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## **FINDING THE RIGHT DIRECTOR**

By Yvette A. Wallace\*

“Corporate governance” as a buzz word in the Anglo-commonwealth world found its roots in a number of scandals which hit during the 1980’s. Along side these scandals was a significant increase in the *nouveau riche* executives who were generously rewarded by so called “independent” remuneration committees with packages that were considered extravagant. Shareholders and the public in general were nervous. In the United Kingdom, these phenomena led to various Committees (Cadbury in 1991 and Greenbury in 1995) which established “Codes of Best Practice”. However, neither went far enough to curb the over-powerful executives and to empower the corporate investors.


In the United States, there have been glaring examples of the failure of directors to appreciate or discharge their responsibilities. The most noted poster boys of “bad Governance” are Enron<sup>i</sup>, WorldCom<sup>ii</sup>, Xerox<sup>iii</sup>, IBM, and Tyco<sup>iv</sup>. Additionally in Canada, law suits against directors which were previously unheard of, now are commonplace.<sup>1</sup>

To stem the crisis of confidence in the corporate world, the United Kingdoms

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<sup>1</sup> For example see Peoples Department Stores Inc. (Trustee of) v. Wise. [2004] 3 S.C.R. 461



established other Codes and reports which sought to introduce more meaningful and effective internal controls in the corporate environs and thereby reduce the instances of wrongdoing by corporate executives.


So, what are the new rules of corporate governance expected to achieve? Enhancement of shareholder and stakeholder value, control of financial, business and operational risk and reducing the cost of capital<sup>2</sup> This is achieved by:

- Selection of the right candidates for directorship
- Training and proper orientation of new directors
- Effective communication
- Curbing the power of the CEO
- Change in behaviour
- Devotion of time
- Evaluation and Improvement Plan.

The remainder of this article will focus on the first of these which is the “Selection of Directors”. Good directors bring good judgment to their jobs together with a commitment to spend the time that is required and a willingness to ask questions. Where good directors are selected then with proper training and orientation, effective communication, those persons will devote the time necessary for the business of the company, be able to curb the power of the CEO, and generally to manage the company so that it will be a benefit to all stakeholders.

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<sup>2</sup> Richard Smerdon “*A Practical Guide to Corporate Governance*” 2<sup>nd</sup> ed., p 12.




Traditionally, the director's role tended to be narrow and was seen as merely to:

- Provide legitimacy for business purposes
- Provide stewardship to the organisation
- Provide advice on a range of issues
- Provide networking contacts
- Provide supervision to management


However, the role has now been expanded and while the precise role of the board will vary depending on the company' stage of development most include:

- Creation and maintenance of satisfactory governance structures and procedures
- Participation (in an active manner) in the selection, evaluation and compensation of the Chief Executive Officer
- Assist in the creation of appropriate management structures, including the selection, review and development of senior management personnel,
- Participating in the design and implementation of compensation and general human resources policies,
- Participating in strategic planning and in monitoring the performance of management against plans,
- Contributing directors expertise to the solution of specific issues facing the corporation,
- Assisting in understanding the principal risks of all aspects of the

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- business of the corporation and in satisfying itself that there are appropriate systems in place to monitor and manage these risks,
  - Assisting in the communication of corporate policy and events, including advising on the nature of dissemination and participating in the actual dissemination to particular communities,
  - Providing broadened representation (of interested parties, including owners, creditors, suppliers, geographic regions, gender, minorities and others) and sensitivity that comes from this sort of representation,
  - Assisting in management succession planning,
  - Assisting in directors' recruitment and succession planning, and
  - Enhancing and monitoring the performance of the board and of individual directors.


It is therefore imperative to select the right persons for the board of directors. Each time there is an opportunity to recruit a new director to the board, those responsible for identifying potential candidates should consider the following factors:

- The existing composition of the board-are there any skill sets that are currently lacking?
- Does the company have plans that would benefit from the board input that it does not currently have?
- Are there directors who plan to step down in the near future whose skill sets will need to be replaced?
- Does the person have experience with comparable stage companies?

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- Can the person develop strong working relationships with the other board members and relevant members of management (typically the CEO and/or CFO)?
  - Is there a balance of personalities represented on the board?
  - Does the person exhibit good judgment, integrity, competence and a public conscience?
  - Is the person able and prepared to devote the time required?

One of the primary factors in identifying a suitable director is the business experience that the person has and how this would be helpful to the company. For example, the company may need specific experience in the industry in which it operates (e.g., finance, energy generation or real estate development). Management experience may also be desirable, or experience in financial reporting or strategic planning. If a candidate has board experience, inquiries should be made about whether he or she has contributed effectively as a member of those other boards.

The personal attributes of a candidate is an important factor. The board should make enquires about and be comfortable with a candidate's reputation. The person should have a high ethical standard and should have no relationships that would be adverse in interest to the company's interest. The board should be confident that the individual will act in an independent-minded manner and has the temperament what will allow him or her to act effectively on the board.



The candidate must also be willing and able to commit the time to be an effective member of the board. He or she will be required to attend board meeting as well as committee meetings on which he or she serves. The candidate must appreciate the compensation arrangement for directors of the company.

Boards need to take into account whether they will be able to satisfy the legal and regulatory requirements<sup>3</sup> with respect to board membership. The individual must be considered “fit and proper” to hold the position of director, regardless of the qualification and experience of the individual.

As recent corporate scandals have proven, qualifications and experience are only the beginning of good corporate governance. It is critical that director understand their roles and responsibilities have the commitment to exercise their best sense of judgment. Only then will they provide valuable service to the stakeholders of the companies which they manage and avoid the risk of financial and personal embarrassment.

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<sup>i</sup> **Enron Corporation** was an American energy company based in Houston, Texas. Before its bankruptcy in late 2001, Enron employed around 21,000 people (McLean & Elkind, 2003) and was one of the world's leading electricity, natural gas, pulp and paper, and communications companies, with claimed revenues of \$111 billion in 2000. *Fortune* named Enron "America's Most Innovative Company" for six consecutive years.

Enron achieved infamy at the end of 2001 when it was revealed that its reported financial condition was sustained mostly by institutionalized, systematic, and creatively planned accounting fraud. Enron has since become a popular symbol of willful corporate fraud and corruption.

The lawsuit against Enron's directors, following the scandal, was notable in that the directors settled the suit by paying very significant amounts of money personally. Also, the scandal caused the dissolution of the Arthur Andersen accounting firm, which had effects on the wider business world, as described in more detail below.

Enron still exists as a shell corporation (without assets). It emerged from bankruptcy in November of 2004 after one of the biggest and most complex bankruptcy cases in U.S. history. On September 7, 2006, Enron sold Prisma Energy International Incorporated, its last

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<sup>3</sup>For example, see Section 66 of the Companies Act, Revised Statutes of Anguilla, c C65 and Sections 26 and 27 Banking Act 2005 of the laws of Anguilla.

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remaining business, to Ashmore Energy International Ltd. According to the final restructuring plan submitted to bankruptcy court, Enron will be dissolved at the conclusion of the restructuring process.

**ii** For a time, WorldCom (WCOM) was the United States' second largest long distance phone company (AT&T was the largest). WorldCom grew largely by acquiring other telecommunications companies, most notably MCI Communications. In 1985 Bernard Ebbers was selected to be its CEO. He became very wealthy from the rising price of his holdings in WorldCom's stock. However, shortly after the MCI acquisition in 1998, the telecommunications industry entered a downturn and WorldCom's growth strategy suffered a serious blow when it was forced to abandon its proposed merger with Sprint in late 2000. By that time, WorldCom's stock was declining and Ebbers came under increasing pressure from banks to cover margin calls on his WorldCom stock that was used to finance his other businesses (timber and yachting, among others). During 2001, Ebbers persuaded WorldCom's board of directors to provide him corporate loans and guarantees in excess of \$400 million to cover his margin calls, but this strategy ultimately failed and Ebbers was ousted as CEO in April 2002.

Beginning in 1999 and continuing through May 2002, the company (under the direction of Scott Sullivan (CFO), David Myers (Controller) and Buford "Buddy" Yates (Director of General Accounting)) used fraudulent accounting methods to mask its declining financial condition by painting a false picture of financial growth and profitability to prop up the price of WorldCom's stock.

WorldCom's internal audit department uncovered approximately \$3.8 billion of the fraud in June 2002 during a routine examination of capital expenditures and alerted the company's new auditors, KPMG (who had replaced Arthur Andersen, WorldCom's external auditors during the fraud). Shortly thereafter, the company's audit committee and board of directors were notified of the fraud and acted swiftly: Sullivan was fired, Myers resigned, Arthur Andersen withdrew its audit opinion for 2001, and the U.S. Securities and Exchange Commission (SEC) launched an investigation into these matters on June 26, 2002 (see accounting scandals). By the end of 2003, it was estimated that the company's total assets had been inflated by around \$11 billion.

**iii** Xerox was founded in 1906 as "The Haloid Company",<sup>[1]</sup> manufacturing photographic paper and equipment. On April 11, 2002, the Securities and Exchange Commission filed a complaint against Xerox. The SEC charged that the change in how Xerox applied accounting principles not only violated GAAP, but was intentionally designed to fool Wall Street into believing the new management team was working wonders, exceeding Wall Street's expectations nearly every quarter from 1997 through 1999. The complaint alleged Xerox deceived the public between 1997 and 2000 by employing several "accounting maneuvers," the most significant of which was a change in when Xerox recorded revenue from copy machine leases — recognizing a "sale" in the period a lease contract was signed, instead of recognizing revenue ratably over the entire length of the contract. The SEC charged that the change in how Xerox applied accounting principles not only violated GAAP, but was intentionally designed to fool Wall Street into believing the new management team was working wonders, exceeding Wall Street's expectations nearly every quarter from 1997 through 1999.

The SEC also alleged that Xerox's senior management was aware of, either by directing or approving, the accounting actions that were taken for the purpose of what management called "closing the gap" to meet revenue and profit goals. When Xerox's auditors, KPMG, questioned the legitimacy of the company's accounting practices, senior management requested that a new partner be assigned to its account. The SEC further charged that in order to keep the relationship with Xerox that had lasted nearly 40 years, and to protect the \$82 million in audit and non-audit fees KPMG would collect from Xerox between 1997 and 2000, KPMG complied with management's request.

The SEC allegations said that the "accounting tricks" employed by Xerox were a double-edged sword: by accelerating future revenues into present periods, it became increasingly difficult for management to meet investors' expectations in future periods, especially as the economy began to worsen in 1999 and later years.

In response to the SEC's complaint, Xerox Corporation neither admitted nor denied wrongdoing. It agreed to pay a \$10 million penalty and to restate its financial results for the years 1997 through 2000. On June 5, 2003, six Xerox senior executives accused of securities fraud, including former chief executive officers Paul A. Allaire and G. Richard Thoman, and its former chief financial officer, Barry D. Romeril, settled their issues with the SEC and neither admitted nor denied wrongdoing. They agreed to pay \$22 million in penalties, disgorgement, and interest.

**iv Tyco International Ltd.** is a conglomerate with official headquarters in Bermuda, and U.S. operational headquarters in New Jersey. Major business areas of Tyco included electronic components, health care, fire safety, security, and fluid control. In the late 1980s Tyco started another series of acquisitions and growth.

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In 1992, Dennis Kozlowski became CEO of Tyco, and for the next several years, the company adopted an aggressive acquisition strategy, eventually acquiring (by some accounts) over 1000 other companies between 1991 and 2001.

In 1999, just prior to a stock split, rumours of accounting irregularities surfaced. The rumours were strongly denied by Tyco's leadership, who accused the sources of selling Tyco shares short for personal gain. Partly in response to this, shareholders fought a proxy battle to reincorporate in Delaware, but this effort was rebuffed by the board of directors.

Former chairman and chief executive Dennis Kozlowski and former chief financial officer Mark H. Swartz, were accused of the theft of US \$600 million from the company. During their trial in March 2004, they contended the board of directors authorized it as compensation.

On June 17, 2005, after a retrial, Kozlowski and Swartz were convicted on all but one of the more than 30 counts against them. The verdicts carry potential jail terms of up to 25 years in state prison. Kozlowski himself was sentenced to no less than eight years and four months and no more than 25 years in prison.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances. For more information please contact Yvette at [wallace@anguilla-attorney.com](mailto:wallace@anguilla-attorney.com)