

# Closing Keynote: Where Were the Boards?

By C. William Pollock

Directors were busy serving their Board to the best of their abilities—but did they get the help they needed?



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In a recent article in *The Wall Street Journal* entitled “Where Were the Boards?” Bill George concludes that in response to the recent

round of financial failures by the likes of Lehman, AIG, Bear Stearns, Countrywide Financial, Wachovia, Washington Mutual, Fannie Mae and Freddie Mac, “the solution is not to diminish the responsibilities of directors, but rather to hold them accountable to fulfill their fiduciary duties and to enforce negative consequences when they fail to do so.”

Clearly, something went wrong—collectively, shareholder financial losses of the aforementioned companies are staggering. And, unfortunately, that is only a part of the total loss suffered as a result of the recent financial crisis. While I think Mr. George raises an interesting question in his article and I agree that Boards must be accountable, I suggest there is a real systemic flaw in corporate governance in this country that will continue to plague our public corporations and economy until appropriately addressed.

Directors are not being given the resources to do their jobs. And they have to worry about being subject to personal liability if something goes wrong. There have been at least 14 cases in the last 25 years where

directors had to write personal check—including the most recent one, Just for Feet, where directors wrote personal checks totaling \$41million. To make matters worse, most directors have to share their D&O insurance with the company and that coverage can be exhausted in the event of a securities lawsuit (why shouldn’t directors have their own coverage!).

Why would anyone with personal assets be willing to serve on a board today? This country desperately needs talented people to serve on its boards. The board has a huge job—it is supposed to set the strategy for the company and oversee management in the implementation of the strategy—not an easy job! Following the Enron and WorldCom meltdowns, new legislation, new SEC and NYSE regulations, and other regulations were enacted which in part are requiring boards to have more independence. Independence of directors is critical for improving corporate governance. But, in order to be independent, directors need greater resources to perform their jobs. They should ask for and demand the help—they are entitled to it. Otherwise, how can they possibly obtain the information they need on an “early warning basis.”

Will directors be held accountable for the recent round of financial failures? If so, how will they be held accountable? Legally, directors have three duties—the duty of loyalty, the duty of care and the duty of good faith. Simply stated, directors are required to act with loyalty and due care and the

honest belief that they are acting in the best interest of the corporation.

## The Duty of Good Faith

A relatively new concept, the duty of good faith is emerging in the law as a new standard of conduct. Traditionally, the duty of good faith was more closely associated with the duty of loyalty. But, the duty of good faith is arguably becoming an additional duty along with the duty of loyalty and duty of care. The concepts of loyalty, care and good faith form the cornerstone of the business judgment rule, the presumption that business decisions made independently with due care and in good faith will not be overturned or even second guessed by the courts.

So, what about this duty of good faith. Ira Millstein, Senior Associate Dean for Corporate Governance and the Eugene F. Williams Jr. Visiting Professor in Competitive Enterprise and Strategy at the Yale School of Management and Paul MacAvoy, Williams Brothers Professor of Management Studies Yale University, in their book entitled “The Recurrent Crisis in Corporate Governance” (2003) predicted that directors would face an increase in litigation and that lawsuits would go beyond traditional claims based on concepts of loyalty and self-dealing. They opined that the new litigation would be based on failures by directors to embrace certain reform practices and/or the failure to ensure adequate access to information. I believe Millstein and MacAvoy were right—and unless directors take the recent

meltdowns seriously and pursue better corporate governance practices and get help, they will be subject to increased litigation and potentially personal liability.

It's hard not to agree with Bill George that directors should be held accountable in order for our corporate governance system to work properly.

## The Right Equipment

However, we should equip directors with the tools to do their jobs and to protect themselves. What we are doing to directors is the equivalent of sending our military to battle without adequate weapons or training. The enemy will make sure they are held accountable. Unless we equip them to do battle, they are certain to be defeated.

Then, what do we need to do to equip our directors?

First, we should anticipate the trouble before the regulators and the plaintiffs get there; the plaintiff's bar's strategy will probably include:

- Further development of the lack of good faith argument
- Monitoring of corporate governance practices

Second, we should provide more and better information to directors, including access to outside experts and/or staff when needed (recommended by Millstein and MacAvoy in their book.)

Third, directors need better legal protection, including improved indemnification and improved D&O insurance coverage. Boards need to step up and embrace better corporate governance such as adherence to NACD's ten Key Agreed Principles to strengthen corporate governance for US publicly traded companies (recently published by the NACD and Business Roundtable.)

## The Courts Will Decide

Ultimately, the courts will decide whether outside directors will be held accountable and if directors don't take measures to self regulate, we may see new legislation or new regulations or both regulating directors. Our system of governance is flawed— independent outside directors do not typically operate in such a way to adequately defend what the plaintiffs bar is bound to pursue—the duty of oversight based on a new lack of good faith requirement which includes the obligation by directors to know or be informed and follow new corporate governance practices. I think directors are in for a rough period as the various interested parties in the financial chaos sort out their losses and decide who to go after. It will be interesting to see what happens.

It's time for directors to check out their indemnification provisions and their D&O insurance and commit to a new level of corporate governance. They should do everything possible to educate themselves about the business, risks and financials of the

companies they are serving and use outside advisers wherever possible and certainly to a much greater extent than they are being used today. If they are intelligent about their protection (all aspects of it), they will survive the likely efforts of the plaintiffs bar to hold them accountable.

The challenges facing directors are monumental—they have tremendous volumes of material to review and little time to do it. Financial engineering, managed earnings and sophisticated and complex financial statements are putting greater pressure on directors and their duty of care. Directors need to get help. They should retain advisers who have expertise in the business of the company to help the board and give these advisers access to management. They should embrace new corporate governance ideas and policies and communicate them to the shareholders. It is time for directors to obtain help to satisfy their legal requirements regarding the duty of care, good faith, and adequate oversight. Until they do, their legal position will remain very precarious. This country cannot afford to have the best talent refusing to serve on our corporate boards. If we do not fix the system by adequately equipping and protecting our directors, it is only a matter of time before we experience another financial meltdown. This is one battle our country and its directors cannot afford to lose.

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