



The importance of the board of directors. Lessons from Lehman's failure

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Abstract

Motivation: The effective functioning of the board is usually considered a key factor to minimize conflicts agency. In the literature, the composition of the board, including its size and the fraction of independent members is often pointed out as one of the most important elements determining the effectiveness of its work. The research on the effectiveness of supervision also analyze the activities of board committees, frequency of their meetings, separation of functions Chairman of the Board and CEO and the participation of women. It seems to be an interesting observation that research on the effects of the mentioned factors on the firms performance do not produce clear results. This may lead to a conclusion that one should use some qualitative methods to investigate the corporate governance procedures in the individual entity and work out their possible consequences for the analyzed institution. The case of Lehman Brothers seems to be a good choice for this kind of research as its collapse in 2008 may be found as the evidence for wrong supervision and managing mechanisms. Finding the possible causes of its bankruptcy should give then some guidelines to the proposals of improving the corporate governance systems.

Aim: The purpose of this article is to analyze the conditions under which the board the Lehman Brothers performed supervision and find the cause of irregularities in this area.

Results: The study shows that one cannot unambiguously state that all the board directors were competent, able to commit enough time for controlling and independent.

Keywords: corporate governance; Lehman Brothers; risk management; financial crisis

JEL: G21; G28; G32; G33; G38



1. Introduction

A declaration of bankruptcy by one of the largest investment banks in the United States was the result of many factors of macro- and microeconomic nature. It is difficult to identify the dominant area of negligence and irregularities that eventually led to the critical situation of the company. However, it seems that the sometimes neglected issue of organizational culture and corporate governance mechanisms played in this case a very important role, contributing significantly to the occurrence of numerous frauds and irregularities. They involved mainly decision-making processes in the field of risk management and risk supervision that were undertaken in conditions of extreme lack of transparent rules, sufficient competence and involvement of the members of the board of directors.

This paper focuses on the issues related to the functioning of the board of directors of Lehman Brothers. The composition of the board, competence of its members, the involvement in the supervisory processes, and the issue of their actual independence will be subject to a detailed analysis. The aim of this paper is to draw attention to the crucial importance of proper understanding and actual implementation of the tasks imposed on the board of directors. The author also tries to find the answer to the question about the causes of improper functioning of this key supervisory authority and to determine whether the causes involved flawed systemic principles, or rather significant weaknesses of their implementation. To resolve these issues is fundamental to develop guidelines for improving the effectiveness of corporate governance in the banking system because it will provide information about the area on which corrective actions should be focused.

The concepts and rules of operation of corporate governance, that from a formal point of view were to be implemented by the members of the board of directors, will be the starting point for the discussion. They have been adopted and approved by the board or set by external supervising institutions. The concepts and rules will be confronted with the realities in which the bank operated in the years before its collapse. This form of analysis will be useful to illustrate a clear dichotomy between the rules formally adopted, and those actually implemented in practice by the bank.

2. The world research research directions

The problem of separation of ownership and control already described by Smith (1954) in the 'Wealth of Nations' makes a board of directors the institution playing a key role in the decision-making system of modern organizations. It also seems that the board-related issues are often analyzed in corporate governance studies. In addition to research relating to the composition of the boards (the share of independent members, the participation of women, the size of the board), researchers consider the level of board activeness, usually measured by the fre-

quency of meetings, separation of functions Chairman of the Board and CEO and independence of the committees (particularly the audit committee). This latter issue is considered principally important, since the functioning of the board within the committees is considered to be conducive to greater activity and better allocation of responsibilities. It is often investigated whether and how these characteristics affect the performance of enterprises, but there is little research on their correlation with stability or probability of firm bankruptcy.

Table 1 shows the selected characteristics of the boards of directors and their impact on the results that are analyzed in the world literature. On this basis one cannot resolve the probable impact of the participation of independent members and women on the board, as well as the duality of the CEO and chairman function. However, the proportion of independent members in the audit committee seems to be verified as unambiguously positive. It can also be considered that a more active board positively affects performance. The results presented show also no contradiction when concerning the negative correlation of the size of the board and the appointment of risk committee. Nevertheless, although the quantitative results occur unambiguous with some factors (like the board size, existing of the risk committee or the audit committee independence), they seem to be not sufficient to clearly judge their impact in every entity. First of all, there are many methodological pitfalls, which could distort the results of models relating to corporate governance. Börsch-Supan and Koke (2002, pp. 295–326) point to four of these: the reverse causality, missing variables, sample selectivity, and measurement error in variables. Besides, the internal and external environment of each company is so different that the generalization of the importance of particular mechanisms can be very misleading. That is why the case study may be considered as an useful methodology in these kind of analyses.

Despite the significant roles of the boards they are considered today to be one of the weakest corporate governance mechanisms. Jensen (1993, pp. 831–880) points several reasons for this situation, emphasizing mainly slowness of reaction (especially when the dismiss of CEO is being concerned), a kind of ‘board culture’ where the politeness is more important than honesty and integrity, information and communication problems as well as legislative issues that discourage risk taking instead of motivate to action. He also mentions a number of reasons for the inefficiency of boards, such as the lack of participation of members in the company ownership, excessive size and the lack of key investors representation in the board. The existence of these phenomena, as well as frequently observed shortage of competence and commitment of board members, make them acting inefficiently, mindlessly endorsing the management decisions, thereby having a marginal impact on the situation of the supervised company.

3. The methodology of research

This article is a typical case study. As it was mentioned it is useful to analyze particular entity when corporate governance mechanisms are considered. The qualitative research may show some intricacies that are unobserved in general consolidated data. When analyzing governance system this methodology allows to investigate the objectives, assumptions, motives and actions taken by the directors, managers and other corporate stakeholders. As a detailed analysis of the person or the group of people, the case study can be used to indicate the reasons for the person/group or the company he or she managed or supervised has been successful or losing. In other words — case study allows to learn from others' mistakes and that is why the case of Lehman Brothers could be a good one to draw the conclusions.

The analysis will be based on the data regarding the board of directors of Lehman Brothers, whose collapse became a symbol of the financial crisis of 2007–2010. It can therefore be considered as a kind of natural experiment — the bankruptcy of this financial holding confirms that it was poorly supervised and poorly managed. The author will try to identify those areas of the board of directors, which could contribute to the problems.

The paper is organized as follows: there will be presented the requirements of international supervisors and/or declarations of Lehman Brothers regarding the board functioning. They will be compared with their actual implementation in the bank in period preceding its bankruptcy. On the basis of this kind of comparison one can notice how poor was the bank implementation of the recommended or declared standards. There may be even an impression that the Lehman Brothers' board was more a decorative element than the real decision-making body.

4. Board standards implementation — Lehman Brothers case study

4.1. Composition and responsibilities of the board of directors

In their report on the operations of the company the authorities of Lehman Brothers stress that the board of directors, in which ten people sat, was made up only, with the exception of Richard Fuld, of independent members (United States Securities and Exchange Commission, 2007). They formed four committees (Audit Committee, Nominating and Corporate Governance Committee, Finance and Risk Committee, and the Compensation and Benefits Committee), and one of the members of the Audit Committee was a financial expert in accordance with the requirements of the SEC.

It is worth examining the composition of the board of directors at Lehman Brothers and consider if it could make a reliable, expert, and professional as-

assessment of the company and if it could control its actions. Table 2 presents the composition of the board of directors, the functions carried out by its members, their age and experience.

While analyzing the composition of the board of directors it is worth recalling that the Basel Committee on Banking Supervision (1999, p. 23) entrusts this body with all activities related to the creation of careful lending and investment criteria, as well as the approval, implementation and periodic review of all internal policies, practices and procedures. Committee guidelines emphasize the need for proper evaluation of the actions undertaken in terms of the bank's exposure to various risks. Directors and managers are also responsible for the overall corporate governance practices, in particular for the introduction of appropriate remuneration policy and strong internal control mechanisms to minimize the risk of the bank's operations.

It is clear from the above considerations that the board of directors plays the overriding role as the most important link of corporate governance. The Basel Committee (2006, pp. 6–7) emphasizes that board members should be characterized by the necessary qualifications to carry out their functions, have full understanding of their role in shaping corporate governance and be able to make reliable assessments of the bank's operations. In the commentary to the first principle of the sound functioning of corporate governance, the Committee lists duties of the board which considerably strengthen internal supervision in the financial sector. In reference to this document, directors should understand and properly fulfill the supervisory function, avoid conflicts of interest and controversy related to their activities and commitments to other organizations, devote sufficient time and energy to fulfill their duties, possess expertise and supervise the senior management of the bank by asking them questions (...)

It is worth relating these requirements to the realities of the functioning of the board of Lehman Brothers. It consisted of ten people, of whom nine were retired, four were over 75 years of age, and only two had experience in the financial industry (Williams, 2010, p.189). Each of the directors of the bank sat on average in three other company boards, and some actively ran their own businesses.

Given the above, it cannot be concluded that the requirements of the Basel Committee were met in this case. People involved in the activities of many entities operating in very diverse industries certainly were not able to devote enough time and energy to monitor the company's operations and to expand their knowledge of the transactions undertaken by modern investment banks. Members of the board of directors of Lehman Brothers did not have appropriate knowledge in the field of securitization and complex derivative instruments, which were in the bank's portfolio, therefore, they could not reliably assess the risk undertaken by the entity they supervised. Therefore it is clear that this was not a model concept of corporate governance that was inappropriate — in this case rather the mechanisms of its implementation failed in select-

ing the composition of the board, which could not fulfill the fiduciary standard imposed on them.

It is obvious that one cannot require all directors to have detailed knowledge of the structure or the way of constructing complex derivatives. The supervision does not require comprehensive technical knowledge in the particular field of business. Director of the investment bank is not required to know how the particular asset is constructed, however, should be fully aware of the risk involved and how the variable environmental conditions may increase this risk. Directors of Lehman Brothers associated derivatives transactions mainly with double-digit growth of the company's profit, seeming not fully realize that significant involvement in derivatives trading combined with high levels of leverage and inadequate equity is burdened with a higher than average risk of loss, and in extreme cases — bankruptcy¹.

4.2. The problem of the independence of the members of the board

Referring again to the content of the annual report of Lehman Brothers and corporate governance principles for this entity contained therein, it is worth examining the question of the independence of directors, provided in the said document. The New York Stock Exchange — NYSE defines an independent director as the person standing 'outside the interests of the company' (not an interested person) as defined in Section 2 (a) (19) of the Act Investment Company Act (1940) (NYSE, 2003). This act defines in detail a person who is in 'a range of interests' — an interested person. According to the said statute, in the case of an investment company, an interested person is, for example, anyone who is an employee of the company or is the family member of one of its employees, anyone who has a relationship with an investment adviser, attorney, or insurer of the company, as well as all persons and persons related to them who in the past six months have been involved in making any transactions related to the instruments in the portfolio of the particular company and its affiliated companies².

Referring to the above principles, we should mention that the independence of directors declared by Lehman Brothers was a controversial matter. It is sufficient to consider the fact that, although since 2002 the members of the board have been forbidden to use internal investment opportunities, the funds related to the transactions concluded before the ban still flowed into the accounts of people who sat on the board. The Report of the Corporate Library, an in-

¹ This kind of approach arises, for example, from the 'Registration Document' prepared in 2007 for the purposes of providing the information disclosure on Lehman Brothers Holdings Inc. LBHI required by Directive 2003/71/EC. There are emphasized the double-digit revenue increases (several times), while the risk connected with the derivatives is not clearly highlighted (Lehman Brothers Holding, 2007).

² The notion 'interested person' comprises many people, the definition depends also on the type of business entity, in relation to which a person is to be 'independent'.

dependent rating agency evaluating standards of corporate governance, shows significant payments to members of the board of directors, payments which did not result from the remuneration granted to them (Committee on Oversight and Government Reform, 2008, p. 4). These payments are the result of the investment activity of limited partnerships established before 2002 in the form of employee companies trading in securities (employees' securities companies). These companies made it possible to invest in a full range of instruments held in the portfolio of the bank, such as trade credits, real estate, venture capital funds and other assets offered to external investors. It should be noted that the terms of the transactions for directors, employees or consultants of the bank were much more favorable than those applicable to entities outside the bank. Lehman Brothers or its subsidiaries were general partners in limited partnerships established in this way. Table 3 presents income of Lehman Brothers directors and managers resulting from the involvement in this kind of investment entities, as well as the amount of capital not yet reimbursed to individual limited partners.

The Corporate Library report stresses that in addition to the above reported profits of Lehman Brothers directors, derived from activities associated with Lehman Brothers companies, they also received a refund of contributions of capital which amounted to 96.340 USD for Roger Berlind, 81.520 USD for Scott Freidheim (CAO), 397.250 USD for Richard Fuld, 389.400 USD for Joseph Gregory, 75.000 for Henry Kaufman, 86.143 USD for Ian Lowitt (CAO), 125.674 USD for Christopher O'Meara (CFO), 409.737 USD for Thomas Russo (vice-chairman and CLO), 78.140 USD for adult children of John Akers, and 136.580 USD for adult children of John Macomber. The amounts of returned and unreturned contributions to directors illustrate the scale of their capital involvement in the business entities closely linked to the company that employed them, and the amount of profit reflects the benefits of this involvement, which certainly can be considered as a factor undermining the independence of board members.

It is worth repeating that the practice of sitting on the boards of employee companies was prohibited in 2002, which somewhat confirms its negative impact on the mechanisms of corporate governance. However, at Lehman Brothers, only three members of the supervisory board were not involved in this type of investment. In this situation, the statement taken directly from the report of the company for the year 2007; 'The Board of Directors has determined that (...)Mr. Ainslie, Mr. Akers, Mr. Berlind, Mr. Cruikshank, Ms. Evans, Sir Christopher Gent, Mr. Grundhofer, Mr. Hernandez, Dr. Kaufman and Mr. Macomber are independent and have no material relationships with the Firm' (United States Securities and Exchange Commission, 2008) can be regarded as inconsistent with reality.

There are several other elements that argue against a categorical statement that the Board of Directors of Lehman Brothers was fully independent. These issues are less important than the above investment transactions, but they are



worth paying attention to. For example, in 2007, the son of Roland Hernandez was employed by the bank as an analyst, and was to work in the summer of 2008. In addition, each of the candidates for directors, with the exception of Marsha Evans and Jerry Grundhofer, had a brokerage or investment account owned by them directly or indirectly as a person managing a family limited liability company which was involved in the business of Lehman Brothers. Moreover, Lehman Brothers obtained revenue from transactions with entities in which Christopher Gent, Roland Hernandez, John Macomber, and Marsha Evans (or members of their families) served as non-executive directors.

All the above relations provide evidence of connection between members of the board and the company in which they were to play the role of an independent body supervising the activities of the bank. One can question the relevance of these relations for the quality of supervisory processes and the company's performance. The research in this area varies with indicating the direction of impact of the independent directors and the company's performance. Nevertheless, in case of Lehman Brothers, it seems reasonable to claim that the voice of the board of directors certainly was not a model sovereign advisory voice and the oversight exercised was far from the principles formulated both by the Basel Committee and those appearing in the reports prepared by the company.

5. Conclusion

The above analysis of selected issues related to the activities of the board of directors of Lehman Brothers confirms the numerous irregularities in this area of the company's operation. The paper summarizes the model and actual supervisory practices, proving far-reaching discrepancy between the formal principles and their actual implementation. It can be seen that neither the sufficient competency, nor committing enough time for control and being independent were fulfilled within the Lehman's board members. For all problems examined by the author a conclusion can be formulated about the ineffectiveness of the functioning of the mechanisms responsible for the effective implementation of the principles of governance. It follows from this observation that the works on the improvement of the governance should focus more on improving the degree of implementation and the precise wording of the regulation than on their overall substance.

The case of Lehman Brothers is a proof of how important is the issue of sufficient competence and involvement of members of boards of directors in the governance of the banking sector entities. It also shows that many regulations are not reflected in the correctness of their implementation. The situation raises the question about the methods for removing frequent irregularities in economic reality. This issue is extremely important when considering financial institutions with a very wide range of stakeholders and generating the so-called domino effect in the case of possible mistakes in managing the company. In light

of the above arguments, particularly obvious is a high level of confidence in this type of entities which should involve an absolute requirement of appropriate competence and diligence on part of people who supervise operation of these entities. The transparency and integrity of their actions should be ensured, in addition to an effective regulatory system, by effective monitoring exercised by all interested market participants. This however can only occur when all relevant procedures and transactions, including first of all appointments and dismissals of directors, are fully transparent and open. Shareholders must be convinced that they can actually affect the structure and operation of supervisory authorities. Only then it will be possible to eliminate pathological systems of corporate governance, the supervisory function of which is to a large extent actually a fiction, dangerous for the market.

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Appendix

Table 1.
Selected board characteristics and their impact on firm performance

Variable	Impact on performance	Authors
Independence of board members	Positive	Baysinger & Butler (1985, pp. 101–124), Schellenger et al. (1989, pp. 457–467), Pearce & Zahra (1992, pp. 411–438), Dahya et al. (2005, pp. 73–100), Krivogorsky (2006, pp. 176–197)
	Negative	Zahra & Stanton (1988, pp. 229–236), Agrawal & Knoeber (1996, pp. 377–397), Yermack (1996, pp. 185–211), Bhagat & Black (2000, pp. 1–41)
	No correlation	Rechner & Dalton (1986, pp. 86–92), Chaganti et al. (1985, pp. 400–417), Dalton et al. (1998, pp. 269–290), Duchin et al. (2010, pp. 195–214)
	The impact direction depends on the already existing fraction of independent members and the existence of institutional investors	Block (1999, pp. 1–8)
Size of the board	Negative	Yermack (1996, pp. 185–211), Guest (2009, pp. 385–404)
Board activity (the frequency of meetings)	Positive	Collins & Osei (2011, pp. 83–103), Francis et al. (2012, pp. 1–58)
	Negative on Tobin's q, positive on the following-year operational profit	Vafeas (1999, pp. 113–142)
CEO duality	Positive	Pi & Timme (1993, pp. 515–530), Dahya & Travlos (2000, pp. 85–98)
	Negative	Brickley et al. (1997, pp. 1–46), Yang & Zhao (2014, pp. 534–552)
Independence of audit committee	No correlation	Baliga et al. (1996, pp. 41–53), Daily & Dalton (1997, pp. 126–136)
	Positive	Anderson et al. (2003, pp. 315–342), Chan & Li (2008, pp. 16–31), Desi (2008)
Existence of risk committee	Negative	Aebi et al. (2012, pp. 3213–3226), Zemzem & Kacem (2014, pp. 186–200)
Participation of women	Negative	Shrader et al. (1997, pp. 355–372), Darmadi (2011, pp. 524–539), Mínguez-Vera & Martín (2011, pp. 2852–2873)
	Positive	Singh et al. (2001, pp. 206–216), Nguyen & Faff (2006, pp. 24–32), Campbell & Mínguez-Vera (2008, pp. 435–451)
	Depends on the performance indicators	Post & Byron (2014, pp. 1546–1571)

Source: Own preparation.



Table 2.
Composition of the Lehman Brothers' board of directors

Position	Name	Age*	Experience
Chairman of the Board, CEO	Richard S. Fuld Jr.	62	Air Force pilot, since 1969 an employee of Lehman Brothers
Member of the Audit Committee	Michael L. Ainslie	64	A private investor and former CEO Sotheby's Holdings, a member of the boards of directors of numerous companies in the U.S.
Chairman of the Compensation and Benefits Committee, member of the Finance and Risk Committee	John F. Akers	74	Businessman, former CEO of International Business Machines Corporation, a member of the Board of directors of Pepsi, Hallmark, and other companies.
Member of the Finance and Risk Committee and the Audit Committee	Roger S. Berling	78	Theatrical producer
Chairman of Audit Committee, Member of Nominating and Corporate Governance Committee	Thomas H. Cruikshank	77	Retired CEO of Halliburton Company (an oil-field services company)
Chairwoman of the Nominating and Corporate Governance Committee, member of the Compensation and Benefits Committee and of the Finance and Risk Committee	Marsha Johnson Evans	61	Retired U.S. Navy Rear Admiral, CEO of the American Red Cross
Member of the Audit Committee and the Compensation and Benefits Committee	Sir Christopher Gent	60	British businessman, former CEO of Vodafone, Non-executive Director at GlaxoSmithKline plc
Member of the Finance and Risk Committee	Roland A. Hernandez	50	Retired CEO of Telemundo Group, member of the supervisory boards of MGM Mirage (casinos), Wal-Mart and others
Chairman of the Finance and Risk Committee	Dr. Henry Kaufman	81	Since 1998, the president of the company he founded, Henry Kaufman & Company, Inc. which specializes in financial advisory, previously director at Salomon Brothers and economist at FED
Member of the Compensation and Benefits Committee and of the Nominating and Corporate Governance Committee	John D. Maconber	80	Head of JDM Investment Group, former chairman of the Export-Import Bank of the United States and CEO at Celanese Corporation
Member of the Compensation and Benefits Committee**	Dinna Merrill	83	Actress
Member of the Board of Directors***	Jerry Grundhofer	63	Former CEO and Chairman of U.S. Bancorp

* Age given for 2008

** Occupied the position on the board until 2006

*** Appointed director at Lehman Brothers in April 2008

Source: Own preparation.



Table 3.
Involvement of directors and managers of Lehman Brothers in the business of limited partnerships investing in the instruments that were in the portfolio of the bank. As at 30 November, 2007 (in USD)

Limited Partner	Distributions of profits in fiscal year 2007	Aggregate unreturned limited partner capital
Michael L. Ainslie	*	**
Roger S. Berlind	72.670	298.609
Erin M. Callan	*	**
Thomas H. Cruikshank	*	**
Scott J. Freidheim	64.598	499.436
Richard S. Fuld, Jr.	463.460	4.521.124
Joseph M. Gregory	419.020	4.806.682
Henry Kaufman	68.250	**
Ian T. Lowitt	89.007	1.071.042
Christopher M. O'Meara	107.342	2.397.320
Thomas A. Russo	558.447	6.684.320
Adult children of John F. Akers	42.280	**
Adult children of John D. Macomber	107.390	439.489

* This amount, together with the return of contributions did not exceed 120.000 USD

** The amount did not exceed 120.000 USD

Source: Own preparation based on Lehman Brothers Holding (2008, pp. 59–60).

