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JUNE 24, 2002

COVER STORY

Restoring Trust in Corporate America

Business must lead the way to real reform

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The lobbying started early. Even before the New York Stock Exchange could release its far-reaching proposals to upgrade corporate-governance standards, Chairman Richard A. Grasso began fielding calls from chief executives. Then came the letters of protest--at least a dozen of them--from some of the top business leaders in America, including the CEOs of General Mills Inc. (GIS) and AT&T (T).

All of them are members of the Business Roundtable, the elite group of big-league bosses who typically weigh in on public policy issues. Fannie Mae (FNM) CEO Franklin D. Raines initiated the campaign in late May, urging his Roundtable brethren to line up against the NYSE plan to require companies to put all stock-option plans to shareholder votes. In a letter to Grasso, General Mills Chairman Stephen W. Sanger denounced the idea as "counterproductive" and suggested that the exchange "proceed incrementally in this area." In fact, the NYSE governance committee avoided the more controversial and politically charged issue of expensing stock options by recommending this much more modest proposal.

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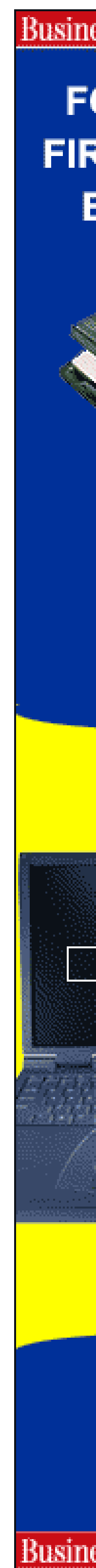
The opposition wasn't unexpected, but it was surprising that the Roundtable, which tried in May to preempt the recommendations by releasing its own much more vague proposals, would pounce even before the report was in the mail. "The letters I received were all from Roundtable representatives," says the NYSE's Grasso. "But they are going to have to balance how the public feels right now with their position, and frankly this market shows that people aren't feeling very good."

To many critics, Corporate America's leaders seem shockingly out of touch, blind to the deterioration in public confidence. A seemingly endless stream of bad news alleging widespread management negligence and malfeasance is chipping away at the trust vital to a free-market system. CEO L. Dennis Kozlowski of Tyco International Ltd. (TYC) was indicted, and Samuel D. Waksal, CEO of ImClone Systems Inc. (IMCL), was accused of egregious breaches of trust and abuse of power within eight days of each other. Meanwhile, in Houston, a jury deliberated on the fate of Andersen Worldwide, once one of the nation's most respected auditing firms, accused of destroying evidence in the investigation of Enron Corp. These scandals follow a parade of outgoing CEOs that included Kenneth L. Lay of Enron, Bernard J. Ebbers of WorldCom (WCOM), and John J. Rigas of Adelphia (ADLAE), all forced to step down amid questions of abuse, incompetence, or both. Over the same period, other CEOs supplemented their mammoth paychecks by cashing in giant option grants just before steep stock declines.

In a recent speech at the University of Michigan, former Secretary of State James A. Baker III said that "the genius of capitalism is to pacify a destructive human characteristic, greed, into benign self-interest--something we know as `incentive."' But in the anything-goes 1990s, greed overwhelmed the system because there were no countervailing forces to keep it in check. Instead, there were accounting firms, which were bent on drumming up lucrative consulting fees; outside lawyers, intent on maintaining their flow of business from corporations; and directors, who failed to exercise oversight as the fiduciary representatives of the shareholders.

Rarely have business and its leaders been held in such low



esteem. Yet even as the crisis becomes more dangerously disruptive for the market and the economy, most of the business community has been silent. Worse, it has lobbied against sorely needed reform. "I can't understand the opposition," says New York Comptroller H. Carl McCall, a co-chairman of the NYSE committee behind the proposed changes in governance standards and candidate for governor. "This is good for corporations. This is an opportunity for corporate leaders to stand up and say: `We are going to do everything possible to restore confidence and safeguard your investment."' Working against reasonable reforms, he adds, will only further undermine public trust in business leadership.

So far, the biggest push for reform is coming not from Corporate America but from Wall Street and the marketplaces, which are acutely sensitive to investor sentiment. The first high-profile CEO to step forward and call for reform was Henry M. Paulson Jr. of investment banking powerhouse Goldman, Sachs & Co. (GS), who anticipates that stock options will eventually be treated as an expense on a company's income statement and believes that corporate insiders should be required to give back any gains from stock sales made less than a year before a bankruptcy: both unwelcome ideas to many CEOs. "In my lifetime, American business has never been under such scrutiny," Paulson said in a widely publicized speech before the National Press Club. "To be blunt, much of it is deserved."

If the nation's business elite fails to recognize the seriousness of the erosion in confidence, it will jeopardize what the business community ultimately wants: a free-market economic system, based on the participation of investors, without heavy-handed regulation or interference from Washington. That's why business must lead the way to reform. "It doesn't appear that Congress will be able to get its act together to do anything," says Leon Panetta, former White House chief of staff and another co-chair of the NYSE governance panel. "Ultimately, this is a responsibility of the private sector to govern itself."

Part of the reluctance of CEOs to step up is the result of how far the taint has spread. The poster children of this crisis are garnering the headlines, but Enron, Global Crossing, Andersen, Tyco, and WorldCom are merely the more visible symbols of a

far deeper and disturbing cultural shift in corporate mores. When a company as respected as IBM (IBM) shovels $290 million from the sale of a business into its income statement to goose results, as the computer giant did last year, it's a sign of pervasive abuse. The maneuver may have been legal, but it was also blatantly deceptive. Indeed, many of the nation's most prominent companies, from Microsoft Corp. (MSFT) to Xerox Corp. (XRX), have been forced to restate their financials. From 1995 to 2001, restatements steadily climbed from 50 a year to more than 150--or a total of 722 public admissions that the numbers were so wrong they had to be redone. And if those restatements continue at the first quarter's pace of 60, they will reach 240 this year alone.

So what happened to corporate ethics? The root of the deterioration dates back 20 years, to the start of an unprecedented era of prosperity that transformed CEOs into cult heroes. From a time when many feared the U.S. would be overwhelmed by a super-efficient Japan, America's business leaders helped to make the U.S. the world's most productive economy. A return to business basics, along with a flowering of innovation and entrepreneurship, led to a celebration of corporate chieftains. Capital freely flowed into a financial system based on trust, stability, transparency, and the assurance that checks and balances made the stock exchanges a fair marketplace for every player.

Nobody got fatter during the boom than the newly invincible CEOs, who were increasingly compensated with massive stock-option grants. That meant their success--and take-home pay--became directly related to how high they could nudge their stock price. Indeed, the great paradox of the so-called "shareholder revolution" of the past two decades is that CEOs gained exponentially in power, influence, and certainly pay. Pressure from institutional shareholders unwittingly led to massive transfers of wealth from investors to senior executives, all under the guise of lining up management's interests with those of shareholders.

Making sure that managers actually act in the best interests of shareholders is supposed to be the job of the board of directors. But as stock prices rocketed upward in the '90s, they became as mesmerized as investors. The incoming CEO of a troubled company recently joked to a governance consultant that his

boardroom "is like an aquarium filled with dead fish." Angry shareholders at many companies today are wondering if it would make any difference if the fish were alive.

Many CEOs seemed to operate almost without restraint. At WorldCom, now under investigation by the Securities & Exchange Commission, the board gave its blessing to a $366 million loan to CEO Ebbers in late 2000 so that he could cover a margin call on his personal investment in the company's stock. Tyco's board approved a $20 million bonus to one of its members for helping with the acquisition of CIT Group Inc.--which the company is now trying to unload at just half of the $9.5 billion it paid only a year ago.

To dismiss the rising swell of calls for substantive reform is to ignore fundamental problems that led to widespread financial manipulation and outright greed. "It's like the cardinals screaming that this whole business of abuse of minors is something concocted by the press," says Jay W. Lorsch, a management professor at Harvard Business School. "The media didn't create that problem, and the media didn't create this problem in the business community."

So why aren't more business leaders willing to speak out publicly? Many are fearful of inviting scrutiny of themselves or their companies. "There is a little circling-of-the-wagons here," concedes the recently retired CEO of a NYSE-listed company. "They're scared. They're afraid that they are going to get it next."

Others simply don't see the problem. Privately, many CEOs say that the companies in the headlines are anomalies that have been blown out of proportion by sensation-mongering media. "Everything is spun as if you did something wrong," says one who declined to be named. "It's this air of implication." The result, he claims, is a search-and-destroy mission by short-sellers and business reporters for any company with even the slightest whiff of accounting impropriety or executive excess.

Many CEOs point out that most American corporations play by the rules and are run by honest people. "I think it's unfortunate that the misdeeds of a few have had the effect of creating questions and undermining the confidence of business in general," says James F. Parker, CEO of Southwest Airlines Co.

(LUV)

Many chief executives also argue that market forces are the best corrective and that much of the investor angst has other origins. They say that economic populists have seized on the spate of bad news as an excuse to legislate issues that should be left to the companies and a self-correcting market. If investors are jittery and disillusioned, many chieftains steadfastly maintain, it's a hangover effect from the bursting of the dot-com bubble, terrorism, and the possibility of a nuclear war between India and Pakistan--not ethical lapses in Corporate America.

Fortunately, there has been no stampede by investors out of the market. The Standard & Poor's 500-stock index is down 10% so far this year--bad, but not disastrous. But holding the public's trust is not unlike damming a river. Small leaks can quickly and unexpectedly gush into a flood that wreaks massive damage. Tyco alone has lost $100 billion in market value, a sum that exceeds Enron's total. With the market down, despite favorable economic news, the dam is certainly leaking--and nearly everyone knows it, from Washington policy wonks to institutional shareholders. "If only 10% of what you read about Enron is true, this is a major, major problem," says Harry M. Jansen Kraemer Jr., chairman of Baxter International Inc.

Behind the sins of Enron and other corporations was the corrupting effect of stock options. They led to massive CEO pay inflation in the 1990s. But the toxic effects of that rise became clear only as the bull market began to ebb. Even while shareholders were losing millions of dollars, executive after executive seemed to be cashing in on an unsupervised lottery. At now-bankrupt telecom provider Global Crossing Ltd., Chairman Gary Winnick sold $735 million in company stock from 1999 to last November. At Enron, Chairman Lay sold more than $100 million in stock over the past three years--even while publicly insisting that he wasn't cashing out. The same was true at Tyco, where CEO Kozlowski and his chief financial officer unloaded more than $500 million of stock, quietly selling it back to the company, a trick that allowed them to delay any public disclosure of their sales.

Why did boards hand over such huge sums to begin with? "Boards get in awe of a Ken Lay [at Enron] as long as the

stock price goes up," says William W. George, former CEO of Medtronic Inc. (MDT), who has broken ranks with many of his colleagues to speak out for more progressive reform in governance. "Greed takes over." It takes unusual courage for a director to challenge a CEO in a company whose share price is doubling every two years or so. As Harvard's Lorsch points out, "every board's worst nightmare is that a good CEO will walk away because he's not being paid enough."

Many of the abuses and lapses that have surfaced in recent months are a direct result of the vast wealth that suddenly was in reach of even mediocre executives. "Corporate responsibility is mainly a matter of attitudes, and the attitudes got corrupted by the mentality of the markets in the 1990s," says Paul A. Volcker, the former Federal Reserve Board chairman. "We went from `greed is good' being said as a joke to people thinking that `greed is good' was a fundamental fact."

If some CEOs are fighting to retain the status quo, it's partly because they've benefited wildly from it. They don't want to see big reforms that are going to cut back on stock options or their own power in the boardroom. Without morphing into an Enron, a lot of companies played games with their earnings, going all out to meet Wall Street's expectations and juice the stock. Few want to stand up and take a firm stand when they know that they, too, pushed the limits.

Meantime, others resist the most moderate idea of reform. Consider Thomas A. James, CEO of NYSE-listed Raymond James Financial Inc. He is publicly against the notion that a public corporation, which avails itself of public capital, should have a majority of independent directors on its board. "In my mind," James said, "there is no evidence that there is any advantage to having more outside members." Only 4 of his board's 13 directors are without a business or family tie to the company. Shockingly, roughly a quarter of the companies on the NYSE, including insurer American Financial Group Inc. and high-tech player EMC Corp. (EMC), still boast a minority of independent board members.

At the same time, there is behind-the-scenes opposition to reasonable reform, such as the accounting profession's aggressive lobbying in Congress against change, accompanied by hefty campaign contributions. Or the Roundtable's

opposition to shareholder votes on stock-option plans. The organization favors the current system--where votes are required only on executive option plans, not on broad-based equity plans that provide options to large numbers of employees. "There is no danger of acting in a self-serving way if management is not a participant in the plan," says Raines, CEO of Fannie Mae and chairman of the Roundtable's task force on corporate governance. "Management should have some flexibility in using the stock if it's compensation for a large number of employees."

Others disagree. "It's the shareholders' money, for goodness sake," counters Charles M. Elson, director of the corporate governance center at the University of Delaware. "This is not a wild-eyed or off-base reform. If you are diluting the dickens out of the shareholders, they have the right to vote on it. It's basic shareholder democracy."

If investor confidence is wounded---as most observers believe--then the best chance of restoring it rests on business leaders getting behind the agenda for change. No one can legislate honesty or competence. But the system cannot afford a business community that is unwilling to speak out against dishonesty or incompetence, or business leaders determined to fight intelligent and legitimate reform. "My fear is that if we don't step up, it's going to look like we all have our fingers in the cookie jar," says former Medtronic CEO George.

Ultimately, Corporate America's business leaders must lead the way to change. As Paulson of Goldman Sachs reminded everyone: "Integrity is the cornerstone, if not the bedrock, upon which all financial markets are based." If business is to avoid a potential flood that threatens to wash away the trust essential to our free market system, its leaders must stand up and lead--not block--substantive reform.

By John A. Byrne
With Michael Arndt in Chicago, Wendy Zellner in Dallas, and Mike McNamee in Washington

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