

# Corporate Governance & Accountability UPDATE™

## HIGHLIGHTS

*The corporate governance revolution is underway. Shareowner activists (and especially institutional investors) are demanding reform inside many corporations. Boards of Directors are exerting their independence.*

CEO pay and compensation issues became front page news for many consumer and business media in 1991 and 1992, helping to fuel the nascent shareowner reform movement.

Critical questions are now raised:

- How much should CEOs be paid?
- Who should set the compensation package?
- Should the entire board be made up of independent directors?
- Should the CEO run the company and a separate chairman run the board?
- Should executive compensation be limited by government action?
- Should the very structure of modern corporations be changed to reflect a greater need to put the community ahead of shareholders?

These and other questions are at the heart of the *corporate governance* debate. In this first issue of *Hank Boerner's Corporate Governance Update*, we provide some background on the issues. Future newsletters will contain a mixture of news, reports on emerging trends and profiles of people and organizations involved in corporate

## CORPORATE GOVERNANCE:

### THE DEBATE IS ENGAGED: THE LINES BETWEEN PUBLIC POLICY CONCERNS AND CORPORATE MATTERS ARE QUICKLY BLURRING

*...A report on emerging trends and issues ...*

Recent events inside the board rooms—and the resulting dramatic headlines—have sent a wakeup call to senior executives and other boards of directors throughout America's corporations. If your company has not yet been involved in internal or external *corporate governance* issues, there is time to analyze the current public debate and prepare for your involvement in the latest movement to sweep the corporate world. *This is not a short-term phenomenon.*

Sooner or later, virtually every publicly-owned corporation in the United States will be involved in the broadening *corporate governance* debate underway; *corporate governance* issues will affect the careers of countless numbers of senior corporate officers.

***Broad-based shareholder activism*** is a relatively new movement—*embryonic*, notes a prominent activist—which is beginning to seriously affect the way that CEOs run their companies and the way the boards and the CEOs get along. *"The times, they are a-changing."*

Shareholder activists motivated by a desire for a greater return on their investment are demanding more accountability from the individual board members—and in some cases, are urging total separation of the chairman and the board from the executive staff.

Boards, in reaction to pressure from large shareholder activists, are making changes in the fundamental ways in which they deal with chief executive officers and full-time executive chairmen. Some prominent board members are even resigning in response to the increased pressure on boards; other directors are leading the charge for change.

*Everyone* is getting involved in the debate—attorneys, public officials, the media, social activists, religious orders, public and private pension fund managers. The range of questions posed (and well covered by the media) cover the entire spectrum of political, social, economic, environmental, lifestyle, and public policy issues. Corporate management has entered a new era of dealing with internal and external challenges.

## CORPORATE GOVERNANCE:

### *The Debate is Engaged; The Lines Between Public Policy And Internal Corporate Matters Are Quickly Blurring...*

#### KEY QUESTIONS ARE POSED.

Here are a few examples of critical questions now being raised within the *corporate governance* debate: Who *owns* the corporation? How should it be governed? What are the corporation's *responsibilities* to the local community, its employees, customer, suppliers, the share owners? Are new forms of *oversight* needed for America's major corporations? Are there better models for governing major organizations (such as the German or Swiss styles)? Should unions and banks have seats set aside on the board, as in Europe? Should the very *charter* of the major corporation be changed by law to reflect society's values and needs (and not necessarily those of the shareholders)? Later in this report we will share with you one influential author's views on the subject.

#### IS MORE GOVERNMENT ACTION COMING?

What kinds of laws will be adopted in 1993 and 1994 by the **103rd Congress**? Why rules by the **SEC**? By individual states that oversee securities activities? What direction will the new **Clinton White House** take regarding the expansion of shareholder rights or to codify the corporation's responsibility to the society? How and when will the federal government intervene in CEO compensation issues? (Hint: Watch for changes in the tax code in 1993.)

#### New Ground Rules:

The ground rules are fast changing for corporate managers, boards of directors and institutional and individual share owners. The new SEC proxy and shareholder communication rules were adopted in October 1992; the 1993 proxy and annual meeting season is the first test of the rules for the shareholder activist community. The federal government has made it easier for dissident share owners to mount an attack on management and the board; among the changes are rules making preliminary proxy statements available earlier for circulation and simplifying voting for independent candidates for director.

*Not everyone in the corporate sector has their eye on the action:* A recent survey by a consulting company revealed that of 290 firms surveyed, 52 percent had not looked at the new SEC rules or had paid them little attention — their managers thought the rules applied only to certain large corporations (*Wall Street Journal* January 1993 report). In fact, the rules apply to virtually *all* companies that are publicly traded.

For 40 years the complex regulations governing communication with shareholders on corporate voting matters have tended to discourage communication even on non-voting matters. The SEC studied the issue for three years, heard public comment, issued two preliminary rules for public review, and reacted to Congressional pressure for reform. Under **Chairman Richard Breeden**, new rules were formally issued in 1992 (becoming effective October 15, 1992).

**The SEC says it has taken steps to facilitate effective shareholder communication and participation in corporate governance by removing unnecessary regulatory barriers; and reducing the costs of complying with the proxy rules.**

#### WHAT IS THE BOARD'S PROPER COMPOSITION AND ROLES?

Questions are being posed by shareowner activists, particularly those managing the portfolios of major pension funds and at the helm of large mutual funds: Should the boards of directors of major corporations be composed of a majority of outside directors who have no direct involvement in the day-to-day management of the organization? (At **PPG Industries**, all of the directors are outsiders except the Chairman/CEO.)

Should these *independent directors* have a full-time staff of their own? Who should determine the compensation packages for CEOs and senior managers? (Some shareowner activists have adopted the position that only outside directors should sit on the compensation committee and set the CEO's salary, performance bonus and stock options.)

#### HOW MUCH SHOULD CEOs BE PAID?

Should the salary of the CEO be determined by a ratio or percentage of that of the highest paid salaried employees? (**Ben & Jerry's Ice Cream**, for example, limits the CEO's pay to seven times that of the rank and file.) Today, CEO pay is 157 times that of the average worker, according to some estimates.

These issues are now on the front pages of the business press. Back in 1959, **Crawford H. Greenewalt**, then president of **DuPont**, proposed that there should be more stock and less cash in the CEO's package — enough stock should be held that the dividends would be at least equal to the executive's retirement pay and five times the fixed salary.

In 1989 the average CEO of the top 200 companies received \$2.8 million in salary and bonuses. CEO salary rose 8% that year, according to consultants **Towers Perrin's** compensation group. Between 1973 and 1975, CEO after-tax pay averaged 24 times that of the average manufacturing worker. By 1987 to 1989, the differential was 157 times (source: compensation consultant and author **Graef Crystal**).

Thanks to tax reform, taxes for CEO's also declined, from 50% to 28%. Meanwhile, the workers' taxes inched up, from 20% to 21%. The pay differential between worker and CEO became an enormous gap, often breeding discontent in the rank and file.

Pay packages of American CEOs are now said to be two to three times those of counterparts in Japan, France, Britain, Germany and the Netherlands, although such comparisons are not simple matters. Throughout 1991 and 1992 a variety of multipliers and ratios were served up by the press to compare US CEO pay with counterparts in Europe and Asia.

News media abound with stories comparing American CEO pay with that of the Japanese, the British and the Germans. As layoffs escalate, the media focus more intensely on CEO compensation.

### HOW SHOULD CEO PAY BE DETERMINED?

Should American senior management be paid according to the company's performance in the capital markets? Many shareowner activists are demanding this type of approach and companies are beginning to adopt this method of compensation.

*Should compensation be increased if the company's fortunes decrease? How much of the pay package should be based on stock market performance?*

*Should a CEO and his senior management team be required to own shares in the company they manage? (That way, they also feel the pain, the argument goes.) What is the appropriate investment in the employer by a senior manager?* **Eastman Kodak** recently announced that four times the annual salary was a suitable target for its CEO and 40 of the company's top managers.

*How many hats can a CEO wear?* Shareowner activists are often demanding that the offices of chairman, CEO and president be separated (The **Sears** chairman yielded to such outside pressure and has now relinquished three of his five posts; at the same time, **Time Warner** has just named **Gerald Levin** chairman, president and CEO.)

*How much financial information about CEO compensation should be required so that the individual and/or institutional investor can make a reasoned decision?* The new SEC rules for annual reports require a five-year profile (in clear, graphic form) of executive compensation with comparisons of other CEOs. *Are more rules of this type needed?* (Activists answer emphatically "yes".) *Will some of these rules actually aid competitors by requiring disclosure of trade secrets and ultra-confidential corporate information?* Opponents of liberalized SEC rule-making claim this will be the case.

### COMING: MORE COMMUNICATION

What else can be done to simplify and broaden communication among and between shareowners, separate of the traditional proxy information disseminated by the corporation? How democratic can we make share ownership and corporate management? Such questions are now evolving into major public policy dialogues.

These specific questions go to the heart of the current *corporate governance* debate. The new **Securities & Exchange Commission** disclosure and proxy rules have greatly strengthened the hand of the shareowners, and most important, the institutional holders, such as the major public pension funds, including CalPERS, the **California Public Employees Retirement System** and New York City's several pension funds (usually referred to as **NYCERS**).

### PENSION FUND ACTIVISM

**CalPERS** is among the most visible and best organized of the major pension fund activists. In January the huge pension fund announced its corporate targets for share owner actions in 1993: **IBM; Champion International; Boise Cascade Corp.; Time Warner Inc.; Chrysler Corp.; General Motors; Westinghouse Electric Corp.; Sears, Roebuck & Co.; Pennzoil Co.; Sizzler International; Advanced Micro Devices, Inc.** According to the fund, meetings are being scheduled with the outside directors of many of these firms — *without the CEOs present.*

The major shareowner activists such as CalPERS, the New York City funds and the grassroots action group representing 70,000 individual share owners, **United Shareholders Association** use the national media, SEC lobbying, Capitol Hill contacts, and a network inside Wall Street to bring about real reforms in the effort to build shareholder value.

Activist groups say their mission is primarily to build shareowner value and point to the success of CalPERS, which claims to have gained \$130 million in portfolio value with an investment of \$500,000 in activist programs. (CalPERS regularly hires outside compensation consultants, share owner activists and law firms.) CalPERS launched the new era of activism in 1986, with letters to major corporations requesting changes and reforms and the start of a dialogue.

**Activists should not be ignored or their demands for reform and change immediately brushed aside by CEOs and boards. They mean business and their work is just beginning, they say.**

### POWERFUL SUPPORT IN THE CONGRESS AND NEW ADMINISTRATION

The shareowner activists have powerful supporters in the **Congress** and **SEC**, and now, in the White House; they have very effective media relations programs; and, they are networked to a degree matched only by the 25 year old environmental movement. In some cases, the shareowner activists are linking up with environmental and social action or public agenda movements to demand reforms of corporations they judge to be errant in *social responsibility terms*. (**The Council on Economic Priorities** recently issued report cards on the environmental activities of **GM, Cargill, DuPont, GE, Georgia-Pacific** and **MAXXAM**, for example.)

The shareholder activist community is serious about real reform and intends to be major players in the *corporate governance* debate. The public is also becoming involved. (An intriguing question emerges: Who owns the pension funds that have become proactive players in the movement? Who makes the decision to target a company, such as **Sears**, and how coordinated should activism programs be for maximum effectiveness short of violating anti-trust laws? How does **CalPERS** best speak for the 950,000 employees with long-term investments in the fund?)

With increased pressure on state and local treasuries, governors, mayors and legislators are [in some cases] looking to their public employee pension funds to generate "profits." New York State's government employee pension fund turns a profit in the market and this relieves pressure on the state to make certain annual contributions to the fund. **Look for more state and local officials to encourage activism on the part of their pension fund managers — it's good for business, they are being told.**

The new **Clinton-Gore Administration** and the **103rd Congress** are focused on many of the *corporate governance* issues identified here. Executive compensation was specifically addressed by candidate Bill Clinton during this campaign. ("**Shut the Door on the 'Something for Nothing' Decade...by eliminating deductions for outrageous executive pay.**")

**President Bill Clinton** said on February 11th that he will keep his campaign pledge to use the tax code *to discourage excessive corporate salaries.*

At least one member of the House and of the Senate have told the writer that they will [each] introduce legislation again this session to address corporate compensation and to set limits on pay and options. Other members are focused on tougher laws regarding plant closings, employee termination packages, employee benefits, mandatory healthcare through employers and employer-funded mechanisms, stricter environmental compliance in *other* countries (as part of the **NAFTA Treaty**), expanding the rights of share owners, tougher operating rules and greater personal liability for corporate directors, the superseding of “cozy” state rules for corporations with tougher federal rules, and a host of related topics. Still other Members of Congress now favor limiting the tax deductibility of executive compensation [beyond a certain limit, often set at a million dollars] for the corporation.

### THE PUBLIC’S ATTENTION IS ENGAGED

Employees and suppliers and customers are watching the recent events with fascination — especially when such powerful executives as the chairmen of **IBM** and **GM** are affected by board room revolts.

Highly publicized stock option packages have helped to focus public attention on corporate governance issues. When **Walt Disney Co. Chairman Michael Eisner** recently cashed in his hefty options before year-end 1992 to avoid anticipated increases in capital gains taxes, the news media reported a \$70 million “windfall.” Editorial writers deplored Mr. Eisner’s excessive compensation while calling for government and board of director action. (*CEO Magazine* asked, “Where’s the beef if **Disney** share owners enjoyed a \$7.2 billion increase in value?” The publication also pointed out that **Chrysler** shareowners “may have a beef because between 1987 and 1990, the value of their holdings dropped \$2.2 billion while **Chairman Iacocca**’s compensation was \$2.2 million in 1990.)

The CEO compensation debate has become highly charged and often is quite personal. Print and electronic media have been critical of executive compensation packages since the economy entered recession in 1988-89 and have singled out individual CEOs for especially intense scrutiny of their performance and pay packages. It is not unusual to see both business and consumer print media prominently calling for the replacement of chairmen and CEOs. This is becoming a *trial by media* for some CEOs.

### BUSINESS PRESS ON THE ATTACK

It would appear that some of the business press has turned 180-degrees in coverage of America’s CEOs. The corporate “heroes” of the early 1980s were later heavily criticized for being *greedy* (as the decade ended). **Chrysler Chairman Lee Iacocca** is a prime example; *Business Week*, *Fortune* and the *Wall Street Journal* featured the chairman in major articles during the 1980-84 period, but later these publications became critics of his company’s performance and his compensation. Individual commentators have credited such investigative programs as *60 Minutes* and *20/20*, and movies (*Roger & Me*) for popularizing the nation’s discontent with its CEO corps -- and directing for editors’ attention toward the corporate sector.

### BUSINESS PRESS FOCUSED, OFTEN ANGRY

Both the business and consumer press are firmly focused on *corporate governance* issues. The tone of recent coverage has often turned nasty. *Business Week* and the *Wall Street Journal* in particular continue to publish extraordinary amounts of corporate governance-related stories (15 of 30 features in one recent issue of the *Journal*).

### WHAT TO DO WHEN YOU AND YOUR COMPANY BECOME THE TARGET?

What does a senior manager do when the media focuses on him (or her) or his or her corporation? How does the corporation deal effectively with a shareholder activist movement that in some ways can resemble the sound and fury and passion of the environmental movement in its earlier days? How do corporate managers sift through the barrage of complaints or critical comments directed their way by shareowner activists or the media or government officials and find a middle ground, a compromise with the critics that will meet the needs of all parties?

How does a corporation cope with a major attack that focuses the heat of the activist community [on it] and brings a wave of critical press coverage and energizes *other* dissident share owners? These questions are at the *heart of survival* for some CEOs and managers.

Some of the business editors are razor sharp in their focus and analysis. **Judith H. Dobrzynski**, senior editor of *Business Week*, has written several dozen major articles and penetrating commentaries on corporate governance issues, including cover stories on the **GM** turmoil. Recently she wrote a commentary calling for the replacement of **IBM Chairman John Akers**. (He resigned days later.) Taken as a body of work, Ms. Dobrzynski’s views on the performance of CEOs and boards have spurred on those activists who are dissatisfied with the lackluster stock market performance of the large corporations in which they have significant investments. (**CalPERS**, for example, owns shares in 1,000 companies.)

**Popular Myths:** *American companies are mismanaged, can’t compete, don’t stress quality and have forgotten how to satisfy consumer demands — and they pay their executives too much while ignoring middle-management and those at the bottom of the pay scale.* These are appealing media themes and send messages to the unemployed or under-employed and all of those who think they are underpaid.

In recent months more layoffs occurred, particularly at large corporations, CEOs increasingly became the target of criticism. The more employees furloughed, laid off or bought out during restructuring and downsizing programs, the greater the criticism in both consumer and business media of CEO compensation. (Middle managers represent 5% to 8% of the workforce and have suffered 19% of layoffs over the last four years, says the **American Management Association/AMA**.)

### TAKING THE MOVEMENT ABROAD

The *corporate governance* debate does not stop at our shores. **CalPERS** announced in January 1993 that it is focusing on its United Kingdom and German corporate holdings and will soon begin activist programs abroad. **New York City Comptroller Elizabeth Holtzman**, a trustee of five pension funds, demanded to know of **German Chancellor Helmut Kohl** what *he* was doing to protect foreigners being attacked in Germany...because such negative publicity would affect the New York City pension fund holdings in German corporations. (She is said to have received an immediate answer.)

### THE TIDE TURNED AGAINST CEOs IN JAPAN

If there is a specific moment that can be identified when the tide of public opinion turned against America's senior corporate managers, it was during **President George Bush's** 1991 trip to Japan (accompanied by the CEOs of the auto industry). Shareowner activists, business writers and members of Congress identified this to the writer as being an *epiphany* of the sort experienced by foes of nuclear power when the Three Mile Island incident occurred; or, of those concerned about ocean shipping of crude oil when the *Exxon Valdez* accident occurred in Prince William Bay. Many Americans did not like what they saw, as [in their view] **President Bush**, the chairmen of **Chrysler** and **GM** and other corporate leaders "groveled" before their Japanese competitors — who, it was widely reported on air and in print, were paid far less money, and achieved far greater success for their companies than their American counterparts.

### PERSONAL ATTACKS ON CEOs MOUNTING

The *corporate governance* debate is now frequently characterized by *personal attacks* on CEOs and members of their boards. Outside directors are being targeted *individually* as the business press continues to focus on the performance and compensation of the CEO. The boards and the CEOs of **IBM**, **Sears**, **Westinghouse**, **GM** and other *Fortune 500s* are under intense scrutiny. Some top corporate heads have been lopped off in recent months (the top men at **GM**, **American Express**, **IBM**, **Compaq**, **Digital Equipment**, **Westinghouse** are the most visible of recent CEO upheavals).

The disappointing financial and stock market performance(s) of **IBM** have focused intense heat on **Chairman John Akers** and some members of his board (IBM has lost half of its market valuation in the past year). **Sears Chairman Edward Brennan** has been the target of shareowner activist attacks for three years running. **Citicorp's John Reed** is a current target of the activists. Activists take credit for toppling **James Robinson III** of **American Express**. (According to *The New York Times*, big institutional investors such as **JP Morgan**, **Alliance Capital** and **Putnam Management** demanded a new management team.) **Digital Equipment Chairman Ken Olsen** was removed by his board in 1992.

These executives have become *symbols* of what was wrong inside the company — notwithstanding external competitive forces, complex trade issues, the general slowdown in the national and global economies, the effects of over-regulation, the impacts of changes in technology, and other agents of change.

### CORPORATE GOVERNANCE MOVEMENT MOVING INTO HIGH GEAR

This focus on the CEO and the board of directors is not a temporary aberration. The shareowner activism phenomenon will not disappear any time soon. *Corporate governance* issues will be the focus of increased board action, continued press coverage, shareholder activism, government oversight and legislative and regulatory action (such as more regulation of the public corporation, perhaps even of CEO compensation) well into the 1990s. Some of the outside players are highly visible public figures while others are quiet professionals who manage billions of dollars' of public employee pension fund monies invested in major corporations. Two of the most public of the activists are **Elizabeth Holtzman**, the Comptroller of the City of New York with \$65 billion under control, and **Dale Hanson**, CEO of the \$70 billion California Public Employees Retirement System — both are powerful forces to be reckoned.

### ENVIRONMENTAL ORGANIZATIONS MOVING INTO SYNCH WITH THE SHAREHOLDER ACTIVISM MOVEMENT

The environmental movement is moving into synch with the shareowner activist movement: In his recent book, *A Fierce Green Fire*, *The American Environmental Movement*, author (former *New York Times* environmental editor) **Phil Shabecoff** argued:

*American corporations are in thrall to the tyranny of the immediate. To achieve meaningful, lasting changes in corporate behavior, it probably will be necessary to make substantial changes in the structure and values of the corporations themselves. This would be done by revising securities laws requiring companies to achieve defined levels of environmental performance. Another possibility is the mandatory rewriting of corporate charters to reflect a set of values similar to the Valdez Principles. Corporate behavior may eventually be regulated by the principle that the health of the common environment takes precedent over the rights of private property.*

The powerful environmental movement — now in its Third Wave, with intensive discussions and negotiations carried on with corporations — is broadening its base to include areas directly related to *corporate governance*.

### TAKING THE ENVIRONMENTAL PLEDGE

In early February the *Wall Street Journal*, *Washington Post* and *New York Times* reported that "*Sun Oil Takes Environmental Pledge.*" **The Sun Company** of Philadelphia, 12th largest oil company in the U.S., became the first *Fortune 500* to endorse *The Valdez Principles*. These are a code of corporate environmental conduct principles crafted by activists after the 1989 oil spill in Alaska.

In May 1992 a resolution endorsing the principles was introduced at Sun's annual meeting in New York City (the New York City pension funds submitted the proposal and got 6% of the vote). After the meeting company officials met with **CERES**, the **Coalition for Environmentally Responsible Economies**, which was formed to coordinate the principles with major companies and many mid-sized publicly-traded firms. Sun joins 51 other companies in signing an agreement and paying \$15,000 in fees annually to the Coalition (others include **Ben & Jerry's**, **Domino's Pizza**).

Sun pledged to reduce pollution, recycle waste, improve the quality of water discharged into streams, and will provide CERES with answers on a detailed questionnaire about toxin levels at its facilities.

The CERES coalition now includes the **Wilderness Society, the Sierra Club, the Audubon Society, California and New York City pension funds**. CERES continues to target **Exxon**, which has resisted adoption of the 10-point principles.

CERES will be active in this proxy and annual meeting season, applying shareholder pressure on large and mid-size companies it believes should adopt the principles. In this way, the shareholder movement and the environmental movements *are coming together*.

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***in the next issue***  
***NEW SEC RULES...***

New proxy and shareholder communication rules were issued in 1992 (effective 10-15-92). The SEC says it took these steps to facilitate effective shareholder communication and participation in corporate governance by removing unnecessary regulatory barriers; and, reduce the costs of complying with the proxy rules.

**Highlights of the New Rules:**

The SEC has adopted a number of reforms to the rules governing shareholder communications; affected are such provisions of SEC regulations as: Promotion of Fair Communication; Disinterested Persons' Rights; Notification for Certain Writings; Anti-fraud Provisions Remain Applicable; No Notification Necessary for Publicized Communications; Announcement of Voting Decisions; Communications by Advisors; No Prior SEC Review for Most Communications; Public Availability of Preliminary Proxy Statements; Circulation of Preliminary Proxy Statements; Elimination of Schedule 14-B; Shareholder Lists; Unbundling of Related Proposals; Voting for Independent Candidates for Director; Disclosure of Voting Results.

*More on the SEC and the new rules in the next newsletter.*

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