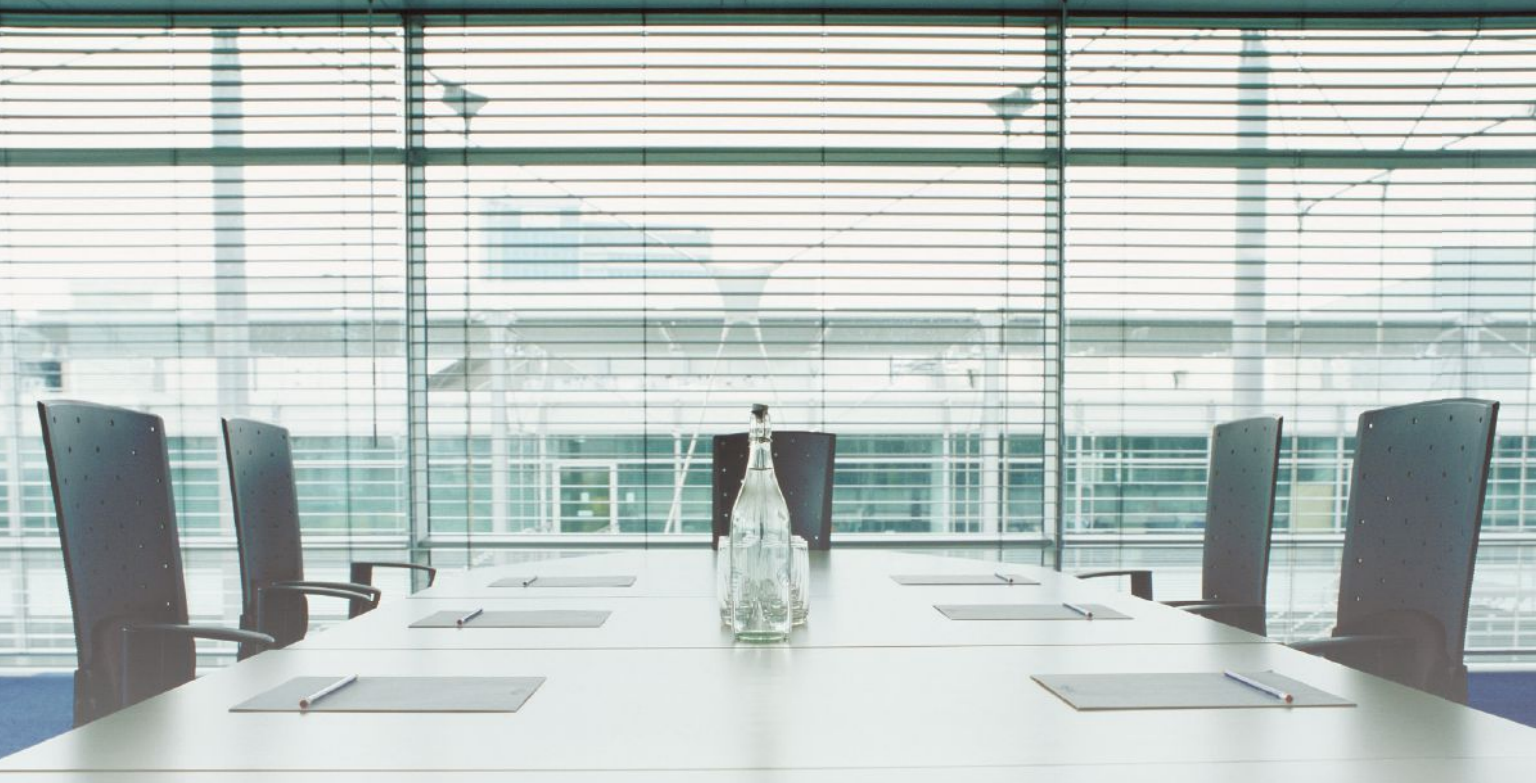

Corporate Governance: Lessons From Life and Litigation – With Implications for Corporate Counsel

By H. Stephen Grace Jr. and John E. Haupert

This article[1] will discuss the evolution of corporate governance that is so obvious today, and the lessons we are continuing to learn from that evolution. The goal of this article is to examine the impact of this governance evolution on corporate counsel. It should be noted that the role of corporate counsel is becoming more complex and defining that role is becoming that much more difficult.

First we will focus on some general lessons emerging from corporate governance studies and then on specific lessons from the well-known Walt Disney Shareholder Derivative Litigation.

Lesson I: Tone at the Top

The first lesson is that a well-written, interesting statement of "Tone at the Top" may imply that senior managers are good stewards of corporate assets but, in practice, may be meaningless. The four "Tone at the Top" statements shown in Exhibit I are thoughtfully written and clearly emphasize the importance of tone at the top.

Exhibit I

- "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."
- "People have an obligation to dissent in this company."

However, as all of you may know, the four individuals connected to these statements (Exhibit II) are currently serving time or have served time in federal penitentiaries.

Exhibit II

- "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." – **Bernard Ebbers**
- "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." – **Dennis Kozlowski**
- "It's more than just dollars. You've got to give back to the community that supported you." – **John Rigas**
- "People have an obligation to dissent in this company." – **Jeffrey Skilling**

The actions of the people at the top did not track what they preached; instead, they looted their companies. Obviously it is necessary that tone at the top statements be backed up by the actions taken by senior staff, which leads to the next lesson.

Lesson II: Checks and Balances

Lesson II is that "Tone at the Top" must be supported by governance tools that make sure that every action can withstand close scrutiny. One way this can be accomplished is with a policy that relies heavily on "Checks and Balances," which play a critical role in assuring that every action is consistent with the firm's stated "Tone at the Top." A firm's "Checks and Balances" must include a working environment characterized by transparency, ensure that the responsibilities of each individual in the organization are well defined, hold all individuals accountable for properly addressing their responsibilities, and make clear and well-understood that there are consequences associated with failing to do so.[2]

There is much to be learned regarding "Checks and Balances" from "ethicless" organizations. By ethicless organizations we mean criminal enterprises, terrorist organizations and other such groups, which we would basically view as being "ethicless." Interestingly, these organizations often have long-standing, highly successful records of operation. At the core level, these organizations' operating structures incorporate well-defined responsibilities for each of the individuals in the organization, hold each individual strictly accountable for the proper addressing of those responsibilities, and have in place well understood and severe consequences for failing to properly address one's responsibilities.[3]

Lesson III: Division of Labor

Turning to Lesson III, it is important to keep in mind a fundamental economic principle – that the division of labor is specific to a firm at a point in time. This basic economic principle is so well understood that you find it stressed in virtually all management and organization 101 texts. This principle explains why the NY Yankees when they acquired Alex Rodriguez – the National League's all-star shortstop and league MVP – placed him at third base. They already had an outstanding team leader at shortstop. Other teams would more than likely have kept Rodriguez at shortstop, but that did not fit the Yankees' labor needs.

In the same vein, corporate governance structures and processes are specific to a firm at a point in time. Two firms might be in the same industry, perhaps even have the same ownership, and appear identical in many respects. Yet these firms may have very different governance structures and processes. The differences in structures and processes are not important. What is important is whether corporate governance responsibilities are being properly addressed to ensure the effectiveness of the organization's operations and will be adequate to justify the organization's actions in any litigation that might develop.

The board, senior management, and corporate counsel must avoid the practice, too often employed, of simply incorporating a variety of "best practices" into their firm's governance structures and processes. Their objective should be to put in place a governance structure and processes that effectively address their organization's needs and responsibilities at that point in time.

Corporate counsel must be involved in the formulation of the firm's "Tone at the Top" and can be an important resource to the board and senior management in ensuring that the proper "Checks and Balances" are in place – for example, checks and balances that discourage unhealthy concentrations of power, encourage transparency, and create an environment that encourages and supports ethical behavior and deters inappropriate behavior. Corporate counsel helps define "what" has to be done, but is not necessarily responsible for determining "how" to do it – that is the responsibility of the board and senior management. However, corporate counsel should assist the board and senior management in examining whether

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the governance structure and processes in place are satisfactorily addressing "what" needs to be done.

Lesson IV: Code of Ethics and Conduct vs. Contract

Lesson IV addresses the issue of Code of Ethics and Conduct vs. Contract of Employment. In a recent matter in which the authors were involved, highly contentious litigation had arisen between an ex-CEO and his former firm in determining if the CEO's resignation was a "qualifying" resignation, which entitled him to a nine-digit sum of compensation and benefits, or whether the resignation met the requirements of a "for cause" resignation, in which case the CEO would be owed no further compensation by the firm. The matter was clouded by the nature of the CEO's employment agreements, which had evolved over time and appeared to give the CEO considerable flexibility in the discharge of his responsibilities, thus limiting the grounds for a "for cause" termination.

In examining the CEO's actions, however, we found violations of the company's code of ethics. The CEO had the company make investments in entities in which he was an investor. He bypassed board approvals in awarding incentive compensation, misled the board regarding a deferred benefits program he had set up and, in several years, failed to properly acknowledge his compliance with the company's code of ethics, in fact hiding his non-compliance. Our position was that violations of the code of ethics were grounds for a "for cause termination," notwithstanding employment contract limitations. While the "code trumps contract" stance was not without legal issues, the point stressed was that codes of ethics are vitally important to organizations, and violations of these codes of ethics are universally not tolerated. Further, the New York Stock Exchange, on which the firm was listed, has made clear its recognition of the importance of compliance with a firm's code of ethics – although at the time of the ex-CEO's resignation this was not set out as clearly as it is now. These points aided the company in achieving a favorable settlement with the ex-CEO.

This case demonstrates the importance of a strong code of ethics, which was useful in supporting the firm's position. To build on this, corporate counsel should consider including in all employment contracts and other such documents a basic statement that, notwithstanding what is written in the various contracts, nothing written constitutes a waiver of the firm's code of ethics, code of conduct, or corporate governance guidelines.

Lesson V: An Effective Ethics Culture

Lesson V looks at the challenge of building an effective ethics culture in an organization. The lesson here is that simply encouraging ethical behavior is not enough. You will hear senior staff and managers saying, "What we have to do is keep talking: tell people to work ethically, tell people to live ethically." Quite frankly, while we think that is a nice try, it seems naïve in many respects. If the desire of an organization is to achieve ethical behavior, it needs an approach that not only encourages and supports all in the organization to live and work ethically, but also deters those who do not. We suggest a method we call the "ESD" approach – Encourage, Support, and Deter (Exhibit III).

Violations of the code of ethics were grounds for a "for cause termination," notwithstanding employment contract limitations.

Exhibit III

- Encouraging Ethical Behavior Is Not Enough
- An "ESD" Approach
  - Encourage
  - Support
  - Deter

We believe that establishing an effective ethics culture is actually an exercise in "control theory": putting in place responsibilities, accountability and consequences that help ensure ESD is at work.[4] Here again, corporate counsel should be an important player, especially in helping to determine rewards for ethical employees and the price paid for violations.

The Walt Disney Shareholder Derivative Litigation

Our organization had a role as the expert for the primary D&O carrier (directors and officers liability insurance) on the Disney litigation regarding termination of Michael Ovitz's employment. The carrier gave us the opinion that the damages being sought by the plaintiffs were excessive, without disclosing the amount of damages being sought. The carrier asked us to make a determination of the settlement value of the case. Our assignment was to arrive at a settlement value based on the merits of the case, as opposed to undertaking a comparison of certain parameters of this shareholder derivative case with other shareholder derivative cases and arriving at some statistical approximation.

Turning to the plaintiffs' allegations, first there was the issue that Michael Eisner, the CEO of Disney, recruited Michael Ovitz as a result of their personal friendship. Then there was the allegation that the hiring of Ovitz was facilitated by Irwin Russell in his role as the chair of the Compensation Committee. Further, there was the allegation

that the Compensation Committee "inadequately" investigated the proposed terms of the Ovitz Employment Agreement (OEA). Another allegation was that, at the September 1995 Compensation Committee meeting, more time was spent on Russell's special compensation for handling the negotiations with Ovitz than on the terms of the OEA. The purpose of this article is not to discuss in depth our work on Disney. The Delaware Chancery Court found 100% in favor of the defendants, and we highly recommend reading Chancellor William B. Chandler's absolutely fascinating opinion. It is very insightful and interesting.

The lessons from Disney are many, and we expect there to be more over time. Our purpose here is to focus on the lessons that have emerged from the litigation that have implications for corporate counsel. In our most recent article published in the ABA's *Business Law Today*,[5] we touch upon three lessons that emerge from Chancellor Chandler's opinion and that we believe merit careful consideration.

Compensation Cultures

The first lesson concerns the question of compensation cultures. The issue of compensation cultures is currently a very hot topic in the governance evolution. A careful reading of the Disney trial materials, and our work wherein we compared the hiring of Ovitz with that of five other senior executives, makes clear that Disney had a defined compensation culture in place. Further, Disney stuck to this compensation culture in its negotiations with and hiring of Michael Ovitz. In simple terms, Disney's approach seems to have been to price the job and then find the best talent available to take the job at the price Disney determined the job merited. That differs significantly from the approach being taken in many cases, which is paying what is required to get the executive that the firm wants to hire, as its CEO or otherwise.

The Disney case strongly suggests that it is time for firms to establish their own compensation cultures. If so, the question that follows is, Who should formulate the compensation culture of the organization? More than likely, it would not be the compensation committee. That committee has responsibility for ensuring that the compensation programs operate inside the established compensation culture. It would appear that the responsibility for the creation of compensation culture could lie with the governance committee and, ultimately, the entire board. This is a challenging issue, and one in which corporate counsel certainly has a significant role.

A Proper Record

The next lesson concerns the issue of board and board committee minutes. In the past, the thinking was "less is best." That is no longer the case. Developing a proper record of the actions of the board and board committees is important in creating a history of what was done and why it was done, as well as being very valuable information should litigation arise. The Disney case is interesting in that the question arose as to whether the Compensation Committee minutes for its September 26, 1995, meeting could, or possibly should, have been drafted differently. If those minutes had incorporated a discussion of the work that had been done in connection with the negotiations with Ovitz and his team, the individuals by whom the work was done, the consultant they employed and perhaps a description of the negotiations, they might have been sufficient to prevent the case from going forward. Again, the role of corporate counsel is critical in the development and circulation of board and board committee meeting minutes.

Vigilance

A third lesson that emerges from Disney concerns the "vigilance" of a board and its board committees. Chandler's thoughtful opinion raises the issue of the board's addressing its responsibilities, as well as the ties many board members had developed with Michael Eisner.

A board must stay vigilant, notwithstanding how spectacular the success of its management team may be, such as was the case at Disney under Eisner and Wells. The board and corporate counsel have got to make sure that the i's are dotted and t's are crossed. Not to do so is to expose an organization's management and board to problems such as arose in the Disney case.

Ongoing Issues

Let us summarize ongoing issues in corporate governance, issues that are of concern to boards and senior management, including corporate counsel. First we believe there is a need to consider putting in place a fundamental management/board focus that fits the organization. Directors come from many different backgrounds. They come with a portfolio full of different activities and an agenda. Having a practice or a process that aids management and the board in focusing on the objectives and the important issues facing the organization would be of considerable value.[6]

A second ongoing issue concerns effective performance measurement. We recognize that there is presently too much reliance on complex financial statements, which are often confusing. Each firm must consider and select from the options it has available to effectively monitor the performance of its organization.[7]

A third issue concerns the industry knowledge, or lack of industry knowledge, of the independent directors. What we have is an issue of the requirement for independence versus the need for industry knowledge on the part of members of the board and the board committees. This issue is front and center, and it is currently receiving a substantial amount of attention. Certainly independence is needed on the board. However, it has also become clear that industry knowledge is a tremendous asset for a board.

Building off the issue of the need for industry knowledge, there is, perhaps, the question of whether a board and its board committees would benefit from the presence of literally a "full-time director" – an individual who is a member of senior management in the company and continues to be employed by the company but has no operating responsibilities. The individual's responsibilities are assisting fellow board members. Such full-time directors do exist. While such individuals are not former CEOs, they bring to the board a potentially valuable depth of knowledge of the firm.

The proper forum for addressing these and other ongoing issues seems to be the governance committee. Our sense is that the governance committee is continuing to emerge, and it appears to be a committee well situated to address the evolving range of corporate governance issues. Corporate counsels should play an important part in providing guidance to that committee. ■

1. This article is based on a speech delivered at the SMU Dedman Law School Corporate Counsel Symposium, October 14, 2011.

2. All individuals in an organization, from entry level to CEO, should have their work subject to oversight and review by others. For further discussion see H. Stephen Grace, Jr., "From 'Tone at the Top' to 'Checks and Balances,'" co-authored with James N. Clark, R. Hartwell Gardner, John E. Haupert and Robert S. Roath, *The CPA Journal*, March 2002, p. 63.

3. *See* H. Stephen Grace, Jr., *Effective Governance in an Ethicless Organization*, CPA J. (May 2005), pp. 6, 8.

4. H. Stephen Grace, Jr. & John E. Haupert, *How to Make an Ethics Program Work*, CPA J. (Apr. 2006), pp. 66–67.

5. H. Stephen Grace, Jr. & John E. Haupert, *Governance Lessons From the Disney Litigation*, *Business Law Today* (ABA) Sept. 2011; H. Stephen Grace, Jr., *Plaintiff Expert Reports: An Insider Revisits Disney*, N.Y. St B.J. (July/Aug. 2009), p. 24; H. Stephen Grace, Jr., *An Insider Revisits the "Disney Case,"* Directors Monthly (Aug. 2008).

6. An article we authored in the November 2011 issue of *Financial Executive*, "Still Searching for the Missing Management Model," dicusses an approach that can be taken to create this fundamental management/board focus, which can be so helpful.

7. In the March/April 2010 issue of *The Corporate Board,* we authored an article titled "Cash Flow Monitoring as a Governance Tool," which sets out what we believe is a valuable approach to the issue of performance measurement.