

H.S. Grace & Company, Inc.

Current State of Board Responsibilities and Board-Management Relationships

An economics-based business perspective built on (1) 1,000 combined years of senior executive and board experience; (2) a successful track record as consultant and expert witness on governance issues in more than 150 matters; (3) 60-plus articles on governance issues in well-respected business and legal professional journals; and (4) more than 70 presentations on these issues to a broad range of business, legal and technical organizations.

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Introduction

The governance bells are tolling for corporate, non-corporate, not-for-profit, governmental and other organizations. Stakeholder and investor demands, regulatory actions, growing litigation risk and associated insurance risks are all increasing the focus on management and director responsibilities for effective governance. In this document, we share our thinking on this critical issue by examining:

- Economics of ownership – the fundamental responsibilities for governance, oversight and management. Page 1
- Intensifying focus on boards and individual directors. Page X
- Responsibilities and relationships of boards, directors and management. Page X
- Ongoing evolution from "tone at the top" to "substantive checks and balances." Page XX
- Use of a board executive committee as a primary check and balance. Page XX

In each section, we share a recent publication authored by our team that delves deeper into the topic.

Economics of Ownership: Governance, Oversight and Management

The economics of organizational governance point to the responsibilities of the owners and the agents of the owners for the governance, oversight and management of the organization.[1] Take for example the simple model of a new business begun by a single individual who provides the required financing from the individual's personal holdings. That individual is responsible for the governance, oversight and management of the organization. Increase the individuals involved in ownership to two, three or more, and the responsibilities of these owners and/or their agents encompass governance, oversight and management.

When there are many owners with various ownership interests, a selection or election of agents may occur. These chosen agents bear the responsibility for governance, for oversight, and for management.

The failure to recognize and properly address these responsibilities underlies the major, very public problems (financial, legal, and otherwise) experienced by a broad range of organizations, including large, well known, for-profit companies and not-for-profits. Examination of these organizations using an experienced-based, business-focused lens confirms the failures stemmed from significant deficiencies in the fundamental issues of governance, oversight, and management responsibilities.

[1] Organizations can and do take many different forms. The demonstrations here often focus on the corporate form, but apply to a broad range of organizational forms.

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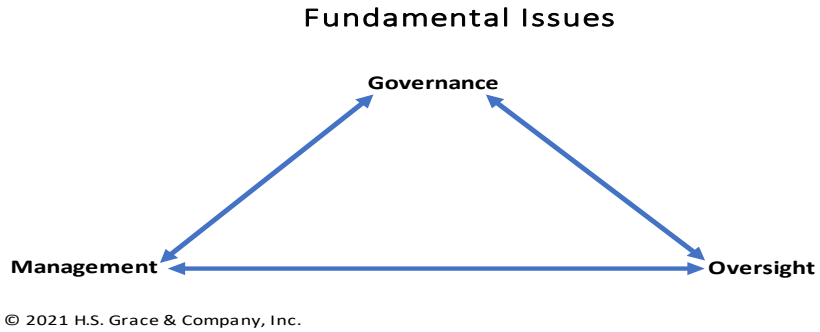


Figure 1

Boards and board committees are key participants in the organization governance process, along with senior management (Figure 2).

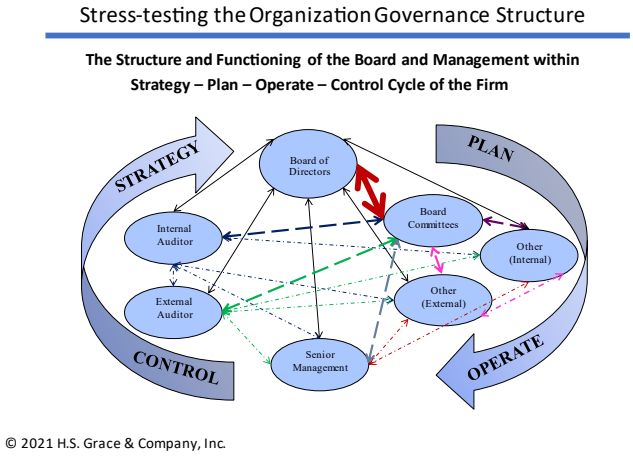


Figure 2

It is widely acknowledged that the roles and responsibilities of boards, board committees, and management have been evolving. These changing expectations have led to penetrating questions regarding the selection of board members, the structure of board and board committee operations, and the board's interrelationships with management and the other participants in the organization's governance process.

Intensifying Focus on Directors and Boards

The evolution of organizational governance continues with an intensified focus on boards and the directors individually. Issues at Wells Fargo, Volkswagen, Boeing, and Alphabet/Google all make clear that this is not solely a middle-market problem. It encompasses the entire range of businesses and organizations.

This evolution continues to move forward with directors and others facing multiple challenges, often accompanied by life-altering consequences (reputational and financial) from perceived failures to address their governance responsibilities.

The Boeing article we authored in the December 2021 issue of the American Bar Association's *Business Law Today* (BLT) makes these points. The Chancery Court findings regarding the failures of the directors are damning and will continually have to be addressed in the ongoing litigation from 346 deaths and related matters. This litigation will outlive many of the involved directors, and perhaps raise issues for their estates.

Boeing and the Ongoing Evolution of Director Responsibilities

The Boeing Company Derivative Litigation evidences the increased focus on director responsibilities for effective governance. That focus is being driven by investors, other stakeholders, regulators, and—as the Boeing case makes clear—growing litigation risk. In November, Boeing's board agreed to a $237.5 million settlement in a shareholder lawsuit that alleged board failures in overseeing the company and the safety of its 737 MAX ahead of fatal crashes in 2018 and 2019. The case emphasizes the need to ensure the existence of substantive checks and balances in board governance and to explore opportunities to create governance structures with a harder edge. Such structures can aid in ensuring proper communication and operational interaction between the board, management and others.

In assessing the Boeing Company Derivative Litigation through this lens, we begin with an examination of Delaware Court of Chancery Vice Chancellor Morgan T. Zurn's September 7, 2021, memorandum opinion in the litigation and her findings regarding Director failures. We then turn to identifying and addressing these fundamental governance breakdowns.

Memorandum Opinion, 9/7/21, Vice Chancellor Zurn

Vice Chancellor Zurn sets out in her opinion:

"The narrow question before this Court today is whether Boeing's stockholders have alleged that a majority of the Company's directors face a substantial likelihood of liability for Boeing's losses. This may be based on the directors' complete failure to establish a reporting system for airplane safety, or on their turning a blind eye to a red flag representing airplane safety problems. I conclude the stockholders have pled both sources of board liability. The stockholders may pursue the Company's oversight claim against the board."

In her opinion, the Vice Chancellor stated, "The Board publicly lied about if and how it monitored the 737 MAX's safety." The opinion cites 2019 interviews of the Board's Lead Director, David Calhoun, who became the CEO of Boeing in January 2020, and certain representations he made regarding the 2018 Lion Air crash and the 2019 Ethiopian Airlines crash. The Vice Chancellor's opinion states, "Each of Calhoun's representations was false."

Shortly after the opinion was issued, Boeing's CEO and other current and former directors asked the Vice Chancellor to clarify her legal opinion that she found the Board "publicly lied." Those defendants have now settled the case, pending court approval. The finding that they "publicly lied" will be a continuing cloud to be addressed on multiple fronts within and outside of litigation.

Identifying And Addressing Fundamental Governance Breakdowns

The Vice Chancellor's finding of "the directors' complete failure to establish a reporting system for airplane safety" and her finding of "their turning a blind eye to a red flag representing airplane safety problems" are indicative of a board operating in a "tone at the top" framework where the board may be dictated to/largely directed by the CEO. As we have previously set out,[1] what is required instead of a "tone at the top" approach is a governance structure that incorporates transparency and substantive "checks and balances." This is not a new concept; members of the board of advisors of Grace & Co. and other experienced business decision-makers addressed it years ago.[2] Yet, a board's perception of its role as only that of oversight, and at times limited oversight, persists at many boards, often with the support or dictates of the CEO.

To the contrary, boards can make use of internal resources to ensure the boards have access to that information necessary to address their responsibilities. We have discussed the value of these internal resources to boards[3] and recognize that boards can also call on external resources.

Under the proposed $237.5 million agreement to settle the litigation, Boeing's board has agreed to add a director with safety experience and has adopted other internal measures, such as creating an ombudsperson program to field certain internal complaints. Boeing has agreed to ensure that at least three directors have safety expertise. It may be that the relationship between those board members, and perhaps other board members, and management will be an ongoing interactive relationship where the company can draw on the talents and experience of those board members.

An example of board members participating in addressing management responsibilities arose when Michael Eisner, the CEO of Walt Disney, utilized the chairman of Disney's compensation committee and another experienced director to handle the employment negotiations with Michael Ovitz and his advisers.[4] Such an interactive relationship between certain directors and members of management helps ensure the quality of the flow of information to the Board and is demonstrative of the nature of the working relationships/checks and balances between the board and management.

The Economics of Corporate Governance

The economics of organization governance point to the responsibilities of ownership and its agents for the governance, oversight, and management of the organization. The board of directors, as owners or agents for ownership, bear the responsibility for the governance, oversight, and management of the organization. The Boeing litigation evidences the increased focus on these fundamental director responsibilities.

[1] H. Stephen Grace, Jr., S. Lawrence Prendergast, and Susan Koski-Grafer, "Board Oversight and Governance: From Tone at the Top to Substantive Checks and Balances," *Business Law Today*, February 2019.
[2] James N. Clark, R. Hartwell Gardner, H. Stephen Grace, Jr., John E. Haupert, and Robert S. Roath, "From 'Tone at the Top' to 'Checks and Balances,'" *The CPA Journal*, March 2002, p. 63. Paul Volcker and Arthur Levitt, Jr., "In Defense of Sarbanes-Oxley," *Wall Street Journal,* June 14, 2004.
[3] H. Stephen Grace, Jr., S. Lawrence Prendergast, and Susan Koski-Grafer, "Corporate Governance and Information Gaps: Importance of Internal Reporting for Board Oversight," *Business Law Today*, January 2018.
[4] H. Stephen Grace, Jr., "An Insider Revisits the 'Disney Case,'" *Directors Monthly*, August 2008, pp. 1, 3-6. H. Stephen Grace, Jr., "Plaintiff Expert Reports: An Insider Revisits Disney," *New York State Bar Association Journal*, July/August 2009, pp. 24-29. H. Stephen Grace, Jr. and John E. Haupert, "Governance Lessons from the Disney Litigation," *Business Law Today*, September 2011. H. Stephen Grace, Jr., and John E. Haupert, "Corporate Governance: Lessons From Life and Litigation – With Implications for Corporate Counsel," *New York State Bar Association Journal*, March/April 2013.
Authors: Suzanne H. Gilbert, H. Stephen Grace, Jr., S. Lawrence Prendergast
*The authors benefit from the thoughts of fellow advisors, in this case, Al Fenichel and Steve Grace.

Addressing Responsibilities & Relationships of Boards, Directors & Management

The presentation "Stress Testing Your Corporate Governance Structure: Examining Board Oversight to Enhance Operations and Minimize Litigation Experience" given to the Annual Meeting of the Business Law Section of the American Bar Association and the follow up article in the October 2021 issue of *Business Law Today* both opened by recognizing that "the governance bells are tolling for corporate, non-corporate, not-for-profit, governmental and other organizations. Investor and stakeholder demand, regulatory actions, and growing litigation risk are all increasing the focus on management and director responsibilities for effective governance."

An initial step in examining and evaluating the responsibilities and relationships of your board, the individual directors and management is to understand where you are at the present time. How are the fundamental issues of governance, oversight, and management currently being addressed?

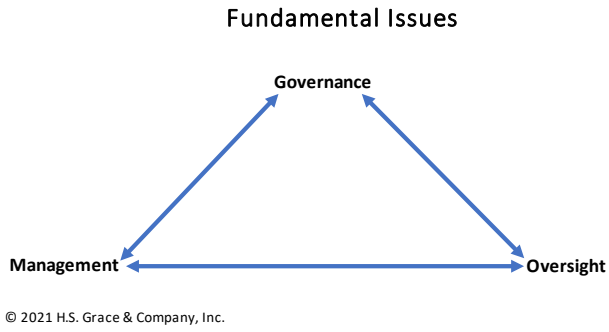
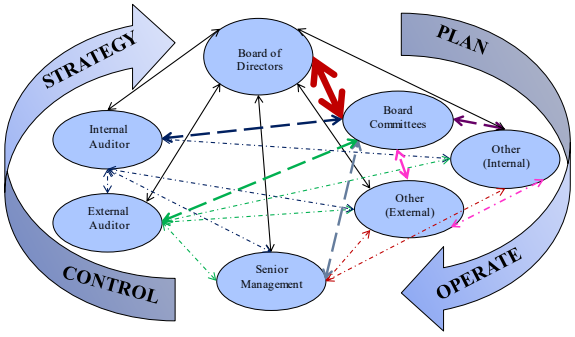


Figure 1

Stress testing the governance structure addresses these issues. The stress test provides a critical look at what is in place presently and whether it is working.

The Structure and Functioning of the Board and Management within Strategy – Plan – Operate – Control Cycle of the Firm



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An article we authored on stress testing in the October 2021 ABA's Business Law Today follows.

Stress Testing Your Corporate Governance Structure

The governance bells are tolling for corporate, non-corporate, not-for-profit, governmental and other organizations. Investor and stakeholder demand, regulatory actions, and growing litigation risks are all increasing the focus on management and director responsibilities for effective governance. There is therefore the need to stress test governance structures and examine the viability of the existing checks and balances, to review the increased focus on board governance and oversight responsibilities, and to explore opportunities to create governance structures with a harder edge, while continuing to recognize governance's often pivotal role in litigation. While exemplary corporate governance practices will never eliminate all occasions for suits, a sound governance structure will enhance the ability to successfully defend those suits to an early resolution through a motion to dismiss or for summary judgment.

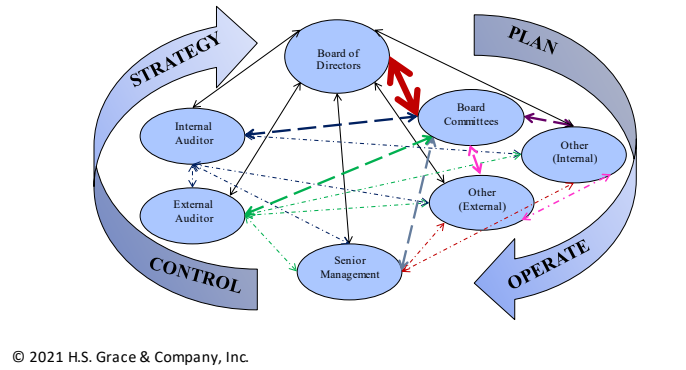
The article introduces the importance of effective corporate governance, key points to consider in assessing governance, and resources—including many written by the expert co-authors—for gaining further understanding of these issues.

Strategy-Plan-Operate-Control Cycle

The diagram below sets out the basic governance structure of an organization. Stress testing determines the effectiveness of the governance structure in addressing the needs of the particular firm at that point in time. Stress testing examines how, and how well, an organization's management and board are directing current operations and are prepared to react to specific risks and challenges, whether those challenges come from business competition, economic events and conditions, regulatory inquiries, changing shareowner expectations, litigation, or other causes.

This is not a middle market situation. The need for effective stress testing is exemplified by the recent breakdowns in the governance structures of Wells Fargo, Volkswagen, Credit Suisse, and Boeing, among others, with this focus on the governance structure going back to the well-known Walt Disney Shareholder Derivative Litigation involving the hiring and the subsequent termination of Michael Ovitz. In Disney, at that time referred to as "the corporate governance case of the century," the Court made the board's governance and oversight responsibilities clear, and examined the manner in which Disney management and its board addressed those responsibilities. The Disney litigation was eye-opening to many in the corporate sector because it was previously presumed that the business judgment rule defense would bring a quick end to the litigation. The Delaware Supreme Court did not quite see it that way and remanded the case to the lower court where the derivative suit would be tried on the merits. Ultimately, the Disney directors prevailed, but only after incurring significant legal defense expense. Our February 2019 Business Law Today article "Board Oversight and Governance: From Tone at the Top to Substantive Checks and Balances" examines the difficulties being experienced by the Wells Fargo board in addressing its responsibilities. We have authored four articles on our work in Disney, the first of which was "An Insider Revisits the 'Disney Case'" (Directors Monthly, August 2008).

Stress-testing the Organization Governance Structure



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"Tone at the Top" vs. Checks and Balances

The long-revered concept of "tone at the top" as the guiding hand of an organization's governance structure—where tone at the top took the form of a CEO/Chair essentially governing and managing the organization and the board being relegated to oversight—is still valued but now less emphasized. Today, there is broad-based recognition of the need for the appropriate "Checks and Balances" positioned in an environment characterized by transparency. The 2002 *CPA Journal* article "From Tone at the Top to Checks and Balances" authored by members of the Grace & Co. Board of Advisors, and the 2004 *Wall Street Journal* op-ed where Paul Volcker and Arthur Levitt Jr. point to the breakdown in checks and balances as the fundamental cause of major corporate collapses, both contributed to this evolving view of governance.

Board Governance: The FED and Wells Fargo, Credit Suisse, Boeing & Volkswagen

One needs only to examine the 2018 Order to Cease and Desist between the Board of Governors of the Federal Reserve and the Board of Wells Fargo, and recent developments concerning Credit Suisse, Boeing and Volkswagen to gain a perspective on the current state of board, board committee and senior management "business" duties to govern, manage and oversee. Indeed, the troubles of Wells Fargo continue, with Senator Elizabeth Warren sending a letter on September 13, 2021, to Federal Reserve Chairman Jerome H. Powell urging a revocation of the bank's operating license and forcing a break-up splitting the banking operations from Wells Fargo's other financial and investment services.

Our 2019 article "Board Oversight and Governance: From Tone at the Top to Substantive Checks and Balances," and the writings of former Delaware Supreme Court Chief Justice Norman Veasey and former Delaware Court of Chancery Chancellor William Chandler further contribute to that perspective that the board of directors will actually direct and monitor the management of the company, recognizing that Delaware law is clear that the business and affairs of a corporation are managed by or under the direction of its board of directors.

Chief Justice Veasey, in his May 2005 *University of Pennsylvania Law Review* article, stated "the board of directors will actually *direct* and monitor the management of the company, including strategic business and fundamental structural changes." Chancellor Chandler, in his opinion in the Disney Shareholder Derivative Litigation, stated, "Delaware law is clear that the business and affairs of a corporation are managed by or under the direction of its Board of Directors." The Federal Reserve website describes a board's responsibility to create and enforce prudent policies and practices with the following statement: "Directors are placed in a position of trust by the bank's shareholders, and both statutes and common law place responsibility for the affairs of a bank firmly and squarely on the board of directors. The board of directors of a bank should delegate the day-to-day routine of conducting the bank's business to its officers and employees, but the board cannot delegate its responsibility for the consequences of unsound or imprudent policies and practices."

A recent Delaware case involving Boeing is illustrative of a board's oversight responsibilities. See In re The Boeing Company Derivative Litigation, 2021 WL 4059934 (Del. Ch. Sept. 7, 2021). This decision from the Delaware Chancery Court arose from the Boeing board's conduct after two crashes of its 737 Max aircraft and serves as a cautionary tale for directors with regard to the importance of board and executive board committee level oversight and monitoring of "mission critical" product safety risks. Aircraft safety to a company such as Boeing would certainly be a mission critical area.

Governance with a Harder Edge

Governance with a harder edge merits consideration. By harder edge, we mean identifying opportunities to ensure board members are informed, involved and have skin in the game; and that the directors understand their responsibilities, are accountable to the organization—not the CEO, and bring an attitude of service and not entitlement to the position. The July 2020 ABA *Business Law Today* article "Why a Company Should Consider Using an Executive Committee of its Board of Directors" and January

2018 BLT article "Corporate Governance and Information Gaps: Importance of Internal Reporting for Board Oversight" examine the need to put in place governance structures with a harder edge, structures that ensure the voice of the General Counsel is heard. This improved governance positively impacts a firm's operations; preparations for institutional investor visitations, activist inquiries, and plaintiff firm filings (often supported by litigation funding entities); and the availability and cost of liability insurance.

The current state of the D&O insurance marketplace is what is commonly called a "hard insurance market." That means premiums for policies are at a relatively high level compared with earlier "soft market" years, and policy terms and conditions may be more restrictive. Also, and perhaps most important, insurance underwriters may look more critically at a risk's corporate governance in order to select only the more desirable risks for acceptance. Because D&O insurance is frequently the sole or primary funding source in the settlement of securities class action or shareholder derivative litigation, the board and executive management must remain attuned to D&O insurer concerns.

The harder governance edge that exists in certain general partnerships merits examination, and contrasts with corporate governance. In these general partnerships, representatives of the general partners are informed—they understand the business of the partnership; they are involved in the operation of the partnership, and they have skin in the game. They understand their responsibilities, they are accountable back to the general partner they represent and not to the managing general partner, and they bring an attitude of service.

Governance's Often Pivotal Role in Litigation

Governance issues, which encompass plaintiffs and defendants, often occupy a pivotal role in litigation. The December 2016 *BLT* article "The Interplay between Corporate Governance issues and Litigation: What is Corporate Governance and How Does It Affect Litigation" and September 2011 *BLT* article "Governance Lessons from the Disney Litigation" demonstrate the importance of stress testing an entity's governance structure as part of minimizing litigation. Actual cases, and the value of examining these cases under a business lens are explored in these articles and are commended to the reader in addition to the present article.

By: Suzanne H. Gilbert, H. Stephen Grace Jr., Joseph P. Monteleone, S. Lawrence Prendergast, October 12, 2021

Assuring Implementation & Operation of Substantive Checks & Balances

Understanding where your organization is in terms of governance structure and operation is an initial step of the highest order. One of the questions that follows is, "Given where we are, where do we want to go and how does that contrast with where today's governance focus says we have to go?"

A fundamental fact is that board, board directors and management must strive to ensure that substantive checks and balances are in place, literally throughout the organization. "Tone at the top," while still valued, is much less emphasized. Many board members and senior managers have functioned

effectively in a tone-at-the-top governance structure that depends on ethical behavior at senior leadership levels flowing throughout the organization to ensure appropriate behavior at all levels. However, history has made clear that many high-profile governance catastrophes involved organizations with a tone-at-the-top structure that either lacked checks and balances or when those checks and balances broke down. Substantive checks and balances must be the objective.

The article we authored in the February 2019 issue of ABA's *Business Law Today* looks at the Wells Fargo governance breakdown that resulted in the removal of senior officers and directors by the Board of Governors of the Federal Reserve Bank, loss of reputation for the bank, and the cloud placed over the directors' otherwise notable careers. The litigation will last for years and will follow these directors, notwithstanding their removal from the board.

Board Oversight and Governance: From Tone at the Top to Substantive Checks and Balances

In the aftermath of the widely publicized control breakdowns at Wells Fargo Bank, and in a number of regulatory actions occurring this past year, boards of directors of public companies and financial institutions have been directed to improve oversight and corporate governance. Reacting to demands from regulators and shareholders to improve board oversight and governance, it seems that boards are evolving from an approach of focusing primarily on "tone at the top" to one of instituting substantive checks and balances and considering broader aspects of ethics, values and corporate culture.

In making this shift, boards not only oversee checks and balances being put in place, but also may take on direct responsibilities regarding the design of the checks and balances, especially checks and balances related to the CEO and other members of senior management. Because a number of reported ethics problems and failures in corporate controls have involved the senior-most executives, the responsibility for addressing these risks falls to a company's board.

This article addresses the integration of board oversight and governance responsibilities along with what we believe to be the evolution from a focus on "tone at the top" to a focus on "checks and balances." We also discuss the importance of ethics and values in corporate culture within the context of board governance.

Mandating Improved Board Oversight and Governance

Responding to widespread abuses in consumer sales practices and control breakdowns that occurred at Wells Fargo Bank over a period of several years, on February 2, 2018, the U.S. Federal Reserve Board announced consent and cease and desist orders requiring improvements in the firm's governance and risk management processes, controls and board oversight. The orders included a restriction in the company's growth until sufficient improvements are made. The public announcements of both the Fed and Wells Fargo confirmed the need for improvement, stating, "Within 60 days the company's board will submit a plan to further enhance the board's effectiveness in carrying out its oversight and governance of the company." The Fed also criticized the job performance of the bank's board and CEO in a press release, stating that the Fed "has sent letters to each current Wells Fargo board member confirming that the firm's board of directors during the period of compliance breakdowns did not meet supervisory expectations. Letters were

also sent to former Chairman and Chief Executive Officer John Stumpf and past lead independent director Steven Sanger stating that their performance in those roles, in particular, did not meet the Federal Reserve's expectations."

The Fed's regulatory action expanded what many individuals and organizations have heretofore considered as a customary and general oversight responsibility to instead comprise a significant mandated obligation to institute procedures for enhanced oversight and governance. The action also required reporting on the same. This was no small step; however, the view that a fundamental responsibility of a governing board is to *govern* is not new. Retired Delaware Supreme Court Chief Justice E. Norman Veasey, in his Pennsylvania Law Review article of May 2005, stated that stockholders should have the right to expect that "the board of directors will actually direct and monitor the management of the company, including strategic business and fundamental structural changes." Further to the point that directors have management as well as oversight responsibilities, retired Delaware Chancery Court Chancellor William B. Chandler also stated in his opinion in the 2003 Disney shareowner derivative suit, "Delaware law is clear that the business and affairs of a corporation are managed by or under the direction of its Board of Directors. The business judgment rule serves to protect and promote the role of the board as the ultimate manager of the corporation." In a discussion of internal controls and director responsibilities on the Federal Reserve website, the Fed describes a board's responsibility to create and enforce prudent policies and practices with the following statement: "Directors are placed in a position of trust by the bank's shareholders, and both statutes and common law place responsibility for the affairs of a bank firmly and squarely on the board of directors. The board of directors of a bank should delegate the day-to-day routine of conducting the bank's business to its officers and employees, but the board cannot delegate its responsibility for the consequences of unsound or imprudent policies and practices."

Boards seeking to address expectations for enhanced oversight and governance face many challenges, among them a lack of definition of what constitutes "effective governance" in organizations. Economists have long recognized that the division of labor of a firm is specific to a firm at a point in time. Similarly, there is no single standard and no single metric for what constitutes effective governance—no common best practice, no "one size fits all" approach to follow. Just as the division of labor in an organization is unique to each organization and to each point in time, effective governance is necessarily both organization-specific and time-specific. Models and practices are useful sources of information to consider in designing governance and control structures, but there is no off-the-shelf, "one best way" for any organization. What is needed in an organization will inevitably change over time, sometimes unexpectedly and rapidly in response to a crisis or other change in circumstances.

The "Principles of Corporate Governance," issued by the Business Roundtable (BRT), an organization of the CEOs of America's leading companies, is one document that speaks to this reality. The following is a short excerpt from a recent update of the Principles, issued in 2016:

"In light of the evolving landscape affecting U.S. public companies, Business Roundtable has updated Principles of Corporate Governance. Although Business Roundtable believes that these principles represent current practical and effective corporate governance practices, it recognizes that wide variations exist among the businesses, relevant regulatory regimes, ownership

structures and investors of U.S. public companies. No one approach to corporate governance may be right for all companies, and Business Roundtable does not prescribe or endorse any particular option, leaving that to the considered judgment of boards, management and shareholders. Accordingly, each company should look to these principles as a guide in developing the structures, practices and processes that are appropriate in light of its needs and circumstances."

The BRT's Principles as well as other corporate governance references underscore the importance of each company's senior management and board of directors devoting time and attention to designing structures, policies and processes that will provide effective governance in their organization's unique situation. It is also important to examine and evaluate governance on an ongoing basis, especially as special events and circumstances arise. Mergers, acquisitions, takeover attempts, product failures, breakdowns in controls, lapses in ethical conduct—all these and other special conditions can arise at any time.

There is a very wide range of structures, functions, and players involved in considering a company's governance and control system, as illustrated in the following diagram developed in H.S. Grace & Company's services assisting senior management and boards of directors.

FIGURE 1

Stress-testing the Organization Governance Structure

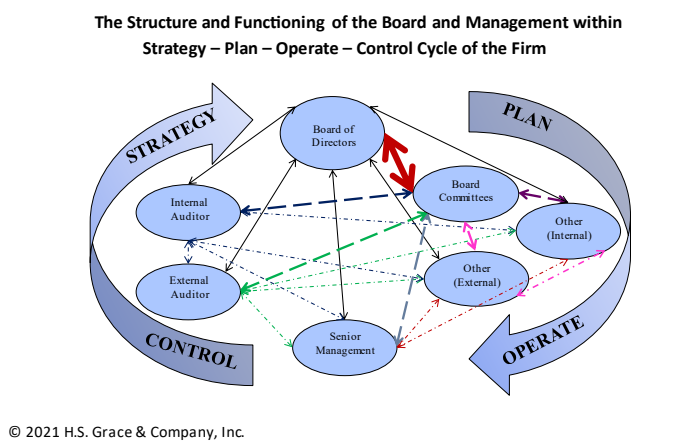


Figure 1 sets out the breadth of relationships which must be addressed by the board in formulating and activating effective corporate governance practices.[1] Once addressed, these relationships will require monitoring and updating.

Evolving from "Tone at the Top" to "Checks and Balances"

For the past several decades, corporate governance experts focused on an approach of improving the "tone at the top" out of a belief that a strong CEO setting the right tone was the best way to ensure good management practices and adequate controls throughout a company. But as failures occurred, at times involving CEOs who had ostensibly set "a right tone" in statements to employees and the general public, the limitations of such reliance became apparent. Now a distinct shift in approach is underway, focusing on a substantive set of checks and balances as essential in carrying out effective governance.

A substantive checks and balances approach addresses the roles, responsibilities, and relationships among the key elements and players in a firm's governance, controls, and oversight system. Institutional investors, individual investors, and other market and regulatory interests increasingly demand that those involved in corporate governance recognize their responsibilities and are held accountable in addressing these responsibilities. An additional emerging expectation is that senior leaders in an organization, both board and management, recognize that a leader's role is one of service rather than entitlement. Experience has shown that governing structures which consolidate power and authority into fewer and fewer hands, while conceptually attractive in terms of potential efficiency and effectiveness, often fail to meet conceptual ideals if individuals in power come to feel entitled to do as they please. Without effective oversight and a system of checks and balances, conditions are ripe for misconduct. In response to this reality, boards must not simply witness the implementation of the checks and balances, but also involve themselves in formulating the checks and balances and occupy active roles in the execution therein. Carrying out these active roles will necessarily lead to regular interaction with the CEO and others in senior management as well as with a company's internal and external auditors. While tone at the top may sometimes remain only as words that do not actually affect behavior, the institution of checks and balances can exert considerable influence.

Careful inspection of what drives or underlies the effectiveness of successful organizations would indicate that over time they have put in place highly effective policies, procedures and controls. Individuals have well-defined responsibilities; the organizations make certain that individuals understand those responsibilities, and the organizations demand strict accountability. Individuals are expected to understand the organization's mission and values and have an attitude of service. Moreover, there are well-understood consequences for falling short in discharging responsibilities, a clear measure of accountability.

Effective Governance Includes Ethics, Values, Corporate Culture

In addition to the structures, policies and processes that provide checks and balances, effective governance includes an organization's ethics, values and corporate culture. Many problems in recent years have involved CEOs and other members of senior management. Much less often have board members been involved, but some instances of failures have occurred. Ethics problems can arise at any level; however, most corporate efforts at addressing ethical issues have seemed to involve developing broad programs for the entire organization, with limited attention being paid specifically to those at the top.

There are good business reasons to consider installing ethics programs for senior leaders—programs that are based on long-standing principles and that boards implement for themselves and senior management. In such an approach, the board would create a program and a set of expectations, then continue to monitor and periodically review the program, modifying where and when appropriate. Such programs integrate oversight and governance with ethics, values and corporate culture in a way that can enhance success of an organization.

A successful organization is attractive to prospective employees who will be the source of its intellectual capital. There is increasing recognition today that a firm's most valuable asset is its intellectual capital. One need only look at the emergence and growth in value of innovative firms such as Google, Apple and WeWork to see evidence of the recognition accorded their intellectual

capital. Although difficult to measure, intellectual capital is credited with significant portions of economic productivity increases and can play a critical role in the achievement and continuation of profitability in organizations. However, beyond the issues of profitability and monetary returns that have been traditionally sought by providers of financial capital and the owners of the physical components of production, the owners of intellectual capital —the skilled individuals who are "today's professionals" — tend to seek to maximize their economic wellbeing via a *combination* of monetary and non-monetary compensation. Economic well-being is a broad concept that encompasses numerous factors affecting the overall quality of one's life, as opposed to financial well-being, which considers only monetary compensation and the accumulation of wealth. One component of non-monetary compensation of interest to many of today's professionals is a management culture based on ethics and values and respect, one that incorporates an attitude of responsibility, accountability, and service, as well as expertise and performance excellence.

The most effective managers of today's intellectual capital and today's professionals will be those who demonstrate a sense of responsibility, a willingness to be accountable, and an attitude of service. Today's professionals tend to believe that "doing well" and "doing good" are not mutually exclusive, and that a combination of the two will result in the maximization of their individual economic well-being. Boards and management leaders who understand the difference between economic well-being and financial well-being and the complementary relationship between "doing well" and "doing good" are the most likely to be successful today. In contrast, management scenarios that are structured around entitlement or privilege are unlikely to be tolerated or sustainable. Intellectual capital is highly mobile, and individuals providing capital can exercise that mobility if management is not clear in its recognition of responsibilities, accountability, and an attitude of service.

It is interesting to note the research and insights of Robert Fogel, a Nobel laureate and one of the world's leading economic historians. Fogel in his book, The Fourth Great Awakening: The Future of Egalitarianism in America (2000), discusses profound long-term trends in individual work habits. He points out that over the last 100 years there has been a considerable reduction in the time individuals spend in "earnwork" —that is, work associated with earning wages which in turn permits the acquisition of material possessions. He points out that what has increased is the time individuals spend in "volwork" —that is, personal time directed toward what he calls "non-material" and "spiritual" goods. Fogel found that individuals have consciously and deliberately made the decision to reduce the amount of "earnwork" and thus the material possessions they might otherwise acquire, and, instead have directed their time to family, community, religious, and other related activities. An important lesson for management that emerges from Fogel's analysis is that as individuals seek to maximize their personal utility and personal satisfaction, not just to maximize their financial wealth, they become more cognizant of the activities from which their economic well-being springs. They see many more options and alternatives available to enable them to achieve an increased level of economic well-being. Today's professionals look management directly in the eye. They call for management to have a comprehensive understanding of and a willingness to address responsibilities. They call upon management to be accountable, and to put in place appropriate sets of checks and balances for their own activities which will ensure accountability on the part of all the involved parties. Perhaps most importantly, they call for management to bring an attitude of service to leadership. Smart, well-trained, and

mobile, today's professionals will gravitate to working environments where management has their respect. The need for management to demonstrate an attitude of service is not surprising—one only has to recall that an attitude of service is a shared quality amongst the leaders from all walks of life who have been most widely revered and remembered.

Improving Oversight and Governance Is Timely and Good Business

In furtherance of achieving and maintaining effective oversight and governance, and in the interest of earning the respect and loyalty of workers, the time is ripe for boards to focus on the ethics of management as well as the traditional focus on the ethics of the overall organization. It is both timely and good business for boards to put in place systems of substantive checks and balances that start with the CEO, senior management, and the board itself, and then proceed through the entire organization. Improving board and organizational oversight and governance can not only lower the risk of failures and problems in the organization, but can also bring sustainable operating benefits to a company and its shareholders.

By: H. Stephen Grace, Jr., Susan Koski-Graffer, S. Lawrence Prendergast

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[1] The authors, in their January 2018 *BLT* article, "Corporate Governance and Information Gaps: Importance of Internal Reporting for Board Oversight," discuss the roles of internal reporting in corporate governance processes.

Executive Committee of the Board: A Primary Check and Balance

Board meetings occur only periodically, which can make it challenging for boards to meet their obligations to companies and organizations of all sizes. The creation of an "executive committee" can improve the flow of information that assists an organization's management and board in governing effectively.

An enhanced ability to monitor and consult can aid a company's CEO, senior management, board of directors and general counsel/chief legal officer in carrying out effective organization governance.

An article we authored on the subject in the July 2020 issue of ABA's Business Law Today follows.

Why a Company Should Consider Using an Executive Committee of its Board of Directors

In Brief

- In companies of all sizes, the fact that board meetings occur only on a periodic basis can make it challenging for boards to meet their obligations.
- The creation of an "executive committee" can improve the flow of information that assists a company's management and board in governing effectively.
- An enhanced ability to monitor and consult can aid a company's CEO, board of directors, and general counsel/chief legal officer in carrying out effective corporate governance.

The role of a public corporation's in-house general counsel/chief legal officer has always been a difficult balancing act. The general counsel must be an expert advisor to the company's CEO and board

of directors. He or she must fulfill significant legal obligations to the company's owners and creditors. An effective general counsel also must function as a knowledgeable business partner in senior management. The complex responsibilities of the position have been written about extensively in numerous professional publications and have been amplified by laws passed, regulations issued, and court cases over many years.[1]

Similar complexity is involved in the obligations of boards of directors to monitor, oversee, and direct the affairs of a public corporation—to carry out effective corporate governance. In companies of all sizes, the fact that board meetings occur only on a periodic basis can make it challenging to meet these obligations. To fulfill governance responsibilities, a board must be able to understand and address issues and developments that can arise in a company at any time.

Given that management is a continuous process and boards of directors' processes are intermittent, the creation of an "executive committee" can improve the flow of information that assists a company's management and board in governing effectively. Providing relevant and timely information is one of the important checks and balances in managing and directing the affairs of a company.

What Is a Board Executive Committee?

Public company boards of directors typically have three standing committees that are mandated by regulators and listing exchanges: an audit committee, a nominating and governance committee, and a compensation committee. The responsibilities of these standing committees are described and discussed in a company's public disclosures. Financial institutions are also mandated to have a committee to address risk.

Companies may have other committees of the board to specialize in such matters as technology; risk identification and management; safety and security; environmental issues; human capital; and other subject areas. In addition, some companies have created an executive committee to address matters that may need monitoring and attention between regularly scheduled board meetings. The roles of such executive committees can vary among companies and with changing circumstances within a company. One company describes its executive committee in its annual report as follows:

Executive Committee (3 directors) is to, as more fully specified herein, (1) monitor and review the operations of the Company and its subsidiaries (collectively, the "Group"), (2) exercise specific delegated powers of the Board, (3) review and provide recommendations on matters that would require the approval of the Board and (4) exercise such other powers and responsibilities as may be delegated to the Committee by the Board from time to time consistent with the Company's Amended and Restated Certificate of Incorporation (the "Certificate") and Amended and Restated Bylaws (the "Bylaws"), within the parameters delegated by the Board. *The Committee shall meet as and when any member of the Committee deems necessary or desirable, subject to notice (or waiver of notice) being given in accordance with the rules and procedures of the Committee.*[2]

Charters for executive committees may also describe specific limitations on committee activities. Information about a company's board committees and board committee charters can generally be obtained from annual reports, proxy statements, or upon request to a company's investor relations organization.

Three Reasons for a Company to Consider the Use of an Executive Committee

First, an executive committee can be a flexible resource to monitor a wide range of developments on a continuous basis. Without a necessity for periodic meetings requiring scheduling or travel, and with good use of technology, such a group can be nimble in staying abreast of internal and external developments affecting the business and can act *whenever such matters arise*. It can be on the lookout for issues that warrant consultation and discussion among the CEO, CFO, general counsel, and other senior management.

Second, an executive committee can serve as a sounding board for the general counsel and CEO, other members of senior management, and/or independent directors to explore emerging issues or concerns that may or may not ultimately require a presentation to the full board. Having a small, knowledgeable group with whom the CEO and general counsel can consult can facilitate preliminary evaluation of a matter and provide practical and useful advice. Such an approach enables issues to be discussed and evaluated—and possibly in some cases resolved—before they progress to a point needing to be placed upon the formal board agenda. Preliminary evaluation also facilitates definition and preparation of matters that do go forward to the full board.

Third, the effectiveness of a company's corporate governance—its system of "governing the corporation"—is heavily dependent on creating the right checks and balances and information flows. A small executive committee can institute flexible and efficient information processes that start, stop, and change easily as needed.

Executive committee access to "inside the company" sources, with an ability to inquire about matters as needed, can strengthen the checks and balances in the corporation. One cannot help but wonder if better communications and stronger information flows at early stages might have helped to avoid the widespread and highly publicized control breakdowns that occurred at Enron, Worldcom, and more recently at Wells Fargo. In these cases, massive reputational and financial damage was done to companies and individuals.

Some Caveats for Creating and Using an Executive Committee

It is important to distinguish between "monitor, discuss, and advise" versus "make decisions." In creating an executive committee, a company must not create an undesirable "two-tier" power dynamic inside the board, whereby the executive committee takes on decision-making authority that under the bylaws properly belongs with the full board. To minimize this risk, the committee should have a well-defined charter with clearly described delegations, along with its own internal set of checks and balances.

An executive committee's processes for information gathering should be relevant, timely, and efficient, as well as cognizant of the need to avoid placing unnecessary burdens on management. Reporting to the full board should similarly be efficient, using written summaries to advantage in order to avoid taking up time on routine matters in periodic board meetings.

An executive committee should be small, generally not more than three to five people, including the CEO. It should include two independent directors who have relevant experience and business knowledge, as well as a mix of desirable personal and professional attributes.

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[1] *See* E. Norman Veasey & Christine T. Di Guglielmo, Indispensable Counsel (Oxford University Press, 2012) (a comprehensive description of the responsibilities and obligations of counsel, the relevant legal environment, and numerous experiences of job incumbents).

[2] CBOE Annual Report 2019, at www.cboe.com.

Conclusion

Given the heightened expectations of boards to govern, and govern effectively, it has never been more important to ensure governance, oversight and management structures are defined and operate effectively.

The following example is an excellent illustration of what can go wrong and how a stress test in advance of issues arising could have made a real difference.

Poor Governance Leads to $35 Million Plus in Litigation Damages

The family of an individual killed in an accident involving Company X's equipment sued. Plaintiff's counsel retained H.S. Grace & Company, Inc. to evaluate the company's governance, particularly in relation to safety.

- Obtain a clear definition of the roles and responsibilities of the board, committees and executive management, and how they relate to the identified risks.
    - HSG Assessment: Company X's roles and responsibilities had no specific reference to certain business operation risks, such as safety.
- Ascertain the nature of regular and specially requested reporting by management to the board and/or applicable board committees.
    - HSG Assessment: Neither the Company X's board nor board committees received any safety information despite ongoing litigation and regulators' reports indicating concerns.
- Determine if safety, related to its internal operations and its business activities, was an identified concern, including in its strategic and operational planning.
    - HSG Assessment: Company X's business strategy was to insure the costs of accidents, in lieu of focusing strategies to help preclude accidents.
- Determine if ethics and related policies established responsibilities throughout the organization.
    - HSG Assessment: Company X's ethics and related policies were very generic, and its hotline was singularly focused on accounting and financial issues – again, despite the fact many company officers and employees were aware of safety concerns.

HSG's findings and related factors resulted in the jury returning a $35 million-plus verdict in a case that would normally settle for between $1 and $1.5 million. A preemptive stress test would have pinpointed these deficiencies, saving the organization and its insurers significant money, and potentially – and more importantly – a human life.

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