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## Credit Crisis: Are Boards to Blame?

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As the difficulties and challenges from the global economic crisis continue to mount, one recurring question has been – how could things possibly have gone so wrong?

One way to try to answer this question is to look at the root causes – that is, the financial and economic conditions that produced the current circumstances. A February 19, 2009 memorandum by my friend [Faten Sabry](#) of [NERA Economic Consulting](#) and her colleague [Chudozie Okongwu](#) and entitled "How Did We Get Here?: The Story of the Credit Crisis" ([here](#)) does an excellent job explaining how "problems that first manifested in a relatively small part of the mortgage market" have "led to a contagion" that has "quickly spread to threaten the liquidity and possible solvency of many financial institutions around the world."

As alternative to looking for root economic causes is to try to determine *who*, rather than *what*, is responsible for the current mess. It is perhaps inevitable given the magnitude of the current crisis that attempts would arise to assign blame. *Time Magazine's* recently published gallery ([here](#)) of the 25 persons most responsible for the financial crisis is just one manifestation of this inevitable fault finding process.

The supposed regulatory shortcomings of the SEC are among the contributing factors cited by some commentators. Indeed, former SEC Chairman [Christopher Cox](#) is among those whose names appeared on the *Time Magazine* list.

With the SEC under scrutiny and facing questions, the incoming agency leadership faces pressure to burnish the agencies' supervisory credentials. It appears that this rehabilitative exercise may include in part the assignment of responsibility for the financial crisis, a process that apparently may target corporate boards.

According to a February 20, 2009 *Washington Post* article entitled "SEC to Examine Boards' Role in Financial Crisis" ([here](#)), one of new SEC Chairman [Mary Schapiro's](#) "first tasks" will be looking into "whether the boards of banks and other financial institutions conducted effective oversight leading up to

the financial crisis," as part of an SEC effort to "intensify scrutiny at the top levels of management."

This process, described as an "inquiry into what went wrong at the board level," will examine boards that "signed off on the risks the companies took." The *Post* article quotes observers who note that "the boards of top financial firms had characteristics that promoted risky business practices and harmed shareholders." Among the characteristics the article cites are: board members overloaded with commitments to multiple boards; failure to separate the CEO and Chairman functions; and insufficient oversight of compensation issues.

To a certain extent, the *Post* article, and perhaps even the reported SEC initiative to scrutinize boards, reflects something of a faulty premise. The article states that "with few exceptions, boards have received little media attention as the country has sought explanations for financial firms' taking on such perilous risks. Whether or not boards have received "media attention," they certainly have not escaped scrutiny, as the boards of numerous companies already have been subjected to extensive private securities class action litigation by shareholders. Were there to be an SEC initiative targeting boards, plaintiffs' attorneys' undoubtedly would be emboldened to bring even further litigation in the SEC's wake.

To be sure, the *Post* article also cites comments by other observers who question whether boards should be "held culpable for a financial crisis that just about everyone missed." One commentator observes that the "universe of people who misread the risks...is very broad" and "could extend to rating agencies, managements and regulators." (The mention of regulators' own potential culpability adds a certain ironic note here.) Regrettably, in the current environment, this observation about the broad dispersion of culpability may represent less of a statement of exculpation than a justification for enlarging the list of persons on whom blame might be cast for the present predicament.

The causes of the current situation may be myriad and the responsibilities widely dispersed. Nevertheless, for cultural reasons buried deep in the American psyche, particularized blame apparently must be assigned. The prospect of the SEC deliberately targeting financial institutions' boards unquestionably elevates directors' potential liability exposures. This heightened exposure extends not only to the boards of the high profile companies that have already failed, been bailed out or been merged out of existence. It also extends to the boards of the many other banks, insurance companies and other financial institutions, and even companies outside the financial sector, that are currently struggling.

The prospect of heightened board scrutiny inevitably leads to questions concerning the adequacy of the potentially targeted board members' D&O insurance. Now more than ever, board members will want to ensure that they have appropriate insurance structures in place to protect themselves should they attract the unwanted attention either of regulators or plaintiffs' attorneys.

**Potential Liability of Other Professionals:** Consistent with the suggestion cited above that a wide range of persons potentially culpable for misreading the risks, investors seeking to recover their massive losses are targeting numerous other "gatekeepers," in addition to the directors and offices of the troubled companies. These gatekeepers include companies' outside professionals, many of whom have been named as defendants in the subprime and credit crisis-related securities lawsuits.

On February 24, 2009 at 2:00 p.m. EST, the *Securities Docket* will be hosting a webcast on the "Liability of Professionals in the Financial Crisis." In this free webcast, [Stuart Grant](#) of [Grant & Eisenhofer](#) and [Michael Young](#) of [Wilkie Farr and Gallagher](#) will be addressing questions surrounding the potential liability of professionals such as auditors, investment bankers, rating agencies, lawyers and others.

For further information about the webcast and to register, refer [here](#).

**Did the Media Fail Their Gatekeeper Function, Too?:** Add the media to the list of gatekeepers that arguably failed in their gatekeeper responsibilities. In a February 21, 2009 interview in the *Wall Street Journal* ([here](#)), NYU Professor [Nouriel Roubini](#) observes that

in the bubble years, everyone becomes a cheerleader, including the media. This is the time when journalists should be asking tough questions, and I think there was a failure there. The Masters of the Universe were always on the cover, or the front page -- the hedge-fund guys, the imperial CEO, private equity. I wish there had been more financial and business journalists, in the good years, who'd said, 'Wait a moment, if this man, or this firm, is making a 100% return a year, how do they do it? Is it because they're smarter than everybody else . . . or because they're taking so much risk they'll be bankrupt two years down the line?'

And I think, in the bubble years, no one asked the hard questions. A good journalist has to be one who, in good times, challenges the conventional wisdom. If you don't do that, you fail in one of your duties.

There is, it seems, no shortage of blame to spread around. The question remains whether anyone in particular can or should be held directly responsible for failing to see what no one else saw – and if so, whom.

**The Week Ahead: The PLUS D&O Symposium:** This week, I will be in NYC to help co-Chair the annual [Professional Liability Underwriting Society](#) (PLUS) D&O Symposium, which will take place on Wednesday, February 25, 2009 and Thursday 26, 2009, at the Marriott Marquis hotel in Times Square. Details about the Symposium, including the agenda and registration information, can be found [here](#).

I know that many readers will be attending the Symposium, and I hope readers at the conference will make a point of greeting me, particularly if we have not previously met. I look forward to seeing everyone in New York.

Because of the Symposium and related PLUS duties and functions, *The D&O Diary* will not be appearing according to its usual schedule. Regular publication activities will resume next week.

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