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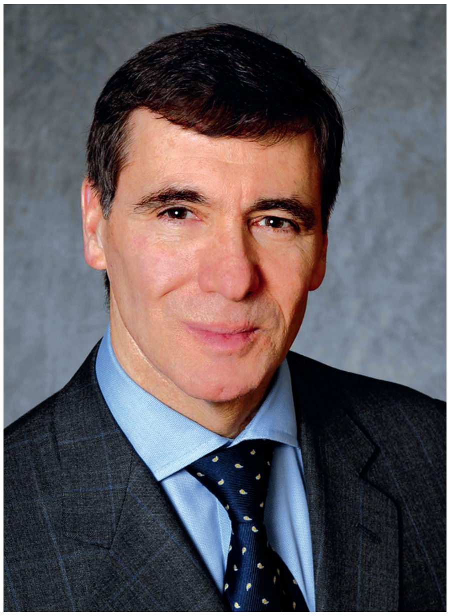
'Where was the board?' Where was I?

I had occasion to ask that when we board members put a company through Chapter 11.

By Richard Salomon

Former directors of Bear Stearns Companies Inc. won a rare early litigation victory in December, a summary judgment motion exonerating them from liability for their hasty decision to sell Bear Stearns to JP Morgan Chase in March 2008. Before they got to trial, class action plaintiffs were defeated in their claims that the directors violated their fiduciary duty, despite expert testimony that there were better options than a fire sale price of $10 per share (14 months earlier, Bear Stearns shares reached $171.52). In a 44-page opinion that no doubt cheered directors everywhere, the New York judge provided a lucid explanation and affirmation of the business judgment rule, writing: "The Court should not, and will not, second guess their decision."

It may be comforting in this time of financial debacles and business failures for directors to be assured they will not be personally liable if they have acted in disinterested good faith. But legal immunity is cold comfort to directors who are accustomed to winning — not just avoiding trouble. It is simply not good enough for ambitious men and women with histories of personal success to know that they will be covered if the company fails. They came to the board to build value for shareholders inside a durable company. When that doesn't happen, thoughtful directors of the distressed company will ask themselves, "Where was the board in all this — and where was I?"



I had occasion to ask that question in the previous bubble — the dot-com meltdown — about my own service as a director of a small public company. After dramatic growth through a series of acquisitions, our company suddenly could not meet its debt burden when the collapse of so many high-tech companies sharply reduced demand for our product. We put the company through Chapter 11, more or less wiping out all shareholder equity. The outside directors ran an efficient, low-cost bankruptcy event from which the operating company emerged and continues today. We were thanked for our work.

But I could not help thinking about what we might have done differently to build a more durable company for the shareholders. Obviously, the time to have prepared for emergencies was when things were going well. Our board had some very smart and seasoned members. Why didn't we take more precaution against the possibility that the marketplace would cease to reward our growth model and that we might have to weather a storm?

All external evidence had favored the course we had been on. The share price increased dramatically. As we grew in gross revenue, we drew more coverage from Wall Street analysts and we moved up the food chain of more prestigious senior lenders who required ever less-onerous loan covenants. Investment bankers called on us with flattering talk of bigger deals in the future. Outside professionals — sober types like lawyers and accountants — also shared the joy. It seemed our only task was to find more growth, and soon.

A skunk at the picnic

Maybe what we lacked was a skunk at the picnic. As in today's corporate disasters, it seems that enthusiasm eventually overcomes caution, and the idea of protecting against downside or against a mistake in the business model finds no favor. In an overheated atmosphere of success upon success, naysayers are not welcome. Those who do not enthusiastically embrace the new paradigm are given less important roles and ultimately excluded from decision making until eventually there is no one left in the room who will say, "Hey, does this make any sense?" or "What if we're wrong?" when a critical voice is needed most.

This is not an argument in favor of the curmudgeon, who refuses to accept the consensus for the sake of being con-

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trary, insists on past methods while ignoring changes in the marketplace, and generally lays a foundation for saying at some point, "Told you so." A posture of negativity will, like the famous stopped clock, be right eventually — but not always in time to be useful. Such dyspeptic individuals deserve to be marginalized.

Boards need directors who are balanced in their thinking and keep an open mind, who possess wisdom, experience, and character; who can engage constructively with management; who can challenge without being destructive; who know when things are going too far and can sense when markets are changing or risks are looming; and who can weigh the virtue of steadfastness with the need for flexibility.

What is needed, in short, is good judgment. Unfortunately, no one has found a recipe for good judgment. It cannot be measured, and it cannot be taught. But its evanescent nature does not mean good judgment should not be methodically assisted. Good judgment is grounded on good information, presented and considered with objectivity. Good judgment may become shy in the face of ego, bias, peer pressure, or bullying. We need to prepare the ground well, so that when good judgment turns up it will feel welcome. What sort of board practices can we adopt that will help assure that good judgment will flourish and carry the day?

One board process that is valuable is the type that helps assure the sort of immunity from legal liability enjoyed by the Bear Stearns directors. The well-counseled board will have engaged in a process that builds a record that — quite apart from the substance of its work — assures that the board can be *seen* to have done its work.

Other governance practices are promulgated by groups such as the California Public Employees Retirement System (CalPERS) and the Council of Institutional Investors, and boards are evaluated for compliance with their "best practices."

A chance to breathe

I suggest that what are needed are processes that:

• support good judgment;
• care little for appearances; and
• drive only toward enhancing decision making.

Let's return to the need for the skunk at the picnic. Perhaps the board on which I served should have had (and maybe all boards should consider) a formal challenge process — a process in which strategy is reviewed for the openly acknowledged purpose of its reformulation. In a challenge process, underlying assumptions are surfaced and questioned, goals re-evaluated in light of changing conditions, experience to date is probed for lessons learned, and implementation examined for defects and tweaked for improvement. One member of the group may be expressly tasked with playing the role of devil's advocate, or of asking the "what if" questions. Ground rules should include that no issue is sacrosanct or beyond question, and that derisive remarks, playing "gotcha," and other idea-chilling tactics are out. There must be no arguing from authority; i.e., ideas must stand and fall on their merits, not on the basis of whose idea it is. For the challenge process to function, its members must remind themselves that loyalty means loyalty to the mission, not to the plan — and certainly not to individual leaders. A challenge process (like any other) must have a finite ending point at which criticism and analysis ends and decisions are taken. It must be constructive, and cannot be allowed to stifle speed, authority, and leadership spirit.

Any board will, of course, want to have in place processes that assure legal protection for directors and compliance with contemporary industry standards for good governance. Beyond that, board process should be aimed at assisting fallible humans in their decision making and giving their best judgments a chance to live and breathe. ■

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