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The Agency Problem of Lehman Brothers' Board of Directors

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Introduction

Lehman Brothers is often cited as an example of corporate governance failure largely due to poor oversight by the board.[1] Richard Fuld, former CEO of Lehman Brothers during its bankruptcy in 2008, still does not agree with this general evaluation. Seven years later in 2015, he gave a speech at a conference in New York.[2] Fuld spoke about Lehman's risk management, as quoted in *The Wall Street Journal*: "Regardless of what you heard about Lehman's risk management, we had 27,000 risk managers because they all had a piece of the firm."[3] The problem, however, remains that Lehman's employees owned a very small portion of the company stock, which did not solve its agency problem.

Lehman Brothers had a high-leverage, high-risk-taking business strategy supported by limited equity.[4] For instance, it took its leverage ratio up to 30 times its equity.[5] It also had a culture of aggressive growth strategy, which focused on risky and complex financial products such as subprime, derivatives and commercial real estate markets, and failed to carry out deleveraging strategy in 2007 when the commercial real estate market slowed down.[6]

Why did Lehman's board of directors not effectively oversee Lehman and leave it bankrupt? Their responsibilities are the oversight of and advisory to the company. After Lehman Brothers collapsed, many obervers have pointed out that it should not have taken excessive debts, diversified product portfolio and the board of directors should have monitored its strategy and risk management more carefully.[7] All of the root

causes of Lehman's failures can be traced back to the dysfunction of the board of directors and the agency problem.

What is the agency problem of the board of directors?

The agency problem arises in a situation where an agent (i.e. a director of a company) does not act in the best interests of a principal (i.e. a shareholder). When a principal chooses to act through others and its interest depends on others, it is subject to an agency problem. "The problem lies in motivating the agent to act in the principal's interest rather than simply in the agent's own interest."[8] The main problem is the asymmetrical information between a principal and an agent. An agent is hired in the first place largely because an agent can carry out the tasks a principal may not be able to perform due to lack of time commitment, skillsets or specific knowledge to run the business. After the agent starts working for the principal, he will likely have a greater level of information for the company, because he is the one who actually performs specific tasks on a regular basis.

The principal, on the other hand, can easily be left in the dark because she is not sure the performance that the agent carries out is exactly what is promised in their contractual relationship.

[T]he agent has an incentive to act opportunistically, skimping on the quality of his performance, or even diverting to himself some of what was promised to the principal. This means, in turn, that the value of the agent's performance to the principal will be reduced, either directly or because, to assure the quality of the agent's performance, the principal must engage in costly monitoring of the agent. The greater the complexity of the tasks undertaken by the agent, and the greater the discretion the agent must be given, the larger these 'agency costs" are likely to be.[9]

Lehman Brothers' employees' having a very small piece of the company ownership does not guarantee that they will act in the best interest of Lehman and effectively manage its risks. If Lehman were incorporated as a partnership firm such as general partnership or limited partnership where general partners put their own capital on the firm and personally assume personally unlimited liability, those partners would object to such a high risk. In other words, Lehman's taking excessive risks was a classic example of the agency problem because employees and executives acted in their own best interest, which was performance-based compensation. To avoid this problem, the

board of directors is formed. However, do directors effectively function as a safeguard for the interests of shareholders?

The board itself often creates the agency problem. A large public company such as Lehman has so many shareholders, and the composition of the shareholders constantly changes even by minute on the stock market. It is almost impossible for shareholders to directly run the company. Thus, shareholders hire third parties, directors, to minimize such agency problem between shareholders and employees including executives. Directors' roles are to monitor and incentivize management on behalf of shareholders, their principal, including oversight of the company's external audit (the audit committee), setting of the compensation scheme for executives (the compensation committee), evaluation of the company's governance structure and processes (the governance committee), nomination of new directors (the nominating committee) or making decisions on the distribution of dividends.[10]

Under corporate law, the board of directors has the "ultimate responsibility for managing the business and affairs of a corporation."[11]. In carrying out their responsibilities, directors have a fiduciary duty to act in the interest of the corporation and should exercise the duty of care and duty of loyalty. For instance, under the Delaware General Corporation law, directors may exercise their business judgment in the fulfillment of their obligations to the corporation.[12] Consequently, Delaware's case law imposes fiduciary duties on directors to ensure their duty of loyalty and care toward the company.[13] "[T]he fundamental principle of Delaware law [is] that the business and affairs of a corporation are managed by or under the direction of its board of directors. 8 *Del.C.* § 141(a). In exercising these powers, directors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders."[14]Black's Law Dictionary defines "fiduciary relationship" as: "A relationship in which one person is under a duty to act for the benefit of another on matters within the scope of the relationship. Fiduciary relationships . . . require an unusually high degree of care."[15] Once elected, directors become fiduciaries with powers to act on behalf of the shareholders and are bound by two important duties: (i) duty of care, "[d]irectors are not merely bound to be honest; they must also be diligent and careful in performing the duties they have undertaken,"[16] and (ii) duty of loyalty, "[t]he rule that requires an undivided and unselfish loyalty to the corporation demands that there be no conflict between duty and self-interest. . . . the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."[17]

However, a director may choose his own interests rather than shareholders' in conflicts of interest or if he is not fully engaged in his responsibilities. "A director is interested if he will be materially affected, either to his benefit or detriment, by a decision of the board, in a manner not shared by the corporation and the stockholders."[18] Directors own interests are more closely aligned with executives than with shareholders because executives protect their jobs. Once hired, a director maintains a closer relationship with executives, who he is supposed to monitor, than with shareholders, who elect him. It is probably because 1) the board of directors meet executives in person on a regular basis, thus developing interpersonal relationships with executives while indirectly communicating with shareholders through the company's employees, executives or indirect communication channels such as investment relations (IR) information and 2) the job security of directors in fact lies in the hands of executives. CEOs often use their own contacts or executive search firms that the company has been using to hire directors and the nominating committee comprising of directors themselves control the hiring and firing process of directors. [19] Thus, the job security of directors is actually determined by executives and directors (agents), not shareholders (principals). The agency problem is subject to arising if directors and executives continue to have authority over controlling directors.

Effective ways to mitigate the agency problem of the board of directors

In fact, several safeguards have been developed to solve the agency problem such as director stock ownership and mandatory appointment of independent directors.

Director Stock Ownership

One of the ways to reduce agency costs is to align an agent's interest with a principal's interest, because the agency problem arises due to divergent interests. For example, requiring directors to own company shares can motivate directors to work for the company's best interest, rather than directors' interest. However, because directors are monitors and advisors, not managers, tying directors' compensation with the company's financial success may compromise their ability to provide effective oversight.[20] For instance, a director may become unwilling to approve risky projects that will negatively affect the company's short-term profits but create long-term value, [21] if he prefers immediate financial gains from the company.

There is mixed evidence on this issue. Some scholar such as Mehran did not find a relationship between director stock ownership and improved company outcomes.[22] However, Cordeiro and other scholars found that there is a positive correlation between equity ownership among directors and future stock price performance.[23]

Even if there is a positive correlation, is it sufficient to eliminate the agency problem? Lehman Brothers' 27,000 employees and directors had a small piece of the company, but Lehman collapsed. It is questionable that retaining a very small piece of shares will trump a director's strong interest in job security and the reputational benefits from serving on the board.

Independent Directors

The New York Stock Exchange ("NYSE") requires that listed companies have a majority of independent directors.[24] To be independent, directors should have "no material relationship with the listed company." [25] For example, a director is not considered independent if the director or an immediate family member 1) has been employed as an executive officer at the company within the last three years, 2) "[has] received, during any twelve-month period within the last three years, more than $120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service," 3) has been employed as an internal or external auditor of the company in the last three years, 4) is an executive officer at another company where the listed company's present executives have served on the compensation committee in the last three years, or 5) is an executive officer at a company whose business with the listed company "exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenue" [26]

Unfortunately, the requirements do not stop directors from acting in their own intersts; they only "reduce" the possibility that a director makes a judgment based on his immediate personal gains such as approving and overly risky project that is directly aligned with another business he has interests in. In fact, many studies fail to find a significant correlation between board independence and improved market returns or long-term performance.[27] The NYSE also acknowledges the risks that directors do not reliably make independent judgment even though they meet the NYSE independence standards.[28]

In Lehman, 8 out of 10 directors met the independence of standards of the NYSE in 2006,[29] but they lacked the financial expertise and failed to reliably monitor Lehman. For example, the finance & risk committee met only two times a year and the compensation committee met more times (eight) than the audit committee (seven). [30] Berlind was a theatrical producer, and Evans was a career officer and rear Admiral in the United States Navy.[31] Retired CEOs' professional experience inclued Sotheby's, Vodaphone Group, IBM, Telemundo Group, which are not financial services areas.[32] Until 2006, Lehman's board included Dina Merrill, an 83-year-old actress.[33] In

addition, there were no current CEOs of major public corporations and former CEOs were well into retirement.[34] Did the board properly understand the complexity and severity of financial markets well enough to weather the storms when the financial market slowed down? Could these "independent" directors who did not have most updated financial expertise represent the shareholders' best interests? Did they exercise fully their fiduciary duty that they owe to Lehman and act in good faith in exercising their oversight responsibilities solely in the best interests of Lehman's shareholders?

It is very difficult to raise doubts when a company's financial performance has been very strong, because it is a good way to evaluate executives' capabilities of running the business whose purpose is often to maximize the profits. Fuld was the embodiment of Lehman's huge success. During Fuld's tenure, Lehman's revenues grew 600%, from $2.7 billion in 1994 to $19.2 billion in 2006.[35] A culture was created where employees were afraid to ask questions.[36] Lehman's directors failed to challenge Fuld. "[T]his [risky] strategy was fully endorsed by Lehman's board of directors."[37] In this dynamic, executives such as Fuld become a principal and the board of directors become executives' agents, not shareholders'. This reversed relationship resulted in the agency problem between Lehman's shareholders and directors.

Conclusion

The agency problem cannot be eliminated as long as there is an agent who is not the 100 percent true owner of the company. Regulators have been recognizing this problem and trying to safeguard listed companies by requiring them to comply with numerous regulations designed to promote the independence of the board of directors. However, such compliance with regulations is not sufficient to ensure that directors would act in the best interests of the company and its shareholders. Companies need to develop more effective ways to minimize agency costs and maximize the shareholders' benefits, rather than relying on compliance with federal regulations. It may be too late to fix the problem at Lehman Brothers because, the 158-year-old firm with 25,000 employees, no longer exists, but other companies should consider ways of avoiding an agency problem of their own.[38] In addition, directors should keep in mind that they are bound by the fiduciary duty to ensure that they govern the company in the best interests of the company and its shareholders, not themselves, including the duty of care and the duty of loyalty to the company.

[1] Stanford Graduate School of Business, *Lehman Brothers: Peeking under the Board Facade*, Jun 4, 2010

[2] Maureen Farrell, *Lehman's Fuld Says It Wasn't His Fault*, The Wall Street Journal, May 28, 2015

[3] *Id.*

[4] Rosalind Z. Wiggins, Thomas Piontek & Andrew Metrick, *Yale program on financial stability case study 2014-3a-v1*, Oct 1 2014

[5] Randall D. Harris, *Lehman Brothers: Crisis in Corporate Governance*, Harvard Business Review, 2012

[6] Rosalind Z. Wiggins, Thomas Piontek & Andrew Metrick, *Yale program on financial stability case study 2014-3a-v1*, Oct 1 2014

[7] *Id.*

[8] John Armour, Henry Hansmann, Reinier Kraakman, The Harvard John M. Olin Discussion Paper Series, *Agency Problems, Legal strategies and enforcement*, July, 2009

[9] *Id.*

[10] David Larcker & Brian Tayan, *Corporate Covernance Matters*, p.70-74, 2011

[11] *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989) (see also 8 *Del.C.* § 141(a))

[12] *In re Goldman Sachs Grp., Inc. S'holder Litig.*, No. CIV.A. 5215-VCG, 2011 WL 4826104, at *23 (Del. Ch. Oct. 12, 2011)

[13] *Id.*

[14] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993), *decision modified on reargument,* 636 A.2d 956 (Del. 1994)

[15] *Hawkins v. Voss*, 29 N.E.3d 1233, 1239-40 (Ill. App. Ct. 2015) (citing Black's Law Dictionary 1315 (8th ed. 2004))

[16] *Burt v. Irvine Co.*, 237 Cal. App. 2d 828, 852 (1965)

[17] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), *decision modified on reargument,* 636 A.2d 956 (Del. 1994)

[18] *Seminaris v. Landa*, 662 A.2d 1350, 1354 (Del. Ch. 1995)

[19] David Larcker & Brian Tayan, *Corporate Covernance Matters*, p.105

[20] David Larcker & Brian Tayan, *Corporate Covernance Matters*, p.114, 2011

[21] *Id.*

[22] *Id.*

[23] *Id.*, p.114-15

[24] NYSE Corporate Governance Rules, available at http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F

[25] *Id.*

[26] *Id.*

[27] David Larcker & Brian Tayan, *Corporate Covernance Matters*, p.144, 2011

[28] *Id.*, p.143

[29] Stanford Graduate School of Business, *Lehman Brothers: Peeking under the Board Facade*, Jun 4, 2010

[30] *Id.*

[31] Randall D. Harris, *Lehman Brothers: Crisis in Corporate Governance*, Harvard Business Review, 2012

[32] *Id.*

[33] Dennis K. Berman, *Where Was Lehman's Board,?* The Wall Street Journal, Sep 15, 2008

[34] Randall D. Harris, *Lehman Brothers: Crisis in Corporate Governance*, Harvard Business Review, 2012

[35] Rosalind Z. Wiggins, Thomas Piontek & Andrew Metrick, *Yale program on financial stability case study 2014-3a-v1*, Oct 1 2014

[36] William M. Klepper, *The CEO's Boss: Tough Love in the Boardroom*, p55-6

[37] Randall D. Harris, *Lehman Brothers: Crisis in Corporate Governance*, Harvard Business Review, 2012

[38] Maureen Farrell, *Lehman's Fuld Says It Wasn't His Fault*, The Wall Street Journal, May 28, 2015

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