

# BAILEY CAVALIERI LLC

ATTORNEYS AT LAW

One Columbus 10 West Broad Street, Suite 2100 Columbus, Ohio 43215-3422  
telephone 614.221.3155 facsimile 614.221.0479  
www.baileycavalieri.com

## RETURN TO BASICS: D&O LESSONS FROM RECENT CLAIMS

**Prepared by  
Dan A. Bailey**

A number of recent large and highly publicized claims against directors and officers provide valuable lessons for others who wish to avoid being subjected to similar claims and the adverse publicity, embarrassment and potentially catastrophic financial consequences resulting therefrom. Ironically, the underlying causes of these claims are not new or exotic. Rather, almost without exception, the subject directors and officers strayed from simple and basic concepts of fiduciary duties, prudent management processes and common sense.

Although the most publicized corporate governance failures occur in large public companies, many of the same mistakes occur in small non-profit organizations. The following summarizes numerous lessons for D&Os which can be gleaned from the recent corporate debacles.

- A. Measure Company Performance. Directors should agree on and monitor key performance criteria which indicate not only the company's financial stability, but also its fulfillment of strategic goals. This is particularly challenging for non-profit and privately-held organizations since there are few obvious metrics to judge the organization's performance.
  
- B. Don't Ignore Basic Fiduciary Duties. Directors and officers owe to their company and its shareholders basic fiduciary duties of care and loyalty. Several recent claims primarily involve alleged breaches of the duty of loyalty, which generally precludes directors and officers from engaging in personal conduct that would injure or take advantage of the company. In some instances, officers routinely participated in transactions with the company and otherwise created blatant conflicts of interest with seemingly little regard for their fiduciary duty of loyalty. D&Os should make a renewed commitment to avoid even the appearance of conflicts of interest whenever possible, and should fully disclose and recuse themselves from any truly unavoidable conflicts. In addition, in some cases directors failed to appreciate and respond to the risks and dangers faced by the company. In fulfillment of their duty of care, directors should thoroughly understand the basic operations and economics of the company and periodically assess the company's strategy and key performance indicators. Management should encourage and directors should raise challenging questions, and directors should insist upon satisfactory answers. The primary responsibility of directors is not to simply approve Board resolutions, but to effectively oversee the business and affairs of the company by probing into all aspects of the company and by exercising healthy skepticism about what is presented.

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*The material in this outline is not intended to provide legal advice as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.*

- C. Investigate Warning Signs. In most instances of corporate financial or operational problems, warning signs are visible to senior management and directors long before the problem fully develops. D&Os should be vigilant in identifying those warning signs and should adequately respond on a timely basis. Important decisions should be thoroughly investigated and approved by knowledgeable, informed and truly independent persons based on the advice of qualified outside advisors where appropriate.
- D. Don't Manage to Artificial Indicators. Too often, meeting analysts' expectations or internal budgets can become a near obsession for D&Os, creating pressure to do whatever it takes to meet these artificial indicators. Such a mindset unduly emphasizes short-term performance to the detriment of long-term corporate strategies and may encourage deceptive conduct.
- E. Avoid Vague, Confusing or Exaggerated Disclosures. Directors and officers should insist upon full and meaningful disclosures to regulators and company constituents. Clever "spin" or other vague or confusing communications should not be tolerated. Instead, communications should be plain, easy to understand, convey the whole truth and warn investors of potential future problems. Even unsophisticated investors should be able to readily understand the disclosed information. Bad news should not be understated and good news should not be overstated. Instead, companies should strive to build long-term credibility, and should seek to avoid unreasonable expectations by investors, employees and others.
- F. Don't be Arrogant. Successful managers are frequently tempted to believe they have all the answers and can ignore the input of others. Such arrogance typically leads to disaster sooner or later. Instead, directors and officers should recognize that others may have helpful ideas, perspectives and suggestions and may raise legitimate concerns. An atmosphere of candid and open exchange of views should be fostered. Senior executives should encourage and carefully consider concerns and criticisms expressed by subordinates and should meaningfully respond to inquiries. Directors and officers should not surround themselves with "yes" employees and advisors who are either unwilling or incapable of challenging faulty reasoning or decision-making.
- G. Manage Risk. Many companies do not adequately identify, evaluate and manage risks. The recent failures of numerous huge financial institutions were in large part due to improper risk management. A comprehensive enterprise risk management ("ERM") program should be maintained, which focuses on the company's financial, reputational, operational and strategic risks. Far more than purchasing insurance and implementing routine loss prevention, an ERM program should seek to identify, quantify and manage those risks and to align business decisions with approved risk tolerances. The directors should approve and monitor the program, and a senior chief risk officer should implement and oversee the program.

H. Improve Audit Committee Functions. Despite increased accountability of audit committees in recent years, a widespread perception still exists that these committees remain ineffective in many situations. Some suggestions to enhance the committee's effectiveness include the following:

- Audit committees should be composed of only financially literate members who can fully understand and critique the company's financial statements.
- Audit committee members should be truly independent from management and the auditors. Business, social or other relationships which may impede the independent thinking and decision-making of committee members should be considered when determining a member's qualifications for service on the audit committee.
- Audit committees should meet regularly and frequently, not just in connection with the annual audit.
- The audit committee, not the CFO, should have full responsibility for the selection, hiring and termination of outside auditors. A periodic turnover of auditors (or at least the partner in charge of the audit) is advisable.
- The audit committee should discuss annual financial statements in one-on-one meetings with each of the company's auditors, management and internal accountants and should review any representation letter from management to the auditors and any management letter from the auditors to management.
- The audit committee should particularly examine very closely the financial reporting and accounting policies for significant transactions that can materially effect the company's earnings performance for a quarter or year.
- The audit committee should insist upon the highest quality accounting standards, which reflects the true economics of transactions and business operations.
- The audit committee should pre-approve any non-audit services to be performed by the outside auditor. Preferably, the only meaningful business relationship with the outside auditor is the audit.
- The audit committee should establish procedures to receive, investigate and respond to complaints or confidential information from employees or others relating to the company's accounting or financial controls.

I. Work with People of High Integrity. Directors and senior management should demonstrate and insist upon a strong commitment to the highest level of legal, moral and ethical conduct. A company's culture of integrity is established

primarily through the actions of its leaders. Companies should not tolerate at any level activity which is perceived to be deceptive, manipulative, self-serving or otherwise improper. It only takes one person's illegal conduct to cause enormous harm to the company and to expose numerous other directors and officers to potentially dangerous litigation.

- J. Little Things Matter. Many of the largest corporate frauds commence by a relatively small misrepresentation or manipulation of information. Individuals frequently believe that future results will allow them to unwind or cover up the small misstatement, thereby effectively leveling out company performance or disclosures. However, too often subsequent performance is inadequate and therefore requires additional misrepresentations or manipulation to avoid disclosure of the initial problem. Quickly, the initial small misrepresentation can snowball into a huge fraud. Obviously, the best way to prevent this problem is to never tolerate even the smallest wrongful act.
- K. Don't Follow the Leader. Recent systemic problems relating to stock option backdating and the subprime crisis highlight the importance of management making prudent decisions and acting with high integrity regardless of common practices at competitors or within the company's industry. Wrongful behavior does not become proper behavior simply because everyone else is doing it. Management should constantly filter decisions through its own sense of right and wrong regardless of what management believes others are doing.
- L. Be Strong. Too often, doing the right thing is different than doing the easiest thing. It is frequently tempting to rationalize why wrongful behavior may be acceptable given the unique circumstances. Directors and senior management must develop a strong moral compass which guides behavior regardless of the amount of external or internal pressure to act inconsistent with that moral compass.
- M. Don't Aggravate Existing Problem. When a significant problem is identified either internally or externally, directors and officers should promptly address the problem through a comprehensive investigation and analysis, through decisive action and through forthright communications. If at all possible, timely and meaningful explanations should be made to employees, other constituents and the public regarding the source and consequences of the problem and the plans to address the problem. Facts and evidence relating to the problem should be preserved for later reference, particularly if investigations or litigation are expected or pending. In addition, directors and officers should avoid the appearance of receiving special treatment either before or after the matter is disclosed. In any event, do not deny the truth, even if the truth seems harmful.
- N. Be Prepared. The single most important lesson from the Enron-era is that no corporation is immune from wrongdoing by some of its leaders, and therefore all corporations should assess their governance procedures and implement as many "best practices" as possible. Often, outside consultants with extensive governance expertise can provide objective and fresh ideas. In addition,

corporations should be sure they have high quality D&O insurance and indemnification protection in the event problems arise and claims are made.