

TESTIMONY OF
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to the

AMERICAN BAR ASSOCIATION'S
TASK FORCE ON CORPORATE RESPONSIBILITY

November 11, 2002

Good morning. My name is Damon Silvers and I am an Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. The AFL-CIO is grateful to the American Bar Association for both undertaking a review both of standards designed to facilitate corporate responsibility and best practices in corporate boardrooms and of the ABA's Model Rules of Professional Conduct in light of the corporate scandals of the last year.

The AFL-CIO is the federation of America's labor unions. We represent more than 66 national and international unions and their membership of more than 13 million working women and men. Union members participate in the capital markets as individual investors and through a variety of benefit plans. Union members' benefit plans have over \$5 trillion in assets. Union-sponsored pension plans account for over \$400 billion of that amount. Worker-owners and their benefit funds have become increasingly active participants in corporate governance in the last fifteen years— in 1999 sponsoring a majority of the shareholder proposals that themselves received majority votes. Not

surprisingly, we see corporate governance as inextricably intertwined with workers' retirement security.

LABOR MOVEMENT'S ROLE IN CORPORATE REFORM

Worker funds have led a number of important corporate governance initiatives, ranging from the AFL-CIO's opposition to the renomination of Enron directors, to the Laborers and Machinists Unions' opposition to companies seeking to reincorporate in Bermuda, to the Sheetmetal Workers' National Pension Fund's successful effort at Disney to end that company's auditor's involvement in consulting work for Disney.

The labor movement has also been deeply involved in responding to the collapse of Enron and its aftermath at many levels. The AFL-CIO wrote to Ken Lay in early November, suggesting corporate governance reforms that might have helped restore both customer and investor confidence. Our Secretary-Treasurer, Richard Trumka testified at the first Congressional hearing on the impact of the collapse of Enron about what had happened to Enron workers, both union and non-union as a result of the collapse of Enron's 401-k and the mass layoffs that accompanied its bankruptcy. We have been vocal supporters of reform at every level of the system of market regulation— including comprehensive legislative reform efforts addressing problems the events of the last year have revealed in the areas of securities and pension regulation and in our bankruptcy code.

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Perhaps most importantly, unions and their members have been supporting the efforts of thousands of Enron and WorldCom workers (most of them not union members) to win severance money frozen in the bankruptcy process. These efforts have resulted in more than \$35 million in new money for Enron workers and the payment of full severance to WorldCom workers.

PURPOSES OF CORPORATE GOVERNANCE

Our corporate governance system today is in dire trouble in two fundamental respects. At large cap company after large cap company, the system seems to have failed to give investors the accurate, timely information investors must have for our capital markets to work—that is for our markets to be able to price securities manner reflective of issuers’ real economic prospects. And perhaps more seriously, our system seems incapable of generating checks and balances necessary within the public company to ensure that smart and loyal management decisions are made. To be specific, it wasn’t just that Enron and WorldCom and the others were hiding losses from the public, they were pouring capital into money losing businesses, including the ultimate money losing business—insiders’ pockets.

Corporate governance is a web of relationships. These relationships should work toward getting companies to make smart, long term focused decisions that lead to sustainable benefits for all who participate in the company. Unfortunately, the chain of collapsing major companies over the last year have given us a window into a set of pervasive

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conflicts of interest that defeat the purposes of corporate governance and threaten the retirement security of America's working families. At Enron the management, the board of directors, the outside auditors and the sell-side analysts all failed to protect investors. Similar events have occurred at Global Crossing, Tyco, Cendant, Computer Associates, Waste Management, McKesson, Worldcom, Reliant, Adelphia, Qwest, El Paso Energy, Halliburton, Dynegy, and more. A critical source of these failures lies in the unregulated conflicts of interest that permeate the relationships between the management of these companies and the people who were supposed to be protecting investors.

But corporate governance is more than disclosure. A good corporate governance system should provide investors and market makers with the information they need. But it should also help firm executives strike a healthy balance between being completely driven by the views of whomever is trading from day to day in the markets and being accountable to no one. When conflicts of interest weaken corporate governance protections, the CEO who is bent on making reckless decisions aimed at hitting quarterly numbers is free to do just that—and in the end the losers are the company and its long term investors.

Some have talked about the events of the last year as being about bad people. And judging by what one reads in the newspapers there certainly seem to have been a fair number of sociopaths loose in our nations' executive suites. But bad people are always with us. The real question is why our corporate governance structures appear to have

empowered bad people and pressured good people to do bad things and how can we get these structures to the point where they empower the best of us, rein in the worst, and help the rest of us be our better selves.

THE TASK FORCE'S INTERNAL CORPORATE GOVERNANCE

RECOMMENDATIONS

With that conceptual background, I would like to now turn to the work of the Task Force.

The Task Force in its preliminary report essentially makes recommendations in two areas. The first is the relationship between the board of directors and the executive officers of the company. The second addresses the role of corporate counsel in light of the Sarbanes-Oxley Act's provisions requiring corporate counsel

While the internal corporate governance recommendations of the Task Force are all of value, the Task Force's decision to restrict its recommendations to the interaction of the Board with the CEO severely limits the impact of the Task Force's work. If the relationship between the CEO and the board is a closed system, when that system becomes dysfunctional, there is no way absent extraordinary activity by investors to correct it. We strongly believe there needs to be intermediate structures of accountability linking boards and investors.

I say intermediate in the sense that today investors have few meaningful options between moral suasion, whether by telephone, letter or shareholder proposal, and costly and

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conflict-intensive measures like tender offers and shareholder litigation. I will discuss this further in a moment when I lay out the labor movement's program for corporate reform. However, the Task Force's choice to discuss internal governance as though there were no investors leaves the core governance problem of how to create self-correcting mechanisms for dysfunctional boards unaddressed.

Secondly, the Task Force's decision to not address in any fashion the interaction of executive compensation with the law other than through Compensation Committee process recommendations. There is no question but what Compensation Committees should be made up of independent directors. However, in the context of widespread debate about whether state fiduciary duty law places substantive limits on executive compensation size or structure, silence on this subject from the Bar seems inappropriate.

In this context, executive stock options are key both to the immediate crisis of untrustworthy numbers and the deeper crisis of corporate governance. The AFL-CIO opposes the use of stock options as compensation for senior officers and executives. Options are not good instruments for aligning executives with the interests of long term investors. Rather we support the use of restricted stock with long-term holding requirements, beyond the actual tenure of the executive.

As a first step, the AFL-CIO, together with organizations like the Council of Institutional Investors has long supported both expensing options and putting all option plans which

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the directors or the top five officers participate in to a shareholder vote, as is required by the new proposed NYSE listing standards. However, we feel that those standards mistakenly require shareholder approval for option plans that directors and the very highest officers do not participate in. In those circumstances the conflict of interest that necessitates shareholder approval of executive option plans is absent, and the rule merely serves to lessen managerial flexibility in designing compensation for line employees.

In addition to requiring a vote on executive option plans, we believe that for such a vote to be conducted with adequate information, issuers should have to value the options they are proposing to grant using the Black-Scholes method with appropriate modifications to address the differences between executive options and exchange-traded options.

As to the issues the Task Force does address, we commend the Task Force for endorsing the NYSE approach to director independence over the NASD's approach. The requirement of identifying all potential conflicts and then having the board itself make a reasoned determination is the right approach, compared to a bright line test. However, we believe this approach should be strengthened by requiring disclosure of any potential conflict that the Board considered to shareholders, which the NYSE does not do.

Without the safeguard of disclosure, there is no way to prevent the sort of board that existed at Enron, with nominally independent directors whom detailed research revealed had ties violating the Council of Institutional Investors' standards of independence.

Some of these Enron board members had important conflicts of interest that had a minor

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direct economic component and a major political component. Under the NASD approach not only would these individuals have counted automatically as independent directors, there would have been no obligation on the part of Enron to disclose the conflicts to shareholders.

We also see particular value in the construction of a Governance Committee of independent directors charged with nominating new independent directors. While we believe it is not adequate to address the problems of a dysfunctional board, we think it is the best step that could be taken regarding the selection of directors within the paradigm of pretending that directors do not have any relationship to shareholders or other corporate constituents.

Our view is that independence must be tied to genuine accountability to shareholders. Currently, management's nominees to the board of directors have access to the corporate treasury to cover the costs of their campaign, including most importantly the costs of legalizing, printing and mailing the basic proxy solicitation. Shareholders, no matter how many they are or how much of the ownership of the company they represent, must bear all the expenses of nominating a candidate themselves. In most circumstances this is a prohibitive barrier to the election of shareholder-nominated directors. Either the NYSE, as a listing standard, or the SEC as part of Rule 14a-8, could require listed companies to give shareholders representing a certain percentage of shares, say in the 5-10% range, access to the proxy for their director nominees for short slates in non-takeover contexts.

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Or companies' could adopt such a procedure voluntarily, say at the behest of groups such as this Task Force. Such a reform would create real accountability and foster genuinely independent directors without subjecting listed companies to frivolous expenditures or inappropriately subsidizing takeover efforts..

In addition, as some of you may know, under the SEC's Rule 14a-8, shareholders are entitled to have their proposals included in management's proxy materials if those proposals meet a series of requirements. Some of the requirements get the SEC involved in making substantive judgment calls about the proposals—such as whether they constitute ordinary business. We believe that in general this process while imperfect serves both investors and issuers well.

However, this process does not and cannot do a good job of distinguishing between when something like an accounting practice, which usually is ordinary business, rises to a non-ordinary business level, as certainly accounting practices have at Enron and many other companies. The way to make these type of distinctions and give shareholders meaningful voice in extraordinary matters is to create an override—access to the proxy for any legal proposal sponsored by a significant percentage of shareholders—say 5%. Again, like access to the proxy for independence director candidates, this reform could be accomplished through listing standards or by the SEC. Together these two measures would measurably add to investor voice in corporate governance.

The remainder of the proposed internal corporate governance standards in general either restate the content of the NYSE listing standards or, in the case of independent director oversight of insider transactions, the clear long-time views of the Delaware courts and those states that follow Delaware in the application of the business judgement rule and the principles underlying futility of demand analysis in derivative litigation. They are worthy principles and reinforce the appropriate place where the SRO's should converge, but do not break new ground in the debate.

TASK FORCE RECOMMENDATIONS REGARDING THE CONDUCT OF
LAWYERS

I will now turn to the Task Force recommendations involving the conduct of corporate counsel. The AFL-CIO strongly supports the ABA addressing this issue and revising its Model Rules of Professional Responsibility to bring them into compliance with the provisions of the Sarbanes-Oxley Act.

Corporate counsel are key first lines of defense of an organization's interest against misconduct by the organization's employees. The Model Rules and the various state ethics codes generally in the past not provided clear guidance that meaningfully operationalized counsel's duty to the organization as opposed to its principal officers or directors. Sarbanes-Oxley properly did so, and properly did so at the federal level.

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In general, we support the Task Force's recommendations in this area, as we support generally the recent proposed implementing rules issued by the SEC. In particular, we believe the Task Force's recommendations on communicating information she is aware of beyond information "related to the lawyer's representation" is very positive, as is specific instructions as to when it is appropriate to bypass compromised chains of command and changing the standard for determining a responsibility to act affirmatively in the case of prospective crime or fraud from actual knowledge to circumstances when the lawyer "reasonably should have known." Finally, the elimination of language such as that referring to a duty to minimize "organizational disruption" is positive.

THE UNFINISHED BUSINESS OF CORPORATE REFORM

Finally, let me then address what the labor movement believes are some of the remaining key unfinished business for the corporate responsibility agenda after the passage of the Sarbanes-Oxley Act.

The practice of public accounting continues to await meaningful, consistent oversight. The controversy surrounding the appointment of the first Public Accounting Oversight Board has endangered the substantial reforms made by the Sarbanes-Oxley Act. The Board needs to quickly take steps to restore public confidence. The most important immediate step would be to determine that the Board will define its own standards of public auditor conduct, and not defer to the accounting industry or its proxies in this vital area.

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With respect to the GAAP rulemaking process, anyone familiar with the political pressures brought to bear on FASB around accounting for executive stock options in the mid-1990's, not to mention the decade long paralysis on SPE accounting knows that FASB is too open to pressures from issuers and those beholden to issuers. Here there are a variety of options available for how to make FASB more independent -- ranging from merging with a public auditor oversight body to closer ties with the SEC.

Then there are the Wall Street analysts. These people play a vital role in our markets and have played an increasingly powerful role in the real governance of public corporations through the influence they exert on CEO's who hold large packages of exercisable options. But analysts have become captive to the investment banking side of their firms. That's why part of a comprehensive package of reforms must be a provision banning basing analyst compensation not just on specific investment banking transactions, but also barring tying analyst compensation to investment banking performance generally.

In this area, we are hoping that a global settlement involving state attorneys' general, the SEC, the SRO's and the financial services industry will enact these needed reforms. We frankly believe it would have been better for our regulatory system for the SRO's to have take this step through in the context of their oversight authority over their members firms. But in the absence of such comprehensive action, we have strongly supported the efforts of Eliot Spitzer and the other Attorneys General.

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Finally, I'd like to say a word to you about the role of employee-owners in the public corporation. We live in a world where workers all over the world are owners of every publically traded corporation both directly and indirectly. But too often now some of that ownership is large amounts of employer stock held in that same employer's sponsored 401-k program. And that is just wrong. It is wrong to hold a significant amount of a single security, any security, in a fund designed to supply a worker with a basic retirement benefit. Anyone who has the slightest understanding of modern investment management knows this—yet our public policy and our private corporate behavior continues to not just allow but encourage this practice.

Concentrations of employer stock in employee pension plans gave us the Enron and Global Crossing pension fiascos, and if this practice continues it will certainly bring us more pension disasters in the months and years to come. That must change, but I fear it will not change without responsible leadership from both business, labor and government. The ABA could play a very useful role in building a responsible consensus in this area.

Two other similar issues are the treatment of employees in bankruptcy and the treatment of worker 401-k plans with claims against their sponsoring employer in bankruptcy. These areas are outside the scope of corporate governance but not of corporate responsibility, and deserve to be addressed in this broader process.

CONCLUSION

In closing, I wish to strongly emphasize the labor movement does not view what happened in corporate America over the last year as the product of a few bad people at Enron, WorldCom or any other company, for that matter. While those individuals who have been given the responsibility to manage workers' and the public's money need to be held to a single high standard, we see believe at the heart of what happened are systemic problems that need systemic solutions. We hope we can work together with the Task Force as we have with the NYSE and the SEC to help find real solutions to the problems with our corporate governance system. All of us have too much at stake to allow business as usual to continue. Thank you.