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Observations on Governance
for Halsey Lane First Annual Dinner Party

by Martin J. Bienenstock
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Introduction: Thanks Mark, Alex, and Neal, I think. I want to assure everyone that I understand totally that I stand here as an obstacle to the main course and to Darrell Hammond. So, I guess it's lucky Mark said I should talk no more than 90 minutes.

Background: The bulk of my career for over 32 years has been reorganizing distressed companies and governance. I've seen the world from the dark side. I'm in the boardroom when the company is failing and the directors and management discover the causes of their corporation's collapse. As a result, I see first hand the litigation and other fallout from distress, and I work backwards to see what went wrong. I've been fascinated by the causes of failure and the linkage and non-linkage of corporate governance to both failure and to resurrection.

Halsey Lane: Halsey Lane and I have found we have a natural bond. Halsey Lane helps boards optimize value and avoid distress from a business viewpoint, and I try to do it from a legal perspective.

Funny Thing about Distress – Directors Usually Don't See it Coming:

"In every single business failure of a large company in the last few decades, the board was the last to realize that things were going wrong."

Peter F. Drucker [1]

So Here's the Question: How and why did these companies fail with the best business and legal advisors money can buy?

Enron, Worldcom, Adelphia, Lehman, Indy Mac, GM, Chrysler, WAMU, Bear Stearns, Merrill Lynch

Fraud? Because some eye-popping failures were caused by fraud, many people, and perhaps Congress, believe fraud is a primary driver of failure. Actually, it's not. Only about 7% of business failures arise from fraud according to the business consulting firms. But, frauds are interesting and come in two varieties. So, let's chat about fraud. When I teach, the students really like this.

First, a Little Fraud History. Going back to the salad oil scandal in the Ira Haupt bankruptcy, the commodity broker purported to store oil in those gigantic, cylindrical vats along the New Jersey Turnpike. When auditors climbed up the outside of the vats and stuck their dipsticks inside, they found oil marks high up on the dipsticks to corroborate the oil inside. Little did they know the vats were actually full of water, with salad oil forming the layer on top.

Fast forward to Equity Funding in the 1970's. The auditors would drive out to headquarters and ask to see various insurance policies. The company printed them up over night, forged signatures, and tendered them for inspection the next day.

[1] "What Business Can Learn from Nonprofits," *Harvard Business Review*, July 1989. Having personally witnessed the distress at Texaco, Enron, old General Motors, Capmark, and numerous other companies, we can attest that Peter Drucker's warning in 1989 is equally applicable today.

OPM Leasing: In the early 1980's, two men purported to purchase super computers with bank debt, on the strength of their leases of the computers to AAA corporates. At the closing of each computer purchase, when the bank-lender asked to verify that it was leased to a major corporation, the OPM Leasing ceo would provide the lender's lawyer with the phone number of the treasurer or executive officer of the lessee, and the lawyer would call and verify. The problem was that the phone number was the number of a shill sitting somewhere across the street, but a woman answered the phone by announcing the name of the lessee and the shill corroborated the lease.

In Worldcom, the company somehow convinced its auditors to capitalize $11 billion of expenses to make its income statements look astoundingly good. Nobody in the industry could figure out how Worldcom could be so much more profitable than its competitors, but until money ran out, the fraud worked.

Adelphia. The Rigas family used the corporation as its private piggy bank.

What Explains these Frauds? The people involved were far too smart to believe they could get away with these frauds. The similarity among all of them is that they were each 'simple-stupid.' Why do smart people engage in simple-stupid acts that will land them in jail? The only explanation that seems to fit each case is that the executives felt the urge to cheat to make their numbers for one quarter, thinking they would make up for it with higher profits the following quarter. Instead, each quarter worsened and they repeated the fraud as they were dragged down into quicksand.

Enron was Much Different. The bulk of Enron's profits that propelled it into a $70 billion market capitalization, were earned based on a perfectly legal transaction known in accounting circles as FASB 140 transactions. Under the version of Financial Accounting Standard Board Opinion 140 then in effect, Enron and any corporation could sell a business to an entity it owned and controlled. The entity would purchase Enron's business (whether it be broadband trading, windfarms, refineries, water purification, etc.) with debt borrowed from banks and guaranteed by Enron. Notwithstanding Enron's guaranty, Enron did not have to include the debt on its balance sheet as long as an investor purchased 3% of the entity and its money was at risk of loss. Thus, Enron could create huge profits each quarter by selling its businesses which sometimes were little more developed than ideas, and Enron could maintain a pristine balance sheet having little debt because almost all the debt was 'off balance sheet' debt based on FASB 140. This was all legal. Enron is known as a fraud case because at some point, the 3% investors asked for assurances they would not lose their investments, and the bankers who would stop earning bonuses for making the loans if the FASB 140 deals ceased, gave assurances the 3% investors would be protected, which voided the applicability of FASB 140. Simultaneously, Enron's chief financial officer, Andy Fastow, engaged in self dealing and stole approximately $40 million from Enron. The Enron board, and most likely Ken Lay and Jeff Skilling, probably never knew about any of this wrongdoing. I've never spoken to Jeff Skilling, but I suspect he left Enron because he realized the FASB 140 transactions could not continue getting bigger and bigger to generate higher and higher profits. In other words, he realized the business plan had to run into a brick wall. I was sitting in their boardroom when the directors read the special report that exposed Fastow's tricks. They were shell shocked.

<u>What happened at GM</u>? GM certainly was not a fraud case. What probably explains it best is that when the crisis managers asked GM how much cash it had in October 2008, the answer took weeks to assemble and GM ran out of cash, but for the U.S. government bailout, in December 2008.

If Not Fraud, What are the Major Causes of Failure? In my experience:

1. Unplanned for change;

2. Illiquidity in the high yield market; and

3. Boards unaware of their corporations' actual business risks, including Professor Clayton Christensen's "disruptive innovation," and Jim Collins' "hubris."

4. NOT, mismanagement.

Not Mismanagement. Let's start with my last observation. If crisis managers were here, they would contradict me in spades. 'Mismanagement is always the cause of failure.' I respectfully disagree. If that were correct, then (a) all airline management were inept, (b) all telecom management were inept, (c) most real estate management is inept, and (d) all stadium theatre company management were inept, etc. I don't buy it. Frequently, Wall Street makes a bet on an industry and the bet works or doesn't.

Unplanned For Change: When President Carter deregulated airline ticket prices in 1980, virtually all major airlines failed over the next 20 years, except for American which got the benefit of the other airlines' new collective bargaining agreements after the unions knew an American bankruptcy would yield the same result. The airline industry cost structure was based on 1/3, 1/3, 1/3: fuel, capital, labor. When airline ticket prices plummeted with competition, fuel and capital costs could not plummet. Labor cost was the only elastic cost and absent consensual give-backs, the labor costs pushed nearly all airlines into bankruptcy. By the way, management cannot be blamed for that reality.

When OPEC lost control of oil prices in the 1970's, the nation's oil exploration and production companies could not be blamed for having businesses and cost structures based on economics that fell out of bed.

Today, deflation, changes in healthcare reimbursement rates, increased global competition, and Congress passing new laws provides ample unplanned for change to launch much distress in the near term.

Illiquidity in the High Yield Market: The high yield market was in its infancy when Michael Milken graduated Wharton Business School in about 1972. According to Professor Altman's report, high yield debt was approximately $6.1 billion in 1971, and $1.2 trillion at the end of the first quarter of 2010. The rise in high yield debt does not signal distress. Rather, when it stops rising temporarily, distress abounds because distressed debt cannot be refinanced.

Boards Unaware of Material Risks: As Peter Drucker wrote, boards of failing companies always seem to be in the dark. Some have tried to address this by creating risk committees. But, Warren Buffet has another idea:

> "…Charlie [Munger] and I believe that a CEO must not delegate risk control. It's simply too important….If Berkshire ever gets in trouble, it will be *my* fault. It will not be because of misjudgments made by a Risk Committee or Chief Risk Officer."
>
> Warren E. Buffett[2]

Myth: Compliance With Sarbanes-Oxley Act ("SOXA") and Related SEC and Listing Rules is Sufficient Governance: Sarbanes Oxley doesn't solve the problem. It is true that under Sarbanes Oxley's 'real time disclosure' requirements, if a company's most critical facility is on fire, the financial press may hear about it before the fire station. But, Sarbanes Oxley does nothing to reduce the risk of fire.

Why Does Sarbanes Oxley Not Solve the Problem of the Board Not Knowing? Simply put, Sarbanes monopolizes the board agenda to

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[2] Letter to Shareholders, dated February 26, 2010, in Berkshire Hathaway Inc. Annual Report for 2009, at p. 16.

where none of the right things can happen, except preventing fraud. A typical board's 8 meetings a year for a day or two at a time, are dominated by reports on the company's section 404 compliance, audit committee reports, compensation committee reports, and the like. Getting down to real business risks and opportunities is squeezed out, for the most part. Sarbanes Oxley is almost exclusively keyed to avoiding the pitfalls in Enron. Those pitfalls have little to do with most of corporate America.

How Can Boards Avoid Not Knowing? The board agenda must include reports from senior management of their identification of material business risks throughout their corporate enterprise and their determinations for each risk as to whether it can be (a) eliminated on a cost-beneficial basis, (b) mitigated on a cost-beneficial basis, or (c) best dealt with thoughtful contingency plans developed in advance. These risks include external (i.e., illiquidity in the capital markets, recession, competition, changes in laws…) and internal (loss of key employees, major accidents, legal noncompliance…) risks. Very recently, the SEC started mandating some of this which is little more than common sense.[3]

Tales of Actual Business Failures illustrate the risks boards don't know about until it's too late. If Professor Clayton Christensen[4] of Harvard Business School were here, he would put it this way based on his groundbreaking research into "disruptive innovations": If you do everything you're taught to do at Harvard and other great business schools, your company will likely fail, or at least decline substantially. That's a pretty good sound bite you won't forget. Is he serious? Yes.

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3 SEC Disclosure Requirements Compel Management to Identify and Assess Material Risks:

"…Item 503(c) [of Regulation S-K] specifies that risk factor disclosure should clearly state the risk and specify how the particular risk affects the particular registrant."

17 CFR PARTS 211, 231 and 241 [Release Nos. 33-9106; 34-61469; FR-82] Commission Guidance Regarding Disclosure Related to Climate Change (SEC Interpretive Release, Effective Date: February 8, 2010).

4 Clayton M. Christensen, *The Innovator's Dilemma* (Harvard Business School Press 1997, 2000, 2003); Clayton M. Christensen and Michael E. Raynor, *The Innovator's Solution: Creating and Sustaining Successful Growth* (Harvard Business School Press Sept. 2003).

It goes like this. Most businesses follow the 80:20 rule, meaning 80% of their profits are generated by 20% of their customers. As a result, businesses concentrate on perfecting and improving their leading, highest margin products for their most lucrative 20% of customers. When an upstart comes along with a cheaper less perfect product based on a new technology, the successful company will likely ignore it due to its inferior characteristics and performance. But, guess what? 80% of customers may not need the best product. The new product may be more than adequate for their needs. Next, two things happen.

Disruptive Innovations. First, entities that never used the product may start using it because it's less expensive, thereby creating a new market. Second, the inferior product will continue to be improved and may become superior to the established company's product. At that point, it's too late to catch up, as many companies found out, such as IBM and Storage Technology in the disk drive market, Korvettes and Montgomery Ward found out in discount retailing, and Bethlehem Steel and LTV found out when Nucor and others upended them with minimills.

Hubris. Jim Collins[5] identifies attributes of the stages of failure. Poignantly, he shows that when management loses sight of the actual causes of past success and lapses into platitudes lacking substance to substantiate new investments, such hubris brings down large companies. Ames and Walmart were virtual equals in the 1970's. Walmart understood its business was successful due to its value proposition. Ames lost sight of the root cause of its success and simply expanded. Ames is now dead and Walmart …is Walmart.

The Legal Front:

Boards and Management Have Been Protected Well, Even in Massive Failures.

Citigroup: When the directors and senior management of Citigroup were sued for breach of their fiduciary duties by failing to carry out their risk oversight function in respect of Citigroup's $55 billion

[5] Jim Collins, *How the Mighty Fall and Why Some Companies Never Give In (2009).*

exposure to securities linked to subprime mortgages in the face of many "red flags" showing a deteriorating subprime mortgage market, the claims were dismissed before trial because Citigroup had a process that considered the risks and had not disregarded them, and the business judgment rule protected directors and management from personal liability for having made bad business decisions after identifying the risks.[6]

Disney: After The Walt Disney Company terminated its president's employment and thereby created a termination liability of $130 million, shareholders sued directors for breach of their duty of care for, among other things, not having exercised due care in approving the employment contract that created the termination liability.[7]

Amsouth: When present and former directors of Amsouth were sued for breaching their duty of care because Amsouth was compelled to pay $50 million in penalties and fines when its employees failed to file 'Suspicious Activity Reports' related to the Bank Secrecy Act, 31 U.S.C. § 5318, the Delaware Supreme Court affirmed the dismissal of the complaint before trial because directors are exculpated from liability for their duty of care when they attempt to carry it out in good faith, and their establishment of an information reporting system permitting them to monitor legal compliance satisfied the good faith standard.[8]

The Law Has Actually Required Management and Directors to Identify Business Risks for At Least 14 Years: *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959, 970 (Ct. Chancery, New Castle 1996), after the company paid $250 million in fines and damages for failure to comply with health provider

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[6] *In re Citigroup Inc. Shareholder Derivative Litigation*, 906 A.2d 106, 125, 131 (Del. Ch. 2009).

[7] Sections 145 and 102(b)(7) of the Delaware General Corporate Law deny indemnity and exculpation, respectively, to directors not acting in good faith. The Delaware Supreme Court ruled that "adopting a we don't care about the risks' attitude" amounts to bad faith. *Brehm v. Eisner (In re Walt Disney Company Derivative Litigation)*, 906 A.2d 27, 63 (Del. 2006). Fortunately for the directors, they had considered the liability arising from the employment contract. *Id*. at 60.

[8] *Stone v. Ritter*, 911 A.2d 362, 367, 373 (Del. 2006)("In the absence of red flags, good faith in the context of oversight must be measured by the directors' actions 'to assure a reasonable information and reporting system exists' and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome.").

regulations, the court ruled: it is an "elementary fact that relevant and timely information is an essential predicate for satisfaction of the board's supervisory and monitoring role under Section 141 of the Delaware General Corporation Law."

When Have Directors and Management Failed to be Protected by the Business Judgment Rule? Two main categories:

Lack of Proof of Director Diligence. Shareholders can sue directors for breach of their duty of care and for waste of corporate assets notwithstanding exculpation provisions under corporate law because their conscious disregard of known risks can show lack of good faith for which there is no exculpation.[9]

Failure to Have Independent Directors. Private equity firms have unnecessarily had to defend against actions for the portfolio company's losses when the plaintiffs have postured the actions as being for breach of the private equity firm's duty of loyalty. Private equity firms can avoid that result by having independent directors vote on issues on which the private equity firms have dual loyalties.[10]

A Living Example of Failure to Prepare for Risks – BP. How different would it be if BP had planned in advance for its actions in the face of a horrible accident? CEO Tony Hayward would have known from the outset that world opinion would depend on his being on site immediately. President Obama would have spared himself similar public criticism. Any experienced pr executive would have told them that immediate presence and attention to a public safety hazard is critical. Moreover, the accident's consequences would have been contained earlier with less harm had contingency plans been prepared for something as predictable as an oil spill (i.e., is Exxon Valdez forgotten?).

It's Not Too Late for BP to Impact the Next Chapters and Avoid the Death Spiral. Few companies understand the death spiral and how

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[9] *In re Abbott Laboratories Derivative Shareholders Litigation*, 325 F.3d 795, 810-811 (7th Cir. 2003).
[10] Martin J. Bienenstock, "*A Fiduciary Duty to Kill a Company?,*" *New York Law Journal* (September 8, 2008) at p. 9.

fast and unexpectedly it can ignite. The death spiral is the failure of one or more lifelines a company requires to continue as a going concern. Typical lifelines include a company's customers, suppliers, lenders, investors, key employees, and sometimes regulators. It's intuitively obvious that when a company's financial situation is unknowable, suppliers, lenders, and investors withhold support, at least until they obtain collateral security or other assurances for new credit. Customers become afraid to depend on the company and initiate contacts with competitors. Employees fear for the longevity of their jobs. The meltdown can accelerate rapidly and without warning, and is independent of the facts because they often fear the worst and don't have the facts. Therefore, a good portion of arresting the death spiral involves educating and staying in touch with all the lifelines. This requires much effort and planning.

<u>The $20 Billion Escrow Fund</u> does not cap BP's damages. Far from it. It actually does the reverse. It increases the 'propensity to sue.' Now that there's a $20 billion fund that can be accessed without going to court, armies of lawyers are even more inspired to comb through the Gulf Coast and neighboring areas to line up every man, woman, child, and business that may have a claim. The escrow has increased BP's ultimate cost. Its survival depends on its assuring the world that its lifelines will remain intact. The benefit BP has is that huge legal judgments will take years. But, rumors of the actual liability already exist. BP faces the choice between (a) being the 'walking wounded/dead' shrouded by clouds of financial uncertainty for the foreseeable future, which will likely lead to bankruptcy and/or a takeover and piecemeal liquidation, (b) providing a compelling disclosure showing how BP's cash flow and liquid reserves will be adequate to cover litigation judgments, while BP can provide suppliers and lenders collateral security to assure them it is safe to do business with BP while litigation continues, or (c) creating a new beginning by resorting to bankruptcy for the purpose of routing all damage claims to a fund from proceeds created by selling the operating company free and clear to new shareholders. Congress is already considering potential legislation to prevent the latter result,

which could give everyone the worst of all worlds if bankruptcy becomes necessary!

Will BP Get it Right? Let's go back to my original question. Why did Lehman, Bear Stearns, WAMU, IndyMac, GM, Merrill Lynch, and Chrysler fail, notwithstanding that there was no fraud and they each had the best advisors on the planet?

Before Answering the Question, Let's Acknowledge their Failures were Not Equal. Lehman, WAMU, and IndyMac crashed and burned wiping out shareholders and seriously harming their creditors. They each attained the worst possible result in the entire universe of possibilities. GM and Chrysler survived as standalone businesses, but also extinguished their shares and seriously impaired their creditors. Bear Stearns and Merrill Lynch were heroes by comparison! Not only were their creditors unimpaired, but their shareholders obtained approximately $10 per share at Bear Stearns and $30 per share at Merrill Lynch.

So, What Caused the Variation among the Results? Most of Us Refuse to Find and Consummate the LEAST WORST. What these companies had in common was that none of their boards appreciated and planned for the risks their companies were undertaking. What distinguishes these boards of directors and managements, in my opinion, is a unique psychological phenomenon I see over and over, though I have no training whatsoever in psychology. American management and directors are generally brilliant and more than capable of analyzing complex alternatives and identifying the best…IF the best alternative is in the upper right quadrant of the graph, namely if it produces success all around. The psychological phenomenon we observe over and over again, however, is that brilliant minds literally turn off when the quest for the BEST alternative arises in a situation where the BEST is the LEAST WORST. In that scenario, brains simply stop functioning. The exercise is abandoned. Ever since Bear Stearns failed, Lehman was on the front pages as the next domino to fall. Lehman had alternatives, but each one was suboptimal from the point of view of its board and management. So it stopped the exercise and bet the ranch on a deal with Barclays that the UK rejected. IndyMac and WAMU similarly failed to take painful steps to attain the least worst result, so they also attained the worst worst. Bear Stearns and Merrill Lynch succeeded in accomplishing the least worst. Those were great accomplishments.

Thus, the Real Question is: Will BP Be Capable of Choosing the Least Worst Result?

Thanks for listening to this en route to Darrell Hammond, and thanks to Halsey Lane.