction to a bubble, Parliament over regulated, joint-stock companies were banned, and the British economy suffered as a result

The Millennium Bubble – U.S. 2002

- Enron, WorldCom, Adelphia, Global Crossing, Tyco and several hundred other 1998-2001 high-fliers collapse
- Congressional investigations
- State attorney general investigations
- SEC investigations
- Grand jury investigations
- Arrests, perp walks, indictments, fines and jail sentences
- Spectacular bankruptcies
- The President demands change

- The NYSE adopts new corporate governance rules
- The SEC adopts new disclosure rules
- Congress passes the Sarbanes-Oxley Act
- Perhaps as much as \$10 trillion of value has disappeared and the U.S. economy languishes

What went wrong – Wall Street

- As a result of the poor performance of U.S. companies in the 1970s and 1980s and the prevailing view that we had lost our competitive edge against Japan and Germany, shareholder activism grew and companies were pressured to create shareholder value. Shareholder value became the mantra. Managements, who should have had a broader, long-term perspective, were increasingly motivated to manage for short-term stock appreciation by mega grants of stock options and an attitude in the boardroom that any level of compensation is fine as long as the shareholders do well.
- Analysts and portfolio managers glorified and overvalued steady earnings growth leading companies to strain (if not break) the rules in order to meet Wall Street expectations by achieving the expected growth rate and in many cases by reporting an extra penny or two per share in order to hit the “whisper number” (usually pennies or a nickel more than the analysts’ consensus number). The impact on CEOs is cogently stated by Daniel Vasella, Chairman and CEO of Novartis, in the Nov. 18, 2002 issue of *FORTUNE* Magazine: “The practice by which CEOs offer guidance about their expected quarterly earnings performance, analysts set ‘targets’ based on that guidance, and then companies try to meet those targets within the penny is an old one. But in recent years the practice

has become so enshrined in the culture of Wall Street that the men and women running public companies often think of little else. They become preoccupied with short-term ‘success,’ a mindset that can hamper or even destroy long-term performance for shareholders. I call this the tyranny of quarterly earnings.”

- Structured finance, using special purpose entities, was marketed for the purpose of creating fictitious revenues, keeping debt off the balance sheet, postponing or not recognizing losses and creating earnings where none existed
- Analysts and portfolio managers accepted pro forma earnings as a substitute for GAAP earnings, allowing companies with little or no real earnings to sell at astronomical prices
- Hot IPOs became a currency for currying favor with venture capitalists, institutional investors, hedge funds and corporate officers and the underwriting process was manipulated through “spinning” and “laddering”
- The media extolled the “new era,” CNBC became a hot channel and a cheerleader for the bull market, it was impossible to rent office space on Sand Hill Road at any price, and investment bankers abandoned suits and ties to better resemble dotcomers
- Although all of these problems were open and notorious during the bubble, the SEC basically ignored them and did little to protect the public from the bubble or even warn the public of the dangers; at the same time Congress kept the SEC on a starvation diet, the White House was not heard from and the Federal Reserve, after one warning of “irrational

exuberance” from its Chairman, continued to pump air into the bubble.
Government stood idly by as the bubble grew

What went wrong – Corporate Governance

- Boards of directors, while independent in name, were not really independent and did not act as independent monitors of management
- The imperial CEO dominated the board
- Ethics codes were waived without directors understanding the real purpose of the transactions in question and without disclosure to the shareholders
- Board and board committee meetings were short and unfocused
- Audit committees didn't understand the accounting and failed to insist on the accountants describing the principal issues necessary to an understanding
- Whistleblowers were not heard or sluffed off
- Nonmanagement directors did not have a leader or a forum for independent discussion of management issues
- Companies made large unsecured loans to CEOs and senior officers
- Large stock option profits were realized by management in advance of collapse of the market price of their company's stock
- Executive compensation, including Welchian type perks, increased exponentially and, while viewed by many as excessive, was routinely recommended by compensation consultants and approved by Boards of Directors. We entered the era of the centamillionare CEO

What went wrong – Accounting

- Auditors failed to insist on true transparency and went so far as to initiate gimmicks to create false revenues, false earnings and false balance sheets
- In many companies there was a revolving door between company financial staff and auditors staff, creating too cozy a relationship
- Independent auditors were doing internal audit as well as external audit
- Failure of accounting profession and SEC to exercise effective oversight of accountants' performance; weak peer reviews; too many bad audits
- Slavish adherence to rules-based GAAP even when it presented a false or misleading picture; financial statements, particularly the footnotes, became obtuse
- Auditors' basic relationship was with management, not the audit committee
- Many companies paid their auditors more for consulting than for auditing, raising the question of whether auditors were prostituting their audit work to protect the more lucrative consulting

What went wrong – Gatekeepers

- CEOs and CFOs of failed companies that used “creative accounting” denied knowledge and blamed subordinates and the independent accountants
- Boards of directors and audit committees blamed management and the independent accountants
- Accountants blamed management
- Lawyers approved questionable transactions and did not force recognition of accounting or disclosure violations by going to the audit committee or the full board

- Investment bankers assisted accountants and management in “creative accounting” by developing more and more sophisticated structured finance vehicles

What are we doing about it and where will it go:

- Tectonic shift in power away from the CEO to the board, board committees and shareholders
- New Stock Exchange rules require a majority of really independent directors
- Marked decrease in board interlocks
- New rules require meetings of non-management directors and a presiding director, lead director or non-executive chair to chair the meeting and to act as a conduit from shareholders to the board
- Shareholder approval of stock compensation
- Activist shareholders will make greater use of 14a-8 proxy resolutions and will exercise power and influence through withhold-the-vote campaigns
- There will be more proxy fights for full control
- Proposed SEC rules on investment adviser and investment company disclosure of proxies enhance shareholder power
- CEO tenure will be shorter and there will be increased tension between CEO and board when performance falls below peer companies or a very significant nonordinary-course transaction is proposed
- Board and committee meetings will be longer and more meaningful
 - The new attitude is reflected in the GE announcement of corporate governance changes on November 7: GE Chairman, Jeffrey Immelt

said: “I want directors to probe with hard questions which stretch management so that, within the context of mutual respect, board meetings can deal in depth with core issues affecting the long-term interests of shareowners and other stakeholders. By the same token, I expect directors to have even greater involvement and participation in GE — in understanding the Company and advising the management team. Directors need to be our most constructive critics and our wisest counselors. In short, they need to be engaged and committed partners in our task of continuing to make GE a great company, and a good company.”

- In an article, “What Makes Great Boards Great” in the September 2002 issue of *The Harvard Business Review*, Professor Jeffrey Sonnenfeld of Yale says: “What distinguishes exemplary boards is that they are robust, effective social systems The highest performing companies have extremely contentious boards that regard dissent as an obligation and that treat no subject as undiscussable.” Professor Sonnenfeld’s prescription for an effective board will be widely adopted (attached as Exhibit A)
- Boards will undertake strategic reviews and facilities visits by directors will be customary
- Audit, compensation and nominating-governance committees will consist only of independent directors
- If the SEC does not soften the definition of the “financial expert,” required by Sarbanes-Oxley to be at least one member of every audit committee, given the difficulty in recruiting a suitable board director who meets the definition, a large number of companies will continue with their present audit committee which has been functioning

successfully, and instead disclose why they do not have an audit committee member who meets the SEC's definition

- Directors will serve on fewer boards
- Boards will be smaller (ten or fewer directors)
- Boards and committees will do meaningful self evaluations and peer reviews
- Boards will seek help from independent advisers on accounting, legal and strategic issues much more frequently
- Boards will be less tolerant of poor performance or recurring problems
- Directors' compensation will be higher
- In a June 2, 2002 paper entitled, "A Post-Enron Paradigm for Board Meetings" I said: "As major companies during the past 30 years moved away from predominantly local boards, with few outside directors, to national boards consisting of a large majority of outside directors, who were mostly CEOs of comparable major companies, a pattern of board and board committee meetings developed that in many cases involve a working breakfast for committee meetings followed by a board meeting that ends at noon with a buffet lunch attended by only a few directors because most leave for the airport as soon as the meeting ends. With this type of schedule, committee meetings, including the audit committee, are usually limited to one-to-two hours and the board meeting itself to not more than three hours. Post Enron this will not do. The SEC, the President, and the Congress have criticized directors for not adequately monitoring the corporations they serve; the legal community, including prominent

judges, have stated that Enron's short meetings are evidence of failure by the directors to fulfill their fiduciary duties; and the New York Stock Exchange and The Business Roundtable, as well as various organizations representing investors, have advised more extensive agendas for boards and committees and more intensive discussion and review by directors. These agendas and duties make it difficult, if not impossible, to properly discharge the directors' obligations in the four-to-five hour time frame that has become customary at many companies.

In order to provide the time necessary in the post-Enron environment, committees with extensive agendas, like the audit committee, should have their meetings scheduled for early in the afternoon of the day before the board meeting and, to the extent required, meetings should continue through a working dinner. This time frame could also be used for regular meetings of only the non-management directors. The board meeting itself could then start earlier in the morning and continue through a working lunch, with adjournment planned for mid-afternoon. This schedule should permit the consideration and discussion of all that is today necessary to satisfy post-Enron requirements.

In addition, boards should consider the desirability of an annual two-to-three-day board retreat with the senior executives at which there is a full review of the company's financial statements and disclosure policies, strategy and long-range plans, and current developments in corporate governance. Frequently, this retreat is held at a location close to one of the company's operations so as to give the directors an opportunity to become acquainted with a number of the company's

operations as the annual retreats are rotated among the company's various locations. During the retreat, meals and social activities should be arranged in a manner that encourages the directors on a one-to-one basis to get to know the senior executives.

Companies should also provide comprehensive orientation for new directors so as to acquaint them with the company's strategy, long-range plans, financial statements, properties and operations, corporate governance guidelines and senior executives. The annual retreat could satisfy a major portion of such an orientation.

Assuming directors make good use of the time, this paradigm, which many companies have already adopted, will improve significantly the functioning of boards and board committees and will ensure that the directors cannot be faulted by regulators or in litigation as to the manner in which they performed their duties.”

- Accounting and disclosure will be much more transparent
 - The Sarbanes-Oxley requirement that the financial statements fairly present the financial condition and results of operations independent of GAAP and the significantly enhanced SEC rules broadening MD&A disclosure will result in a major shift from rules-based accounting to principles-based accounting; the FASB is working on moving to convergence with the IASB and thus away from rules-based and to principles-based accounting
 - The new SEC rules eliminating the ability of pro forma earnings releases to obfuscate real earnings will result in a marked reduction in use of pro forma earnings

- Audit committees will review carefully the auditors' and audit firm partners' qualifications, quality controls and history of problems and restatements and whether rotation of audit firms is appropriate
- Audit committees will insist on the auditors taking more responsibility for the financial disclosures or the committees will bring in other accountants or legal counsel to advise them
- The emphasis will be on transparency; again a very significant observation by Daniel Vasella: "To me transparency means that I will communicate truthfully what I do and don't know about my company's performance and prospects, the doubts that I have, and the things that I don't doubt. The goal of transparency is to give the shareholder an opportunity to form an opinion about you, to make a judgment. That's not to say one has to be naïve and publicly share information that will harm your company from a competitive standpoint. But in general one has to be transparent to a degree that allows fair judgment of both the company and the strength of the underlying business."
- Gatekeepers will be gatekeepers
 - Required certification by CEO and CFO will result in internal certifications by subordinates and a demand for comfort from audit firm and legal counsel
 - Companies will follow the advice of the SEC and form disclosure committees to review internal controls and disclosure; the committee process will reduce danger that a rogue officer will cook the books
 - New SEC rules requiring lawyers to go "up the ladder" when confronted with a securities law violation will result in lawyers

reporting such matters to the audit committee and the audit committee then overseeing an inquiry or investigation

- PCAOB oversight of accountants is off to a very unfortunate start which could provoke additional legislation resulting in more intrusive oversight by government
- Despite the litigation fallout from the bubble scandals, directors' liability exposure will not change significantly and the current reluctance to serve on boards will fade
 - SEC and NYSE have stated the new rules were not intended to change liability exposure of directors who act in good faith
 - Norman Vesey, the Chief Judge of the Delaware Supreme Court in an October 28 lecture said: Today, the utter failure [the emphasis is Judge Vesey's] to follow the minimum expectations of standards of director conduct or the minimum expectations of Sarbanes-Oxley or the NYSE or NASDAQ Rules might likewise raise a good faith issue. There is no definitive answer to that question, but counsel should advise the directors of that possible exposure, and encourage the utmost in good faith behavior.
 - As part of the trend to increased due diligence, boards will insist on expert opinions on significant matters; as Chief Judge Vesey also said: "It is important to Corporate America that we have directorial candidates who are willing to serve, and that they be provided with adequate pay, indemnification and insurance. Also, they should not be seen as guarantors of good results or preventors of the malfeasance, misfeasance or nonfeasance of others. They should be entitled to rely

in good faith on corporate documents, committees and experts to a significant degree in making their business judgments.”

- D&O insurance will continue to be available, including direct insurance for individual directors
- There will be a bubble in director education programs that will not collapse in the near future
- Corporate governance, as well as accounting, in the US and the EU will converge
- In a November 4, 2002 report by a group of experts it was recommended that corporate governance in the EU be improved by:
 - “! Enhanced corporate governance disclosure requirements
 - Providing for a strong and effective role for independent non-executive or supervisory directors, particularly in three areas where executive directors have conflicts of interest, i.e. nomination and remuneration of directors and supervision of the audit of the company’s accounts
 - An appropriate regime for directors’ remuneration, requiring disclosure of the company’s remuneration policy and individual directors’ remuneration, as well as prior shareholder approval of share and share option schemes in which directors participate, and accounting for the costs of those schemes to the company
 - Confirming as a matter of EU law the collective responsibility of directors for financial and key non-financial statements of the company
 - An integrated legal framework to facilitate efficient shareholder information, communication and decision-making on a cross-

border basis, using where possible modern technology, in particular the company's website”

Building an Effective Board

Good board governance can't be legislated, but it can be built over time. Your best bets for success:

Create a climate of trust and candor

Share important information with directors in time for them to read and digest it. Rotate board members through small groups and committees so they spend time together meeting key company personnel and inspecting company sites. Work to eliminate polarizing factions.

Foster a culture of open dissent

If you're the CEO, don't punish mavericks or dissenters, even if they're sometime pains in the neck. Dissent is not the same thing as disloyalty. Use your own resistance as an opportunity to learn. Probe silent board members for their opinions, and ask them to justify their positions. If you're asked to join a board, say no if you detect pressure to conform to the majority. Leave a board if the CEO expects obedience. Otherwise, you put your wealth and reputation – as well as the assets and reputation of the company – at risk.

Utilize a fluid portfolio of roles

Don't allow directors to get trapped in rigid, typecast positions. Ask them to develop alternative scenarios to evaluate strategic decisions, and push them to challenge their own roles and assumptions. Do the same thing yourself.

Ensure individual accountability

Give directors tasks that require them to inform the rest of the board about strategic and operational issues the company faces. This may involve collecting external data, meeting with customers, anonymously visiting plants and stores in the field, and cultivating links to outside parties critical to the company.

Evaluate the board's performance

Examine directors' confidence in the integrity of the enterprise, the quality of the discussions at the board meetings, the credibility of reports, the use of constructive professional conflict, the level of interpersonal cohesion, and the degree of knowledge. In evaluating individuals, go beyond reputations, résumés, and skills to look at initiative, roles and participation in discussions, and energy levels.