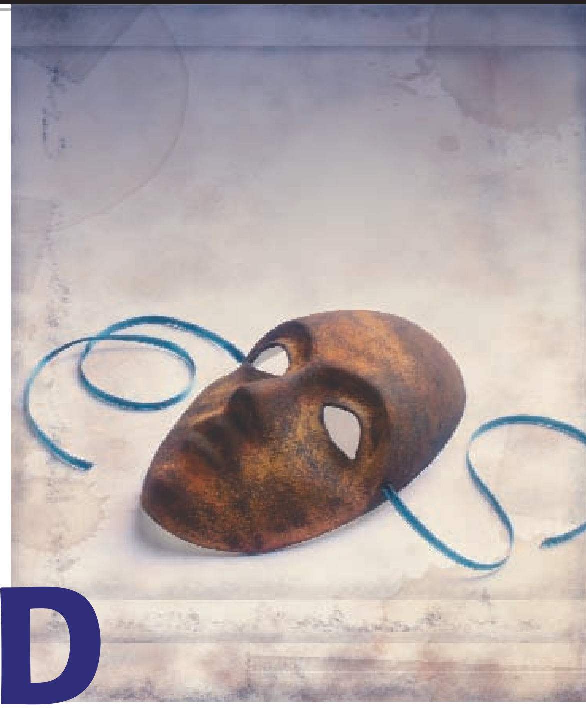
BOARDROOM

Board failure EXPOSED



- Directors, employed to analyze and mitigate risk, can actually create it
- Few board members see their company or its culture as it really is
- Company employees should not be enlisted to do the board's dirty work
- Outside lawyers are failing in their role as corporate counsel and advisers
- Companies should consider professional help for communication issues

By Erik Sherman

Few things are as gruesomely eye-catching as a major accident. Maybe that's why Hewlett-Packard's recent public train wreck has been so strangely enthralling. Or perhaps it's the eerie sense of familiarity.

Most companies don't put themselves in the headlines with espionage, resignations under fire, an incomplete 8K and criminal indictments. However, those are just flashy symptoms for HP. The decision-making and board dynamics that caused these issues may have also affected the company's ability to operate effectively, and similar problems can be found in varying degrees – just less visibly – at many firms.

Nearly everything in the case of HP – from a director going to the press about problems rather than addressing them within the board to corporate officers taking orders that had them essentially spying on their own bosses – suggests inherent weaknesses in how its board operated.

'When people believe that directors are talking outside the boardroom, particularly to the media, it causes a great deal of angst and consternation,' says Howard Steinberg, a partner at McDermott, Will & Emery who previously was general counsel of Prudential Equity Group and Prudential Securities. 'What is puzzling to a lot of people is taking that consternation and turning it into an investigation, hiring private investigators. One has to question the judgment, the wisdom and the viability of choosing to do that.'

Not only did the board expose the company to risky behavior, but it was 'certainly exacerbating whatever tensions are inside the boardroom,' Steinberg says. 'If you have a split and antagonistic board that is not able to work together to solve problems, you have to suspect that attitude will seep down to the management ranks and have some effect on the company.'

On one level, the biggest problem at HP was a lack of communication. 'The board could have chosen to close the door, discuss its problems and solve them rather than do the most cloak-and-dagger, dramatic and possibly illegal thing you can do,' explains Constance Dierickx, an organizational psychologist and senior consultant with RHR International.

Going deeper, though, what happened inside HP's board was really about the potential dangers involving organizational dynamics and group psychology. 'They operate in such a small, close-knit group that it's easy for them to succumb to dynamics and to adopt what psychologists call *group think*,' Dierickx says.

Looking for approval from their powerful and accomplished peers, individual directors can shy away from expressing minority dissent. 'Even [with only] a small minority of directors who are not functioning well, this sort of thing can happen very rapidly,' she says. In varying degrees, such problems can appear in other companies. 'The way they used tactics was rare, but the dysfunction of the board was all too common.'

A few years ago at a different company, Dierickx remembers, a board was ready to fire its CEO for allegations that he used corporate money for personal expenses such as massages. However, no one had asked the CEO if he had done this or even checked with the CFO about the allegations. The board brought in Dierickx to talk to the CEO, who said she was the first to speak of the rumor to him. The consultant discovered 'an unholy alliance' between the chair and a director, both of whom were trying to oust the chief executive.

'The real problem was not that the CEO was falsely getting reimbursed for personal expenses, but that the board was functioning very poorly as a group,' Dierickx recalls. In the end, the CEO stayed, but the chairman had to resign and the board had to work to improve its own functioning.

Compounding problematic dynamics is that board members, particularly non-executive directors, often come in for short periods of time and don't really participate in or even observe a company's overall culture. When the company's principles and actual practice are at odds, chances are that the directors won't notice.

Even if there is a well-developed ethics program, there's always some gap between that and actual practices, according to Frank Navran, practice director of ethics and leadership at LRN. 'What you see in a lot of organizations is confusion as to what standard to operate to,' he says.

When the gap that always exists between standards and actual behavior grows wide, it turns into actual business risk. In the case of HP, that risk became publicly apparent as the company has had to distance itself from any criminal action, deal with any civil liabilities it might face from those it investigated and face having possibly made itself less desirable to employees and managers either currently working there or who might have considered a position with the company.

The ethics gap

Unfortunately, boards tend to focus on such topics as strategy, economic performance and compliance, and they seldom address the standards of behavior to which they and their companies should aspire. As a result, a company can fail to address the significant risk it faces from the gap between standards and corporate culture and wind up blindsided. Navran points out that in the late 1990s, 'Enron was getting kudos for having a comprehensive, effective, well-managed and well-conceived ethics program.'

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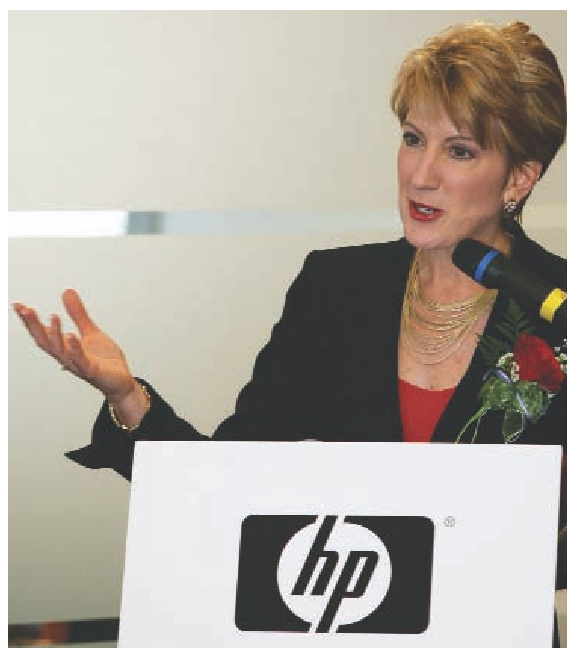
'If someone had really thought about the risks to the reputation of [HP] and to the impact of the kinds of practices it was apparently engaged in, they might have thought two or three or four times before they engaged in it,' says Rick Steinberg, founder and principal of Steinberg Governance Advisors. 'I've seen the insides of many boardrooms, and there's a tendency, especially among directors of large companies, to feel that they know exactly how to be a good director and a good



REUTERS/Kim Kyung Hoon

Carly Fiorina Leaks apparently had existed even when she had been HP's CEO board. Unfortunately, experience shows that's not always the case, especially as the environment changes.'

From one aspect, it is understandable that a board chair would feel driven to uncover any leak by a director to the press. All members of the board have a legal duty to their companies. Moreover, it is easy to see the rationale that the leaks were in the press, so therefore the board knew about it, and that these leaks had existed even when Carly Fiorina had been HP's CEO. If confronted, would a director admit to providing the information?

There's no such thing as perfect

According to Leonard Fuld, competitive intelligence expert and president of Fuld & Co, companies get into a common position where they feel that they need perfect information and perfect control. For example, a quick search of the web might have shown an historic connection between a reporter and one or more of the board members, providing enough data to draw a picture of what probably happened and provide an opportunity to address the problem early on.

'If you try to pursue perfect information, you will do a lot of stupid things, including dumpster diving and pretexting, when it's not necessary,' he says.

It only took the right set of circumstances at a well-regarded and respected company. 'If it can happen at HP, it certainly raises the question whether other companies are doing this secretly,' says Kenneth Lee, partner at Thacher Proffitt & Wood. 'The fact that they were able to hire a third party to do this and that the firm knew how to do this and was able to get all the information [suggests the investigators had done this previously].' In other words, there's little question that others had sought such services in the past.

The potential results of a board acting in a dysfunctional manner are bad enough. However, it gets worse when the board exercises its will through the rest of the company. Employees and even management will feel pressure to do whatever the board asks and might take questionable measures in the process, assuming that they are only doing what is necessary. Now the board or even management has triggered a series of events and may not learn whether any inappropriate tactics are in play.

'I [can] envision a scenario where, quite candidly, even very smart people don't at times even know what question to ask other than *Is it legal?*' says David Nosal, chairman and CEO of San Francisco-based executive search firm Nosal Partners. 'I've seen in the press [that] the people at HP, no matter what level or what role they were in, were reassured that what was being done was within the bounds. At what level do you stop asking questions? At what level do you have other legal counsel look at it? [HP CEO Mark] Hurd came into this late and [former HP chairman] Patricia [Dunn] is one of the most highly respectable people I have known over the years.'

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> *David Nosal*

If the worst happens, scandal and liability are only the most obvious costs. Potentially more serious is that management and the board might become gun-shy, cutting back on necessary activities like regular competitive intelligence and risking the impact of poorly informed decisions months or even years later.

It could happen to you

The question facing any director on any board is: 'Could it happen here?' There's a good chance that given the right conditions, the answer would be yes. Fortunately, there are a number of steps a board can take in advance. The first is to amend corporate confidentiality policies to include directors.

'I think probably half the companies out there

Mark Hurd is sworn in for a hearing held by the US House Energy and Commerce Committee investigating Hewlett-Packard

REUTERS/Kevin Lamarque

A TIMELINE TO DISASTER

- **Jan 2005:** WSJ publishes a story based that the HP board is dissatisfied with CEO Carly Fiorina
- **Feb:** Patricia Dunn announces Fiorina has been fired
- **March:** Mark Hurd hired as CEO
- **May:** HP launches leak investigation
- **Jan 2006:** HP targets phone records of reporters Dawn Kawamoto and Tom Krazit and director Thomas Perkins
- **March:** Investigations team led by Kevin Hunsaker briefs Dunn, Baskins and Hurd and identifies the source of the leak
- **May:** Perkins resigns after Dunn exposes director George Keyworth as leak source; HP notifies SEC Perkins has resigned.
- **June:** Perkins demands minutes of May meeting be changed to reflect the reason for his resignation
- **Aug:** California's attorney general commences investigation
- **Sept:** HP admits it used pretexting; California Attorney General announces pretexting broke state laws; Dunn announces resignation; Keyworth resigns; House Committee asks Dunn, Baskins, Sonsini and DeLia to testify; HP updates SEC filing; Baskins resigns as general counsel
- **Oct**: Attorney General files charges against Dunn, Hunsaker and three outside investigators

specifically mention them and half don't,' says Steinberg. 'I think you're going to see close to 100 percent now. Any thinking general counsel or CEO is going to be seeking clarity.'

A company and its investors also cannot assume that all the directors know how to participate on their particular board, so development is imperative. That includes finding the right mix of directors, working on the right processes and relationships and using an outside facilitator, if necessary, particularly during times of change. New management, an acquisition or changes in the business conditions – all of which happened simultaneously at HP – can signal a time to reevaluate the board.

When the board is in place and operating effectively, Navran suggests that directors spend some introspective time discussing the standards under which they should operate. 'They lack a common sense, if you take the phrase literally, of what our standards are and where our boundaries are,' he says.

Should problems present themselves, any investigation should start with the appropriate board committee and then include outside counsel – and make sure that the lawyers give a frank opinion. 'My own increasing view is that you're seeing a failure of lawyers to play the role of corporate counsel and adviser, that they are too caught up being an advocate or too involved with what the client was doing,' says Scott Harshbarger, former attorney general of Massachusetts and senior counsel at Proskauer Rose in Boston. 'We're periodically asked, *Can we check someone's record? Can we check their e-mail? We think they're leaking stuff*.'

Having that candid advice is important because, as the HP case shows, it doesn't take the entire board to start an inappropriate course of action.

Winning the PR war

In case the worst does happen, a company should have a crisis plan in place, including a well-thought-out communications strategy.

'A board consists of high-profile, type-A personalities, each of whom has his or her own agenda,' explains Michael Robinson, vice president of Levick Strategic Communications in Washington, DC. 'Eventually board members will do what others would do – protect themselves at all costs.'

By having a plan and sticking to it – which Robinson says may include bringing in 'a Harvey Pitt, Steve Cutler or Warren Rudman … whose personal integrity will transcend any scandal' – the board and company can avoid battling a series of independent PR campaigns from directors, speak with a unified voice and help ensure that they get press for results, not fallout.

Erik Sherman regularly covers business and technology for national and international magazines and is also a book author and playwright