Can the CEO Be the Board’s Chief Education Officer?

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Equifax presents a cautionary governance tale. Founded in 1899, Equifax is an Atlanta-based public company with a market capitalization of US$14 billion. It employs 9,500.

Fifteen years from now the Equifax Case will be taught to aspiring business leaders as a good example of what NOT to do in a crisis. The purpose of this article is to focus on governance lessons to be learned.

It “Hits the Fan” at Equifax.

In September 2017 Equifax revealed a cybersecurity theft of the records of 143 million people living in the United States and Canada. Thieves stole names, Social Security numbers, birth dates, addresses, and driver’s license numbers. The hackers also secured 209,000 credit card numbers and 182,000 documents containing personally identifying information.

It is estimated that hackers can sell this information for up to $30 per identity on the black market. Over the next years, those armed with this information can open bank accounts in your name, establish lines of credit, obtain new credit cards, and steal your tax refund. (Goldman, 2017).

The quality of data stolen plus the scale of the theft make this a signature threat for U.S. and Canadian consumers.

Investment advisors are telling their clients to assume their data was stolen even if Equifax reports that it was not. You can search the web for articles on actions you can take to protect yourself.

Equifax’ Response to the Data Breach.

Looking at the individual biographies of the top management one can only be impressed. These people must be very intelligent and know their business.

As a collective, however, they made decisions that I doubt any one person would have done individually:

Kept the data theft from the public for six weeks after discovery, thus giving the hackers a six-week jump on consumers.

Some of the VP level people at Equifax sold shares of their Equifax stock during the time Equifax was keeping the data breach secret. These sales will likely be judged by the courts as a violation of insider trading laws.

Initially proposed that individuals whose data was compromised by Equifax be given only one year of free credit monitoring service---in return for a promise not to sue Equifax.

Where Was the Board?

It is the nature of Board work to be hands-off with operations. The cliché in Board circles is, “Nose In Fingers Out.” In the Equifax situation, members of the Board of Directors had no direct hands-on experience with the data breach at Equifax. They probably were not totally aware of the inappropriate and illegal decisions made by management after the discovery of the data breach.

And yet they will be dragged into the legal turmoil:

It is the role of the Board of Directors to establish governance in the interests of investors. And investors have been harmed by the failure of the Board to appropriately govern Equifax.

Corporate Culture is set at the top. And the top is the Board of Directors.

There must have been something about the Equifax Board culture that made the CEO believe his decisions in response to the crisis would receive Board approval.

Director and Officer Liability Insurance (D&O) will probably cover the costs of legal fees and eventual claim settlement.

But insurance will never cover the costs of the ruined reputations of the Board members.

“It is not a good day to be on the Equifax Board,” says David Finke. He heads global technology at the executive search firm Russell Reynolds Associates. (Keitz, 2017)

It’s About Governance:

The Merriam Webster dictionary definition of governance is “to exert a determining or guiding influence.”

In other words, CEOs left unchecked may mange a company so that it focuses on providing maximum short-term benefit for the CEO’s personal wealth, while leaving the interests of long-term shareholders at a disadvantage.

Such CEO behavior should be expected:

Boards are hiring confident business leaders and not impartial philosophers.

It is the role of the Board to keep the CEO on track so that the company is being managed in the best interests of those shareholders the Board wishes to most help. Short term or long-term investors. The Board should make a clear decision:

The interests of speculators and short-term investors can be at odds with the interests of long-term investors.

The Board of Directors Nominating & Governance Committee:

Because Board members are subject to election by a vote of the shareholders, every Board of Directors has a Nominating & Governance Committee.

It is the job of this Committee to ensure that the right talent is on the Board and that the Board is educated to execute on its responsibilities.

In Equifax’ website, there is a document outlining 12 duties of the Governance Committee. Of importance to the Equifax case:

There is no specific requirement that the Governance Committee will provide Board members with the education/information required for Board members to do their jobs.

If the Nominating & Governance Committee fails to explicitly take the initiative to educate Board members, then who has that responsibility?

Nature and CEOs will fill power vacuums. In the absence of a Chief Learning Officer resource ten the CEO and the CEO’s direct reports will fill in the role.

We do not have direct access to Board members at Equifax, but the Board's own published documents suggest this was the framework.

There is an inherent conflict between making the CEO the Board's Chief Education Officer and the Board's responsibility to evaluate CEO performance.

Equifax Board of Directors: insufficiently curious.

We submit that the Equifax Board was insufficiently curious. The absence of a clear mission for the Governance Committee to ensure an educated board suggested that the Committee depended on the CEO to provide them with the education they need. And one of the things they needed was best practices in crisis management.

Another diagnostic sign of insufficient curiosity comes from the Institutional Shareholder Services (ISS).

The Institutional Shareholder Services (ISS) evaluates the quality of board of director governance so that institutional investors can assess the risk of class action shareholder law suits. ISS will also advise their clients to vote for/against specific Board members or entire Board candidate slates proposed for election.

ISS has been evaluating the quality of Boards of Directors for more than thirty years. It covers 20,000 public companies around the world.

The ISS ratings are a useful, impartial clue about the quality of governance in a public company.

For an in-depth discussion about what goes into the ISS Governance Quality Score:

https://www.issgovernance.com/solutions/iss-analytics/qualityscore/

While institutions purchase ISS services, the ISS scores are available to individuals at no charge by going to your favorite search engine and typing “yahoo finance profile (name of company).

For example, if you wish to get the ISS Score for Equifax:

https://finance.yahoo.com/quote/EFX/profile?p=EFX

Understanding ISS Scores

ISS Governance Quality Scores range from 1-10. The higher the number the higher the probability that the company will be hit with shareholder class action law suits. A high score is not good.

On September 1, 2017 the ISS overall ranking for Equifax was “5.”

Consistent with our thesis of “insufficiently curious, “5” is like a “Gentleman’s C:” it does not ring alarm bells nor is it reason to celebrate.

An insufficiently curious Board would have viewed 5 as “good enough.”

When thinking about joining the Board of a public company, investing in a public company, or being an employee at a public company, beware of ISS ratings of 5 or less. One can have a company producing excellent Return on Investment with an ISS score of 5 or less. But a 5 or higher gives a negative diagnostic signal about the corporate culture at the top.

Summary and Conclusions:

The Equifax break in of September 2017 is the financial equivalent of a Class Five Hurricane. Its impact will be felt for years. Management’s response to the disaster will educate generations of business leaders about how not to respond to a crisis.

We also suggest that there are governance lessons to be learned from the Equifax case.

All Boards of Directors have Nominating & Governance Committees. That includes profit, non-profit, public, and private.

The Governance Committee’s role is to ensure that there is the right talent on the Board and the right education of Board members. If it fails to take the lead on Board education, then it implicitly is saying the “CEO will tell us what we need to know so that we can appropriately evaluate the CEO’s performance.”

We recommend the following:

Once a year, the members of the Nominating & Governance Committee should sit down with the CEO and a third party to discuss industry, regulatory, and governance issues that will impact the company over the next twelve months. Based on that discussion, a list of twenty-four topics should be created. Someone hired by the Nominating & Governance Committee should be tasked with finding “best in class” articles, webinars, and podcasts for each topic. Board members will receive two online education briefings a month. Two articles a month respect the limitations of Board member time but it does raise the bar on excellence.

The ISS score is a diagnostic tool to understand the dynamics of the Board. Numbers range from 1-10. When you see scores in the 8-10 range, you should worry about shareholder class action lawsuits and whether the Board is powerful enough to manage the CEO. When you see numbers in the 5-6 range, you should worry that this Board is insufficiently curious.

No Board would ever describe itself as “insufficiently curious." Many Boards do describe themselves as “collegial.”

There can be a dark side to collegiality.

References:

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A. Keitz. “Equifax board faces scrutiny as probes mount following cyberattack.” News.thestreet.com/story/14299086/1/Equifax-board-faces-scrutiny. September 13, 2017

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