Governance Issues for Closely-held Corporations
By Dr. Richard McDaniel

To the typical challenges that all commercial enterprises face, there are a few additional ones that accrue to closely held corporations and family owned businesses. Most of these challenges derive directly from the market perception that the quality of corporate governance is compromised in the closely-held corporation. Notice our invocation of the term “market perception.” Sometimes “perceptions are reality” in the minds of investors, regulators and the pesky plaintiff’s bar.

Access to capital – either debt or equity issues – can be restricted because of the widely held belief that the directors are less likely to think independently of management and to hold management accountable to “best practice” standards. This is especially troublesome when the board IS management. The need for either outside directors OR a third party-monitored decision making process … becomes imperative to open the money spickets for debt and equity capital.

Pressing the firm’s competitive advantage in the marketplace depends on capably prosecuting a portfolio of complex, interrelated value-creation and risk-attenuation tasks. The judgemental component of these decision tasks is very demanding. Without the Board having been conferred with a superior decision making capability – it is unlikely that the firm can optimize its competitive positioning. This is a serious matter … because of an immutable central reality: revenue growth and earnings growth derive from the magnitude of the firm’s competitive advantage and its sustainability. Boards that fail to perform independently of management’s preferences and biases - rarely achieve superior decision making capability.

And, finally – the absence of outside or independent directors tends to elicit greater fiduciary liability. This factor derives from both the market perception of fallible judgement that derives from non-independent boards – and from the reality that non-independent boards are rarely able to “challenge the boss” and thereby widen the domain of alternative courses of action. A long-standing principle of complex decision making under conditions of risk and uncertainty … is that quality decision making is facilitated by driving an exhaustive search for alternative courses of action. Failure to do so … truncates the range of alternatives and elicits faulty decision making. Adversarial constituencies don’t need much of an excuse to litigate against a board for alleged violations of the duty of care or the duty of loyalty.

These issues intersect with certain beliefs widely subscribed to by business leaders in both closely-held corporations and those with significantly distributed ownership.

The Myths of Corporate Governance

Corporate governance, like every performance area, has developed a “culture” that is sometimes informed by myth as much as reality. These are some of our favorite corporate governance myths.

Myth #1: **Responsible, credentialed people can make superior fiduciary decisions without any sophisticated support tools.** It goes something like this: talented, responsible professionals will make good fiduciary decisions in the board room precisely because they are talented, responsible professionals and because they are able to make good decisions in their field.

We have long believed that we must place our most responsible people on boards. We want our most responsible people in those positions of authority and power – because we understand that the **decisions** they make will inevitably impact the lives of many, many people.

The genesis of that Myth lies in the distinction between a body of knowledge that defines a particular professional discipline and *the judgmental algorithms that are used to operate on that content information.*

Consider a comment that we have heard before – “these people are the tops in their field. You cannot find people to serve on your board who are more brilliant and more responsible than these.”

We understand – the patent lawyer may be tops in her field. The union organizer may be tops in his field. But neither of them – generally speaking – is informed about the consequences of *violating stochastic transitivity* or what it means to fail *to structure choice alternatives as a Pareto optimal efficient frontier*. These are terms with which experts in human judgment and decision making routinely deal. In the same way that you would not ask your expert union organizer to function as a patent attorney – so you don’t ask your patent attorney to function as an expert in human judgment and decision processes.

An experienced baker will tell us that the first requirement for making a pretty and tasty cake is buying the best ingredients. But you don’t get the delicious cake without combining all of those best ingredients in a particular order, using specific techniques and specialized tools and operating on the mixture in various ways at each stage. Without following the recipe – the instructions for combining the ingredients – you never get a cake – you just have a counter top of assorted ingredients – eggs, a sack of flour, a canister of sugar, a bottle of vanilla.

Consider a board room of blue-chip fiduciaries. The best ingredients. Top executives, bankers, union officials, financial executives, policy experts, engineers, experts in many content areas. This group must examine and combine all kinds of content information and then extract inferences and make decisions.

Unfortunately, however, because our exemplar Board has no specialists in human judgment and complex decision making - they do what most people do when we are faced with information overload. Behavioral scientists tell us that when even the most capable people are faced with information overload conditions – they respond by adopting *intellectual shortcuts* of different kinds. These intellectual shortcuts – which are called *judgmental heuristics* – are very useful because they empower us to make decisions when, otherwise, "paralysis-by-analysis" would often prevent our being able to do so. Accordingly, these judgmental heuristics are very adaptive. The downside, however, is that they introduce a characteristic distortion into the inferential judgment. This distortion of judgment is especially problematic when you consider that scientists have identified three or four dozen of these judgmental heuristics – and each one delivers a different kind of distortion.

Behavioral scientists, primarily experimental psychologists, have long known about the depth and breadth of human judgmental fallibility. The line of research that discovered and documented these judgmental heuristics was developed in 1971 by our colleagues Daniel Kahneman and Amos Tversky. Much of their work is embedded in our ad hoc decision audit – which is the third stage of our Smart Governance program. Dr. Kahneman was awarded the Nobel Prize in Economics for 2002 for this line of research in judgment and decision making. Unfortunately, Dr. Tversky had died a few years earlier and by the rules of the Nobel Committee was ineligible.

And, by the way, isn't it curious that people are happy to tell you about how bad their memory is. They will share long, detailed and comical stories about how bad their memory is. But you never hear anyone referring to how bad their judgment is. A person's judgment is perceived to be like their character or moral fiber. A sure-fire way to insult somebody is tell them you don't think their judgment is very good.

Myth # 2: **With some good training – our talented Directors can discharge their fiduciary duties to the company.**

To satisfactorily manage fiduciary decision making – you must implement a *refereed decision environment*. A *refereed decision environment* is one in which decision making specialists facilitate the fiduciaries' decision making process by structuring the decision tasks, monitoring the fiduciaries' judgmental activities and holding them accountable to the highest standards of decision making. And, then, by grading their performance and attesting to that performance in a written document.

A bestselling book by John Molloy published in 1988 – Dress for Success – was written for people who wanted to accurately simulate the way American executives routinely dressed in the office place. If you were finishing up your MBA or law degree and wanted to look like you would easily assimilate into Morgan Stanley or Goldman Sachs - you could read this book and carefully follow the coaching guidelines and dress like a Fortune 500 executive.

It is not true, however, that you can read a book about behavioral decision theory or decision analysis and then go apply the principles in challenging real world decision making situations.

Perhaps Jethro Bodine of the Beverly Hillbillies can explain it better than we can. Remember Jed Clampitt, Granny, Ellie Mae and Jethro from the old television series? Jethro was always trying to improve himself and get ahead in life – but he never quite understood the complexities of modern life. He frequently told his Uncle Jed that he wanted to take a correspondence course to become a brain surgeon.

Directors and officers and other fiduciaries can no more learn how to manage complex decision making processes by taking a two day seminar than Jethro Bodine can become a brain surgeon *via* a correspondence course. This is not about fiduciaries being slackards in intellectual firepower – it is about one type of decision task that is now too difficult for the brightest humans to dispatch without support from experts. **The culprit is the complex futurity decision rendered under conditions of risk and uncertainty.**

For the most part, organizations like pension funds, public companies and others have been relatively unaware that they need a *refereed decision environment*. And here's why: they are unfamiliar with the *Fundamental Fiduciary Error.* We'll get to that in a minute.

Myth #3: **The #1 criterion for being a good Director – for performing well in behalf of the shareholders and other stakeholders is – purity of intent and steadfast effort.** We all know that the performance of our fiduciaries must be the most responsible kind of behavior that we can imagine. Responsible behavior must be behavior characterized by a certain quality of intent, a certain amount or intensity of effort – but also it must be accompanied by some threshold-level capability. *Intent, effort and capability*. We know that the fulfillment of good intent requires some minimal amount of effort and that the effectiveness of that effort assumes a certain level of capability. *Intent, effort, capability*.

Consider the *Fundamental Fiduciary Error:* the failure to provide a normative control mechanism at the locus of decision making events that can measure, grade and remediate fiduciary performance – that is, the quality of those decisions.

Without such a control mechanism, there is no evaluative framework with which to discuss Director Performance or governance practices.

Consequently, there is no way to imagine progress or to contemplate improvement. "If you can't measure it, you can't manage it."

Contemporary "best of breed" governance practices provide for no metric at the locus of decision making events – which implies that there is no management of the decision making process – and we know that decisions are the predicate act of fiduciary performance. Therefore, contemporary "best of breed" governance practices provide no reliable way for Directors to regulate the quality of the Board's fiduciary performance.

So, the fiduciaries have no way of knowing when they are in danger of being sued and losing.

So, while intent and effort are necessary to drive acceptable fiduciary performance – they are not sufficient; capability is also required – and competence in one's area of expertise is not enough.

Myth #4: **Many states have passed "director protector" statutes in their attempt to limit the personal liability of directors and officers. If the corporation is domiciled in one of those states and has indemnified the directors from such liability and also makes a substantial annual investment in D&O liability insurance, it is protected, isn't it?**

Liability attenuation issues are no less important because of the passage of "director protector" statutes. These statutes limit the liability of directors only for violations of the duty of care. Violations of the director's duty of loyalty are accepted, as are self-dealing and "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."

Legal scholars have predicted that in coming years, as plaintiffs face dismissal of “care” claims on the basis of a protection statute, many plaintiffs will elect to “recharacterize their claims and tailor them to fill one of the excepted categories.” The duty of loyalty exception is a particularly likely “backdoor” for such litigation since the line between the *duty of care* and the *duty of loyalty* is not always clear. Inevitably, the same set of circumstances previously characterized as breaches of the duty of care will be framed as breaches of the duty of loyalty. Recall our suggestion that the relationship between “care” and “loyalty” derives from conceptual roots of “effort” and “intention.” We understand that, conceptually speaking, amount of effort can be perceived to be a function of intent --- in the sense that a very modest effort may raise the question of the purity of intent.

Recently (2006), as a result of several instances of litigation against the Disney board, the Delaware Supreme Court has formulated a bridge-concept anticipated in the previous paragraph – the so-called *duty of good faith*. This new, stand-alone fiduciary duty addresses the failure of vigilance in the absence of a violation of the loyalty regime. By distinguishing “good faith” from “care,” the Court has furthered narrowed the protective value of the “director protector” covenants.

By these reckonings, the “director protector” statutes will provide only limited and temporary relief. And, importantly, the *business judgment rule* cannot be invoked for loyalty violations and D&O liability insurance does not apply to the excepted categories. **Clearly, the net effect of “director protector” statutes may be a major increase in director and officer liability exposure because future complaints will be recharacterized in terms of those fiduciary breaches which are uninsurable.**

Further, a recent phenomenon reported in Business Week magazine (February 27, 2006) underscores the danger of relying on D & O liability insurance as a major risk attenuation strategy. Several of the larger institutional shareholder plaintiffs in class action securities cases have been declining to accept court-approved settlements – preferring instead to follow through with the litigation in the belief that a court-adjudicated settlement will achieve a much higher financial award. Accordingly, the traditional practice of relying on one’s D & O insurance to settle out of court and avoid a trial – has, itself, become a questionable idea.

Myth #5: **Fiduciary performance – at its core - is about compliance with laws, case law precedents, SEC directives, ERISA regulations, DOL Memoranda and other legal nostrums.** One of the significant reasons for the perseverance of the governance crisis in the boardrooms of Corporate America has been the dominance of a legalistic approach to governance regimes. It is very understandable and eminently forgivable that in the early days of corporate governance – directors and officers looked to their legal counsel for direction on matters of fiduciary compliance. And so began, quite innocently and rationally – a strategic misdirection in governance thinking that, arguably, is the root of governance deficiencies today.

Commercial organizations – whether they’re primarily custodial franchises – like pension funds or more expansive in their outreach like public corporations – are, necessarily and thoroughly – at their core – value creation operations. Their mandate is not primarily about compliance with somebody’s rules – but, instead, about methodical and reliable value creation performance for its constituencies.

Smart Governance may be thought of as a specialized value creation-risk attenuation platform. Despite that, there is merit in reviewing one aspect of the value creation platform that is typically under-addressed in our discussion of the Smart Governance program. The usual emphasis on the methodical elicitation of optimizing decisions tends to ignore one of the most important features of the value creation architecture. The teleological or purposive element is premised on the *sine qua non* of capitalism for a commercial operation - which is the achievement and maintenance of competitive advantage in its marketplace(s). **It is only by the programmatic achievement of competitive advantage that a firm can simultaneously deliver a superior value to its customers and deliver a superior return to its shareholders**. For that reason, the core purpose of the business entity is the aggregation and alignment of its resources for the express purpose of creating value that will allow its offerings to be perceived as the best (value) in the marketplace.

The first decision for fiduciaries is always – "what decisions should we make?" "Making the right decisions" is as important as "making decisions right." Without a *values foundation* – there would be no way to determine "what decisions we should make." Preferences are primitive, root realities; they derive from values that may have no logical or intellectual genesis. The **FIG Value Creation Architecture** derives its *values foundation* from the fundamental mission of the American corporation – which is to engage in activities calculated to pay shareholder return to the investors – typically some combination of *dividend pay-out* and *net share-price appreciation*.

The *values foundation* embedded in the **FIG Value Creation Architecture** assures that the right decisions will be made. Making those decisions competently is something else altogether - not only about mission preferences – but about managing the decision making process. Nevertheless, the important observation is that decisions with instrumental value must not only be sound from the management of the inferential process – but the assumptions that lead to placing a decision task on the agenda must also be managed correctly. And this begins with the adoption of the proper *values foundation*. Lest we seem to be emphasizing a miniscule point, we should note that the course of corporate governance practice has been misdirected for two centuries because of the failure to get the *values foundation* laid correctly. Consider the role of attorneys from the earliest days of corporate governance.

In the early 19th century, the corporation was not only a legal construct given birth by state jurisdictions – it was also a politically volatile construct to many Americans because of their sense of abused privilege that characterized their perception of British charters of 17th and 18th century origin. Though the American corporate form was to morph into a distinctively different creature by mid-nineteenth century – the evolutionary path was not always clear and apparently resulted in a dependence on the advice and counsel of attorneys. The clearly reasonable practice of directors and officers relying on barrister perceptions in the Antebellum Era for navigating the legal paths of commercial conduct – generalized in the late 19th century and decades following to a dependence on legal advice for demarcating the domain of fiduciary responsibility. No one would realize, until the late 20th century, that this lapse in judgment would elicit the "train wreck" of dysfunctional governance practices in post-WW II 20th century.

Return to our observation about the importance of the *values foundation* in driving the fiduciary's ability to make the right decisions. The *right decisions* are decisions about how to achieve and maintain competitive advantage in the marketplace in order to deliver super value to customers and simultaneously return a superior value to shareholders. Determination of how much authority a board has in pushing the limits of executive compensation, for example, is not one of those *right decisions* that a board should take on. The right decision must be about the pursuit of a commercial outcome with a correlated economic result – and the determination of how much must be paid to a leader who can deliver that result.

The CEO compensation question or any other issue before the board must be examined from an economic/value creation perspective rather than from a legalistic perspective. And, so – we discover the counterintuitive finding that lawyers are and have always been - part of the problem – not part of the solution. Ultimate culpability, of course, must be laid at the feet of the fiduciaries – not the attorneys - who are simply providing legal advice and doing what lawyers do. Though a legal construct – the American corporation exists primarily for an economic purpose – not a legalistic one. When fiduciary decisions are made based on matters of competitive advantage – CEOs do not get paid a few hundred million dollars as part of their separation package. That kind of result does not compute when the frame of reference – the values foundation – is about *achieving and maintaining a competitive advantage.*

Compliance with laws or norms without a pro-active mission to accomplish something … is similar to *not thinking about the end of your nose* – difficult to do and stay on task at the same time.

The fiduciary duties of directors are cast in terms of the way their decisions are made. They must be imbued with care, loyalty, independence and candor. But the decisions are not first and foremost about "coloring within the lines" or being compliant with law. The frame of reference of fiduciary decisions derives from economics and equity – creating substantive value and distributing it among the stakeholders in equitable ways.

The Sometimes Tricky Matter of *Decorum*

In forums of this type … it is customary to offer generic instruction and solutions that are free of "crass commercialism." We appreciate the principle and are interested in complying with it in this venue. Regardless, we also recognize the difficulty in getting a grip on the number and type of issues addressed in this brief paper. Accordingly, a cursory presentation of our suite of Smart Governance services … highlights important organizing principles that may empower the reader to think about these issues more constructively. Please forgive our immodesty.

FIG Product Offerings for Closely Held Corporations

Board Incubator™ Program

When a Board makes a decision to add more outside directors – two challenges are immediately apparent: 1) time and resources are required to find competent board candidates – a problem if "time is of the essence" and, 2) by what evaluative procedure can a board determine the suitability of candidate qualifications?

The FIG Board Incubator Program addresses these two issues – shortening the time requirement and vetting the candidate qualifications for board service.

By this program FIG can provide two-to-four qualified directors immediately (within thirty days). These directors will be temporary and will typically serve for one year or less – contingent upon permanent directors having been sourced, trained and placed.

Following placement of the temporary directors, FIG will conduct a search, selection and training of directors who can serve on a permanent term basis. The training conferred by FIG's Smart Governance Team will be specific to the dynamics of complex futurity decision making and the Decision Audit and Smart Governance Audit principles embedded in these FIG board services. In other words, this is not grandpa's typical board training regimen.

Smart Governance Audit™

The purpose of the **Smart Governance Audit** is to identify how a board makes its most important decisions. This task requires understanding how information (including decisions made elsewhere in the organization) flows to the management team before it is presented to the board in the form of a proposal, feasibility study or recommended course of action. And, importantly, it includes how the board interacts with management in making decisions specific to management's recommendations.

A generic *decision topography map* is developed to portray these decision-and-information flows.

The value of the **Smart Governance Audit** is its demarcation of the most significant decision process errors and sub-optimalities that characterize the board's and the organization's routine decisional performance.

By providing an informed basis for addressing systemic underperformance – the board can hold the organization accountable for upstream decisional deficits that would otherwise introduce incumbent error into the boardroom decision making process. Specific benefits include:

- The board's ability to discharge its duty of care in holding management accountable is enhanced
- The board is empowered to be adopt a healthy skepticism about claims made in any management recommendation - which is the proper supervisory attitude required to fulfill the fiduciary oversight role
- The board demonstrates its interest in and commitment to superior decision making within the corporation – an action oriented posture that serves the best interest of the shareholders

Ad hoc Decision Audit

Fiduciary Guaranty (FIG) presents a remediation methodology for boardroom decision making that elicits a threshold of fiduciary decision making performance that is difficult for aggrieved stakeholders, including dissident shareholders or politically motivated regulators, to challenge. This means that – aside from the occasional manifestation of Murphy's Law - the directors, officers and other corporate fiduciaries participating in the decision making process will never lose a fiduciary lawsuit brought against them for alleged violation of their fiduciary *duty of care*. This is achieved by establishing a *refereed decision environment* in which the decision making process is monitored and groomed in real time - inside the boardroom - by independent, third party experts.

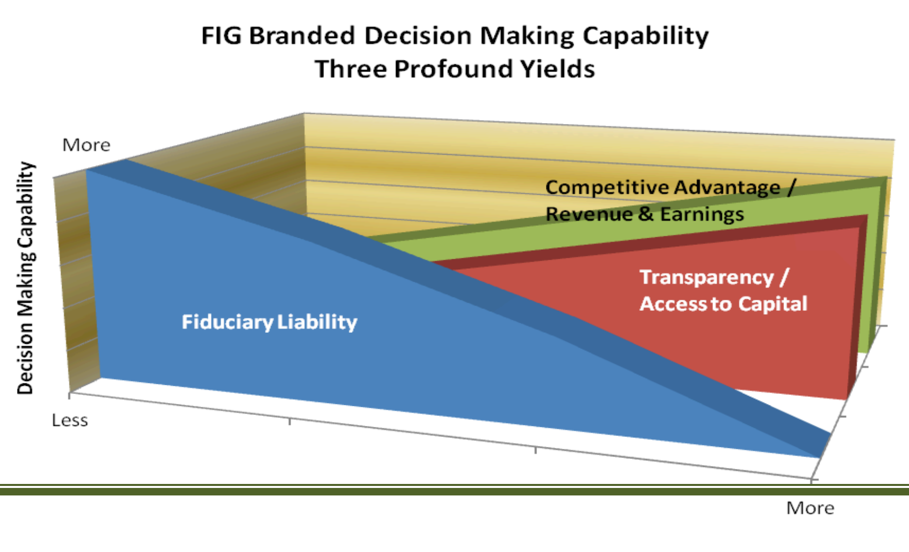
The ad hoc Decision Audit not only protects the directors from the personal liability of fiduciary risk – but also delivers superior decision making capability to the company – which optimizes the firm's ability to achieve and retain a significant competitive advantage in its marketplace(s). It is widely recognized that it is the magnitude of competitive advantage that drives the extent and duration of revenue growth and earnings growth. When company leadership makes better quality strategic and operating decisions – it will make more money as a commercial enterprise.

And, curiously, because the level of analysis conducted by the ad hoc Decision Audit is at the level of the judgemental activity that informs the decision making process, the Decision Audit can demonstrate a complete transparency to investors and other permitted stakeholders. Recall the decades-long quest by shareholders to extract greater transparency from the boards of their portfolio companies. Recall the resistance by boards to comply with a meaningful transparency standard because directors have always viewed board transparency as inimical to the interests of the company, viz., and transparency implies disclosure of competitive strategies, new product offerings, trade secrets and other information which would necessarily compromise the competitive advantage of the firm. By analyzing fiduciary performance at the level of judgements rendered – the Decision Auditors can certify that the complex decisions of the firm were made as well as humans can make them – and that certification does not have to be expressed in terms of any business content issues. By this protocol – investors can be provided evidence collected by outside third party experts that the Board is performing at the highest level – without disclosing proprietary information of any kind.

Specific benefits of the ad hoc Decision Audit include:

- Attenuation of board liability with a product performance indemnification feature that guarantees that the client board will never lose a duty of care lawsuit against a FIG decision audit refereed decision. This guarantee is backed by an insurance mechanism which pays for any court adjudicated settlement (up to a pre-defined amount) as well as attorneys' fees.
- Delivery of perfect transparency in the board's decision making tasks. This allows key investors and other targeted stakeholders to see exactly how well the board is performing without disclosure of any sensitive company information
- Delivery of superior decision making capability which will, over time, accelerate the company's competitive advantage in its market place(s). This will reliably elicit greater revenue growth and earnings growth.

The Centrality of Decision Making to Coveted Instrumental Outcomes



Decision making capability has been plotted in a Cartesian space against its impact on competitive advantage (and its progeny – revenue growth & earnings growth), board decision making transparency (and its progeny – access to capital) and fiduciary liability. We have qualified the independent variable ***decision making capability*** by attaching a ***FIG-Branded*** prefix to it for the following reason: without the application of the ***FIG ad hoc Decision Audit*** – there is no way to confirm whether a corpus of decision makers has achieved optimality in its decisional performance. It is the decision science based algorithms inherent in the Decision Audit intervention that confers this capability. Hence, without the FIG imprimatur*,* there may not be a compelling way to persuade either investors or plaintiffs that superior governance practices have been achieved.

As a matter of full disclosure, the functions plotted above represent conceptual relationships between the variables. These functions are not based on data collected in a formal empirical study[1]. Regardless, the functional relationships described are unassailable if the underlying assumptions are credible. There are three underlying assumptions: 1) if a board reliably and consistently makes better quality decisions – its competitive positioning will improve and that improvement, over time, will lead to enhanced revenue growth and earnings growth, 2) if a board can demonstrate to its investors *via* third-party-expert-testimony that its decision making performance is superior – those investors will experience greater confidence in the firm's governance practices and will be more likely to assume an investment position – debt or equity, and 3) if a board can demonstrate to any aggrieved stakeholder or to a court-of-law that it has optimized its decision making process specific to its discharge of its fiduciary duties of *care* and *loyalty* - the consequent likelihood of losing a fiduciary lawsuit will approach zero as a limit.

[1]One further observation: the design of an empirical study to demonstrate the validity of these functional relationships would require a multi-year longitudinal study with a level of access to the corporate participants that may not be possible to achieve on the scale required for making proper inferences from those data. Accordingly, working from plausible assumptions is a recommended approach.

Summary

Serious business observers understand the magnitude of contribution made to the American economy and the quality of life of millions of people - by closely-held corporations and family-owned businesses. Nested within that prolific value creation capability, for some of these companies, is a structural vulnerability that derives directly from governance practices that are perceived by governance ecosystem players (e.g., investors, regulators and other aggrieved stakeholders) as deficient and that, because of board independence issues – are – in fact, sometimes, deficient.

In collaboration with Dr. Steve Moyer and his colleagues at The Network of Family Businesses, Fiduciary Guaranty has developed a program to address those structural vulnerabilities.

THE NETWORK OF FAMILY BUSINESSES

FIDUCIARY GUARANTY CORPORATION OF AMERICA
"spearheading a revolution... in boardroom decision making"