CORPORATE COMPLIANCE INSIGHTS

A Prescription for Corporate Governance

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In May of 2009, President Obama signed a bill which led to the establishment of the 10-person Financial Crisis Inquiry Commission, whose purpose is "to examine the causes, domestic and global, of the current financial and economic crisis in the United States." In essence, the Commission will be performing an "economic MRI" on the credit crisis, reporting its findings to the President in December of 2010.

In its search for the root causes of the Crisis, it is my hope that that the Financial Crisis Inquiry Commission will closely examine the backbone of our market economy: corporate governance. Economists may disagree on the base causes of the current crisis, but there is ample evidence that defective corporate governance practices have played a pivotal role.

It is our belief that many financial services company boards were ill-prepared for the credit crisis.

The boards of financial services companies that grew through serial acquisitions have been especially guilty of not reconstituting their boards to insure the right skill sets existed. Instead, these boards would select two to three of the longest serving board members of an acquired institution—not because these directors had any risk management or capital markets acumen commensurate with the business model of a growing financial institution, but because they could help maintain a nice geographic representation between the acquirer and the acquired.

Yes, good chemistry among directors is important, but chemistry is a moot point if the directors unwittingly approve an acquisition that is the death-knell of the company because the directors do not understand the risks imbedded in the acquisition or the implications of the acquirer's capital position and balance sheet.

To address poor corporate governance among financial services companies and address a source of our economic problems, we prescribe the following:

S.W.O.T. The Company. First and foremost, the Nominating & Governance Committee of corporate boards should identify the Strengths, Weaknesses, Opportunities, and Threats (S.W.O.T.) of the company.

This can best be accomplished with an outside facilitator surveying each director individually, and then analyzing the responses for themes and trends in the data. If there is alignment of opinion relative to the S.W.O.T. facing the company—there is a greater chance that there will be alignment between the members of the Nominating & Governance Committee (N&GC) on the type of skill sets needed on the board.

Determine the "End Game" for the Company. The companies that have stayed healthy, relatively speaking, in 2009 are those that have "begun with the end in mind," to borrow from Tom Peters.

Capital One CEO Rich Fairbanks makes no secret of the fact that his organization "maintains a relentless focus on the 'end game,'" i.e., the state of the business in three to five years. This focus on the “end game” led the Capital One Board to approve the purchase of three substantial retail banking organizations over the past five years, which allowed Capital One to move away from asset securitization as a funding source. This same focus on the “end game” led the company to quickly jettison the subprime lending businesses it inherited via its North Fork Bank acquisition—just before the window closed on such transactions in 2007.

While other companies were in denial that the mortgage business was in crisis, Capital One executives, in concert with their board, were acting with lightening speed to avoid infecting the firm’s balance sheet with the toxicity of a subprime mortgage business.

Reconfigure the Composition of the Board in light of the “End Game.” The N&GC of corporate boards needs to assess the composition of its membership against the results of its S.W.O.T. analysis, in light of the company’s strategies that will take it to its “end game” in three to five years.

To successfully do this, the board must possess an ingredient that cannot be prescribed, but must be found in the corporate organism naturally—courage. It takes a courageous board member to look beyond his or her own self interest (and board fees) and admit that a new set of skills is needed on the board if the company is to leverage its strengths, address its weaknesses, move with alacrity to seize its opportunities, and respond to its threats. It takes even greater courage for a board member to proactively resign in order to make room for a better qualified director.

Reconfiguring the composition of a board takes a strong dose of self discipline, because there is nothing in SEC rules governing public companies that forces a board to self assess and reconfigure itself in accordance with future strategies or present market conditions. It is incumbent upon the Board to undertake such an effort.

We cannot mask the economic crisis by simply prescribing treatments for its symptoms. Better corporate governance practices going forward will enable companies to stay out of the emergency room, and avoid the life support that we are paying for dearly.

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