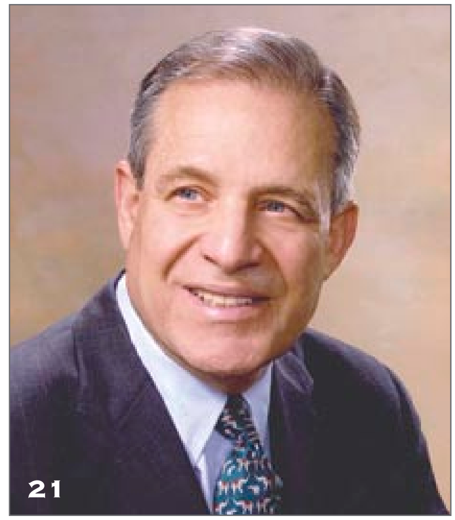
Directors & Boards

Vol. 37 No. 5 • Third Quarter 2013

CONTENTS

Continued on next page



21

28

72

COVER DESIGN: BILL COOKE

The 'toxic' director: It takes only one to derail the board

I have seen numerous examples of one director's dysfunctional behavior significantly impairing the effectiveness of a board. **By George Isaac**

One of the major benefits of having a board of directors is the ability to spread authority among many talented advisors. Drawing on that talent by design, a company's board of directors' "power" is based upon resolutions duly approved by the board as a whole, not by directives from individuals. Some board resolutions require simple majority voting, others super majority (i.e. two-thirds approval), and even others ratification by the shareholders. In all circumstances, individual directors do not have individual power and must therefore function as part of a larger organization to effect change.

As a result, a board's effectiveness depends upon group dynamics, which can be fateful if one director is toxic from various behaviors that undermine management or the board. As will be shown, an individual director's ability to successfully work within a group becomes critical to the performance of the entire board. That is not to say a director must be compliant or go along with so-called groupthink. It also doesn't mean that a director can't voice a strong minority position or concern. It does suggest, however, that positive group dynamics are essential to board effectiveness. The "soft" interpersonal and communication skills, not just technical or business expertise too often used exclusively in board candidate evaluations, should not be overlooked. We need to find ways to measure these qualities in director recruitment. Directors should be independent, respectful, and critical thinkers, but not confrontational, abusive, or petty.

Having served on 25 boards, of which 14 were corporate boards, I have observed numerous examples of one director significantly derailing the effectiveness of a board. In certain instances as discussed in the following four case studies, one director caused so much disruption that key board fiduciary duties and directives got sidelined over less relevant pet-peeve issues or biases raised by a dysfunctional director.

George Isaac has served on 14 public and private corporate boards. He is founder and president of GAI Capital Ltd., a national consulting and investment firm that provides specialized board and management consulting services through its George Isaac Consulting division to mid-market private and family-owned businesses, typically addressing issues associated with succession planning, corporate/family governance, realization of captive family business wealth, operating performance improvement, and M&A transactions (www.georgeisaac.com).

Case 1: The 'Policeman/Witch-Hunt' Director

This board represented the owners of a real estate company where an outside property management firm was engaged. The mission of the board was typical: oversee management's effectiveness and approve basic business policies, operating and capital expenditure budgets, property improvement plans, and risk assessments. The directors were functioning very effectively and working well with management. However, after two years one board member was replaced with a new director. The new director had lots of knowledge related to real estate development and management and on paper appeared to be a great addition to the board. He was hard working, energetic, and quite smart about the business. He became a strong and active director who initially won the appreciation of his fellow directors and management.

One year later, however, this director began to show several toxic traits that changed the entire dynamics of the board and its relationship with the management team. He became excessively skeptical and distrusting of management and changed from a supportive director to one primarily focused on "catching" management. In this "policeman's" role, the director became adversarial and disruptive both in and out of board meetings. He took it upon himself to initiate actions directly with management and with outside business suppliers that were not discussed or approved by the board. He constantly challenged management and regularly confused the role of director with that of management. He lost objectivity and made accusations that in the end could not be substantiated. He became a "loose cannon" and created havoc everywhere. Relationships deteriorated significantly in his interactions with his fellow directors and management.

As a result, the board became dysfunctional, one of the key directors resigned, and issues that required board attention were circumvented due to the crises this lone director was creating. Property owners became dissatisfied as they heard directly from this rogue director about various issues that either turned out not to be true or not of any significance. In essence, the basic governance process of the board was hijacked by this director's actions. In the end, this director was forced off the board. He wrote a mea culpa letter to the board, the owners, and the management company and resigned in disgrace. Unfortunately for the owners, two years were lost in addressing key issues and a significant amount of funds were expended on legal fees and other nonproductive activities forced by this director.

Case 2: The 'Founder Knows Best' Director

This fiduciary board was established by the founder and 95% owner of a financial services company. The company had a successful 30-year track record partially due to the tenacity of its founder/CEO, despite being grossly undercapitalized. As business conditions tightened and profits were declining during the Great Recession of 2008, the board directed the CEO and CFO to raise more capital to support the asset base of the firm. All outside directors voted for an equity capital raise; the founder/CEO wanted to raise more subordinated debt.

To placate the board, the CEO tried to raise equity capital but insisted upon unrealistic valuations for the stock, and not unexpectedly failed in all instances to close a transaction. He was more concerned about his personal ownership dilution than bringing in equity capital. The board was concerned about survival! In the end, equity was not raised due to the CEO ignoring the advice of his outside board and the company folded due to lack of capital when the business took another turn for the worse. This example of the "founder knows best" director who did not listen to his independent board resulted in the founder losing his company and all of the equity he had built up over 30 years.

Case 3: The 'Lackadaisical' Director

This four-member board represented a group of professional angel investors in a start-up technology company. After losing one director for personal reasons, the board dropped to three directors — two outsiders and the founder/CEO. With a hands-off approach by the two outside directors, the board was for years unofficially controlled by the founder/CEO. As one might expect, the board represented the CEO's interest, which often did not represent the investors' interests.

The 'founder knows best' director lost his company and all of the equity he had built up over 30 years.

The board finally added another director. Unfortunately, even with the new addition, the outside directors still never took initiative to challenge the strong-willed CEO, who was a great promoter but never delivered his projected results and proved to be a very poor businessman. The company continued to lose money and impair its capital base.

The three outside directors became more complacent over time. They were afraid to challenge the technically proficient CEO since there was minimal backup to replace him. In essence, the board became a rubber stamp and hostage to the CEO's thinking. As a result, the CEO became even more nonresponsive to the board. Recently, the CEO put the company into Chapter 7 bankruptcy when its financings were pulled. The ultimate irony is that the board learned about the bankruptcy after the fact and two hours prior to the CEO emailing the shareholders that the business had been shut down. The investors lost their entire investment, several customers lost prepaid service contracts, and the CEO lost most of his personal assets and damaged his reputation. Of course, lawsuits were filed. So the ultimate out-come of this tragedy is still not known. In essence, this company ran without an effective independent board and ended up a disaster for all involved.

Case 4: The 'Conflicted' Director

This board represented the shareholders of a third-generation family manufacturing business. The board was composed of several family members, most of whom worked for the company, and three outside and independent non-family directors. Initially, the board was very high-functioning and professionally run. The three outside directors helped create the formality/structure for professional board meetings. The board had annual strategy retreats with senior executives and was focused on the right issues. The business was growing by double digits in both its top and bottom lines. The management team was expanding with non-family executives, who helped drive further growth.

Directors should be critical thinkers but not confrontational.

A major problem arose when one of the outside directors lost his job and was trying to start up various business ventures. This (now "conflicted") director wanted the family business to be the major investor in his various projects. This put the CEO in the awkward position of needing to evaluate business deals proposed by one of his independent directors.

In the end, the CEO, with other board members' concurrence, rejected all of the investments in the conflicted director's proposed businesses. The CEO had to ask him not to present any more proposals for investment.

This created tension and anger with this director, who then used his position on the board and relationships with various other family members to undermine the CEO. It quickly became personal. Even though the business results continued to exceed expectations, turmoil and unrest in the boardroom eventually became noticed by the senior executives. The other two outside directors would not intervene to address the internal family issues or the conflicted director's cancerous role in the boardroom. The problematic family/board member dynamics that had been triggered by one disgruntled and conflicted director led this third generation family business to be sold in order to pacify various family stakeholders.

Early assessment is needed

Toxic directors can come from any element on the board: the CEO, founders/owners, and inside or external board members. It only takes one toxic director to impact a board's effectiveness. Each case demonstrates the failure of boards to function effectively. None of the reasons for poor board performance were due to incompetence of the board members but rather from the softer issues of how directors functioned in a group. Careful evaluation of these issues must be included in any assessment of prospective new board members. ■

The author can be contacted at gisaac@gaicapital.com and can be followed on Twitter at twitter.com/georgeisaac888.