

Corporate Governance Issues – Structure, Operation & Litigation

H.S. Grace & Company, Inc.

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Tuesday, September 15, 2020

Examining Governance Basics

Presented by

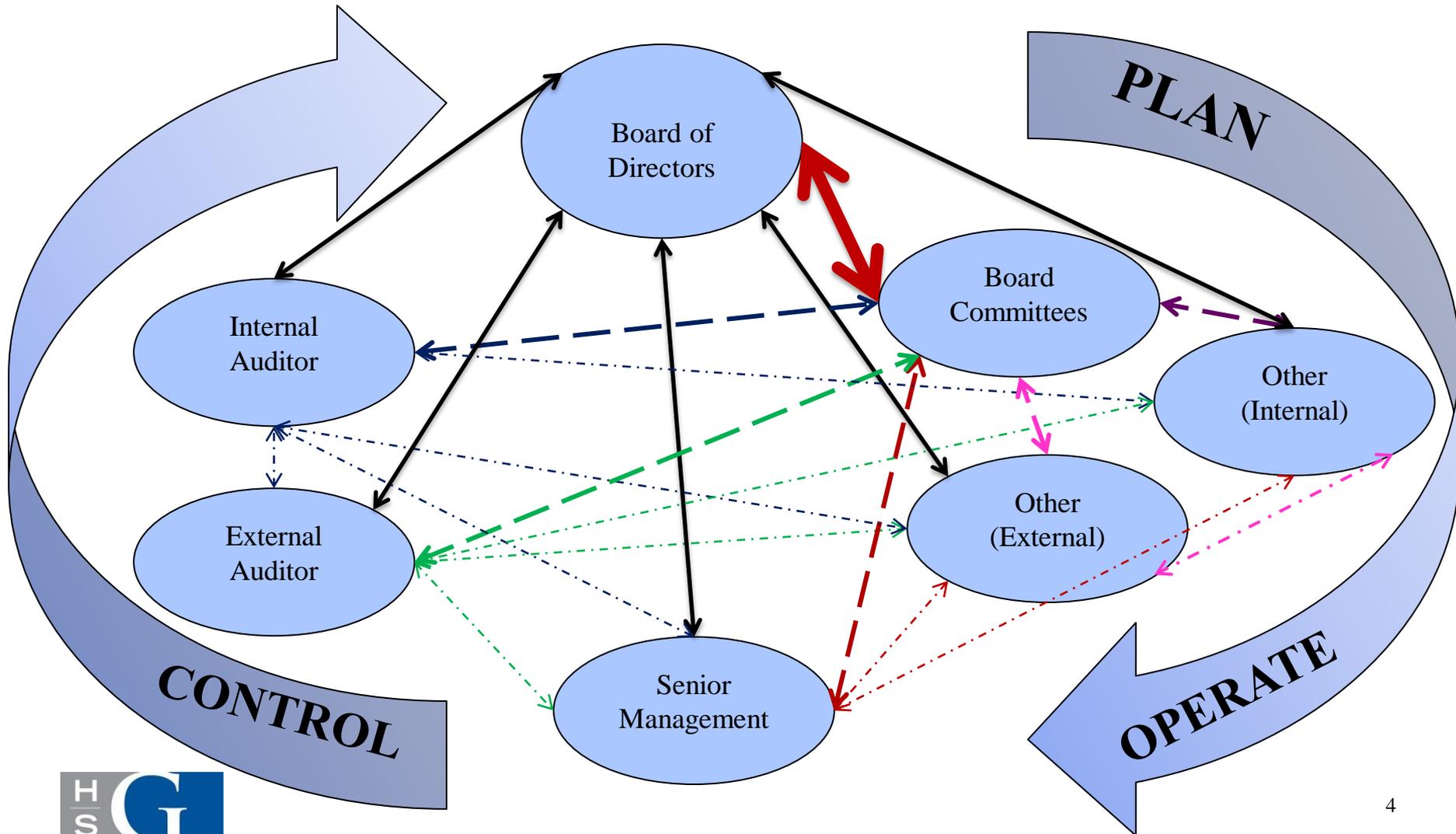
HS Grace & Company, Inc.

(Jeffrey E. Curtiss, Suzanne Gilbert, H. Stephen Grace Jr., S. Lawrence Prendergast)

Actionable Advice for Boards, Board Committees and Senior Management

- The Evolution of Business Governance Structures
- The Need for Substantive Checks & Balances
- The Effective Use of Internal and External Reporting
- Other Issues

The Structure and Functioning of the Board and Management within the **Plan-Operate-Control** Cycle of the Firm



The Role of the Board

- ❑ Delaware Supreme Court Chief Justice E. Norman Veasey:

“The board of directors will actually direct and monitor the management of the company, including strategic business and fundamental structural changes.”

- ❑ Delaware Chancery Court Chancellor William B. Chandler:

“Delaware law is clear that the business and affairs of a corporation are managed by or under the direction of its Board of Directors,” (Walt Disney Shareholder Derivative Litigation)

Wells Fargo Board

- ❑ From a “Hall of Fame” to a “Hall of Shame”
- ❑ Board of Governors of the Federal Reserve Bank Actions
 - Required a plan within 60 days to enhance board effectiveness in carrying out the oversight and governance of the company.
 - Criticized board member job performance: “did not meet supervisory expectations.”

The COVID Challenge

A Basic Example

- ❑ Firms working diligently responding to the pandemic
- ❑ Maintaining operations
- ❑ Reopening operations
- ❑ Relocating operations – China threat
- ❑ Ongoing decision-making challenges
- ❑ Key questions
 - Board involvement
 - Board oversight

Lord Acton

- ❑ Power corrupts, and absolute power corrupts absolutely.

Tone At The Top Quotes*

- ❑ "Boards should be absolutely certain that the company is run properly from a fiduciary standpoint in every degree. I am a great believer in the audit committee having full access to the auditors in every way, shape and form."
- ❑ "You'll see people who in the early days...took their life savings and trusted this company with their money. And I have an awesome responsibility to those people to make sure that they've done right."
- ❑ "We are offended by the perception that we would waste the resources of a company that is a major part of our life and livelihood, and that we would be happy with directors who would permit that waste...So as a CEO, I want a strong, competent board."
- ❑ "It's more than just dollars. You've got to give back to the community that supported you."

* "Effective Governance in an Ethicless Organization," The CPA Journal, May 2005.

Tone At The Top Quotes – The Authors

- ❑ "Boards should be absolutely certain that the company is run properly from a fiduciary standpoint in every degree. I am a great believer in the audit committee having full access to the auditors in every way, shape and form." – **former Sunbeam Chairman Al Dunlap**

- ❑ "You'll see people who in the early days...took their life savings and trusted this company with their money. And I have an awesome responsibility to those people to make sure that they've done right." – **former WorldCom CEO Bernard Ebbers (convicted in March 2005 on nine counts of fraud)**

- ❑ "We are offended by the perception that we would waste the resources of a company that is a major part of our life and livelihood, and that we would be happy with directors who would permit that waste...So as a CEO, I want a strong, competent board." – **former Tyco CEO Dennis Kozlowski (convicted)**

- ❑ "It's more than just dollars. You've got to give back to the community that supported you." – **Adelphia founder John Rigas (convicted in February 2005 on 18 counts of fraud)**

BOARD DUTY TO SET THE RIGHT “TONE AT THE TOP”

CURRENT COMPLAINT

- ❑ Hertz in March 2019 brought actions against the CEO, CFO, GC and Group President.
- ❑ Defendants’ wrongful tone at the top was a form of misconduct and gross negligence.
 - ❑ CEO “berated subordinates” for not coming up with enough “paradigm-busting accounting strategies” and instilled an aggressively pro-growth culture.
 - ❑ Pressured employees to engage in aggressive accounting practices.
 - ❑ Strained Hertz’ inadequate internal controls.
 - ❑ General Counsel failed to inform the Board and take corrective action of CEO’s inappropriately forceful tone, failed to disclose what he knew about improper payments, failed to inform the Board and take corrective action when CFO approved certain accounting changes.

CURRENT COMPLAINT, cont.

- Breached Representations made in defendants' separation agreements.
- Not claiming fraud nor breach of fiduciary responsibilities thus not covered by D&O insurance.

SUMMARY

- ❑ The wrong “tone at the top” could lead to claims of gross negligence and resulting damages.
- ❑ General Counsel will be in a better position by reporting up to the Board even when it does not rise to potential misconduct or material violation of securities laws.
- ❑ Officers should consider potential liability due to breach of contract claims when negotiating D&O and indemnification protections.

Effective Governance

- ❑ Establishing the Committee Structure
 - Address Specific Needs – Health, Safety & Security Committee
 - Monitoring Risks

- ❑ Board/Board Committee Interaction
 - The CEO, CFO and the Chief Legal Officer
 - Critical to Go Beyond CEO, CFO and CLO

- ❑ A Board Breakdown (Trucking Case)

Impact of Governance on Litigation

“Y” State Public Employees Retirement System (YPERS) vs XBank

YPERS \$75M Investment

- ❑ YPERS Special Purpose Development Fund (\$300M) invests \$75M in the Debentures of a Intrastate Financial Institution.
- ❑ Intrastate Financial Institution Fails.
- ❑ YPERS Sues Indenture Trustee (XBank) for \$200M (Principal Plus Accrued Interest):
 - Alleged that Indenture Trustee had the opportunity to declare a default and recover the \$75M,
 - Damage claim stated that \$75M compounded at rate earned by YPERS over the relevant time period would be \$200M.

YPERS Asserted that XBank

- ❑ Failed to thoroughly examine the borrower's certifications in accordance with the Indenture.
- ❑ Failed to trigger a default when the borrower did not deliver various documents within the "cure" period.
- ❑ Failed to have a working "follow-up" system and training programs to support the Indenture Trustee.
- ❑ Was negligent and breached its fiduciary duties to YPERS.

Analysis by H.S. Grace & Company, Inc. Found

- ❑ XBank did have some deficiencies with systems and the training of its corporate indenture trustees.
- ❑ However, XBank as Indenture Trustee had neither the obligation nor the factual basis to call a default in the situation cited.
- ❑ Other allegations of XBank negligence and mismanagement were contradicted by the facts.

H.S. Grace & Company, Inc. Analysis Found Other Relevant Information about Plaintiff

- ❑ YPERS had flaws in the operation of their Board of Trustees and in their efforts to staff the Special Purpose Development.
- ❑ Chairman of the YPERS Board of Trustees had engaged in serious conflicts of interest that tainted the decision-making process.
- ❑ YPERS lacked personnel to manage “alternative” investments.

H.S. Grace & Company, Inc. (HSG) Analysis and Calculation of Damages

- ❑ YPERS Special Purpose Development Fund experienced significant losses - 90% of the \$300M was lost.
- ❑ HSG's Estimate of Actual (real) Damages was calculated as follows:
 - If the total of \$75M had been recovered and invested by YPERS according to its investment policies, 90% would have been lost,
 - Therefore only 10% of \$75M = \$7.5M was the Actual loss and Proper Damages Amount (plus applicable interest).

Outcome of this Case

- ❑ When faced with information about the findings in the HSG analysis, YPERS dismissed its case against XBank.
- ❑ YPERS continued their litigation with the remaining defendants and collected a total of approximately \$100M from them.
- ❑ XBank was not required to pay any damages.

Addressing Board Issues

- ❑ Changing Business Practices
- ❑ Using Internal and External Reporting Materials
- ❑ Committee Charters/Board Duties
 - What is Defined
 - What is Properly Addressed
 - Stress Testing the Oversight & Control Systems (“OCS”)
 - Management’s OCS
 - The Board’s OCS
 - Stress Testing Constitutes an Affirmative Defense

Integrating Ethics

The Essence of an Effective Ethics Program

- Encourage
- Support
- Deter

Overarching Point

- ❑ If you do not identify and address your governance structure deficiencies outside litigation, you will pay for these governance deficiencies in litigation.