Institute for
Corporate Responsibility

Challenges in Corporate Governance: The Role of Corporate Directors in Dealing with Corporate Crises

The Challenges in Corporate Governance project is one of the activities of the Governance Program at the Institute for Corporate Responsibility at the George Washington University School of Business. The project examines the issue of what policies are associated with good corporate governance and promotes a dialogue on how those policies are translated into practice. The project is co-directed by John Forrer, Director of the ICR Governance Program and Dr. Cynthia A. Glassman, an ICR Senior Research Scholar.

On October 21, 2013, ICR conducted its seventh program on Challenges in Corporate Governance. This program was sponsored jointly with C-LEAF, the Center for Law, Economics & Finance at GW Law School. Previous panels have addressed how corporate directors deal with new rules, the importance of diversity on Boards, and the role of directors with respect to risk management, executive compensation, CEO succession and setting the 'tone at the top.'

In this continuing series, our distinguished panel focused on the role of Corporate Directors in a Corporate Crisis. The panel was moderated by **Cynthia A. Glassman**. Dr. Glassman is a Senior Research Scholar at the ICR. She served as an SEC Commissioner from 2002 to 2006, including Acting Chairman during the summer of 2005, and served as Under Secretary of Commerce for Economic Affairs from 2006 to 2009. Currently, she is a Director of Discover Financial Services, where she serves on the Audit Committee, and Navigant Consulting, where she serves on the Nominating and Governance Committee and the Compensation Committee. She is a Trustee of the SEC Historical Society and the Washington Tennis and Education Foundation and is a member of the Advisory Board of C-LEAF. She has spent over 40 years in the public and private sectors focusing on financial services regulatory and public policy issues. She has served on the Boards of the Federal Reserve Board Credit Union, the National Economists Club, Women in Housing and Finance, the Commission on Savings and Investment in America, and Hopkins House, a preschool for low income families. She has written extensively on corporate governance, financial reporting, risk management and competitiveness issues. She speaks nationally and internationally before professional and business groups.

The panelists were:

Alan Beller is the executive director, Cleary Gottlieb Steen & Hamilton. His practice focuses on a wide variety of complex securities, corporate governance and corporate matters. Mr. Beller advises regularly senior officials of both U.S. and non-U.S. entities on these subjects, including in connection with SEC filings, corporate transactions and other corporate matters and public and private offerings of securities. Mr. Beller served as the Director of the Division of Corporation Finance of the U.S. Securities and Exchange Commission and as Senior Counselor to the Commission from January 2002 until February 2006. During his four-year tenure, Mr. Beller led the Division in producing the most far-reaching corporate governance, financial disclosure and securities offering reforms in Commission history. Among his accomplishments were the implementation of the corporate provisions of the Sarbanes-Oxley Act of 2002, the adoption of corporate governance standards for listed companies and the successful completion of comprehensive securities offering reforms.

John Olsen is a founding partner at Gibson, Dunn & Crutcher. He represents business organizations in corporate governance, corporate securities, corporate finance and merger and acquisition matters. He has acted as special counsel for boards of directors and board committees on governance issues and in assessing shareholder litigation, responding to business combination proposals and conducting internal investigations. He has represented

corporations, broker-dealer firms and individuals in Securities and Exchange Commission and other federal agency investigations and regulatory matters. Mr. Olson is a member of the American Bar Association (ABA) Standing Committee on Government Affairs. Mr. Olson served (2000 – 2005) as Chairman of the ABA Business Law Section's Committee on Corporate Governance, and as a member of the Presidential Task Force on Corporate Responsibility appointed by the President of the ABA. Previously, he was Chairman of the ABA's Committee on Federal Regulation of Securities (1991-1995). He is a member of the Executive Council of the Securities Committee of the Federal Bar Association.

Lawrence Trautman is a professional corporate director. He is an entrepreneur (responsible for more than a dozen start-ups) and professional corporate director, having held numerous corporate directorships in publicly-traded and privately-owned corporations engaged in such diverse industries as dairy processing, financial services, franchising and fast food, mortgage banking, publishing, software and information technology, oil & gas, social media, and others. He served as chairman of the committee of independent directors in the sale of Orange Julius, Inc. to International Dairy Queen. As Senior Vice President of the New York-based investment banking firm Donaldson, Lufkin & Jenrette, he had a diverse corporate finance practice, having sole client responsibility for the origination, negotiation and processing of $Hundreds of Millions of merger and acquisition transactions and public equity offerings for both traded and going-public situations. His other transaction experience includes: venture capital, real estate, public finance, and private debt and equity placement.

Laura Unger is a special adviser with Promontory. She provides clients with strategic advice about matters relating to the SEC, regulatory and legislative process. A former SEC Commissioner (and Acting Chairman) and Senate Banking Committee Counsel, Laura has unique insight into a wide range of challenges faced by clients. She also draws upon her public company board experience over the last decade to provide guidance and insight on governance and business. Laura's career at the Securities and Exchange Commission and on Capitol Hill spanned a decade and a half. Most recently, she served as the 78th member of the SEC and as Acting Chairman for six months. Prior to returning to the SEC, where she began her career in New York and later D.C. as an Enforcement Attorney, Laura worked for several years as Securities Counsel to the Senate Banking Committee. She left the government in 2002 and expanded her expertise by working as an on camera CNBC Regulatory Expert for a year, and as the Independent Consultant to JPMorgan Chase for six years as part of the Global Analyst Conflict Settlement. She has also served as an Independent Director on a number of public corporate boards over the last nine years.

In a public company, owned by a large and diverse set of shareholders, the role of the Board of Directors is to oversee management in order to protect the interests of the shareholders.

The Board is elected by the shareholders and has a fiduciary duty to them. Their key duties are:

- A duty of care – which means they are expected to get sufficient information and fully deliberate on Board decisions
- They also have a duty of loyalty, which means they must act in the best interests of the shareholders and the company
- They must act in good faith
- And they must maintain confidentiality of any information that has not been disclosed to the public.

The roles of the Directors include:

- Review of corporate strategy
- Developing a plan for CEO succession
- Setting CEO and other senior executive compensation
- Overseeing compliance, risk management and financial reporting, and
- Setting the appropriate tone at the top

Corporate Boards typically have several standing committees to deal with their responsibility to oversee the financial reporting, risk management, CEO succession, CEO and senior management compensation, and corporate governance. Further, the Board as a whole typically addresses corporate strategy issues.

Corporate crises come in many varieties. Some have internal causes; some result from external events. There are examples of these crises in the newspaper almost daily. However, when a crisis hits, the Board cannot rely on routine processes. Rather, the Board needs a more time sensitive and intense approach in order to react quickly and appropriately to the immediate issue.

Internally generated crises include financial issues, such as a significant loss or a potential or actual bankruptcy, for example, Lehman Brothers. Other internal issues are people related – a CEO health or ethics issue – such as Apple or HP experienced, or a rogue trader like the one that brought down Barings. Crises can also result from possible illegal activities including fraud; Enron is a poster child for this. Antitrust issues such as the one that held up the merger of USAIR and American Airlines or a Foreign Corrupt Practices Act violation, for example at Siemens, are other possible causes of a crisis to be addressed by the Board.

External events or pressures can cause a crisis as well. Potential or actual cyber-attacks can seriously disrupt or harm a business. A weather event, such as hurricane Sandy can cause acute unexpected problems. A significant shareholder activist, hostile takeover, or proxy fight could be seen as a crisis as well.

Whatever the cause, the Board is expected to act quickly and effectively to mitigate the damage to the company. The panel discussion focused on how boards accomplish this. The panel discussed three hypothetical crises and addressed:

- how Boards proactively plan to prevent or deal with a crisis,
- how the Board learns about the crisis,
- how they respond to the crisis — both with internal and external resources,
- what pitfalls the Board may encounter in dealing with the crisis,
- how they determine what and when to disclose and communicate,
- how they resolve the crisis, and,
- and what is the follow-up after the crisis is resolved.

Any resemblance to a real event was pure coincidence. The discussion was not meant to be about any particular company.

The first hypothetical was an issue concerning the CEO, e.g., a significant health problem or an ethical issue. The panelists noted a key distinction between the health issue versus the ethics issue. In the former, the CEO may

participate in the planning for the solution. In the latter, however, the CEO would be sidelined from the discussions.

The panel laid out certain steps that should be taken before a crisis hits. The Board should have resources identified in advance to deal with possible issues. Also, the Board should have a short term and long term plan for CEO succession. Once the Board becomes aware of the crisis, the first step is to find out the facts. The Board will likely need outside expertise to investigate and evaluate the issue. Outside counsel, a public relations firm, and medical expertise in the case of a health issue, were all mentioned as resources the Board might need.

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Once the facts are established, the Board must then address the timing of any actions. In a medical problem, the decisions depend on the nature of the problem – whether the CEO can continue to perform effectively for some amount of time or whether the situation is acute and a replacement is needed immediately. If a significant ethical lapse has occurred, the CEO would likely be replaced quickly.

After the decision is made regarding what will happen to the CEO, the next question is what to disclose and when to disclose it. The discussion made clear that the answer to these questions is not always obvious. A number of issues arose. Privacy concerns were raised, not just for the CEO, but also for his or her family. If the CEO could continue to perform for some time, would it be in the best interest of the company or not to disclose to the public? If the CEO was replaced, did the public need to know why if the CEO was no longer there? Would the story leak if the company did not disclose it? There was agreement that the Board cannot mislead the public, so once the Board decided to disclose, the information had to be complete and accurate and kept current. Overall, there was a sense that corporate integrity, tone at the top, corporate culture and protecting the company's reputation all point in the direction of disclosure, especially in the post Sarbanes-Oxley environment, in which standards and expectations of corporate boards have become much more rigorous over the past 10 years.

The second hypothetical was a company facing a possible enforcement action. The panel focused on a Foreign Corrupt Practices Act (FCPA) violation. The law essentially prohibits payments to a foreign official to generate business. Although the law is decades old, enforcement focus has picked up significantly in recent years.

The panel highlighted a variety of ways in which the company could learn that it had violated the FCPA: a whistleblower complaint to the audit committee, a press article, a competitor losing a contract, or a disgruntled employee. However the company learns about an alleged FCPA violation, the Chair of the Audit Committee, as well as the General Counsel should be informed immediately. They, in turn, would determine next steps. Large, multinational companies typically have an internal group to review and investigate such allegations. However, for both large and small companies, if the alleged violation appears to be significant or if someone in senior management may be involved, it is important to undertake an independent investigation. In addition, the outside auditor and outside counsel needs to be informed quickly.

While this is typically not a life or death situation, timeliness is important. Unless a regularly scheduled Board meeting is imminent, the Audit Committee Chair should inform the Committee members within a few days, and the Committee would likely want to have a special meeting of the Board, typically by phone, to inform the Directors and discuss options, including self-reporting to the enforcement authorities. Since self-reporting is looked upon positively, at least in the U.S., the company would likely want to report to the enforcement authorities within two to three weeks of the Board discussion.

There was general agreement among the panelists that Board members should be informed in a timely manner so as not to be surprised by a press article or an enforcement action. Their reputation and the reputation of the company are at risk, and Directors would take an alleged FCPA violation very seriously.

The third hypothetical was a suspected fraud by senior management. The panel focused their discussion on an ongoing, material financial fraud by someone in senior management. In this situation, the panelists agreed that action needed to be taken quickly. Delay was not an option. The Audit Committee Chair and the lead independent director would need to be notified right away, and an investigation would be started quickly. If a fraud had been committed, it would need to be reported and stopped.

To be prepared for such an event, the independent directors should insist that the General Counsel have identified outside legal expertise that can be brought in immediately. Similarly, the CFO should have identified potential audit resources other than the firm's external auditor. If a fraud is suspected, the independent directors would need to bring in such outside expertise to conduct the investigation.

One of the first decisions is what to do about the perpetrator of the alleged fraud. The individual would likely not admit to the fraud, at least initially, but rather would have a story to explain the action. Whether to bench or "ring-fence" the executive would depend on how strong the allegations were. However, the executive should not be left in place without constraints on his or her activities.

The panel emphasized that for his or her own continued career, it was important for the executive to cooperate with the investigation. In this regard, the panel agreed that the company should provide excellent legal counsel for the person to make sure that the legal advice given is constructive.

The question was raised regarding when to go to the SEC. If a quick investigation did not corroborate the fraud, the company could continue to monitor the situation without reporting anything unless and until a full investigation revealed a fraud. Alternatively, the company could report to the SEC early in its review, but would risk losing control of its investigation if the SEC starts its own investigation. Once a financial fraud is determined, however, both the company and its auditor would have to file with the SEC within four days that the company's financial statements cannot be relied upon.

The panel agreed that this situation would be both time sensitive and time intensive for Board members, and could require daily Board calls until the situation was resolved.