WHY BOARD OVERSIGHT FAILS

By

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Trustees and directors of not-for-profit organizations are typically blamed for scandals at their organization on the ground that they failed in their duty of oversight over management. Boards at public companies are similarly blamed after financial disasters which destroy shareholder value. This criticism overlooks the fact that these boards usually meet only a few times a year and must rely primarily on the chief executive officer, chief financial officer and the auditors for their information. Criticism is heaped upon trustees and directors even though they may have complied with all of their legal obligations.

The public's perception of the board oversight duties is influenced by the media and tends to impose duties far exceeding the actual legal obligations of these boards. Thus, even though board members may satisfy all of their minimum legal duties, their personal and business reputations can be seriously tarnished by scandals at their organizations. Media publicity arising from the scandal in particular can be very unfair to board members of both not-for profit and public companies For example, Herbert "Pug" Winokur, a former Enron director, lost his directorship of the Harvard Corporation after the Enron bankruptcy, allegedly because of his association with Enron.

Trustees and directors of both not-for-profit organizations and public companies must therefore consider whether they wish to protect themselves and their organizations from reputational damage by taking a more proactive view of their responsibilities than what the law requires. How can boards prevent themselves from being misled by top management when they

must rely so heavily on them for information? How can a board of directors or trustees, which only meets a few times a year, really know what is going on in a large organization?

One answer is for boards to establish more robust internal controls, particularly an internal whistleblower system, which gives the independent directors direct access to employees who have important information. These internal controls would require the audit committee or other appropriate committee of the board to receive direct hotline communications from employees and establish incentives for employees to use the hotline. It also requires a "tone at the top" which features not only the CEO but also identifies to employees the chairperson of the audit committee or other important independent directors so that employees feel comfortable in communicating directly with these directors/trustees. Currently, employees at large organizations rarely know the name of the audit committee chair, let alone how to communicate with him or her.

Just having a hotline is not sufficient even though it may satisfy legal requirements for public companies. According to the 2011National Business Ethics Survey, only 6% of employees surveyed would use a hotline to report employee misconduct. Most will just report the misconduct to their immediate supervisor.

For example, according to the Lehman Bros. Bankruptcy Examiner Report, Matthew Lee, a Senior Vice President of Lehman Bros. finance division, was aware of accounting improprieties at Lehman Bros. In May 2008, he sent a letter to his superior, Martin Kelly, the Lehman Bros. controller, about the Repo 105 transactions which were used by Lehman Bros. to move assets off the balance sheet at quarter-end. According to the Report, this letter was never received by the board and Mr. Lee was laid-off a few weeks later.

Employees will not normally report misconduct directly to the board unless the culture of the organization not only permits such direct communication, but actually encourages it. Employees must not only be protected from retaliation but should be rewarded for risking their careers in order to expose misconduct. This requires that the identity of the internal whistleblower be fully protected in order to motivate the employee. One method of protecting the identity of the internal whistleblower is by permitting the employee to use his or her personal attorney to make the disclosure, with the organization paying the cost if the information is legitimate. This permits internal whistleblowers the ability to disclose bad conduct directly to the board without being concerned that they will be known as a "snitch" or their identity disclosed.

The whistleblower system must also protect the employee from retaliation, even if such retaliation is legally permissible. For example, once misconduct is reported, no action should be able to be taken by the HR department to terminate or demote the whistleblower without the consent of the independent directors. A robust whistleblower system would also permit customers and suppliers to report misconduct directly to the board. For example, if suppliers are required to pay a "kickback" to the purchasing manager, a supplier would be permitted to use the hotline directly to the board to report this misconduct.

Employee concerns about communicating with the board can only be remedied by internal controls established by the board which create a culture where employees are encouraged to communicate important information directly to the independent directors. Until that happens, we should expect to see many more disasters which are blamed on the lack of board oversight.

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