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Third Quarter 2004

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INSTITUTIONAL INVESTOR

Advocate

A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

CORPORATE BOARDS...OR SOCIAL CLUBS?

By Beata Gocyk-Farber

In this issue, it is our pleasure to share with you insightful corporate governance observations by *The New York Times'* Pulitzer Prize-winning financial reporter and investigative journalist, Gretchen Morgenson. In "Just a Friendly Group of 'Independent' Directors," Gretchen explores the meaning of directors' independence and questions the adequacy of regulatory definitions ascribed to this term. The timeliness of this issue is highlighted by many of the recent corporate scandals, including, for example, the failure of Hollinger International's board to prevent what has been described as "aggressive looting" of Hollinger's coffers by its top officers, Lord Conrad Black and David Radler.

Continued on next page.

JUST A FRIENDLY GROUP OF 'INDEPENDENT' DIRECTORS

By Gretchen Morgenson

Pulitzer Prize-winner for Beat Reporting,
The New York Times

Gretchen Morgenson

At most corporations, new rules to ensure that a majority of directors are independent and serving shareholders' interests are finally in effect. But just how assiduously are they being followed?

The short answer is, not as much as shareholders may have hoped. The way the New York Stock Exchange and the Nasdaq market wrote their rules, it is pretty much up to a company's board to judge whether a director is truly independent. And some boards—the one at Computer Associates, for example—appear to be taking liberties.

Both exchanges now require companies whose shares they trade to have boards with a majority of independent directors. In addition, audit committees and compensation committees must be made up entirely of independent directors. And Securities and Exchange Commission rules call for at least one member of a board's audit committee to be knowledgeable in accounting and financial reporting.

The exchanges even give boards some clear-cut tests. For example, someone who receives $100,000 or more a year in compensation that is not related to directors' fees, pension or deferred compensation is not considered independent by the Big Board. The Nasdaq draws the line at $60,000.

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SOCIAL CLUBS

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A report prepared by a special committee of Hollinger's board and filed with the Securities and Exchange Commission in August characterized Hollinger as a company in which corporate abuse and malfeasance prevailed. For example, the special committee's report found that in the period 1997-2003, Lord Black and David Radler siphoned off more than $400 million from the publishing concern, representing approximately 95.2% of Hollinger's adjusted net income for that period. The report also observed that, while Black and Radler "were by far the most culpable people in causing damage to Hollinger,. . . Hollinger's board (and particularly the audit committee) was not alert and didn't notice when Black and Radler were driving their bloated fee requests past them." According to the report, Hollinger's board "functioned more like a social club or public policy association than as the board of a major corporation, enjoying extremely short meetings followed by a good lunch and discussion of world affairs . . . [a]ctual operating results or corporate performance were rarely discussed." The Report further noted that with respect to the compensation of Hollinger's founder, Lord Black, the board displayed "inert behavior."

> *According to the report, Hollinger's board "functioned more like a social club or public policy association than as the board of a major corporation."*

A board's abdication of its fiduciary responsibilities on matters relating to executive compensation has become a recurrent topic in corporate America. In our last issue, we highlighted the Delaware Chancery Court's seminal opinion in *In re The Walt Disney Company Derivative Litigation,* 825 A.2d 275 (2003), in which Chancellor Chandler concluded that the decision by Disney's board to approve Michael Ovitz's $140 million compensation package for less than fifteen months of service "suggest[s] that the [the board] consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision" Id. at 289.

The theme of inert directors present in *Disney* and *Hollinger* only highlights the need for director independence. As long as directors lack true independence from corporate executives, corporate officials will continue to be paid at astronomical rates bearing no relation to the earnings these executives deliver to the company's shareholders.

Gretchen Morgenson's article is reprinted here in its entirety because of its importance to institutional investors as they consider the important gatekeeping role of boards of public companies.

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Inside Look

This quarter, the *Advocate* explores one of the most critical and hotly debated issues in corporate governance: corporate directors' independence. In "Just a Friendly Group of 'Independent' Directors," Gretchen Morgenson, a *New York Times'* Pulitzer Prize-winning journalist, explores recently promulgated regulatory definitions of directors' independence and surveys companies' compliance with new regulations. Sadly, Gretchen's article concludes that while there is some improvement in independence among board members, some companies' claims to directors' independence are flat out "dubious."

In "A New Public (But Very Private) Watchdog," Avi Josefson touches upon another important topic for the investors: the results of the first inspection of the nation's most prominent accounting firms by the newly formed Public Company Accounting Oversight Board. As noted in Avi's article, although the accounting firms managed to successfully keep most of the details of this first inspection hidden from the public, the little public disclosure that is available from the PCAOB unfortunately reveals that each of the Big Four accounting companies is under intense scrutiny for questionable auditing practices.

As usual, we also draw your attention to our regular *Eye on the Issues* column. As has been the case for quite a while now, we could fill the entire *Advocate* with news reports affecting securities and corporate law. In this issue, Tim DeLange, our *Eye on the Issues* correspondent, has again insightfully compiled the most significant developments in the field for your easy reference.

This *Advocate* also comes on the heels of our 10th Institutional Investor Forum, which we hosted on October 7 and 8, 2004 in New York City. We would like to take this opportunity to again thank everyone who attended the Forum. We are told that the attendees found the Forum valuable, informative and fun. If you would like to attend our next Forum, please contact us.

We hope that you will enjoy reading this issue of the *Advocate.* As always, we endeavor to make it worth reading and we welcome your comments, questions and input.

'INDEPENDENT' DIRECTORS

Continued from page 1.

But the rules also note, correctly, that it is impossible to anticipate all the situations that may compromise a board member's independence. Therefore, according to the Big Board's rules, "it is best that boards making independence determinations broadly consider all relevant facts and circumstances." The exchange goes on to say that each board should consider the issue not only from a director's point of view, but also from that of the people or organizations with which he has an affiliation.

In other words, relationships matter.

The regulations, of course, were a response to downright chummy boards at Enron, WorldCom, Tyco and other companies that let executives do as they pleased with shareholders' money. Most American companies must comply with the new rules by Oct. 31.

Read any recent proxy statement and you will see how a company is responding to the requirements. The filings usually say flatly that the board has determined that a majority of directors meet independence standards.

Not so fast, says Donn Vickrey, a founder of Camelback Research in Scottsdale, Ariz. He says some of the companies' claims of independence are dubious. And the disclosure of directors' relationships with management, he said, leaves much to be desired.

"There is definitely a noticeable improvement in independence among board members," Mr. Vickrey said. "But there are also a significant number of firms who are clearly making things sound better than they really are."

Mr. Vickrey and his colleagues conduct extensive background checks on directors, looking for relationships with management that could impair their independence.

"They always take a nap after their milk and cookies—otherwise they get cranky."

He sees the Select Medical Corporation, a health care concern, as Exhibit A. Select Medical, based in Mechanicsburg, Pa., is traded on the Big Board. In his view, longstanding relationships between management and certain members of the company's board call into question its claims that directors are independent.

Consider this: Select Medical's founder and chief executive is Rocco A. Ortenzio. Russell L. Carson, a director who is on the compensation committee, is co-founder of a private investment firm, Welsh, Carson, Anderson & Stowe, that focuses on health care concerns. According to a proxy statement of U.S. Oncology, on whose board both Mr. Carson and Mr. Ortenzio have served, Mr. Ortenzio often invests with Welsh, Carson.

The web gets even stickier. Leopold Swergold, who serves on Select Medical's audit committee, founded Swergold, Chefitz & Company, a health care investment firm. But Mr. Swergold has been a director of Rehab Hospital Services, a company founded by Mr. Ortenzio in 1979 that was sold in the mid-1980's. More recently, Mr. Swergold has been an advisory partner in Select Capital Ventures, a health care investing company founded by Mr. Ortenzio. Neither of these associations is mentioned in this year's Select Medical proxy.

"There's no doubt that most of the board members have friendships and relationships over time," said Michael E. Tarvin, general counsel at Select Medical. "I think it's pretty clear that the N.Y.S.E. and any governing authority that would make rules would have to avoid any standard that would focus on friendship or relationships." And the friendship between Mr. Carson and Mr. Ortenzio is no secret. "They have known each other for some years, consider each other friends and Welsh, Carson has provided some financial backing to another company started by Mr. Ortenzio," Mr. Tarvin said. "Based on their current relationships, interlapping board service and other factors, I think the conclusion is they are friends but Russell Carson would act independently."

He added that Mr. Swergold's affiliations with other Ortenzio ventures created no independence problems.

Select Medical's board affirms in its proxy that its audit committee members have the required financial or accounting expertise, and calls them "financially literate." But then comes this unusual disclaimer from the audit committee: "We are not accountants or auditors by profession or experts in the field of accounting or auditing," the proxy notes. "Furthermore, our considerations and discussions with management and the independent auditors do not assure that the company's financial statements are presented in accordance with generally accepted accounting principles, that the audit of our company's financial statements has been carried out in accordance with generally accepted auditing standards or that our company's independent accountants are in fact 'independent.' "

Mr. Tarvin said that the remarks were "intended to state that although these persons are financial experts, they have not conducted an audit."

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Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES
AND RECENT DECISIONS OF INTEREST

By Timothy DeLange

Spitzer Is At It Again. New York State Attorney General Eliot Spitzer has struck again. After taking on the securities, mutual fund and banking industries, Spitzer stunned the insurance world by charging the giant Marsh & McLennan with blatant bid-rigging and fraud, costing its clients hundreds of millions of dollars. The suit, alleging deceptive business practices and false advertising, was filed under the state's "public attorney general" statute, which allows virtually anyone to file a lawsuit on the public's behalf. The same day, two executives of AIG, long seen as a pillar of the industry, pleaded guilty to felonies and agreed to cooperate with Mr. Spitzer. The implications extend to other insurers, including Aon, Ace and Hartford Financial Services Group. "The insurance industry needs to take a long, hard look at itself," Mr. Spitzer said. "If the practices identified in our suit are as widespread as they appear to be, then the industry's fundamental business model needs major corrective action and reform." *The Wall Street Journal October 15, 20, 21, 2004*

Qwest Engaged In Over $3.8 Billion Accounting Fraud. The Securities and Exchange Commission filed a complaint against Qwest Communications International alleging that between 1999 and 2002, the company engaged a "pervasive fraud led by top management." According to the complaint the fraud extended to almost every part of Qwest's business and included generating phony revenue through sham transactions; booking inflated results for its phone-directory business and accounting for employee vacation time. The SEC claims that Qwest fraudulently recognized more than $3.8 billion. The company agreed to pay a $250 million penalty. *The Wall Street Journal, October 22, 2004.*

Revival Of Dead Claims Takes Center Stage. The Securities and Exchange Commission, in an *amicus curiae* brief filed with the Second Circuit Court of Appeals, is urging the federal appeals court to make retroactive a provision of the Sarbanes-Oxley Act that provides investors more time to sue companies for fraudulent behavior. The SEC argued in its friend-of-the-court brief that, without the ability to revive claims that had expired under the old statute of limitations, investors who lost money in the recent wave of corporate malfeasance might be disadvantaged. The Sarbanes-Oxley Act, enacted in July 2002, extended the time period to file suits from within one year of discovering the fraud and three years of the violation to two years and five years, respectively. Several district courts have already taken the opposite view, finding that Congress did not expressly state that the Act would apply retroactively. *The Wall Street Journal, September 1, 2004.*

SEC Expands 8-K Filing Requirements. On August 23, 2004, a new SEC rule took effect requiring companies to file Form 8-K reports with the SEC more quickly than previously required, and increasing the number of events requiring disclosure. In the past, ten events had to be disclosed in a Form 8-K, used to report material developments between quarterly and annual reports, and two that could be at the company's discretion. The new rule adds eight events that must be disclosed, such as terminations of material agreements, notice of de-listing from a stock exchange and financial restatements, and expands upon two existing ones. In addition, companies must file the Form 8-Ks faster, generating reports for most events within four business days, down from the prior five business days (or 15 calendars days) requirement. The SEC, which receives approximately 80,000 Form 8-Ks each year, expects the new rule to generate an additional 60,000 8-Ks. *The Wall Street Journal, August 23, 2004.*

Directed Brokerage Banned. In the latest move to reform the $7.6 trillion mutual fund industry, the SEC unanimously approved a new rule barring mutual fund companies from steering trades to brokers who promise to promote the funds in exchange for stock and bond business. Regulators said the widespread practice, known as directed brokerage, raises questions about whether brokers are recommending the best products for investors. SEC Commissioner Cynthia Glassman said the rule will help curtail serious conflicts of interest that "have grown dramatically as the mutual fund industry has grown." Responding to concerns expressed by trade groups, agency officials said that mutual fund companies could continue to use the same brokers both to sell their products and to execute trades on behalf of the funds, as long as the fund companies have policies to prevent *quid pro quo* deals. *Los Angeles Times, August 18, 2004.*

Interest In Corporate Governance Law Heightens. Following its business school counterparts, law schools throughout the country are adding or revamping courses on ethics in response to the recent wave of corporate scandals. Many law schools say they are adding courses to address legal issues raised by corporate misconduct and the new regulations encompassed by the Sarbanes-Oxley Act. Thus far, students' interest in the governance courses has been greater than anticipated. For example, at Tulane University Law School, the professors expected only twenty students to sign up for the course on "Corporate Governance in a Post-Enron World." Instead, more than 75 students signed up. *The Wall Street Journal, September 1, 2004.*

How Safe Is The "Safe Harbor?" The Private Securities Litigation Reform Act of 1995 created a so-called "safe harbor" for forward-looking statements to encourage companies to provide investors with information regarding future plans and prospects. Pursuant to this "safe harbor," a defendant is not liable with respect to any forward-looking statement if it is identified as such and is accompanied by "meaningful cautionary statements" warning investors about factors that could cause actual results to differ. A recent ruling by the Seventh Circuit Court of Appeals held that it may be impossible, on a motion to dismiss, to determine whether a company's cautionary statements are "meaningful." The opinion authored by Judge Frank Easterbrook, finds that there is "no reason that a court can accept at the pleading stage, before plaintiffs have access to discovery — that the items mentioned in [the company's] cautionary language were those thought at the time to be the (or any of the) 'important' sources of variance." *The Wall Street Journal, September 8, 2004.*

Accounting Fraud/Settlements Remains High. According to the PricewaterhouseCoopers Securities Litigation Study and a preliminary analysis of the first six months of 2004, the number of accounting-related securities litigation cases remains well above historical averages. In fact, the number of cases with accounting allegations totaled more than 60 percent in 2003, and 57 percent of the 11 cases filed in the first seven months of 2004. According to the studies, excluding the recent $2.65 billion partial WorldCom settlement, the average settlement in the first six months of 2004 has swelled to over $32 million, up from the average settlement of $23.2 in 2003. Meanwhile, during the first six months of 2004, the average accounting case settled for over $38 million. *PRNewswire, August 2, 2004.*

Mixed Reports On Corporate Fraud Task Force. Following the high-profile corporate scandals of 2002, the federal Corporate Fraud Task Force, consisting of attorneys from the Department of Justice, the SEC and other regulatory agencies, was created to crackdown on corporate crime. Since its creation, the Task Force takes credit for more than 500 corporate fraud convictions or guilty pleas; for charging more than 900 defendants and more than 60 corporate chief executives; and for filing charges against more than 30 Enron defendants and obtaining 11 convictions. Despite these numbers, some are critical of the Task Force's results. Tyson Slocum, research director for Public Citizen in Washington, D.C., highlighted that the Task Force failed to break the mutual fund scandal. Likewise, Frank Partnoy, author of "Infectious Greed: How Deceit and Risk Corrupted the Financial Markets," criticized the breadth of cases targeted, noting that the Task Force has gone after the "easy" cases "because prosecutors don't want to lose." *San Diego Union-Tribune, August 8, 2004.*

Quarterly Quote

"[If] [d]isinterested, independent directors knew that they were making material decisions without adequate information and without adequate deliberation, and . . . they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss . . . they consciously and intentionally disregarded their responsibilties. . . and therefore could be in violation of their fiduciary duties to the corporation."

Vice Chancellor Noble in *Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, et al,* Del., C.A. No. 20228-NC, slip op., Noble, V.C., (August 24, 2004) (quoting Chancellor Chandler in *In re The Walt Disney Company Derivative Litigation, 825 A.2d 275 (2003).*

Guilty Pleas Abound In Enron Case. Kenneth Rice, the former chief executive of Enron Broadband, Kevin Hannon, the former chief operating officer of Enron Broadband, and Mark Koenig, Enron's former investor relations chief, all plead guilty to securities fraud and have agreed to cooperate with government prosecutors in its ongoing investigation of who was responsible for Enron's collapse into bankruptcy in late 2001. The cooperation of these individuals is expected to provide prosecutors with significant witnesses against Enron's indicted top leaders, Jeffrey Skilling and Kenneth Lay. Meanwhile, the court rejected Lay's request that his trial begin by September 14. *The Washington Post, July 31, 2004, August 26, 2004, September 1, 2004; The New York Times, August 12, 2004.*

Companies and Auditors Parting At Record Pace. According to a recent report by *The Wall Street Journal,* companies and auditors are parting at record rates in 2004. By the end of July, more than 900 companies had either fired or ended relationships with their auditors, or roughly the same number as in all of 2003. Since companies must disclose when they change auditors, investors are able to stay informed of the changes. A change in auditors can signal that the company has disclosure issues and investors can dig deeper into what is going on. Unfortunately, nearly 700 out of the 900 companies in research analyst Glass Lewis & Co.'s survey did not say a word about the circumstances surrounding their auditor change. *AccountingWEB.com, August 3, 2004.*

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A NEW PUBLIC (BUT VERY PRIVATE) WATCHDOG:
The Public Company Accounting Oversight Board Issues Its First Reports

By Avi Josefson

The epic frauds that unraveled in recent years revealed that, in many cases, the auditors—those most critical guardians of the company's financial statements and the public trust—operated with no meaningful supervision. The revelation of the financial scandals at companies such as WorldCom, Enron, Adelphia and Freddie Mac shook investor confidence in the auditing firms that were supposed to be scrutinizing those companies' financial statements, and, in one case, resulted in the implosion of one such firm, Arthur Andersen. Now, only four big auditing firms remain: Deloitte & Touche ("Deloitte"), Ernst & Young ("E&Y"), PricewaterhouseCoopers ("PwC") and KPMG (collectively, the "Big Four"). The sheer magnitude and number of frauds that have occurred on these firms' watch have proven, among other things, that the "peer review" system in place at the time—under which accounting firms periodically audited each others' work—was a complete failure.

"Oh, that three billion dollars."

Congress' response to these and other financial scandals—the Sarbanes-Oxley Act—created the Public Company Accounting Oversight Board ("PCAOB") in 2002. The Act required that accounting firms that audit public companies register with the PCAOB and submit to annual inspections of their audit work. The PCAOB recently released the results of its first annual inspections of the Big Four accounting firms. Unfortunately, a recent inspection by the PCAOB revealed that these big four accounting companies are under intense scrutiny for questionable auditing practices.

The Secret Findings of a Public Board

While the PCAOB may now be attempting to supervise auditors, investors are unable to fully evaluate the effectiveness of that supervision because the Sarbanes-Oxley Act provides that certain key deficiencies uncovered by the PCAOB will not be publicly released until the accounting firm at issue has had a full year to resolve that deficiency, a provision resulting from pressure applied by the Big Four firms. Now that the first inspections have been conducted, those firms are clearly reaping the benefits of the secrecy provisions for which they successfully lobbied. Although these inspections uncovered significant audit and accounting issues in the work of each of the firms, the specifics of those issues may never reach the light of day. As Lynn Turner, a former chief accountant at the SEC, observed, "Unfortunately, we don't know how many more infractions were not made public as a result of Congress allowing those to remain behind closed doors." Included in the non-public sections of the PCAOB's reports are discussions of the accounting firms' risk management policies, their internal inspection procedures and the tone set by each firm's management. So while William J. McDonough, chairman of the PCAOB, stated that "none of our findings has shaken our belief that these firms are capable of the highest quality auditing," investors still have nowhere to turn to form their own beliefs about the quality of the audits on which they are being asked to rely. Keeping key findings of the PCAOB under wraps may suit the auditors who would prefer not to share their dirty laundry with their clients (or their clients' investors), but it does little good to a market increasingly focused on improving transparency in the financial statements of public companies.

KPMG Breaks The Silence – And The SEC's Rules

Deloitte, E&Y and PwC opted to hide behind the confidentiality provided by Congress, and refused to discuss publicly the results of the PCAOB inspections into their respective audit work. KPMG sounded a slightly more positive note by publicly responding to the PCAOB's secret findings; however, the substance of those findings appears to be anything but positive. The PCAOB found that KPMG performed accounting work on a contingency basis, charging fees to audit clients based upon the amount of tax savings the firm was able to generate for them. Such fees can violate rules intended to prevent conflicts of interest that can blur the objectivity of an independent audit firm. Indeed, SEC rules prohibit accountants from charging contingency fees to audit clients. KPMG claimed that it is in the process of restructuring its remaining contingency fee agreements. Yet, because of the secrecy provisions the audit firms forced into Sarbanes-Oxley, the market still does not know which companies may have benefited from those contingency fees, or which other firms charge contingent fees. Nor is the public likely to ever learn the full extent of the PCAOB's findings as to the audit work of the other Big Four firms.

An Across The Board Failure To Apply An Accounting Provision

The limited information that the PCAOB made public does little to bolster faith in the audits conducted by these firms. For example, the PCAOB identified a particular accounting rule that all four firms misapplied, leading twenty companies to restate previously issued financial statements. The provisions in question are those of Emerging Issues Task Force No. 95-22 ("EITF 95-22"). These provisions address the proper classification of outstanding balances under revolving lines of credit in certain circumstances.

The Oversight Board found the firms to be too willing to rely on their clients' representations in lieu of performing adequate tests of their own.

The PCAOB initially identified twelve of the Big Four's audit clients that had improperly classified such balances, errors that their auditors failed to detect. When asked by the PCAOB to investigate further, the firms discovered an additional eight companies with the identical problem. This finding begs the question of what other problems are waiting to be discovered, particularly when the PCAOB expands its inspections beyond the Big Four in the coming years.

Documented Failures In Basic Audit Functions

The PCAOB's findings also demonstrate that the Big Four are rife with problems of a far more basic nature. The PCAOB found the firms to be too willing to rely on their clients' representations in lieu of performing adequate tests of their own, and discovered significant problems in each of the firms' efforts to document their audit work. For example, in one case, the PCAOB found E&Y too dependent on its client's internal audit department, having failed to determine the effectiveness of the company's internal auditors. On another audit, the PCAOB found that an E&Y auditor replaced a missing management representation letter with another letter from the client dated as of E&Y's original audit report. At PwC, the PCAOB found that auditors had altered the dates of electronic work papers to circumvent the firm's automatic archival of work papers after the issuance of an audit report or the close of an audited period. While these are individual examples, they demonstrate the sort of basic breakdowns in the audit function that can facilitate the perpetration of corporate frauds.

Conclusion

The initiation of inspections by the PCAOB must, in the end, be viewed as a positive development resulting from the passage of the Sarbanes-Oxley Act. However, the issuance of the PCAOB's first reports indicate that there is significant room for improvement both in the amount of information being reported publicly, and in the quality of the audits being conducted. Without question, the secrecy provisions that provide for confidential treatment of the PCAOB's most damning findings benefit only the audit firms that pushed those provisions into the law. Greater transparency can only motivate higher quality audits by these firms, and increased public confidence in those audits.

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'INDEPENDENT' DIRECTORS

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Another standout on director independence is Computer Associates, the software company that has been plagued by accounting irregularities. Its shares also trade on the New York Stock Exchange; the company, based in Islandia, N.Y., held its annual meeting of shareholders last week.

Computer Associates' board, led by Lewis S. Ranieri, a former Salomon Brothers vice chairman, says the chairman of its audit committee, Walter P. Schuetze, is independent. But this view can certainly be questioned, given that, according to the proxy, the company paid $125,000 in "additional director fees" for "his extra-ordinary services in connection with the audit committee investigation concerning the company's prior revenue recognition practices." None of the other audit committee members received additional payment for the investigation.

Mr. Schuetze, a partner at KPMG for more than 20 years who then became chief accountant to the division of enforcement at the S.E.C. from 1997 to 2000, certainly has the necessary accounting expertise to run the audit committee at the company. And because of the company's aggressive accounting in the past, he may have had to do some heavy lifting.

Before joining the Computer Associates board in 2002, Mr. Schuetze served as a consultant to the company on financial matters; he received $100,584 in fees and expenses in fiscal 2002.

Last summer, with prosecutors investigating Computer Associates' accounting practices, the company authorized the audit committee of its board to conduct an "independent investigation" into the company's activities relating to recognition of software sales. The committee, led by Mr. Schuetze, found that sales were recognized prematurely in 2000. Four executives resigned; three pleaded guilty to securities fraud charges.

Last April, Computer Associates restated its results for fiscal 2000 and 2001. Two months later, Sanjay Kumar, its chief executive, resigned.

Mr. Ranieri said in a statement on Friday that "any claim that Walter Schuetze's role in heading C.A.'s audit committee investigation was anything but independent is misguided."

The statement went on to say that "the additional director fee paid to Walter was consistent with the highest standard of corporate governance including the requirements of Sarbanes-Oxley and related S.E.C. and N.Y.S.E. rules." As a director fee, the statement continued, it was in compliance with all legal requirements and was approved by the company's inside and outside counsel.

In an interview on Friday, Mr. Schuetze declined to comment.

Typically, when there is an internal investigation, a board hires independent experts to conduct it. Since Mr. Schuetze led the one at Computer Associates, he then, as chairman of the audit committee, had to review the adequacy of his own inquiry. That presents a potentially glaring conflict.

Gary Lutin, an investment banker at Lutin & Company who is conducting a forum for Computer Associates shareholders, said: "Based on the information C.A. has provided so far, all we know is this: that directors who are being sued, personally, decided to give one of their colleagues a $125,000 bonus for heading up an investigation of the evidence against them, and that they decided to call their colleague independent. This is not a foundation for confidence."

Of course, the New York Stock Exchange could weigh in on whether the directors of Select Medical or Mr. Schuetze at Computer Associates are indeed independent. Under the Exchange's rules, it can issue a public reprimand letter if a company fails to comply. Janice O'Neill, vice president of corporate compliance at the Big Board, says the staff is scrutinizing proxy materials and supporting documents related to director independence for every listed company. No violations have been identified yet, she said.

Investors, meanwhile, are left to wonder if the independence that they need from their directors is the independence they are getting.

Contact Us

We welcome input from our readers. If you have comments or suggestions, please contact Editor Beata Gocyk-Farber, at 800-380-8496 or beata@blbglaw.com. If you would like more information about our firm, please visit our website at

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