



Financial Executives International Committee on Governance, Risk & Compliance

Stress Testing and Governance

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Stress Testing and Governance

Introduction

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Stress Testing Corporate Governance Structures

- Plan Operate Control Cycle
- “Tone at the Top” vs Checks and Balances

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Case Studies

- State Employee Retirement Fund Sues Global Bank
Evaluating Plaintiff and Defendant Governance in Assessing Causation
- Accidental Death Involving Company-owned Vehicles
How Board Governance Can Impact Damages
- Governance and Damage Issues in Grey Markets
Admitted fraud: Financial damages?
Fraud alleged: Fraud Causation and Financial Damages?
- Walt Disney Shareholder Derivative Litigation: Critical Governance Issues
Impact of Governance on Shareholder Derivative Litigation

Stephen Grace

Integrating Ethics and Governance

- Understanding the Role of Ethics Within the Evolution of Corporate Governance
- Checks & Balances, Tone at the Top, Codes of Ethics and Conduct
- Governance and Ethical Collapses
- Critical Fundamentals: Encourage, Support and Deter

Johnnie Williams

Suzanne Gilbert

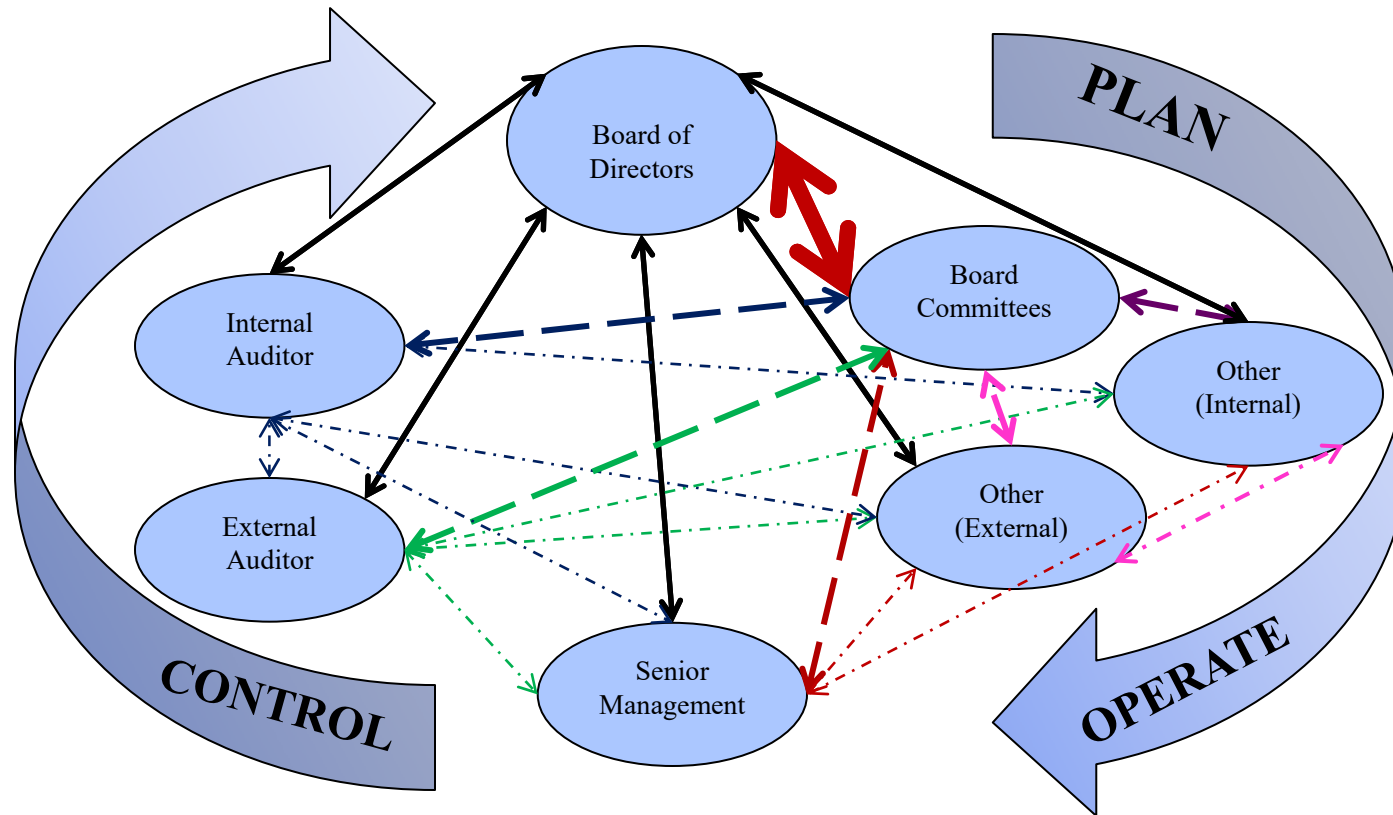
Summary & Questions

Stress-Testing Corporate Governance Structures

- ❑ Corporate governance is the system of rules, practices and processes by which a company is directed and controlled.
- ❑ Corporate governance is crucial to the day-to-day operations of firms, their boards, senior management and their operations.
- ❑ Corporate governance issues often lay at the heart of complex commercial litigation that seeks to establish fault and responsibility for losses, or more technically, litigation that seeks to determine liability, causation and damages.

Stress-Testing the Corporate Governance Structure

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)

- ❑ Institutional Shareholders, Activists, D&O Carriers – Different Views

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

Addressing Board Issues

- ❑ Contrasting Management's and the Board's Oversight and Control Systems
- ❑ Utilizing Internal and External Information
- ❑ Evolving Business Practices and Committee Structure

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 Ethic-less 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)**

□ Consequences of Board Failures to Meet Responsibilities

- Personal & Company Reputation
- Attacks from Activists, Board Watchdogs and Institutional Investors
- SEC Inquiries and Investigations
- Consequences of Litigation – costs, time, uncertainty
- Board members will be evaluated individually by the Courts in determining the appropriateness of actions taken and decisions made.
- Chandler (Disney Opinion) “What follows is my judgment on whether each director of The Walt Disney Company fulfilled his or her obligation to act in good faith and with honesty of purpose under the unusual facts of this case.”

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.”
 - A sad ending for careers of many directors.

Case Study 1: “Y” State Public Employees Retirement System (YPERS) vs XBank

- ❑ State Employee Retirement Fund Sues Global Bank
- ❑ Evaluating Plaintiff and Defendant Governance in Assessing Causation

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):

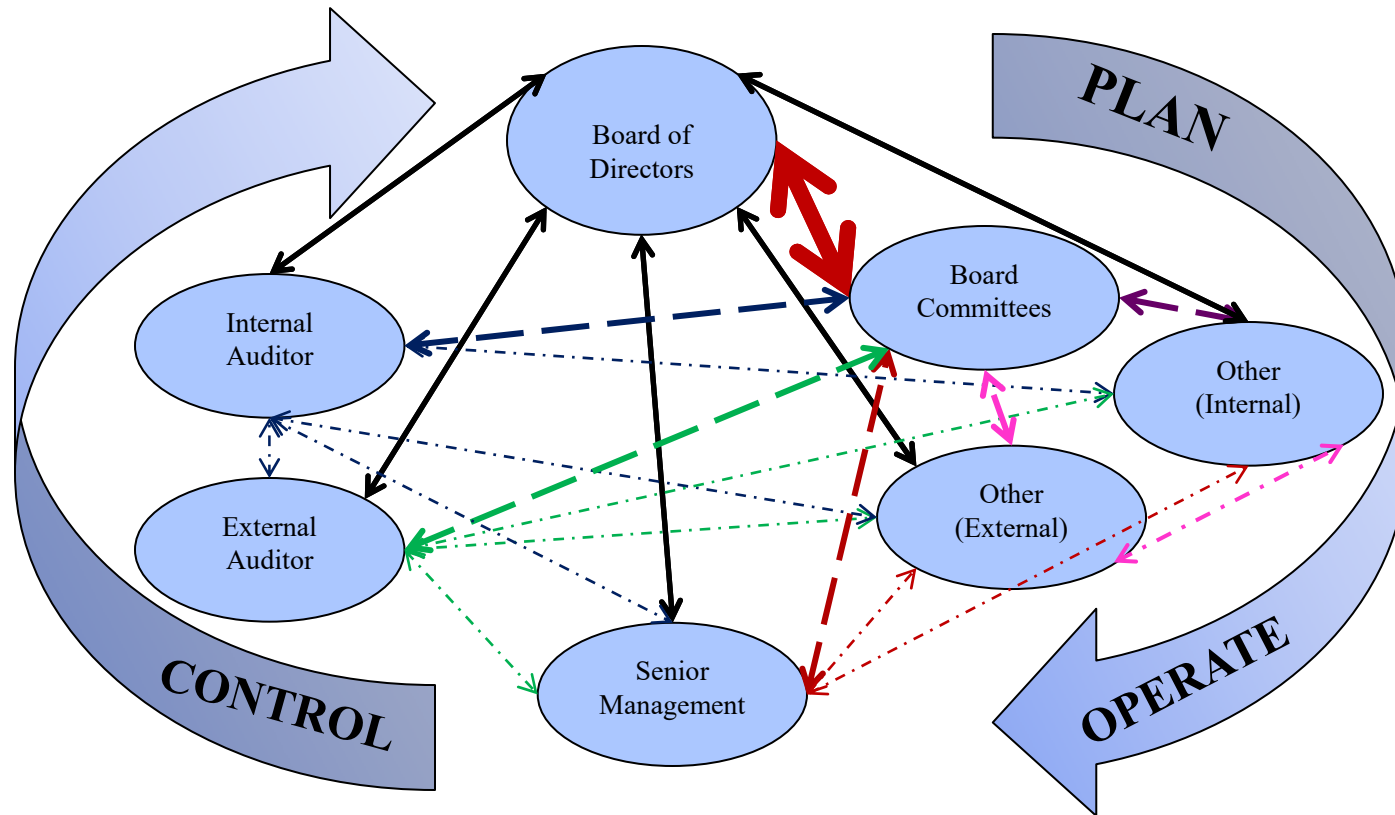
H.S. Grace & Company, Inc. (HSG) Analysis: Calculation of Damages

- ❑ YPERS Special Purpose Development Fund experienced significant losses - 90% of the \$300M was lost.

- ❑ HSG's Calculation of Actual (real) Damages:
 - 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).

Stress-Testing the Corporate Governance Structure

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Outcome of this Case

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

What improvements in corporate governance may have precluded this litigation?

- ❑ Opportunities for improving Xbank's Trust Operations were identified – reduced possible litigation.
- ❑ YPERS special purpose development fund required a more rigorous structure.

Case Study 2:

Accidental Death Involving Company Owned Vehicle

How Board Governance Can Impact Damages

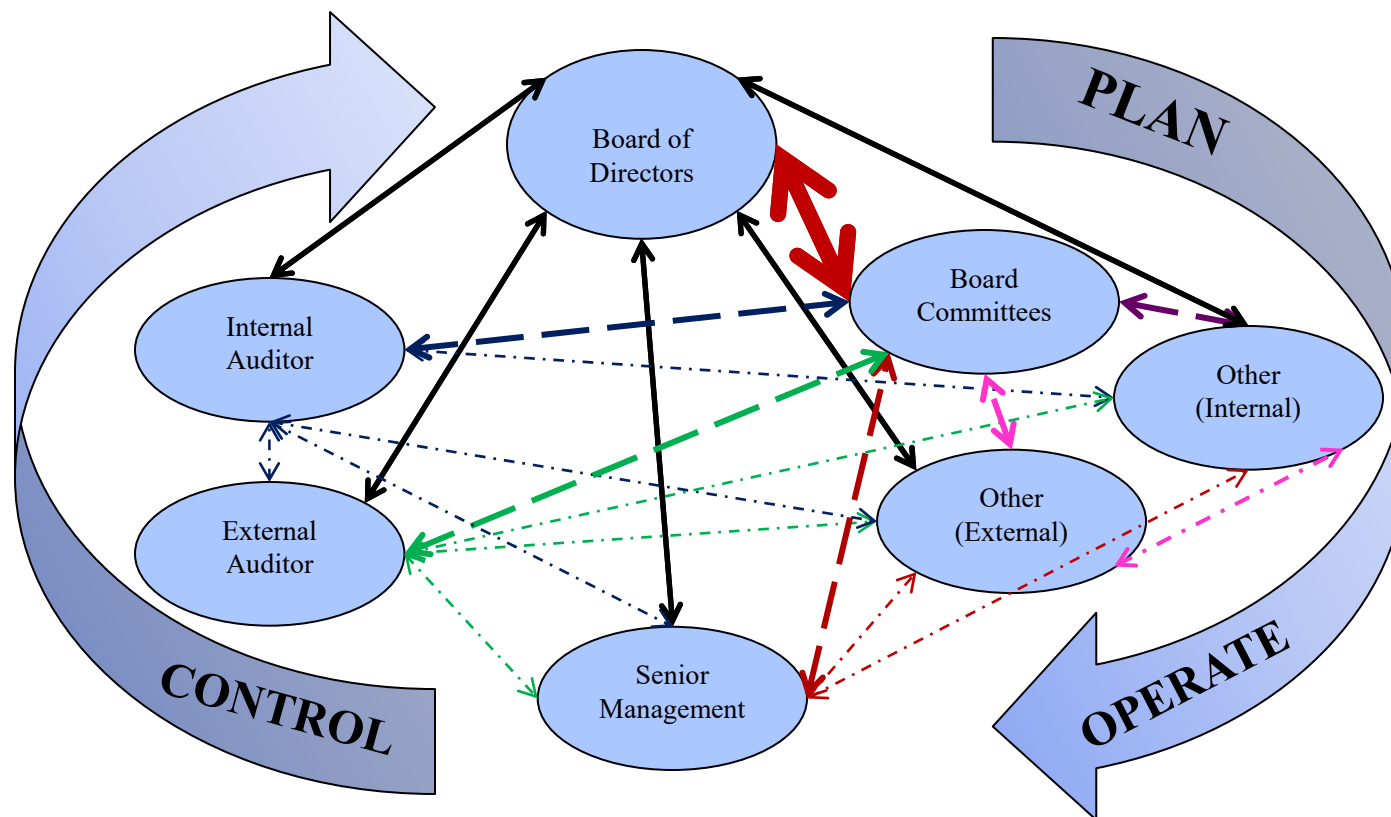
- XYZ company vehicle strikes vehicle and kills single occupant.
- Examine XYZ board oversight and governance in addressing identified equipment and vehicle risks.
- Impact of board governance on jury award.

XYZ Risk Factors

- ❑ XYZ public filings discussed risk factors related to specialized equipment and company vehicles.
- ❑ XYZ filings further identified risk factors in discussion of its risk related insurance.

Stress-Testing the Corporate Governance Structure

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Stress-Testing the XYZ Governance Structure

- ❑ XYZ listing requirements required minimum of three Board Committees – Audit, Compensation, Nominating and Corporate Governance Committee.
- ❑ XYZ had only the required three Board committees Audit, Compensation and Nominating & Corporate Governance.
- ❑ No Board nor committee responsibilities for specialized equipment and vehicle risks.

Stress-Testing the XYZ Governance Structure

- Absence of senior management – Board communications regarding specialized risks.
- Board materials, Board minutes were empty.
- No other communications regarding risks.

Possible Governance Modifications

- Recognize Board, Board Committee and Management Governance, Oversight and Operational Responsibilities.
- Continuously Update and Periodically Stress-Test Governance Structure.

Case Study 3: Governance and Damage Issues in Grey Markets Admitted Fraud: Were There Financial Damages

- ❑ Situation Review

- ❑ Admitted Fraud

- ❑ Sentencing Issue – Financial Damages
 - Multiple Issues Impact Sentencing
 - The Question of Financial Damages to Sellers

Governance and Damage Issues in Grey Markets

Fraud Alleged: Fraud Causation and Financial Damages

Situation Review –

Global Supplier Distributor to Tiny S.A. Country

Fraud Alleged – The Question of Causation

Governance Assessment

The Picture is Clarified (Sale of the Supplier)

Case Study 4: Walt Disney Shareholder Derivative Litigation

- The Hiring and Subsequent Termination of Michael Ovitz
- Impact of Governance on Shareholder Derivative Litigation

Chancellor William Chandler's Memorandum Opinion (May 28, 2003)

“In this derivative action filed on behalf of nominal defendant Walt Disney Company, plaintiffs allege that the defendant directors **breached their fiduciary duties when they blindly approved an employment agreement...**

It is rare when a court imposes liability on directors of a corporation for breach of the duty of care,... But **the facts alleged** in the new complaint do not implicate merely negligent or grossly negligent decision making by corporate directors. Quite the contrary, **plaintiffs' new complaint suggests that the Disney directors failed to exercise *any* business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties to Disney and its stockholders.”**

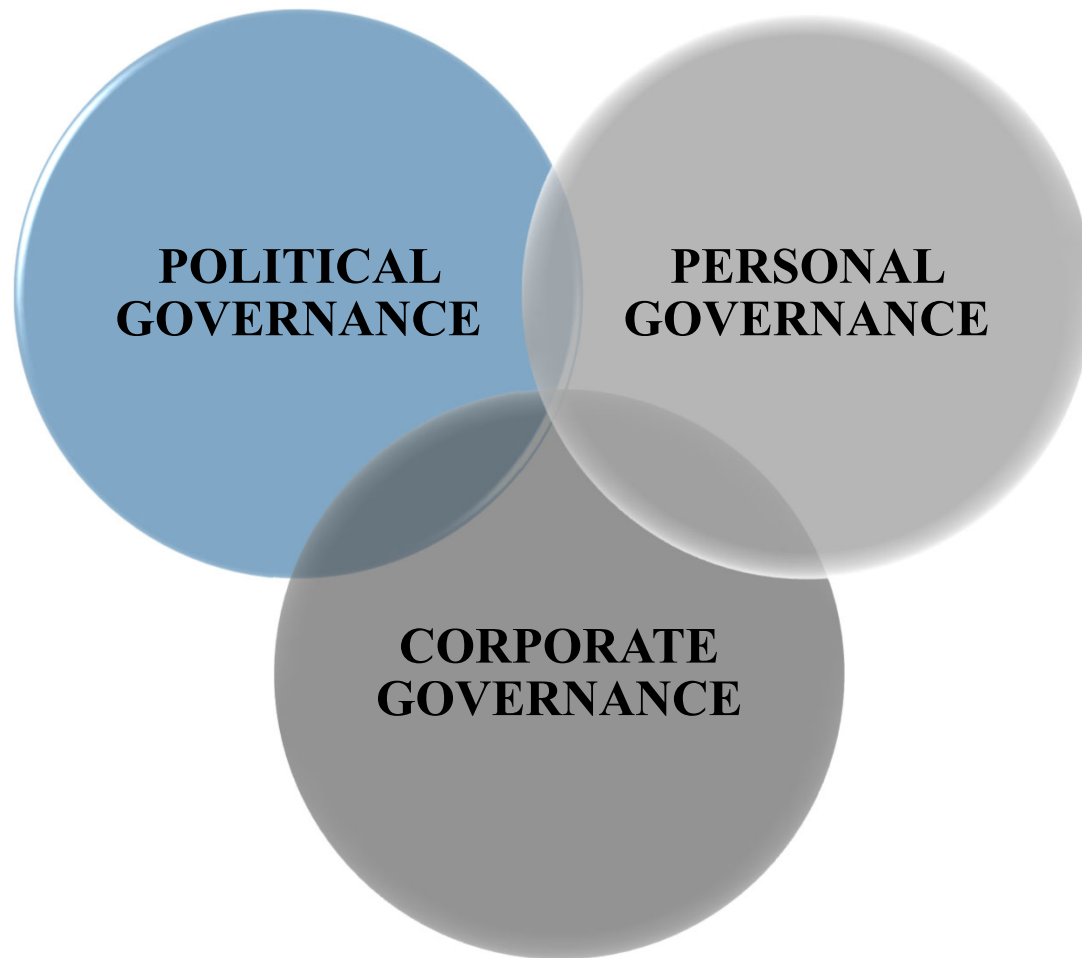
HSG Report

- ❑ **The Assignment:** Determine the settlement value based on business merits of the Plaintiffs' allegations.
- ❑ **HSG analysis established that the decisions to hire and to terminate were business investment decisions.**
- ❑ **Disney was a business process case, not really a compensation case.** The central issue was whether the CEO and Board had followed appropriate oversight and governance practices.

HSG Report

- Business investment decisions involve risk.
- The decision to hire Michael Ovitz.
- The hiring process.
- Reasonableness of compensation package.
- Performance of Ovitz.
- The termination process.

Ethics and the Evolution of Corporate Governance



Political Governance

❑ Rooted in a History of Kings, Monarchs and Dictators

- Structural stresses and troublesome issues continued to arise
- The problem? A consistent failure in “the tone at the top”
- Lord Acton: “Power tends to corrupt and absolute power corrupts absolutely”

❑ Framed by Thousands of Years of Philosophy and Political Theory

- Aristotle
- Tao Te Ching
- Kant
- Jung
- Churchill

Corporate Governance

Board of Directors

- Ultimate representative of the owners
- Role today broader than CEO succession planning
- Responsibility to supervise and monitor
- Must be informed, involved and - - to extent appropriate
- - have “skin in the game”

The Defense of Sarbanes – Oxley

by Paul Volcker and Arthur Levitt, Jr. -- 2004

“Two years ago this summer, Congress passed the Sarbanes-Oxley Act, the most far-reaching corporate reform legislation in 60 years, with the support of all but three members of Congress who voted. It was a moment of rare bipartisan action in response to the breakdown in corporate checks and balances that cost investors hundreds of billions of dollar in losses.”

Ethics and Corporate Governance

First Take-away: Ethics alone will not ensure effective corporate governance.

Second take-away: A robust set of checks and balances among the participants is critical for successful corporate governance.

The third take-away: Successful business governance models do exist.

The Fourth take-away: The board and management must understand and address the challenges of measurement.

Critical Fundamentals

- Encourage
- Support
- Deter

Summary & Questions
