COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
Hearing on AIG
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Testimony from Nell Minow
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Mr. Chairman and members of the committee, I thank you very much for inviting me to submit a statement for this very important hearing. I appreciate your exploration of this very important topic as both example and symptom of the greater instability in the financial services sector and our capital markets.

As with Lehman, however, “We told you so.”

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

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

6/30/2002 – Overall D rating assigned
1/2/2005 – Downgrade to overall F
12/5/2005 – Upgrade to overall D
2/13/2006 – Upgrade to overall C
11/2/2007 – Downgrade to overall D

Here are excerpts from our analyst notes on the company. When we upgraded them in 2006 we wrote:

> The AIG board continues to impress us as it reinvents both itself and, presumably, the entire company. While clearly still struggling with certain issues related to internal controls and accounting, and not yet quite as forward-looking as we'd like to see with regard to compensation policies and practices, we are increasingly confident in the new board's willingness and ability to move the company forward in the best interests of ALL its shareholders, and we're pleased to raise AIG's rating accordingly, from an overall D to an overall C - the company's first movement into low risk territory in several years.

After all, they had engaged Arthur Leavitt as an advisory member of the board, and had already gotten rid of about half of the former Greenberg era directors, so we gave them the benefit of the doubt. By the time of our November 2007 downgrade, however, it had become clear that this was all more talk than walk, and the board continued to reflect Greenberg's influence. They could not seem to solve or prevent accounting problems. We wrote:

> We are downgrading our rating on insurance company American International Group to D from C to reflect very high concerns over executive compensation and a continued violation of Section 404 of Sarbanes-Oxley. Total actual compensation for Chief Executive Officer Martin J. Sullivan is more than 20% greater than median total actual compensation at similarly sized firms and raises concerns over the alignment of executive interests with shareholder interests. Meanwhile, a continued Section 404 violation raises concerns over the accuracy and reliability of the financial statements and raises the specter of an earnings restatement.

Our most recent analyst note on the company addresses continued concerns over CEO pay and internal controls:

> Total actual compensation for Chief Executive Officer Martin J. Sullivan was \$43.9M in 2007 (2006: \$17.7M), of which \$1M was salary, \$36.5M was annual bonus, \$5.6M was non-equity incentive compensation, \$30,021 was change in pension and deferred compensation earnings, \$697,910 was all other compensation and \$4,219 was value realized from the vesting of shares. Mr. Sullivan's bonus compensation of \$42.1M (annual bonus plus non-equity incentive compensation bonus) was 42X his annual salary and his all other compensation was near the 90th percentile for S&P 500 firms. Consequently, Mr. Sullivan's total annual compensation and total actual compensation in 2007 each were above the 90th percentile for S&P 500 firms and raise concerns about the alignment of executive interests with shareholder interests. Mr. Sullivan's other compensation is related to personal use of corporate aircraft (\$322,534), housing, home security and other living expenses (\$160,488), personal use of car service, car allowance and parking (\$153,023) and financial tax

> planning ($41,345). The components and amounts comprising this emolument raise concerns about the link between executive compensation and company performance and in some cases are difficult to justify given the size of the other elements of the compensation package. Elsewhere, the company announced in February 2008 that the company's internal control over financial reporting was not effective as of December 2007 as a result of a material weakness related to the fair value valuation of a credit default swap portfolio. This indicates increased risk of errors, restatements and even fraud related to the company's financial reports.

Neither of the CEOs that followed Greenberg sought to implement significant change at AIG, nor did the reconstituted board apply any real pressure on them to do so. One interpretation might be that they simply weren't up to it; a more cynical, but probably more accurate, interpretation would be that the house of cards constructed by Greenberg in the first place was already too fragile and too far gone for such efforts to work. Certainly it is no accident that AIG was among the first of the giants to be toppled by the mounting credit crisis – the seeds of its destruction had been sown by Mr. Greenberg, and endorsed by the AIG board, several years before.

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

Pay that is out of alignment is one of the causes of poor performance but it is also an important symptom – of an ineffective board. In March of this year, extraordinarily, AIG filed suit against its own former executives for pay abuse. The company alleges that former CEO Greenberg, former Chief Financial Officer Howard Smith and five others breached their fiduciary duty through "misappropriation of a special block of AIG shares worth approximately $20 billion in 2005." Those shares were placed in a separate organization to give those executives more control of the company – and disguised additional compensation amounting to hundreds of millions of dollars. Just a few weeks ago, the company and its former executives settled a shareholder lawsuit on the same charges.

The settlement included a $29.5 million payment by Greenberg and three former AIG officers. The remaining $85.5 million was covered by AIG's directors and officers liability insurance. In other words, most of the money that was returned to the shareholders came from insurance they paid for and not from the executives who were overpaid.

The suit is separate from an earlier action under which the current executives are seeking to have all shares held by Starr International that were allocated for future compensation of AIG employees placed in a trust controlled by current AIG executives.

AIG is a serial offender in the category of outrageous CEO compensation. We encourage this committee to ask how the package awarded to new CEO Edward Liddy will be any better designed to tie pay to performance.

AIG shows us that even the most diligent efforts to improve corporate governance structures are ineffective in preventing compensation so devastatingly abusive that it can bring a company – and all of its employees and shareholders – to the brink of disaster.

How can this be prevented?

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

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

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

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

Thank you very much and I welcome your questions.