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# The Interplay between Corporate Governance Issues and Litigation: What Is Corporate Governance and How Does It Affect Litigation?

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The term "corporate governance" appears regularly in the news media, regulatory pronouncements, and business literature, but it is seldom explicitly defined in the contexts in which it is used. Speaking broadly, one can easily say that, "corporate governance refers to the way that a corporation or other organization is governed." However, given that it is not sufficient to use a term to define itself, and that this answer leaves open the question of what is encompassed by "governed," we begin this article with the following two definitions culled from the many reference sources available.

**Source 1: Investopedia**

Corporate governance is the system of rules, practices, and processes by which a company is directed and controlled. Corporate governance essentially involves balancing the interests of a company's many stakeholders, such as shareholders, management, customers, suppliers, financiers, government, and the community. Given that corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure.

**Source 2: Wikipedia**

Corporate governance broadly refers to the mechanisms, processes, and relations by which corporations are controlled and directed. Governance structures and principles identify the distribution of rights and responsibilities among different participants in the corporation (such as the board of directors, managers, shareholders, creditors, auditors, regulators, and other stakeholders) and include the rules and procedures for making decisions in corporate affairs. Corporate governance includes the processes through which corporations' objectives are set and pursued in the context of the social, regulatory, and market environment. Governance mechanisms include monitoring the actions, policies, practices, and decisions of corporations, their agents, and affected stakeholders. Corporate governance practices are affected by attempts to align the interests of stakeholders.

What these two definitions and many others have in common is the concept that corporate governance relates to *the ways in which an organization is structured, overseen, managed, and operated,* and we will use this concept as our working definition.

Whether broadly or narrowly defined, 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. The adequacy of the structures and processes in an organization and the business conduct of its board, management, and employees can have a significant effect on the outcome of a business dispute. This article will discuss the interplay of corporate governance issues with both plaintiff and defendant strategies in litigation, and describe how governance issues affected the ability of litigants and their counsel to prevail in three actual cases.

## Three Case Histories Where Governance Practices Affected the Outcome

In the first case, a bank was alleged to have, and did have, liability issues in connection with its role as indenture trustee for bonds acquired by a special-purpose investment

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fund established by a public employees retirement system. In preparation for the trial, the bank's litigation team and its engaged expert examined both the defendant bank's governance processes and the governance processes of the plaintiff retirement system and its special-purpose fund. Although the bank-defendant did have some missteps in its own operations and other governance issues, examination of the retirement system's governance processes and actions identified conflicts of interest and weaknesses and errors in their operations, as well as flaws in their damage model, all of which impacted the outcome of the litigation.

In the second case, a plaintiff oil company sued a defendant oil company under a letter agreement and operating agreement relating to the purchase and operation of an oil field. The plaintiff contended that the defendant, as the operator, had intentionally hindered the plaintiff's efforts to participate and had injured plaintiff as a result by lowering its stock price in a subsequent public offering. The defendant's expert team examined the business conduct of both the defendant and the plaintiff and raised issues about the actions and allegations of the plaintiff. The findings of this examination influenced the conclusion of the matter.

In the third case, the U.S. Securities and Exchange Commission (SEC) sued the CEO of a software company, claiming that the CEO had intentionally caused the misstatement of his firm's financial statements through an accounting fraud stemming from various operational and revenue recognition decisions. The defendant CEO expert team reviewed the detailed allegations against a customary understanding of a CEO's roles and duties and reported on the appropriateness of the CEO's conduct, all of which contributed to a satisfactory resolution of the litigation.

### *Case I: Damage Claim by a Public Employees' Retirement System against a Bank as Indenture Trustee*

A major public employees' retirement system attributed losses incurred on investments by its special-purpose fund in debentures of a savings and loan association (S&L) that later failed to the inadequate performance by a bank serving as an indenture trustee, and sued the bank, XBank.

The retirement system asserted that the indenture trustee, XBank: (1) failed to thoroughly examine the borrower's certifications and other documents submitted in accordance with the indenture; (2) failed to trigger a default when the borrower did not deliver various documents in a timely manner as called for under the indenture; (3) failed to have a working "follow-up" system and training programs to support the indenture trustee; and (4) had been negligent and had breached its fiduciary duties to the retirement system.

XBank and other defendants faced an adverse and high stakes legal situation that involved: (1) assertions of actual calculated damages in excess of $200M with additional prejudgment interest of 10 percent due for several years; (2) an extremely adverse venue, given that the plaintiff's retirement recipients likely would comprise approximately 80 percent of any jury in the venue where the trial was to occur; (3) a state legislature that had been loath to raise taxes to correct any shortfall in the investment fund; and (4) a decision by the state supreme court that had overruled 75 years of prior jurisprudence to affirm that the case would be tried in state court in the state capitol, a location that contained the highest percentage of current and potential recipients of benefits from the retirement system.

The bank's litigation team (law firm and a consultant/expert firm) found that XBank did have deficiencies with systems and the training of its corporate indenture trustees. Further, in the case of one of the three defaults alleged regarding the failure of required officer's certificates to be timely received, it was true that the documents were received outside of the specified cure period. However, the analysis conducted by the defendant bank's litigation team established that the indenture trustee had neither the obligation nor the factual basis to call a default when these delays occurred. Timeliness is seldom a sole basis for triggering a business-driven default, and a review of documents made it clear that the S&L was in good financial condition at the time the documents were received outside of the cure period. The defendant litigation team also found that other allegations of bank negligence and mismanagement were contradicted by the facts.

Interestingly, and oftentimes an area that is not fully examined, the team's analysis of the environment surrounding the business and personal dealings of relevant persons on the *plaintiff side* revealed that the chair of the retirement system had engaged in serious conflicts of interest that tainted the decision-making process, which led to the initial and subsequent investments made by the retirement system's special-purpose fund in the S&L that failed. Further, the retirement system had numerous flaws in their own internal management and investment processes that contributed significantly to their losses. The special-purpose fund was focused on a broad range of "alternative" investments, and it was acknowledged in deposition that they lacked the required experience to manage these investments. Further, the defendant litigation team established that the special-purpose fund's cash flows were retained and reinvested in their pool of investments, and 90 percent of their original capital had been lost in so doing. This finding basically undermined their $200 million damage claim because it pointed out that, had XBank returned the principal, 90 percent of it would have been subsequently lost.

The result in this case was that, upon presentation of XBank's key evidence in mediation, including information about weaknesses in the plaintiff's governance practices, the retirement system elected to dismiss its case against XBank. The retirement system continued their litigation with the other defendants and was successful in collecting from every other defendant, with total collections approximating $100M.

### *Case II: Breach of Letter Agreement and Operating Agreement*

Plaintiff ABC oil company sued defendant XYZ oil company under a letter agreement and operating agreement involving the purchase and subsequent operation of an oil field. ABC contended that XYZ, the opera-

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tor, had intentionally hindered ABC's efforts to participate in development of the field by various actions, including failure to provide access to data in breach of both the letter agreement for purchase of the field and the operating agreement. ABC asserted that the resulting delay in development of the field allegedly caused by defendant XYZ's actions had injured ABC by lowering its stock price in a subsequent public offering. XYZ retained an expert team to analyze these allegations and the damages calculated by ABC's expert.

The expert team consisted of four senior executives with energy-related experience. Using available information on the financial and operational condition of both XYZ and ABC, and drawing upon their extensive knowledge of the oil and gas industry and financial experience in damage calculation, the expert team concluded:

1. Plaintiff ABC Oil Company was in dire financial straits and was not capable of financing the proposed development program.
2. Defendant XYZ Oil Company had operated in a manner that benefitted both ABC and XYZ.
3. Plaintiff ABC expert's stock pricing model damage calculation based on historic cash flows violated generally accepted valuation techniques and ignored accepted factors used in valuation, e.g., the timing and amount of future cash flows.

The result in this case was that, after extensive discovery, including production of expert reports and depositions, the plaintiff filed an amended petition basically eliminating the allegations challenged by the expert team. A satisfactory settlement was reached.

### *Case III: Securities Fraud Claim under the 1934 Act*

The SEC sued the CEO of a software company claiming that the CEO had intentionally orchestrated the misstatement of the company's financial statements through an accounting fraud, which ultimately resulted in a restatement. The SEC further asserted that the CEO's certification of the restated financial statements was an admission of wrongdoing. The CEO and his counsel retained an expert team to analyze these allegations and those of the SEC's expert witness.

Drawing upon their extensive experience as officers and board members of major corporations, persons who have actually been involved in business decision-making and internal reporting processes, and in managing the preparation and issuance of corporate financial statements, the expert team was able to review and evaluate these detailed allegations and explain what the CEO's role and duties were in this situation. Specifically, the expert report explained:

1. All companies must rely on a division of labor to operate.
2. By necessity, the CEO must rely on the expertise of others within the company to fulfill his duties and obligations in his role in the overall management of the company.
3. The proper accounting for transactions under GAAP is not always a black-and-white issue and requires accounting expertise.
4. The CEO was not an expert in accounting and had the right, in this instance which involved complicated accounting issues not fully resolved by the accounting rules, to rely on the accounting judgment of both internal and external accounting professionals as to the proper way to account for the transactions in question.
5. The CEO had not ignored his duties, but rather had performed those duties by seeking the advice of internal and external professionals in an effort to fulfill his obligations.

The SEC in this case had originally sought: (1) a permanent injunction; (2) civil penalties; (3) an officer and director bar; and (4) other relief. The result was that, following the pretrial conference with the judge the day before trial was to begin, in which information was shared regarding the CEO's conduct and customary expectations and practices relating to CEO responsibilities, the matter was settled for a nominal five-digit amount.

### The Impact that Corporate Governance Issues Can Have in Litigation

In each of these cases, the corporate governance structure and policies, and the business practices and processes that had been carried by all parties involved in the litigation, were identified in a comprehensive and systematic analysis utilizing the business knowledge of expert reviewers. Having such direct business knowledge was an important factor in the reviews, as there is no single, agreed-upon formula or approach to the details of corporate governance processes and procedures in a particular organization, and the division of labor in any entity is specific to that individual organization at a point in time. Consequently, an effective assessment and evaluation of the decision-making and oversight processes used, and actions taken in a disputed matter, must take into account what information was known or available to decision-makers at the point in time involved, and recognize that good business decisions based on well-accepted business practices and processes can nevertheless sometimes have bad outcomes. To avoid hindsight bias, it is necessary to examine and understand the corporate governance structures of, and the processes and procedures that were carried out by, litigant parties and assess whether and how these processes and actions caused or contributed to any losses claimed. *This identification of whether and how a litigant's governance processes and action(s) impacted matters under dispute is the interplay of corporate governance issues and litigation.*

The interplay may extend to multiple parties directly and indirectly involved in the litigation. In two of the cases described in this article, the assessment of governance issues facing the plaintiffs identified improper actions on their part to the point that these other parties were actually responsible for the damages they had, or allegedly had, experienced. In the third case, corporate governance issues in the form of usual and cus-

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tomary and acceptable practices expected of CEOs provided a sufficient defense to the SEC allegations to result in a substantial reduction in the assessed penalty.

Although the cases in this article involved public companies and addressed corporate governance processes in publicly listed companies, the interplay of governance processes and litigation can affect organizations of all forms and sizes.

An additional insight that can be gleaned from these three cases is the importance of an organization having well-structured, viable business processes that drive proper business conduct, not just for litigation reasons, but for more effective operations as well. The bank was at risk because of its flawed processes; however, the retirement system had its own flawed processes. The plaintiff oil company's conditions and processes undermined its allegations. The software company's appropriate internal processes, when carefully examined, helped to carry the day to a beneficial outcome. In all of these situations, it is quite possible that having better governance and better processes might have avoided or minimized losses or decreased the likelihood of litigation in the first place.

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