DealBook The New York Times

Seeing Red Flags Where None Exist

By Michael W. Peregrine – June 14, 2012

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Recent news headlines making "red flag" references to corporate governance duties have gone a bit overboard. Every corporate controversy seems to be followed by suggestions that warnings had been posted — and ignored — in the boardroom.

Next month will be the 10th anniversary of the Sarbanes-Oxley Act. Ahead of this governance milestone, there have been numerous allegations of executive misconduct, excessive risk-taking, lax internal controls, unqualified directors and misuse of client money. In each instance, the inference is clear: if the leadership had not missed clear signals, scandals could have been averted. Though such "20/20 hindsight" has never been more prevalent, it is detrimental to ensuring that board members do their jobs.

The MF Global investigation has been a particularly rich vein for "red flag" allegations, most recently with the identification of an employee report warning about possible misuse of customer money in the week before the firm's bankruptcy. The suggestion is that corporate officers were placed "on notice" of account deficiencies. Similar characterizations have arisen in a diverse set of controversies, including sex abuse allegations at Penn State, the aborted clawback action against the Mets' owners and the expense account scandal involving a former president of the University of Texas Southwestern Medical Center. But just calling something a "red flag" doesn't automatically make it so.

Even the most casual observer will conclude that corporate controversy seems to be a growth business these days from the government's perspective. It's as if there is a race to disclose the greatest financial loss, the most significant executive indiscretion, the most alarming oversight, the most mind-numbing strategic blunder.

Certainly, some of these cases involve instances where better oversight could have minimized some of the damage. But this allegorical love affair with "red flag" references is harmful. It suggests that there is always an "Aha!" moment, when the problem was staring the board or management in the face, and was ignored. Somebody had to be asleep at the switch for this to happen, right? Well, no — not always.

We're not at the point where the law applies strict liability to simple boardroom misjudgment, but it's not for a lack of effort on the part of prosecutors. The government has increasingly been using theories like "responsible officer" and "willful blindness" to hold officers and directors personally responsible for allegations of corporate misconduct, even when there is no evidence of illegal intent or bad faith. This is consistent with the public's need to assign individual blame when financial problems come to light. In addition, prominent senators continue to press the Justice Department to be more aggressive in prosecuting criminal conduct in financial scandals.

But more often these days, what is described as a "red flag" may have hardly merited board review — even assuming the board had been made aware of it in the first place. What is being brought to the attention of senior management — clear, unambiguous and understandable warnings? Or are these warnings just conversational "toss-offs," routine reports by back-office employees or boilerplate warnings of risk managers buried in larger presentations?

The indiscriminate references to “red flags” create great potential to alter boardroom conduct, inviting over-reaction, exaggeration and needless alarm. In the end, this could result in an unnecessary waste of corporate resources and needlessly damaged reputations.

Certainly, the board has a fiduciary obligation to monitor corporate affairs. The board must keep its collective finger on the pulse of corporate operations, and to act when suspicions are aroused, or otherwise warrant attention.

It’s a duty that has been heavily scrutinized by jurists and commentators since the recession. If there has been a catastrophic corporate failure, it is fair to question the board’s level of engagement. But as outrageous as some of these controversies may have been, the courts have been remarkably consistent in establishing an extremely high burden of proof.

To breach the duty to monitor, board members need to try hard, either by failing to set up a working compliance program or by ignoring developments that would otherwise prompt an immediate duty to take action.

What would rise to the level of a significant development? The courts haven’t been too helpful — there is no “one size fits all” definition of “red flag” that should be addressed by the board. But, as the late Supreme Court Justice Potter Stewart said, you’ll know it when you see it.

There should be an indication of extraordinary circumstances or illegal activity that, on its own or together with other information of which the board is already aware, prompts the need for immediate action. Absent that kind of red flag, the law doesn’t require the board to “ferret out” corporate wrongdoing or extraordinary financial risk.

Of course, this is all subjective. That’s what makes the overuse of “red flag” analogies so dangerous. No reasonable identification of a red flag can be made outside the context of the situation at hand.

This doesn’t mean, however, that a board should just sit back and wait for a “red flag” to be waved in its face. On the contrary, a board should be proactive in monitoring by requiring general counsel participation in all board and committee meetings, confirming the effectiveness of the company’s compliance plan, assuring board access to executive and compliance officers and clarifying with management the circumstances that should be promptly brought to the board’s attention.

In hindsight, it may be easy to identify “red flags,” even though they may not have been obvious at first. But the recent indiscriminate use of the term is not only damaging to individual and corporate reputations, but also can negatively shape regulatory impressions.

A more disciplined and thoughtful approach to using this term would keep board members more accountable to their core monitoring duties, rather than distracting them on fishing expeditions.