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Companies Behaving Badly

CORPORATE governance problems, business-speak for companies that shirk their responsibilities to shareholders, have been front and center for more than three years. While many companies have toned down anti-shareholder practices, investors must remain vigilant for executives and boards that are still in the Stone Age.

That is the conclusion drawn by researchers at GovernanceMetrics International, a two-year-old independent research firm in New York that scrutinizes corporate governance practices for institutional shareholders. "For too long governance screening hasn't been part of the investment process," said Gavin Anderson, chief executive of GovernanceMetrics. "But investors are realizing that this is another area they need to monitor."

The firm has just finished examining practices at 3,220 companies around the world. Of those companies, only 34 received GovernanceMetrics's highest rating of 10. Happily for American investors, most of these - 27 - were United States companies. These companies, Mr. Anderson noted, have outperformed the Standard & Poor's 500-stock index by an average of 11.13 percent for the 12 months ended Feb. 28. The average American company earned a rating of 7 from GovernanceMetrics.

Other good news: the number of independent directors at the companies has climbed to 55 percent from 52 percent in 2003. And fewer companies have chairmen who are also chief executives: 39 percent, versus 47 percent in 2003.

But GovernanceMetrics found questionable practices at many companies. Executive pay was the No. 1 culprit, at least in the United States. Pay issues accounted for 31 percent of the red flags it issued on domestic companies, versus 6 percent of those issued on European companies. Only 5 percent of Asian companies exhibited pay problems.

Of course, lapses in governance do not necessarily lead to poor performance at a company. But enough investors have lost big money in companies where conduct was questionable that governance should be a constant consideration.

Just look at [Krispy Kreme](#), the formerly faddish doughnut maker. A hot stock for many years, Krispy Kreme has lost 81 percent of its value in the past year as its accounting has come under scrutiny.

In June 2003, GovernanceMetrics gave Krispy Kreme relatively low marks for its policies, ranking it 4 out of 10 over all. Then, in January 2004, the firm dropped its rating to 2.5. In July, Krispy Kreme disclosed that securities regulators were investigating its accounting.

The firm's recent study has turned up red flags at a number of companies. For example, it assigned demerits to UnitedHealth Group, a manager of organized health systems, because of the employment agreement it has struck with its chief executive, Dr. William W. McGuire.

The agreement requires the company's shareholders to make generous annual payments to Dr. McGuire if he is terminated, no matter the reason. And if he dies after his departure, his surviving spouse is entitled to half the benefit. Dr. McGuire would have received \$5.1 million a year under this plan if he had retired at the end of 2003.

Mark F. Lindsay, a spokesman for UnitedHealth, objected to GovernanceMetrics's criticism, saying that the payout represented Dr. McGuire's pension and was modest when compared with the lofty returns shareholders in the company have received as a result of his leadership.

"His compensation reflects our corporate performance and that has been, without equivocation, superlative," Mr. Lindsay said. Indeed, UnitedHealth's stock is up almost 50 percent over the last 12 months.

Large companies getting below-average overall ratings from GovernanceMetrics include [Molex Inc.](#), which makes electronic equipment, and [K-Swiss](#), the athletic shoe manufacturer.

Molex received a 2.5 rating from the research firm because of board independence issues and a questionable internal control and financial reporting structure. Indeed, last Nov. 15, Deloitte & Touche, Molex's outside auditor, resigned when it identified errors in accounting for inventory that had overstated the company's income. Molex recorded a charge of \$5.8 million as a result but said that an investigation by its audit committee had found no wrongdoing.

According to company filings, Deloitte had said it would conduct a review of the matter in time for Molex to file its quarterly statement with regulators, but only if J. Joseph King, then Molex's chief executive, and Diane Bullock, then its treasurer, no longer served as corporate officers. Molex declined to remove them.

At the time, Fred Krehbiel, co-chairman of Molex, issued this statement: "We are extremely disappointed with the timing of Deloitte's resignation and strongly disagree with their approach and the condition that we remove as officers valued members of our senior management team."

He added that he and his brother, John Krehbiel, also co-chairman of Molex, had "complete confidence in the integrity and leadership of our senior management team, and believe that the same principles of character, loyalty and integrity that built Molex's hard-earned reputation over its 66-year history are reflected in the board's decision regarding this matter."

ABOUT three weeks later, however, Molex appointed Ernst & Young as its auditor. In connection with the change, Molex announced that Mr. King and Ms. Bullock were resigning their positions. Both would continue at the company in "a staff function," it said. But it added, "neither Mr. King nor Ms. Bullock will be elected an officer of Molex, nor will their positions involve or significantly influence accounting, financial reporting or internal controls."

Molex shares are down 15 percent over the past 12 months. The company did not return a phone call seeking comment.

K-Swiss, which received an overall rating of 1 from GovernanceMetrics, was questioned over its board accountability in part because Steven Nichols, the chief executive, controlled appointment of five of the company's seven directors through his ownership of a class of supervoting shares. The research firm also chided K-Swiss for failing to disclose governance guidelines; for example, the company did not specify whether nonexecutive members of the board ever met without management present.

K-Swiss shares are up more than 22 percent over the last 12 months, so its stockholders are probably unconcerned about governance. But shareholder-friendly practices should be a corporate goal regardless of how a company's stock has performed.

"Our ratings highlight one area of risk, and it's an area of risk that has largely been ignored in the past," Mr. Anderson said. "Our job is to provide investment managers with the information."

Armed with the data, investment managers can choose to sell a given company's stock or buy more. But they can't claim ignorance if a trifling governance problem turns into something more.