

Failure **is** an Option

Not a year has gone by in recent memory without a major corporate scandal being prominently featured by the world's leading media outlets. No matter the era, companies once touted as darlings reliably stumble every year, often mightily and very publicly.

Most recently, organisations have been criticised for sexual harassment abuses by key executives that have gone either undetected or unpunished, false claims about the development and commercialisation of their company's products, illegal consumer practices, and many more.

In the United States, under applicable state corporate law, the board of directors is charged with managing the business and affairs of the corporation. Given this responsibility, the media often turns a spotlight on the board when something unfavourable unfolds – examining the board's actions with exacting scrutiny and applying a standard of review that appears more rigorous than the applicable legal standard. The media and countless others undoubtedly claim that the board was at fault or that the time-tested corporate governance legal framework is failing. Instead of analysing the myriad corporations where the current framework is helping corporations create value and thrive, some commentators inevitably call for an enhanced governance paradigm and increased regulation.

Whether boards, practically speaking, can actually ever fulfil what has become the high standard of absolute accountability is ripe for review. Whether this enhanced standard is actually good for business is another question that deserves analysis.

This article will compare the US legal standard applicable to boards of directors and contrast it with the standard that the press and others often apply to boards. The article will argue that the legal framework in the US is appropriate in providing protections to shareholders and will share lessons boards can learn from the current environment to better protect themselves from a reputational standpoint.

The US governance model strikes the right balance

Delaware law provides that the business and affairs of a corporation are to be managed

Corporate failures should not trigger a change to the governance paradigm

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by and under the direction of a board of directors.¹ In discharging this responsibility, Delaware law imposes certain fiduciary duties on directors, namely the duty of care and the duty of loyalty. The duty of care requires the director to act in an informed and thoughtful manner. The duty of loyalty requires the director to act in good faith and in a manner that the director reasonably believes to be in the best interest of the stockholders and the corporation.

As a corollary to these fiduciary duties, Delaware courts have developed the so-called 'business judgement rule' when called upon to review the actions of the board. Under the business judgement rule, courts will not enjoin board action or impose director liability unless a complaining shareholder establishes that the director breached either the duty of care or the duty of loyalty. Courts have expressly indicated that they apply the business judgement rule because they are operating with the benefit of hindsight and also do not believe that they are in the best position to make business decisions.

Consequently, in the normal functioning of the board, if the directors reasonably inform themselves of available information, act in good faith, and are independent and free from self-dealing, a court will not second guess the board's decision, even if the course of action ultimately fails.

If a stockholder can establish a breach of the duty of care or loyalty by directors in approving corporate action, the directors lose the protection of the business judgement rule. In this instance, the burden would then shift to the directors to demonstrate that

the action taken is 'entirely fair' to the corporation. Should the directors fail to meet this high standard, the court could invalidate the action taken by the board or could, in theory, impose personal liability on the directors.

Another protection afforded directors under Delaware is exculpation for a breach of the duty of care. The corporation may include a provision in its certificate of incorporation that eliminates or limits the personal liability of a director for a breach of the duty of care. Exculpation is not available for a breach of the duty of loyalty. The effect of this exculpation is that an aggrieved stockholder can seek to enjoin the action taken, but cannot seek personal liability against the directors.

Finally, Delaware law allows the corporation to indemnify directors in cases alleging a breach of their fiduciary duties. At a high level, if the director is successful on the merits, the corporation must indemnify the director for any expenses incurred in defending the litigation. If the director is not successful, the director may still be indemnified for expenses and damages if the director acted in good faith and in a manner the director believed to

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be in or not opposed to the best interests of the corporation. The corporation may also advance the director's expenses if the director undertakes to repay such amounts if it is ultimately determined the director is not entitled to indemnification. Most corporations adopt these indemnification provisions in their governing documents and in indemnification agreements with directors, and purchase D&O insurance to backstop these obligations.

Practically speaking, the sum total of these protections – business judgement rule, exculpation, indemnification and D&O insurance – mean that individual directors are rarely held personally liable when an organisation engages in misconduct. This package of protections is beneficial from a business standpoint because it encourages prominent individuals with significant expertise and a proven track record of success to serve as directors without fear that poor performance alone will result in personal liability. Otherwise, these individuals would be reluctant to hold board positions. Nevertheless, the media

and other commentators have not hesitated to second guess director decision-making from the sidelines.

The dismantling of corporate protections

Long before the current wave of shareholder activism, certain individual and institutional shareholders dismantled various board protections. This, in turn, created many of today's activist shareholders, who further accelerated the demise of structural protections like poison pills, staggered boards and restrictions on acting by written consent, calling special shareholder meetings and removing directors, among others. Then came calls to split the chairman and CEO roles, reduce management compensation, eliminate change in control severance agreements, and, more recently, limit the terms of directors. All of these changes were championed in the name of good corporate governance. But these changes do not indict the fundamental elements of the board paradigm under Delaware law, and the essence of the paradigm should stay intact.

There is no question but that a small minority of boards were either asleep at the switch, grossly negligent, or actively engaged in fraud. Similarly, some of these changes were likely beneficial, or at least neutral, at many corporations. In our opinion, however, none of these types of provisions are either beneficial or hurtful on their face.

As with many things, the crucial factor is how these provisions are used. Are they used to allow the board time to adequately consider proposals in the exercise of their fiduciary duties, or are they used to entrench underperforming directors and management or, worse, reallocate economics from the shareholders to directors and management?

The issue, as we see it, is that the actions of a distinct minority have cast a long shadow on the reputations of the many. Everyone can identify the high-profile corporate scandals – Enron, Worldcom, and Theranos. Of course, there are others. The problem is that some people, in particular the media, corporate critics and many academics, extrapolate these isolated situations out to the entire population of corporations and their boards of directors. There are literally over six million companies in the US when privately held companies are added to the mix. The vast majority of these boards of directors function perfectly well, and yet there are calls to dismantle or revise the basic board framework because human nature caused a small minority of directors to implode their boards and companies. »

HANDLING A CORPORATE CRISIS
Boards can learn from mistakes and restore their credibility

Failure is a part of capitalism

The best protection for investors is to conduct thorough due diligence. To the extent shareholders desire to be well-informed about corporate strategy, they have avenues to engage with the board. Not every corporation will succeed for the long run, and the responsibility for making good capital allocation decisions lies with investors themselves. If investors believe an organisation is not living up to its potential or that the board is operating in a manner that is not conducive to corporate growth, they can act through the existing board paradigm to replace directors, or they can reallocate their capital to organisations that are meeting their standards. In our view, if some companies are not routinely failing, the economy as a whole is not progressing. The Kodaks and Blockbusters of the world need to give way to the Apples and Netfixes.

So, in this era of strict scrutiny of boards, how can directors best protect themselves from reputational risk?



SELECTING THE RIGHT LEADER
Capable CEOs can ensure success via good decision-making

Take care to select the right CEO

The board only meets a limited number of times a year. The role of directors in the US is essentially part time, with many directors either holding multiple directorship positions or serving both as a director in one company and as a C-suite executive at another organisation.

The board is firmly the overseer of the corporation and sets strategy, but the chief executive officer and management teams are responsible for day-to-day execution of the board's plan. Thus, the board's most critical task is to ensure that it selects a qualified CEO, capable of fulfilling the board's mission without noteworthy missteps. Investing the necessary time to develop an effective approach to CEO recruitment and oversight is critical.

Tune out the noise from uninformed third parties

As we posited earlier, most boards of directors function properly. Most privately held companies will fly under the radar screen. Notable exceptions include Airbnb and other such high-profile companies. Thus, it is mostly the boards of public companies that bear the brunt of corporate governance criticism. In that regard, too many directors, in our opinion, have let themselves be distracted by things like their 'Governance QualityScores' or similar governance measurements, and withhold votes.

They end up letting irrelevant outside agents with limited, imperfect information influence the function of the board behind closed doors. If directors are confident in their deliberations and their actions, they should own their decisions and dismiss such non-specific criticism as just so much noise. Well-qualified, thoughtful judges have decided that even they should not play too much a role in corporate decision-making.

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If they don't have a seat at the table, why should other third parties with far less information?

Stop fighting the last war

After encountering a troubling situation, boards often go to painstaking efforts to investigate the incident to better understand it and ensure that it doesn't happen again. In many instances, boards will establish special committees whose sole task it is to get to the bottom of the situation. Investigations can involve many, if not all, members of the board in some capacity, lawyers, consultants, and other stakeholders. Oftentimes they can go on for months, if not years, until the board is satisfied there was no stone left unturned. The board then receives a list of recommendations to implement to ensure

the corporation never suffers from the same misconduct again. These excursions can be both time consuming and costly.

The lengthy reports can result in a 'check the box' approach that gives the board a false sense of security – if it just ensures every element is met, the organisation is better protected. The problem with this approach is that organisations operate in a dynamic world, and the risks of yesterday and today bear little resemblance to the risks of tomorrow. A board that operates by spending too much time looking in the rear-view mirror fails to see the landscape through the window before it. In a worst-case scenario, this may cause the board to insufficiently prepare for other risks and threats or, importantly, opportunities that may materialise.

Ensure the board is functioning at a high level

The board should invest the necessary time and resources to develop a framework of mutually agreed upon conduct by individual directors and the board as a whole. Directors should not only attend meetings, but they should also actively participate. Diversity of thought and perspective should be viewed as a necessary protection for the organisation, not a threat. Directors should be able to critically examine issues before them and discuss and debate topics without fear of retaliation. The chairman or lead director should also discourage directors from developing factions or cliques that interfere with the collective work of the board.

Conclusion

The 'sins' of a few corporations should not be attributed to the many organisations that are functioning at a high level. To attribute them to the many exceptionally performing companies that strive day in and day out to make decisions in the best interests of their organisations would be a

mistake. Even more importantly, the time-tested governance framework does not need a major overhaul every time a new scandal emerges. Because of human nature, not all corporations will function at a high level all the time. There will be those that make good decisions and those that make poor decisions. Regardless of how much companies spend on research and development, there is no guarantee they will be the one to develop the next blockbuster innovation. Whether we like it or not, modifying the governance framework will not change these truths. 🌐

¹In the US, Delaware law is considered by many to be the gold standard for corporations. Delaware corporate case law is well-developed, and, as a result, organisations often incorporate in this jurisdiction.