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Failure is not an option: practical advice for directors entrusted with overseeing corporations

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The Golden Rule as an approach to good governance

In the seminal opinion *Meinhard v. Salmon* handed down by the New York Court of Appeals in 1928, future Supreme Court Justice Benjamin N. Cardozo penned the most elegant statement on the duties of a fiduciary, writing, "Joint adventurers, like copartners, owe to one another ... the duty of the finest loyalty. ... A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."

Following the Golden Rule — treating investors how the director would want to be treated — will go a long way on the path to compliance.

The fiduciary duties of directors are generally distilled down to the duties of care and loyalty. The duty of care requires the director act in an informed and thoughtful manner. The duty of loyalty requires the director act in good faith and in a manner the director reasonably believes to be in the best interest of the stockholders and the corporation.

The law governing fiduciary duties of directors is both longstanding and, at its core, relatively simple. Following the Golden Rule — treating investors how the director would want to be treated — will go a long way on the path to compliance.

'How the mighty fall'[1]

Notwithstanding the conceptual simplicity of the law of fiduciary duties, corporate actors all too often engage in behaviors that fall short of the punctilio of an honor that Justice Cardozo articulated. The list of corporate scandals is lengthy and alarming.

Recently, the collapse of Silicon Valley Bank, the largest bank failure since Washington Mutual in 2008, wiped out equity holders, put consumer deposits at risk, and rattled the market. Michael Barr, Vice Chair for Supervision at the Federal Reserve, testified that SVB's collapse was largely caused by gross mismanagement, not exogenous factors.

Similarly, Theranos founder Elizabeth Holmes is currently appealing her conviction and sentence for defrauding investors by misrepresenting the company's blood testing technology. Theranos had a well-credentialed board, but it allegedly had little experience in the health care industry and a clubby atmosphere that led to a weak, almost nonexistent, oversight function.

We do not need a radical overhaul to the governance paradigm.

The path many now-defunct companies followed is largely similar. They appear to be on an extraordinary growth trajectory and receive international attention only to implode seemingly overnight, causing tremendous harm to stockholders, stakeholders, and consumers.

In reality, the implosion is not an overnight occurrence — it's due to a series of missteps and poor decisions typically made over a protracted period of time. It's akin to the question Ernest Hemingway posed when he rhetorically asked, "How did you go bankrupt?" and then responded, "Two ways. Gradually, then suddenly."

A new corporate governance paradigm is unnecessary

The law of the fiduciary duties of directors is time-tested and well-settled — they are to behave according to a higher standard than the morals of the marketplace. Despite calls for a new legal framework, these scandals are a result of poor human behavior that no number of enhancements to the governance paradigm will fix.

Every time a high-profile company fails, there is a call to impose a higher standard of conduct upon directors and officers. We do not need a radical overhaul to the governance paradigm.

Rather, we need faithful adherence by fiduciaries to the well-developed and carefully crafted governance paradigm already in place. Investors should be able to rely on fiduciaries to self-regulate and follow these principles in an effective manner without having to police their behavior. For individuals behaving with integrity, this is not hard.

Recent scandals show that individuals are adept at maneuvering around any governance paradigm. FTX founder Sam Bankman-

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Fried was charged with fraud and conspiracy for stealing customer funds to cover losses at his hedge fund and of conspiring to bribe Chinese officials and violate campaign finance laws.

In addition to having formed the company in the Bahamas to circumvent a variety of laws, FTX was completely founder controlled with limited governance controls. The formation in the Bahamas, the use of celebrity endorsers for complex financial instruments, and the lack of any credible governance structure should have served as a warning to investors about the risks associated with investment in FTX.

Board members need to be able to stand up when it matters most

Board service presents a rich and rewarding opportunity to grow a company to new heights and leave a lasting impact. While some companies stumble their way to sustainable high-growth opportunities, most others get there through a series of good decisions made over time. Being elected to a corporate board of one of these companies is not cause for celebration, as that is when the true work begins.

Effective oversight is an endeavor that requires directors to be present and meaningfully engaged, bringing themselves to the table fully and completely. While the board is charged with oversight and is not involved in day-to-day decision-making, the role of a director is anything but part time. Directors should know the industry their companies operate in, the nature of the business they oversee, their competitive advantages, and their threats, weaknesses, and risks.

In many corporations that have seen their demise, a controlling faction of the board charges forward in an aggressive manner that takes the organization off course and deviates from any moral compass. In the spirit of relationships and comradery, some directors go along, while other directors engage in minimal inquiry or are bullied. In an effort to avoid conflict, some are letting themselves get caught up in situations that are neither good for them personally or the organizations they lead.

The purpose of board meetings is not to network and make friends without ruffling feathers or bruising egos. Good governance requires the ability to question, to challenge, and to make people feel uncomfortable when they are not behaving in the institution's best interest.

There is no room in any quality board for distracted individuals who are not paying attention or wallflowers who would rather choose silence than speak their conscience. Directors should have an ethical backbone that will enable them to stand up for the institution at times when it matters most.

The role of a director is anything but part time.

While many academics believe boards should act through consensus, if a faction of the board is not acting in the organization's best interest, it is critical to vote against any action that is or may be harmful to the institution or may put the organization at risk.

A quality director will vocalize his or her dissent at the meeting and then review the meeting minutes to make sure that the dissent is appropriately included and accurately reflected. As a final measure, a director should be prepared to resign from the board with an appropriate noisy withdrawal.

Conclusion

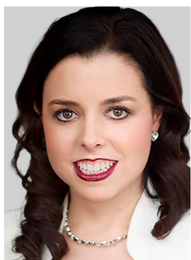
For any good director, adhering to applicable law and the organization's governing documents and viewing yourself as the guardian of the institution you oversee is paramount. Failure may be an option if the corporation fails because board or management, following applicable laws and the organization's governing documents, took a calculated risk that did not pan out as expected.

That said, failure is not an option when it results from the failure of directors or officers to make thoughtful and informed decisions or because they act in their own self interests. It may be fine for a cryptocurrency company to fail because investors lose interest and stop trading. But it absolutely should not fail because the board is behaving like a fraternity house and syphons off its investors' money for personal gain.

Notes

[1] This is a reference to "How the Mighty Fall: And Why Some Companies Never Give In," Jim Collins (Jim Collins May 19, 2009).

About the authors



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