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Nell Minow

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COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
Hearing on the Bankruptcy of Lehman Brothers
October 6, 2008

Testimony from Nell Minow
Editor, The Corporate Library

Mr. Chairman and members of the committee, I thank you very much for inviting me to participate in this hearing. I appreciate your exploration of this very important topic as both example and symptom of the greater instability in the financial services sector and our capital markets.

But I'd give almost anything not to say "We told you so."

The Corporate Library is an independent research firm specializing in corporate governance. Our clients include director and officer liability insurers, executive search firms, law firms, investors, consultants, and scholars. And one of our most popular products is our rating of board effectiveness. We rate boards like bonds – A through F. And unique in this field, our ratings are not based on structural indicators like "independence," director training, or whether the governance principles are posted on the company's website but on the decisions made by the board. As we used to say when I was at EPA and OMB, The Corporate Library relies on performance standards rather than design standards. If the board handles certain crucial defining issues well, they are an effective board. If not, it really does not matter how many directors attended training classes. You can lead a director to a classroom, but you can't make him think. Of course "independence" is important. But you can tell far more about the independence of a director from the board's approval of a good compensation plan (or a poor one) than from what we call "resume independence," the kinds of employment-related disclosures required by the SEC.

With that in mind, I would like to go over the ratings our firm has given the Lehman board since we first began issuing letter grades in 2002:

March, 2002 – Coverage initiated, initial overall D rating assigned
June, 2003 – Rating upgraded to overall B
October, 2003 – Rating downgraded to overall C
June, 2004 – Rating downgraded to overall D
September, 2008 – Rating downgraded to overall F

Here is an excerpt from one of our analyst notes on the company:

Although [CEO Richard Fuld's] 2007 salary of \$750,000 is well below the median for companies of similar size, his non-equity incentive

compensation of \$4,250,000 exceeded the 85th percentile. While typical target bonus is two times base salary, Mr. Fuld's was more than five times his base salary. Additionally, his total annual compensation of \$71,924,178 ranks in top 3% for similarly-sized companies. This figure includes \$40,278,400 from value realized on the exercise of options and \$26,470,870 from value realized on vesting of shares. This raises serious concerns over the alignment of compensation practices with shareholder interests.

And here is a summary of his compensation over the past five years:

<u>5-year compensation - Fuld</u>		
Base Salary	\$	3,750,000
Annual Bonus	\$	41,150,000
Equity Value Realized	\$	225,068,018
All Other Compensation	\$	391,012
5-year total	\$	269,968,018

As I have mentioned in previous testimony before this committee, there is no more reliable indicator of litigation, liability, and investment risk than pay that is not linked to performance. I think it is fair to say by any standard of measurement that this pay plan is as uncorrelated to performance as it is possible to be.

Pay that is out of alignment is one of the causes of poor performance but it is also an important symptom – of an ineffective board.

We have looked at bad boards for several years and we often see patterns other than poorly designed pay packages that recur in the boards later proved to be the most dysfunctional. A number of those patterns are present in the Lehman board. They include inadequate expertise and too-long tenure.

While some of the individual director backgrounds at Lehman reflect more experience in banking and financial services than some of the other recent failed firms, overall it did not have the depth of experience it needed. Notes Dennis K. Berman of the Wall Street Journal:

Nine of them are retired. Four of them are over 75 years old. One is a theater producer, another a former Navy admiral. Only two have direct experience in the financial-services industry.... Until the 2008 arrival of former US Bancorp chief Jerry Grundhofer, the group was lacking in current financial-knowledge firepower. A number of the members did have past financial-markets expertise, but most of their working lives were tied to a different era: The one before massive securitization, credit-default swaps, derivatives trading, and all the risks those products created.

Until recently, one director was actress Dina Merrill, daughter of E.F. Hutton. She retired in 2006 at age 83 after 18 years of service. At the time of her retirement Ms. Merrill was a member of Lehman's Nominating & Corporate Governance and Compensation & Benefits Committees.

Currently serving on the board is Broadway producer Roger Berlind, 76, the longest tenured member of the Lehman board, his only public company directorship. While we do not recommend over-boarding, it is usually not a good idea to have people on boards who have no other board or sector experience. Mr. Berlind is a member of Lehman's Audit and Finance & Risk Management Committees. Also on the board is Marsha Johnson Evans, 60, a former Rear Admiral with the US Navy and head of the American Red Cross and Girl Scouts of the USA. Ms. Evans is a member of Lehman's Nominating and Corporate Governance, Compensation & Benefits, and Finance & Risk Management Committees. She is also an active director of three other large US corporations: Weight Watchers International, Office Depot, and Huntsman Corporation; she is a former director of AutoZone. Michael Ainslie, who has been on the board for 12 years, is the former Chief Executive Officer Sotheby's and former President and CEO of the National Trust for Historic Preservation.

With regard to tenure, which can impair independence of judgment, this is a board with very little turnover. Roger Berlind has been on the board for 23 years and six other directors have served for over a decade.

Another point worth noting is that Lehman's Finance & Risk Management Committee, which is chaired by 80 year old director Henry Kaufman, only met twice in 2007, and twice in 2006. Kaufman has served on the Lehman board for 14 years; he was also a member of the Freddie Mac board, from which he retired in 2004 after 13 years of service. A company in this sector should have a risk management committee that is vitally involved and has a great depth of expertise. A company that had \$7 billion in losses after becoming embroiled in the global credit crisis had a risk management committee that did not understand or manage its risk.

An additional indicator is meaningful stock ownership by the board. It is a public statement of their confidence in the company and it is a powerful reminder and motivator for them as they deliberate issues like executive compensation and risk management. With the exception of the CEO (who sold a significant percentage of his stock for as much as \$500 million), lead director John Macomber, and 23-year veteran Roger Berlind, given their tenure these directors did not put their money where their mouths were.

And another indicator is "related party transactions" that can impair the independence of the board. While Lehman prohibited the participation of the board members in special in-house investment opportunities after 2002, the

grandfathered deals continued to pay out to participating directors, as disclosed in the company's proxy:

The distributions shown exclude the return of the limited partners' respective capital contributions, which amounts were \$96,340 for Mr. Berlind, \$81,520 for Mr. Freidheim, \$397,250 for Mr. Fuld, \$389,400 for Mr. Gregory, \$75,000 for Dr. Kaufman, \$86,143 for Mr. Lowitt, \$125,674 for Mr. O'Meara, \$409,737 for Mr. Russo, \$78,140 for the adult children of Mr. Akers and \$136,580 for the adult children of Mr. Macomber. Aggregate Fiscal 2007 distributions, including the return of the limited partners' respective capital contributions, was less than \$120,000 for all of the other limited partners listed above.

The largest outstanding balance during Fiscal 2007 of the aggregate preferred capital contributions made by the general partner of these investment partnerships as a result of investments made by such limited partners was \$285,802 for Mr. Fuld, \$190,535 for Mr. Gregory, and less than \$120,000 for each of the other limited partners listed above. The largest outstanding balance during Fiscal 2007 of the aggregate preferred capital contributions made by the general partner that was with recourse to the limited partners was less than \$120,000 for each of the limited partners listed above.

As I said earlier, we judge boards on results. But once we have judged them, we can make an educated guess about what led to those results. In this case, the board was too old, had served too long, was too out of touch with massive changes in the industry, had too little of their own net worth at risk, and was too compromised for rigorous independent oversight. There is a lot of blame to go around in a failure like this one. But at the head of the list the blame falls on:

Roger S. Berlind

John D. Macomber

Michael L. Ainslie

Sir Christopher C. Gent

John F. Akers

Marsha Johnson Evans

Richard S. Fuld Jr.

Roland A. Hernandez

Thomas H. Cruikshank

Jerry A. Grundhofer

Henry Kaufman

Paul G. Parker

Dina Merrill

How can this be prevented?

Sarbanes-Oxley did not create this problem but it did not prevent it, either. Corporate governance is a matter of state law, so the governance-related reforms of the post-Enron era focused mostly on disclosure. For example, under Sarbanes-Oxley boards are not required to have a financial expert, but they must disclose whether they have one.

There will always be bad decisions. But we can do a better job of stopping them before they get out of hand. Clearly, from the case of Lehman and the other failing financial services firms, we must have clawbacks for the return of bonuses paid based on financial reports that are later corrected. That is a matter of fundamental fairness and economic necessity. And that is something that can be addressed by Congress.

Furthermore, we must remove obstacles that currently prevent shareholders from exercising the independent oversight and providing the market response that is an essential element of economic sustainability. The House has already passed the “say on pay” legislation with an overwhelming majority and we hope it will move forward. Shareholders should be able to remove conflicted, over-boarded, or just plain ineffective directors by voting against them. Institutional investors, including pension funds, should have to disclose their votes so that their customers, the beneficial holders of the securities, can see who is voting to enable dysfunctional board behavior.

Shareholders want executives to earn a lot of money. They just don’t want them to get paid a lot of money without earning it. Addressing the issue of board effectiveness in linking pay to performance and managing risk is a key element of restoring the credibility of our capital markets.

Thank you very much and I look forward to your questions.