The Board's Responsibility for Corporate Culture

Selected Governance Concerns and Tools for Addressing Corporate Culture and Board Performance

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I. Boards and a Culture of Enterprise Integrity

- What shareholders need most from Boards of Directors and senior management is assurance of an organization's integrity in the broadest sense – which would include assurances regarding the organization's continuing viability; values which embrace ethical conduct, legal compliance; sensitivity towards risk, reward and the creation of sustainable value (including reporting on company sustainability values, standards and initiatives).

- Board and senior management must recognize their joint roles in assuring that the organization has, and practices, values that support a culture of integrity, fairness, trust, and high performance. A culture that values integrity and ethical behavior begins with the tone at the top. The tone at the top begins with leadership at the Board and senior management level.

- The bottom line of governance is that the ultimate authority for the governed entity is responsible for the entity's culture. In many of the United States' corporate scandals Boards "failed" because they did not take responsibility for the development and maintenance of a culture of ethical conduct and legal compliance as required by United States law. The directors in those instances apparently did not see the organizations' integrity as an extension of their own integrity – and ultimately that is a critical point.

II. United States Law and the Issue of Corporate Culture

- A Board of Directors' responsibility for overseeing the establishment and maintenance of a culture of ethical conduct and legal compliance has an antecedent in the 1987 Treadway Commission Report on Fraudulent Financial Reporting. The legal compliance element of corporate culture was given further impetus in the 1996 *Caremark* Case (*In re Caremark Intl. Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch.)). The *Caremark* standard does not require directors to become private investigators. However, to comply with the fiduciary duty of oversight, directors must, in good faith, assure that management has implemented adequate information and reporting systems and processes, monitor those systems and processes to assure they are functioning and effective, and in the event of wrongdoing, exercise reasonable business judgment to remedy any violations. It is important to underscore that the Board's role is oversight. Senior management is responsible for development, implementation and day-to-day operation.

- Corporate culture was a focus of one portion of the Revised Federal Sentencing Guidelines (U.S. Sentencing Guidelines Manual ch. 8). The Revised Guidelines provide that the governing authority of the organization "must perform its assigned duties in a manner consistent with the exercise of due diligence and the promotion of an organizational culture that encourages ethical conduct and a commitment to compliance with the law." (U.S. Sentencing Guidelines Manual § 8B2.1). Such a culture is critical to fostering good corporate citizenship.

III. Common Denominators of Many U.S. and Global Corporate Scandals/Failures

- Board composition was, and remains, an extremely important governance issue.
  - Lack of needed skill sets and experience.
  - Close relationships with company CEOs.
- Inadequate Board leadership.
  - Lack of separation of chair CEO.
  - Inexperienced or underperforming lead directors and committee chairs.
- Many directors didn't understand what it meant to be a fiduciary.
- Many directors didn't truly understand their oversight roles, nor did they understand how to balance their oversight of culture, ethics and legal compliance with their oversight of, and contributions to, strategy (which by definition includes assessment of risk and opportunity).
- Many Boards didn't thoroughly assess governance, organizational, business, financial, legal and personnel risks.
- Some Boardroom cultures were weak in that:

- Non-management directors were intimidated by or overly deferential to, management, particularly certain CEOs, uncritically reliant on the views of management and advisors, or passive.

- Dissent was discouraged.

- Some Boards did not understand/monitor the corporate culture.

  - Result was, in many cases, a culture of "me first," arrogance, greed.

  - Result was a culture where people didn't bring concerns about wrongdoing forward.

  - Management tightly controlled information; information silos developed.

  - Dissent within the management team was discouraged; conformity with the "CEO view" was demanded.

  - High performing employees were exempted from compliance with the values and policies of the organization. In many cases high performing employees were given too much authority, were able to circumvent controls, were not properly supervised or were given a "pass" for policy noncompliance or exceeding their authority because they were deemed too valuable to sanction.

- Boards failed to appreciate the signals they sent about the values and ethics of the organization, such as:

  - Who served on the Board.

  - Who was hired as CEO.

  - Who the CEO hired/promoted into senior management positions.

  - How management was compensated versus how management compensated the employee base.

  - What behaviors were rewarded. What behaviors were sanctioned (or not sanctioned).

  - There have been reports indicating that Goldman Sachs avoided some of the substantial sub-prime losses because it was hedging sub-prime risk to Goldman's capital while continuing to sell sub-prime-backed securities to customers.

- Boards and Board committees failed to appreciate and use the oversight tools at their disposal.

- Boards failed to observe good governance practices.

- Board was passive, not a proactive overseer.
- Board members didn't embrace their responsibilities; didn't exhibit commitment, judgment, leadership, courage.
- Directors were co-opted by pay, perks, relationships - i.e., not sufficiently independent or objective. Many directors were hand-picked by the CEOs and were friends, had business relationships, served on each others' Boards, etc.
- Board, committee and director evaluation was non-existent or deficient.
- Director education was not a priority.

- Committee failures.
  - Governance: regarding Board composition, director independence and director expertise; Board, committee and director evaluation; CEO and director succession.
  - Compensation: excessive CEO and senior management compensation (including bonuses, perks, benefits, and retirement and severance payments and benefits); stock option issues; poor CEO evaluation and senior management oversight.
  - Audit: financial statements (these are the company's statements, not the auditors); compliance; stock options, risk assessment and oversight, including off-balance sheet, leverage and various other risk exposure issues.

- Boards were insensitive to conflicts of interest.

- Boards failed to understand and perform their legal duties.
  - Oversight.
  - Good faith.
  - Care.
  - Loyalty.
  - Compliance.

- Boards failed to embrace Board/director education.
  - Insufficient knowledge about governance, its practices and processes.
  - Insufficient knowledge of corporate strategy.
  - Insufficient knowledge of the company and industry.

- Insufficient appreciation of business risks and corporate vulnerabilities generally, and with respect to various corporate activities specifically.

- Insufficient knowledge of their duties and their liabilities.

- Lack of appreciation for, and often resistance to, the importance of continuing education to enhance their directorship knowledge and skills.

IV. How Boards Might Improve Governance and Oversight to Address Shareholder Concerns about Boardroom Culture, Board Oversight of Corporate Culture and Board Performance

- Understand that governance is a discipline different from management. It's about the Board's proactive, vigorous oversight, examination of and contributions to strategy, being a valued resource to management in times of opportunity and crisis, etc. It's about being attuned to shareholder and other stakeholder concerns, engagement with shareholders and other stakeholders, engagement with management on company performance, and performance of its own duties to serve the best interests of the company.

- Board performance starts with Board composition. If there's dissatisfaction with Board output (performance) then Board input (composition) needs to be examined. In addition to management, a variety of voices, perspectives and skills are needed on today's Boards; *e.g.*, analyst, risk assessment, human resources, stakeholder relations, government relations, institutional investor, internal audit, regulatory, compliance, international, ethics, legal, accounting/finance and governance.

- Recognize that integrity is everything. It is the root of stakeholder and public confidence in a company. Organizational integrity starts at the top, i.e., the Board of Directors and senior management.

- Recognize the Board's critical, multifaceted role in corporate culture. In some instances the Board's role is to require change, in others it is oversight of management's stewardship and implementation of the values which comprise the culture and responsibility for putting in place and enforcing the norms, processes and procedures which form part of, and protect, company culture (which includes ethical conduct and legal compliance). Further, the Board must be mindful of, and continually strive for productive, Boardroom, Board/management and corporate cultures. As to the second, it is critical that the Board/management culture include management's bringing to the Board key issues which management is discussing and any important varying views within management as to these issues.

- Boards must strive to understand risks, pay attention to warnings and confront problems promptly and forthrightly. Policies and procedures for assessing and monitoring risks are essential, and directors must assure that they are in place and functioning well. Warnings need to be heeded and promptly investigated.

- Once again, following substantial write-downs in the financial services sector shareholders are asking where were the Boards?

- Risk is not simply a compliance-related activity; it's integral to strategy. If Boards don't have the skill sets needed to assess management's view of risk and opportunity they should seek independent, outside assistance.

- Boards must also be proactive in addressing the boundaries of management authority. It is inconceivable that any of the Boards of the financial services companies that have suffered the substantial losses during the past three years thought that they had authorized management to take the level of business risk that might place the viability of these enterprises in question or require the level of government assistance and recapitalization that has been needed to maintain enterprise viability.

- In addition to their oversight of operational risk and policies, Boards must focus on the governance and other risks related to activities for which they are directly responsible (*e.g.*, Board composition, Board organization and leadership, CEO selection, compensation, evaluation and succession, the organization's compensation philosophy, establishing management's authority for commitments not requiring Board approval, approving or disapproving matters brought to the Board by management (*e.g.,* changes in mission and fundamental business direction, strategic plans, large capital expenditures, substantial acquisitions/divestitures, capital expenditures and budgets, annual budgets and work plans, etc.)).

- Boards must take more responsibility for compensation, perks and incentives, retirement and severance pay. This subject continues to inflame shareholders, politicians and regulators.

  - Boards must be more aware of the corrosive effect on the corporate culture, particularly trust, which can result from poor compensation practices at the Board and management levels.

  - Boards must realize that excessive director and executive compensation, and a failure to align executive compensation with company performance, reflects poorly on their independence, integrity and judgment.

  - The bottom line is that Boards must assure that management establishes the compensation and incentives for any group in the context of an overall compensation philosophy for the organization which is in fact, and perception, fair, and which does not place the organization's viability at risk by incentifying inappropriate risk taking.

- Boards must carefully assess actual and perceived conflicts of interest. Like the compensation issues, unresolved or poorly resolved, conflicts of interest reflect badly on Boards' independence, integrity and judgment, can have a corrosive effect on the

corporation's culture, and can result in decisions and conduct which destroy rather than build shareholder value.

- Boards must pay more attention to the organization's human capital for it is in the workforce that the culture resides. The positive benefits of a strong corporate culture can enhance a company's value. Conversely, a weak corporate culture can damage a company's value.

- Boards should participate with management in developing and maintaining key shareholder and other stakeholder interaction policies and practices. Boards must improve shareowner and stakeholder communications, seek an understanding of shareowner and stakeholder concerns and views on a variety of corporate governance and business issues, including input into the director nomination process and company performance issues, and demonstrate a willingness to engage with shareowners, stakeholders and their representatives on these matters. Avoidance is no longer workable.

- Directors must pay close attention to their core duties: care, loyalty, good faith, compliance and oversight.

  - Care in every decision. Be informed. Use appropriate process. Directors shouldn't approve matters they don't understand. Real or perceived pressures shouldn't overshadow the duty to make an informed judgment.

  - Loyalty. The interests of the company always come first.

  - Good Faith. Directors must act in good faith. In most states in the U.S., directors may not be indemnified by the organization if their act or failure to act was not in good faith.

  - Compliance. Pay attention to the company's governing documents, policies and agreements, and the laws and regulations to which the company is subject. It is difficult to enforce a company's code of conduct and standards of legal compliance if the message of compliance doesn't start with the Board and senior management, both in terms of emphasis and conduct.

  - Oversight. A Board's job isn't to manage; it's to vigorously oversee management.

  - Position descriptions for Boards, directors, Board and committee leaders, committees, CEOs, CFOs, and other members of senior management are the first step in effective performance evaluations.

  - Rigorous performance evaluations starting with the Board are critical to obtaining high performance, and should be conducted from a "continuous improvement" perspective.

- Recommending the re-election of directors and Board leaders is a "certification" that these persons are performing their duties well.

- Boards must use the tools at their disposal to effectively execute their oversight responsibilities.

  - Encouraging the election of capable directors, known to be ethical and screened for past legal and ethical issues, knowledgeable about governance and oversight, who have the skills, time, energy, knowledge, judgment, leadership and courage to effectively discharge their responsibilities.

  - Selection of a CEO, known to be ethical and screened for past legal and ethical issues, who is experienced and committed to building a corporate culture that is ethical and compliant, and holding the CEO accountable for the development of that culture.

  - Selection of independent Board leadership with the knowledge and skills to assist the Board in meeting its responsibilities.

  - Periodic independent assessments of the company's culture, ethics, values and compliance, and the effectiveness of training programs designed to instill appropriate corporate values, familiarize employees with the company's ethics and compliance expectations and assure those expectations are met.

    - Periodic one-on-one interaction with mid-level managers to gain insight into the mainstream workforce's views as to organizational culture, ethics and compliance.

  - Insistence that management have in place processes and procedures for preventing and detecting violations of laws, regulations, company governing documents and company codes of ethical conduct, and for assessing risk and risk mitigation, followed up with oversight over, and periodic assessment of, the efficacy of those processes and procedures.

  - Oversight over the evaluation, hiring, firing and compensation of employees who are key to assessing, shaping and managing the corporation's financial reporting, human resources, risk assessment, ethical and legal compliance environment, e.g., the CFO, controller, internal auditor, risk manager, investor relations officer, internal counsel, head of information technology. Periodic one-on-one interviews with these individuals are an essential Board/committee assessment and oversight tool.

  - Independent contact with key corporate advisors, including outside counsel, independent auditors and various consultants, is also a key assessment and oversight tool.

  - Engagement of the independent auditors and compensation consultants; oversight over management's engagement of outside legal counsel and other key advisors to

assure that the loyalty of these advisors is to the company and not the personnel at the company who engaged them, and that they recognize their responsibilities to the Board and its committees and their roles in enhancing the effectiveness of the Board and its committees.

- Engagement of independent counsel and consultants to advise the Board, or Board committees, on matters with respect to which the Board requires a "second opinion" or advice from a source which is not regularly engaged to serve the company under management's direction.

- Use of tools such as business intelligence and balanced scorecard software to assist with monitoring the company's operations.

- Use of corporate and outside investigatory and research resources to scan backgrounds of key people and organizations which the company is engaging.

- Engagement with management in vigorous, candid dialog regarding strategy, opportunities, operations and the risks and rewards associated with same, and seeking candid dialog with various management personnel regarding concerns about corporate direction.

- Monitor corporate disclosures. Boards are increasingly aware of the organization's responsibility for accurate, complete disclosure to banks, creditors, insurance companies, government tax and regulatory authorities, the securities markets (in the case of publicly-held companies or organizations which issue publicly-held debt) and others who rely on or require the organization's business and financial information. Boards must be aware of the many ways in which the corporation provides information, e.g., public comments by management, management conduct, media interviews, press releases, websites, broadcast or directed email, regulatory agency filings, a multitude of forms and applications for other third parties, shareholder letters, responses to shareholder inquiries and comments, social media commentary, blogs, etc.

- Monitor external information sources and perspectives such as analyst reports, positions taken by proxy advisors, competitors' public disclosures and advertising, regulatory inquiries of the company and its competitors, litigation involving the company or its competitors, news articles, blogs, websites, chat rooms, other forms of social media commentary, etc.

- Monitor the governance views of business, shareholders, institutional investors, proxy advisors, legislators, regulators, governance commentators, and contrast those views with the corporation's governance policies and practices.

- Transparency is good; obscuring reality is bad. Transactions, schemes or practices which make it difficult for those who rely on the company's business and financial information to clearly understand that information must be questioned. Boards need to be increasingly aware that if third parties' decisions are made based on potentially

misleading omissions or information, litigation and government investigations may ensue.

- Targets are good; quarterly earnings obsessions are bad. Agreed that plans, targets and accountability are good. But not when the targets are unrealistic or the pressures or incentives to achieve them so great as to result in deliberate distortions, or the use of "cutting edge" accounting and business practices which in effect misrepresent financial results.

- Boards must be extremely conscious of the signals they send to the organizations they govern. Signals which come from their own conduct, who they nominate as directors, who they hire as the CEO, what conduct they endorse, what values they espouse directly and indirectly, how they deal with behavior which is antithetical to those values, and situations which test those values – it's about the culture of the organizations for which they are ultimately responsible.

- Boards and management should be very selective in opposing corporate reforms and governance practices advocated by responsible stakeholders. Blanket opposition to Sarbanes-Oxley or Dodd-Frank, laws which focused on improving the integrity and reliability of financial statements and the improvement of a number of aspects of corporate governance, was, for the most part, counter-productive from a shareholder, stakeholder and public relations perspective.

- Boards must focus on protecting the reputational value of their organizations. Reputations take years to build and moments to lose. For most organizations their reputations and goodwill are among their most valuable assets. Boards must be alert to individual and organizational conduct which may compromise a company's reputation for integrity and trustworthiness with its various stakeholders. As we've seen the consequences of a breach of trust can be brutal.

- Directors need to be schizophrenic. Vigilant overseers of management on the one hand, and effective, constructive collaborators with management on the other.

- Boards must embrace good governance practices. Good governance in actuality, not just in appearance. The Boards of many organizations which have been in the news were populated with individuals with excellent credentials. Often the appropriate governance documents and Board structures are in place. However, good governance is about organization, process, education and **EXECUTION**. And finally **EVALUATION** -- evaluation of management, principally the CEO, evaluation of the Board, and its committees and directors. Excellence in governance is a journey of continuous improvement, not a destination.

  See Attachment 1 for comments regarding evaluation.

V. A Concluding Thought: One Company, Many Cultures

- Organizations appropriately strive to create an enterprise-wide culture based on shared corporate values and behaviors.

- On the way to developing an enterprise-wide culture it may be useful to consider the subcultures which exist within the organization. Here are some subculture examples:

    - The Boardroom culture. Boardrooms have them, and they can have a significant impact on Board effectiveness and the enterprise-wide culture.

    - The Board/management culture. What characterizes Board/management relations? Constructive? Open? Candid?

    - Cultures of subsidiaries or divisions. For good reasons or ill, these cultures can unite or divide. The same can be said for cultures of work groups within an enterprise.

The author recognizes Ms. Amber Brown, Fredrikson & Byron, P.A. for her contributions to Section II of this paper.

Attachment 1

COMMENTS AND OBSERVATIONS CONCERNING BOARD, COMMITTEE, BOARD AND COMMITTEE LEADERSHIP, AND INDIVIDUAL DIRECTOR EVALUATIONS

I. Preconditions to Evaluation

1. Board composition:

   – Directors dedicated to progressive governance practices.

   – Implementation of a strong governance regime.

   – A CEO and senior management team dedicated to a strong governance regime and practices, and who see their roles in facilitating effective Board performance.

   – Trusted leadership capable of leading or overseeing a good evaluation process.

2. Boardroom culture which embraces continuous improvement, strong CEO evaluation and Board, Committee, Board and Committee leadership and individual director evaluation, and a commitment to use evaluations in a constructive way focused on continuous improvement at all levels.

3. Excellent, Board approved, position descriptions, governance principles, codes of conduct and ethics, Board charters, chair, lead director, CEO, committee chair and independent director position descriptions.

4. Agreed on criteria and process for evaluations. The Board should identify its objectives and choose the evaluation process and methodology as it is the Board's responsibility to establish a strong governance regime.

II. The Evaluation Process

1. Begin with the end in mind

2. Who is being evaluated?

   - For what purpose?
   - Against what criteria?

3. Who will be doing the evaluating?

   - Independent chair, lead director, governance committee, human resources department, independent evaluator?

4. What will be the process? The methodology?

5. Who will the evaluator seek input from?

   - Other directors.
   - Members of senior management? The use of a 360° evaluation (i.e., Board and management input) can be extremely valuable.

6. How will the information provided by an individual be treated?

   - Confidential? Yes.
   - Attorney/client privilege? Advisable.
   - Attribution of comments to the individuals providing the information? No. The identity of persons making specific comments must be kept confidential in order to obtain candid comments.

7. How will the evaluation be used?

   - Sanctions? Generally no.
   - Termination? Generally no.
   - Recommend against reelection? Possibly.
   - Continuous improvement? Yes, always.

8. Who are the audiences for the information?

   - Subjects of the evaluations.
   - Board meeting discussion? Yes in terms of general themes from the evaluation and specific recommendations for Board improvement.

- Compensation committee? Yes; same comments as applicable to Board meeting discussion.
- Governance committee? Yes, same comments as applicable to Board meeting discussion..
- Audit committee? Yes, same comments as applicable to Board meeting discussion..

9. After use will the information be retained or destroyed? Destroyed, unless special circumstances necessitate retention.

10. Evaluation will provide window on Board culture and window on Board-management culture.

III. Follow-through

1. Setting objectives for addressing output of evaluations? Yes.

2. Assign responsibility for follow-through? Yes.

3. Monitoring follow-through and reporting back on results of follow-through? Yes.

4. Education based on output of evaluations? Yes.

   - Directors
   - CEO
   - Senior Management. If evaluation process shows that senior management doesn't understand the directors' role and responsibilities, and senior management's role in effective Board performance, consider education sessions for senior management designed to address this subject.

5. Basis for next evaluation.

   - Monitor progress or lack thereof over time.

IV. THE ULTIMATE GOAL

1. High performing companies.

2. High performing Boards.

   - To have a high performing Board you need high performing directors. This goes back to Board composition and forward to individual director evaluation. Individual evaluation should drive who remains on the Board, not age or term limits. And the evaluation must include behavioral criteria and performance standards.

3. High performing management.

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