September 8, 2003

A New Voice in the Corporate Governance Debate - The Recommendations of WorldCom's Corporate Monitor

On August 26, 2003, Richard Breeden, the court-appointed “Corporate Monitor” for WorldCom, Inc., published *Restoring Trust*, a voluminous report recommending the adoption by WorldCom, Inc., in connection with its emergence from Chapter 11 bankruptcy proceedings, of 78 wide-ranging corporate governance recommendations.¹ The report by Mr. Breeden, a former Chairman of the Securities and Exchange Commission, was prepared under the terms of a preliminary settlement agreement between WorldCom and the SEC. The proposed settlement, which was approved by the United States District Court in July 2003, includes a civil penalty of $2.25 billion (which, if a plan of reorganization of WorldCom is confirmed by the Bankruptcy Court, will be deemed satisfied by a payment of $500 million in cash and $250 million in WorldCom common stock to a victims’ compensation fund), as well as injunctive relief. Under the terms of the settlement, WorldCom is required to implement Mr. Breeden’s recommendations unless the court gives it leave to do otherwise.

As the title suggests, *Restoring Trust* is part of an unabashed effort by WorldCom to achieve a complete break with its past and restore the confidence of investors, customers, employees, and regulators.² The Breeden report ascribes WorldCom’s disastrous failure to an absence of corporate governance mechanisms and internal controls, abusive compensation practices, and a Board of Directors that was insufficiently engaged, lacking in genuine independence, and excessively deferential to Bernie Ebbers, the company’s CEO. While recognizing that “[r]egulation is a blunt and only partly effective tool in the governance field,” and that “[u]ltimately, the quality of governance depends upon the quality, experience, determination and attitudes of all senior members of management and the board,” Mr. Breeden believes that the new MCI that will emerge from WorldCom’s Chapter 11 reorganization requires an extensive regime of corporate governance standards to ensure past structural weaknesses are eliminated and to establish a

¹ The position of Corporate Monitor was established by Judge Rakoff of the United States District Court for the Southern District of New York at the suggestion of the Securities and Exchange Commission, following the commencement by the SEC of enforcement proceedings against WorldCom in June 2002 arising out of WorldCom’s now infamous accounting fraud.
² WorldCom continues to be the target of new claims and proceedings, with the State of Oklahoma recently filing criminal charges against the company and a number of former officers, and accusations by other telecommunications companies that the company improperly routed calls to avoid paying access charges to other carriers.
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governance structure and systems in which investors, customers, employees and regulators can have confidence.

The recommendations in the Breeden report are a specific response to the conditions that led to the largest reported accounting fraud in history. The report should be viewed in that context, and not, in our view, as a model of corporate governance for other public companies in all circumstances, although Mr. Breeden explicitly urges other public companies to consider carefully the issues discussed in his report. However, a number of the recommendations in *Restoring Trust*, for which there is no current public company precedent and which are likely to be highly controversial, may well be seized upon by corporate governance groups, pension funds, unions and shareholder activists, and some of these recommendations may appeal broadly to investors. In addition, given that the report was undertaken at the direction of the SEC and that its author is a former SEC Chairman, its recommendations could influence future rulemaking activity.

For all of these reasons, *Restoring Trust* should be closely scrutinized. At the same time, however, effective corporate governance, within the framework now established under the Sarbanes-Oxley Act and the proposed rules of the self-regulatory organizations, should involve an examination of the facts and circumstances and the application of judgment and common sense, not rigid adherence to a conceptual model designed by a company that desperately needed to restore its credibility.

With that admonition, the following is a summary of some of the more noteworthy features of Mr. Breeden’s recommendations.

**Establishment of a Governance Constitution for the Company**

In general, the corporate governance reforms that public companies have adopted in response to Sarbanes-Oxley, proposed new NYSE and NASDAQ listing requirements, and the general environment of heightened sensitivity to good governance practices, are embodied in by-laws, committee charters and internal policies which, subject to applicable law, can be modified by the Board of Directors at any time.

A significant number of the governance standards recommended by Mr. Breeden (including many of the recommended Board and compensation standards) would be embodied in the Articles of Incorporation of the company, and thus could be amended only with shareholder approval. This approach shifts to shareholders significant power in matters traditionally left to the Board’s business judgment and sends a clear message that shareholders have a real voice in governance, but limits the flexibility of the Board to waive or modify standards in the future where to do so would be in the best interests of the company and where, in the circumstances, seeking shareholder approval would be impractical.
Heightened Qualification, Skill Base and Independence Standards for Directors

Qualification Standards

The Breeden report requires that the new MCI's Articles of Incorporation establish “qualification standards” for all directors that must be satisfied upon election and continuously thereafter, including (i) a preponderance of members satisfying a minimum level of experience serving on boards of public companies (such as at least three years on boards of public companies with market capitalization of at least $500 million), (ii) the absence of conflicts of interest, as defined in the company’s Code of Ethics, (iii) a maximum limit on the number of public company boards on which a director may sit, and (iv) other appropriate qualification standards. Directors should not have any significant prior personal or financial ties to the CEO. A court finding that a director has, at any time and in any context, violated fiduciary duties (presumably including bona fide actions in a takeover or business combination transaction) would be disqualifying.

Skill Base Requirements

The report establishes extensive skill set or “domain expertise” requirements for directors, such as financial or accounting expertise, telecommunications or technology expertise, senior management expertise with a major company, experience with federal or state government agencies or contracting practices, marketing or strategy and planning expertise, ethical training or regulatory experience. In addition, "domain expertise" is required for the four principal committees of the Board, each of which will be required to have at least three members. The Articles of Incorporation will require that all Audit Committee members have experience exceeding the minimum standards of the SEC, the NYSE or NASDAQ, such as would be gained as a senior lending or investment officer of a financial institution, a supervisor of financial or accounting operations, a senior regulator in a federal or state supervisory agency involved with financial reporting or solvency issues, a senior audit partner in a public accounting firm, an investment or portfolio manager actively managing a portfolio of more than $500 million for not less than three years or comparable financial experience. Each member of the Governance Committee should possess domain expertise in governance issues or have substantial leadership experience. Each member of the Compensation Committee should have experience with compensation and human resources issues. Finally, each member of the Risk Management Committee should have experience in risk management issues and at least one member should have operating experience in telecommunications or technology.3

3 On August 29, 2003, WorldCom announced the appointment of five new directors: David Matlin, a distressed debt investor with a significant position in WorldCom debt; Eric Holder, a former deputy US Attorney General; Grant Gregory, a former chairman of Touche Ross; Judith
Mr. Breeden aims to ensure that the new MCI Board members collectively possess the range of skills necessary to address the areas in which, in his judgment, the old WorldCom lacked appropriate oversight and controls. At the same time, the specialty qualifications required by the new MCI's various committees may limit the universe of qualified director candidates, at a time when the universe of willing candidates is already shrinking. It is also possible that the need to recruit directors with these narrowly compartmentalized skills may detract from the Board's overall business and senior managerial experience. When seeking to fill Board vacancies, it may be necessary for the new MCI to select a candidate in order to satisfy specific committee skill base criteria, even if other candidates have desirable industry expertise and superior overall qualifications.

**Heightened Independence Standards**

All of the directors of the new MCI, other than the CEO, must be independent, and no other officer of the company may be a director. This contrasts with the NYSE and NASDAQ proposals, which only require a majority of directors to be independent, and with the recommendations of the Conference Board, which suggested that a “substantial majority” of directors be independent. Mr. Breeden particularly emphasizes that the CFO should not be a member of the Board. The Articles of Incorporation of the new MCI will specify that directors are independent in any of the following circumstances:

- The individual or any close relative by blood or marriage is or within the past five years has been an employee of the company with compensation above a specified level, such as $75,000.\(^4\)
- The individual receives or at any time in the past 3 years has received any compensation for services as an employee, consultant or other professional other than standard board or committee fees or is a partner or employee of a law firm, investment banking or other firm providing professional services to the company.
- The volume of cross-business between the company and any firm of which the director is an officer, director, partner or employee exceeds a level set by the Board (excluding purchases of telecom or other services by the director’s firm, so long as the director was not involved in the purchase and the purchase is on arm’s length terms), with 1% of revenues for either firm or $3 million in any three year period as the recommended starting level.\(^5\)

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Haberkom, a former Bell Atlantic executive; and Laurence Harris, a lawyer who served as senior vice president of legal affairs at MCI prior to its merger with WorldCom.

\(^4\) The level in the NYSE’s proposed rule, which establishes a presumption rather than a firm rule, is $100,000; the level in the proposed NASDAQ rule (which covers the current fiscal year and three prior fiscal years) is $60,000.

\(^5\) The level in the NYSE’s proposed rule is 2% of revenue or $1 million per year, whichever is greater; in the case of NASDAQ, it is 5% of revenue or $200,000 per year, whichever is greater.
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- The individual is an officer of any company on whose board an officer of the company sits.\(^6\)
- The individual is an officer, director or employee of a non-profit organization that receives donations from the company in excess of $100,000 in any year, except for grants to a university exempted by the Governance Committee after a business purpose review.\(^7\)
- The individual is the spouse or relative living in the same household of (i) any elected political official who has received donations from the company or any senior executive in the past five years, (ii) any senior member of a regulatory authority with authority over the company, (iii) any person with government contracting responsibility for the company, (iv) a governor or member of a political executive body, or (v) a legislator on any committee with jurisdiction to enact laws governing the company.\(^8\)
- The individual has had any personal commercial transaction with the CEO in the past 10 years, or serves as an officer, employee, partner or owner of any organization that has had such a transaction in the past five years, other than routine retail or consumer transactions.\(^9\)
- The individual has previously served as the company’s CEO.\(^10\)
- The individual is the spouse or relative living in the same household as any of the foregoing persons.

Shareholder Participation in Nomination of Directors

The SEC has announced that it will issue in the near future proposed rules relating to shareholder access to the company proxy statement. It is expected that these rules will permit shareholders, under certain circumstances, to nominate alternative candidates for director without disseminating their own proxy materials to shareholders as required by current rules. Under the current, longstanding system, the nominating committee of the Board of Directors determines a public company’s nominees and generally proposes a single slate of nominees who typically run unopposed. The SEC believes that this system gives shareholders insufficient voice in the nominee selection process.

Mr. Breeden recommends that the new MCI adopt a form of shareholder access procedure. The Articles of Incorporation of the new MCI will require the Governance Committee each year to solicit directly nominations from the company’s 10 largest shareholders or such greater number as may be necessary to represent at least 15% of the outstanding shares. This Shareholder Committee would then meet with the Governance Committee to review the company’s suggested nominees. If the Shareholder Committee does not support one or more

\(^6\) The NYSE and NASDAQ proposals only treat such a director as non-independent where an officer of the other company sits on the compensation committee of his company.

\(^7\) There is no comparable provision in the proposed rules of the NYSE or NASDAQ.

\(^8\) There is no comparable provision in the proposed rules of the NYSE or NASDAQ.

\(^9\) There is no comparable provision in the proposed rules of the NYSE or NASDAQ.

\(^10\) There is no comparable provision in the proposed rules of the NYSE or NASDAQ.
of the proposed nominees, the two committees should seek to reach a compromise. Failing agreement, the Shareholder Committee should be able to designate one nominee for each vacancy. Each such nominee must be included on the management proxy card and given equal presentation of background and qualifications in the company’s proxy statement.

The Breeden recommendations would afford new MCI shareholders a greater voice in the nomination process than is anticipated under the rules to be proposed by the SEC. It is expected that the rules to be proposed by the SEC will permit shareholders to nominate only a minority of directors, and that this nomination right would be subject to certain eligibility and triggering event requirements.

**Term Limits for Directors**

Mr. Breeden believes that “hardening of the arteries of the Board is a serious danger for shareholders,” as long-serving directors may lose the spirit of independence over time as well as losing touch with current issues. Accordingly, except for the CEO, no new MCI director may serve for more than 10 years.

**Annual Election of at least one New Director**

Mr. Breeden’s report requires the new MCI to have a Board of 8-12 members, with a recommended size of 10 members, all of whom would be elected annually. According to the report, to control the dangers of complacency, the new MCI Board should have a steady flow of new members. Unless there is an existing vacancy on the Board, one director should not be renominated each year, in order to permit the election of a new director. The report suggests that the Governance Committee should set criteria for selecting the director who will not be renominated or, if the Governance Committee cannot agree on such criteria, that the director who will not stand for re-election be determined by lot.

**Limits on Board Memberships**

The report recommends that the Articles of Incorporation prohibit the CEO from holding any outside for profit Board membership, limit all Board members to not more than 3 public company directorships in total (including the new MCI Board), and restrict the CEO and any full time senior corporate officer of another company serving on the new MCI Board to not more than two public company directorships in total (including the new MCI Board).

**Board Leadership and the Chairman of the Board**

The report discusses the pros and cons of separation of the roles of non-executive Chairman and Chief Executive Officer, noting that such a structure may facilitate devotion of adequate time to Board interaction and communication and the creation of checks and balances against excessive executive power, but may also
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lead to confusion and diminution of management leadership. The report concludes that, on balance, it is preferable for the new MCI to separate the positions of CEO and non-executive Chairman of the Board. Recognizing that the old WorldCom technically had such a separation of roles but believing that there was no separation in practice, the report requires that the Articles of Incorporation spell out the duties and responsibilities of the non-executive Chairman and imposes a number of additional requirements.

Duties and Responsibilities of the Chairman

At a minimum, the Chairman should have power:

- To establish the Board agenda for the year and for each meeting;
- To coordinate the work of each Board committee with its chair, to make sure a self-assessment of committee members is conducted each year, and to review possible committee changes;
- To oversee the distribution of information to Board members to ensure adequate and timely reports;
- To coordinate Board member visits to company facilities;
- To review at least annually the effectiveness of the company’s ethics program, internal audit and legal compliance systems;
- To organize and oversee the effectiveness of the Board and the contribution of each Board member at least annually; and
- To organize an annual Board review of the CEO.

Qualifications

To be eligible for the position of non-executive Chairman of the new MCI, an individual (i) cannot have been an employee of the company in the past 10 years, (ii) must have served either as a director of at least three public companies, one with a market capitalization of at least $5 billion, or as chairman, chief executive or a comparable position of a business or government organization, or as president of a major university, (iii) must never have been the subject of an SEC enforcement proceeding in which he or she consented to injunctive relief, a cease and desist order, a suspension or a limitation on ability to serve as a corporate officer or supervisor, or had any license of any type suspended or revoked due to misconduct and (iv) must not have violated any fiduciary duty to the company or its Code of Conduct. One aspect of these requirements is that, if there were an unexpected vacancy in the CEO position, and the Chairman of the new MCI were to serve as interim CEO, the Chairman could not after serving as interim CEO be reinstated as Chairman or remain as a Board member.
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Term Limits and Performance Review

The report recommends that there be an annual performance review of the Chairman, that the Chairman be elected by secret ballot annually and that the Chairman have a term limit of 6 years.

Separate Compensation of the Chairman

The Governance Committee should establish the compensation of the Chairman each year, which should be competitive with similar positions at other public companies. The report recommends that this separate compensation not exceed two times the applicable Board retainer, although the Board should be free to determine a different level.

Viewed in the context of a schedule of at least eight to ten Board meetings per year, as recommended by Mr. Breeden, as well as the report’s recommendations regarding the responsibilities of Board committees discussed below, the role of Chairman of the new MCI will involve very significant responsibilities and a major time commitment.

Board Compensation

The old WorldCom paid an annual retainer fee of $35,000 to directors, supplemented by meeting fees and stock option awards. Mr. Breeden believes the old WorldCom directors received inadequate cash compensation and were overly reliant on stock appreciation as compensation for their services. According to the report, having directors dependent on large equity issuances for basic compensation is not a healthy practice and may co-opt directors to support excessive equity grants to senior management. Instead, the report recommends that the new MCI Board retainer be paid only in cash and that independent directors not participate in any company equity programs. In addition, each director should be required to invest not less than 25% of cumulative cash retainers paid by the company in its common stock through open market purchases or an automatic purchase program at market prices. All shares purchased would be required to be held until at least six months after a director leaves the Board. In addition, the company should make advance disclosure of equity purchases and sales by directors and senior officers, not less than two and not more than 14 days prior to any transaction (current SEC rules require disclosure by the individual within two business days after the sale).

The report recommends a substantial increase in Board retainer fees (to a minimum of $150,000 per year, with meeting fees being eliminated), reflecting the substantial time commitment required from the new MCI directors, the limitations against serving on other Boards of Directors, and the proposed mandatory director stock investment program. This does not include annual fees for serving on committees, which will be $50,000 for each Audit Committee.
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member other than the Chairman and $75,000 for the Chairman of the Audit Committee and, in the case of the three other principal committees, $35,000 for members other than the Chairman and $50,000 for the Chairman.

Executive Compensation

Among the most controversial recommendations in Restoring Trust are those relating to executive compensation. Virtually every aspect of the old WorldCom’s executive compensation system was, in Mr. Breeden’s judgment, a target for reform, including compensation levels, use of stock options, cash bonus programs, “evergreen” employment contracts, and severance/change in control arrangements.

Shareholder Approval of “Mega Awards”

The old WorldCom paid lavish cash and equity compensation to senior executives, with its CEO apparently having substantial discretion over the allocation of hundreds of millions of dollars in cash bonuses and with its Compensation Committee generally not playing an active oversight role. The report concludes that reliance on a Compensation Committee to establish and enforce compensation policies is not an adequate level of control, and that overall limits on compensation for any individual in any year should be established. The report recommends that the company’s Articles of Incorporation establish a cap of $15 million per year in the aggregate for all forms of compensation (excluding appreciation of equity holdings), subject to adjustment every five years with a shareholder vote.

Cap on Severance Payments

The report is critical of a number of elements commonly found in executive employment and severance agreements, including “evergreen” contracts that contain a severance feature and accordingly have a perpetual severance feature (unless the company chooses not to renew), severance obligations that are driven by “autopilot” formulas (such as 3 times base salary and target bonus where target bonus is a multiple of salary) and therefore escalate as base salaries increase, and change of control severance arrangements that include accelerated vesting of equity grants plus a severance autopilot multiple.

In light of WorldCom’s legacy in the severance pay area (which apparently included a potential $250 million in termination payments to Mr. Ebbers), Mr. Breeden believes that the new MCI Board should not have unfettered discretion in this area. Accordingly, the report recommends that the company’s Articles of Incorporation limit the maximum severance paid to an employee without shareholder approval to $10 million in the case of the CEO and $5 million for any other employee. If an employee is terminated for poor performance, maximum allowable severance should be not more than 50% of amounts payable for any
other termination. These amounts would be adjusted every five years, subject to shareholder approval.

Greater Reliance on Cash Compensation

According to the report, the use of massive option grants created strong incentives to hype the old WorldCom’s stock, or to release misleading or false information. The report recommends that in the future MCI focus a greater portion of total compensation on cash awards through salaries and appropriate bonuses, with not less than 50% and ideally 60-75% of total compensation being in cash. Mr. Breeden does not appear concerned that any cash compensation over $1 million per year to an employee would not be deductible under Section 162 (m) of the Internal Revenue Code unless the payment were approved by shareholders.

Ban on Use of Stock Options

The report concludes that, as a general matter, restricted stock is a “distinctly superior” form of equity compensation compared with stock options. According to Mr. Breeden, the advantages of restricted stock include (i) the ability to deliver a precise amount of compensation using current market prices, a result he says is difficult to achieve through use of options, and (ii) substantially reduced dilution – on average it is necessary to deliver three times as many stock options as shares of restricted stock to deliver the same up front value, according to unnamed studies the report describes. In addition, because restricted stock has some value even if the share price declines after the grant date, Mr. Breeden believes restricted stock is a superior incentive. Based upon these conclusions, the report recommends that the Articles of Incorporation prohibit option grants for a minimum of five years, and thereafter until shareholders affirmatively vote to restore their use. The Articles of Incorporation would also provide that any stock options, if granted, and all other forms of equity-based compensation, must be expensed on the company’s profit and loss statement unless such treatment is prohibited under generally accepted accounting principles.

Long-Term Equity Holding Requirements

The report recommends that senior executives be required to retain not less than 75% of the net after tax value of all equity awards received by them until at least six months following the termination of their employment. In addition, the report recommends that the Board set mandatory levels of stock ownership for different levels of management (such as 200 – 300% of annual base compensation in the case of senior managers) to be achieved after a phase-in period.

Ban on “Retention” Payments

The old WorldCom apparently had a practice of making additional payments to management employees that were characterized as “retention” payments but in
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Effect generally served primarily to increase compensation without meeting a specific retention need. The report recommends that the new MCI prohibit the use of retention payments, other than in situations such as acquisitions, dispositions, facility closings or other events where the Board determines a limited retention program has a specific objective warranting its use.

Ban on “Evergreen” Contracts and Employment Contracts with a Term of more than Three Years

The report recommends a ban on “evergreen” contracts and any employment agreement with a total duration of more than three years.

The compensation recommendations in Restoring Trust represent a pronounced departure from the executive compensation practices prevalent in the last ten years. Significant shareholder groups, including pension funds, unions, activist shareholders and corporate governance groups, as well as some other investors, may applaud the shifting of significant power over compensation decisions from the Board of Directors to shareholders, a regime of more predictable, cash-weighted compensation, and the imposition of overall caps on executive compensation. At the same time, this approach may limit needed Board flexibility to make compensation decisions and to respond to the competitive demands of the job marketplace, and adversely affect hiring and retention. Many of the presumptions and assertions underlying Mr. Breeden’s recommendations will likely be hotly debated, including the appropriate weighting of cash and equity compensation, the relative merits of options versus restricted stock, the desirability of caps on compensation and severance, and the design and purpose of executive severance arrangements.

Board Committees

The report recommends that the new MCI establish an Audit Committee, a Governance Committee, a Compensation Committee and a Risk Management Committee. As discussed above, the governance standards recommended for these committees require each committee member to have specific “domain expertise.” In addition, the standards impose substantial responsibilities and require substantial time commitments from members.

Audit Committee

The recommended Audit Committee standards include:

- Qualification standards for Committee members that would go substantially beyond the requirements of Sarbanes-Oxley and the proposed NYSE and NASDAQ standards, effectively requiring that each Audit Committee member be a “financial expert.”
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- Heightened independence standards will apply to members of the Committee, with members receiving no direct or indirect compensation (excluding Board and Committee fees) or payments from the company, any affiliate or any 1% shareholder.
- The new MCI Audit Committee will be required to meet at least eight times per year with not less than six formal meetings.
- Responsibilities of the Audit Committee will include: review of efforts by management and the outside auditors to enhance internal controls and quality of risk management programs, at least twice a year; meeting with the General Counsel at least twice a year to review compliance activities and the company's ethics office; regular meetings with the outside auditors; annual review of usage of corporate aircraft; review of related party transactions at least twice a year; review of all reports of transactions in company stock and compliance with applicable reporting requirements; annual review of the CFO; review of the performance and independence of the outside auditors; regular review of the activities of the internal audit department, including its long-range work plan and risk assessments; and disclosure review (including meeting with shareholders, portfolio managers and analysts at least annually).
- The Chairman of the Committee will be expected to devote substantial time, including meetings or discussions with internal finance personnel, external audit personnel, analysts or shareholders, experts for the Committee and others.
- Chairmanship of the Committee should rotate at least every three years.
- The Audit Committee should identify and retain an independent law firm. This relationship should be established in advance so that advice can be taken promptly when circumstances warrant.

Governance Committee

The recommended Governance Committee standards include:

- The Governance Committee will be responsible for: all nominations to serve on the Board or committees; recommending Board and committee fees; defining the responsibility of Board committees; overseeing committee charter and membership changes; and handling in the first instance issues of corporate governance. In addition, the Committee would consider and review proposed charter and by-law amendments; review the company's compliance with all disclosure requirements, including the federal proxy rules; assist in annual evaluations of Board members, the CEO and the CFO; and evaluate the non-executive Chairman's performance annually.
- The Committee should meet not less than four times per year.
- The Governance Committee would oversee the company's Disclosure Committee.
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Compensation Committee

The recommended Compensation Committee standards include:

- The Compensation Committee should meet not less than four times per year.
- The Chairman of the Committee will be expected to devote substantial time, including meetings or discussions with internal human resources personnel, external compensation advisors, analysts, shareholders, advisers to the Committee and others.
- Chairmanship of the Committee should rotate at least every three years, and the Chairman should be elected annually.
- Responsibilities of the Committee include: review of related party transactions, compliance with federal proxy disclosure requirements and review of human resources and compensation complaints, disputes or issues; annual review of the HR director; and review of external compensation advisors.

Risk Management Committee

The report recommends the establishment of a Risk Management Committee to identify the major risks involved in the company's business operations and to review the quality of the company's actions to mitigate and manage risks.

Features of the recommended Risk Management Committee standards include:

- The Committee will be responsible for review of the company's risk disclosures in all disclosure documents, including reviewing management's identification of all major risks to the business and their relative weight.
- The Committee should regularly assess the adequacy of management's risk assessment, its plans for risk control or mitigation, and disclosure, and should consult from time to time with major shareholders.
- The Committee should meet not less than six times per year.

The scope of the duties of the members of the new MCI Board and its various Committees will be extensive and, in some respects, will require members of the Board to involve themselves actively in facets of the company in which board members have not traditionally been involved. There may be substantial benefits to this particular company, the new MCI, in having greater Board involvement in its affairs. On the other hand, despite the protections afforded by the business judgment rule, by charter exculpation provisions, and by insurance and indemnification rights, the imposition of these duties may heighten risks of litigation against Board members. This will obviously be so if Board members do not fulfill the extensive and detailed list of their responsibilities.
Mandatory Auditor Rotation and Ban on Consulting by the Auditor

The report recommends that the new MCI’s auditors be banned from all consulting work for the company, other than specifically authorized tax work and work intrinsically tied to the audit. There would be mandatory rotation of the company’s audit firm every ten years, with a solicitation of proposals from audit firms at least every five years.

Electronic Town Meeting for Shareholder Proposals

The report recommends that the Governance Committee establish a website offering shareholders an electronic "town meeting" forum for discussion of issues of concern. Shareholders holding at least 1% of the voting power of the new MCI would be entitled to place any bona fide resolution related to the company’s business on the website for consideration by shareholders, whether or not deemed appropriate under the federal proxy rules under the ordinary course of business exception or otherwise. Any proposal that receives a minimum vote to be set by the Governance Committee (such as 20%) must be placed in the company’s next proxy statement.

General Corporate Issues

The Breeden report also makes recommendations with respect to corporate policy of the new MCI in a number of other areas.

Cash Flow Reporting

The report recommends that the new MCI develop and publish enhanced cash flow reports that will more easily permit investors to track sources and uses of cash generated in its business, including seeking to identify areas in which its earnings include accruals that have not yet resulted in receipt of cash flows, or where profits have been deferred notwithstanding completion of related cash flows. This reporting would involve use of “non-GAAP measures” under the SEC’s recent rule changes and would have to satisfy the SEC’s new requirements for presentation and reconciliation to generally accepted accounting principles.

Dividend Policy

Mr. Breeden believes that dividends enhance the ability of investors to gauge the reality of reported earnings. He also suggests that use of retained cash in acquisitions rather than accessing the capital markets in connection with major transactions may reduce outside scrutiny and discipline of management decision making. While recognizing that Boards need some flexibility to plan for major future expenditures, Mr. Breeden believes that flexibility should not be unlimited, and that shareholders should have an enhanced say in formulation of dividend policy. Accordingly, the report recommends that the new MCI be required to
establish and publish a policy on payment of dividends, with an initial target of 25% of the company's net income. The report also suggests that shareholder consent should be sought for any change in the new MCI's dividend policy.

Change in Control Issues

Given the historic problems at WorldCom and its desire to be a role model for good governance, the report recommends that MCI not adopt any anti-takeover devices that are designed to entrench management. The report recommends one year terms for all directors -- no staggered board -- and limitations on any future shareholder rights plan or "poison pill" or other devices adopted by the new MCI.

The recommended limitations on any MCI rights plan or other devices are:

- Any devices that are adopted should have an automatic sunset of not more than five years unless affirmatively reauthorized by shareholders.
- Plans with a "dead hand" feature purporting to limit future board or shareholder action would be prohibited.
- Any rights plan must be a "chewable" plan that can be avoided by an acquiror without Board approval, such as if a minimum level premium is offered to all shareholders, or a minimum percentage of acceptance is achieved.
- Devices that create time to review a proposal carefully and insure that all shareholders have an opportunity to benefit are acceptable under the current circumstances of the new MCI; those that create an ability for directors or management to prevent shareholders from acting on a proposal or would likely deter any purchase offers are not.

Precatory shareholder proposals seeking the elimination of shareholder rights plans and a commitment by the subject company not to adopt a future plan without shareholder approval remain the most popular type of shareholder proposal during annual proxy season. In response to such resolutions in recent years, some companies have redeemed their plans or allowed their plans to expire, others have accelerated the expiration date and a few companies have added so-called "chewable" features to their rights plans, but in each case without tying their hands as to future Board action. Despite its unprecedented nature, the willingness of the new MCI to make a commitment not to adopt any rights plan, other than a chewable plan, without shareholder approval, may lead to increased pressure on other public companies to follow suit.

Conclusion

Restoring Trust may strike directors and managers of many public companies as an extreme response to corporate governance issues driven by an extraordinary corporate cataclysm. It may be tempting to dismiss it as sui generis, and to reject many of its controversial and unusual features as regulatory excesses, as simply wrongheaded, as inappropriate abrogations of Board responsibilities, or as overly
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mechanistic and inflexible. These criticisms have a real foundation if these “reforms” are adopted without careful analysis as to their appropriateness. However, in the post-Enron, post-WorldCom environment, Boards of Directors and managers have developed an acute sensitivity to corporate governance issues. Regardless of its flaws, the fact remains that the Breeden report raises the bar for public companies in the debate over corporate governance. Certainly, Boards of Directors and management of other public companies and their advisors will wish to reflect on, and be prepared to respond to, the issues it raises.

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