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BUILDING THE BONDS THAT

THE 10 LAWS

MAKE A BUSINESS GREAT

OF TRUST

INCLUDES ALL NEW ASSESSMENT TOOL!

FOREWORD BY STEPHEN M. R. COVEY

New York Times bestselling author

A PDF COMPANION TO THE AUDIOBOOK

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THE POWER OF TRUST

FIGURE 1. Trust Level by Organization

POWER	Low Trust	High Trust
NATURE	**A personal asset** *(owed to self)*	**A stewardship** *(owed to interests of those granting power)*
SOURCE	**Politics** ✓ Breaking Rules ✓ Making Credible Threats ✓ Self-Promotion ✓ Employing Series of Techniques	**Trust** ✓ Knowledge ✓ Competence ✓ Judgment ✓ Hard Work ✓ Fiduciary Behavior
PURPOSE	**To get stuff** *(money, health, intrinsic need)* *...and the tautological "getting things done"*	**To achieve common goals** *(consistent with values)*
MINDSET	"It's all about **ME**."	"It's all about the **mission**."
WHY?	Because the **world is unjust** – *> I must look out for #1.*	Because the **world is** (sometimes) **unjust** – *> I must care for those who've empowered me.*

FIGURE 2. How Leaders View Power

· APPENDIX A ·

A DIAGNOSTIC TOOL

Determining your organization's trust level is vital to increasing it. However, because of the emotional nature of trust, many people are reluctant to talk about their wariness, misgivings, and fears of betrayal.

Training leader FranklinCovey has developed a tool based on *The 10 Laws of Trust*. The diagnostic tool that follows has been tested statistically and psychometrically to give leaders a starting point for addressing their current state of organizational trust in order to build the interdependencies upon which high-trust relationships depend.

For a confidential organizational scoring of this evaluation of organizational-trust levels, go to www.10lawsoftrust.com.

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· WHAT IS THE TRUST LEVEL OF MY ORGANIZATION? ·

Ask each team member to respond to the following ten statements about the organization using a scale of 1 to 5:

1.	2.	3.	4.	5.
Strongly Disagree	Generally Disagree	Neutral	Generally Agree	Strongly Agree

· TESTING EACH LAW ·

- **Law 1: Integrity.** Leaders in my organization *consistently* align their behaviors with the principles to which they aspire.
- **Law 2: Respect.** Individuals in my organization behave respectfully *to a much greater extent* than they behave disrespectfully in their dealings with each other and with customers, suppliers, or other third parties.
- **Law 3: Empowerment.** My organization encourages me to be innovative and to take calculated risks without fearing unfair shame or punishment.
- **Law 4: Measures.** I trust the processes by which my work is evaluated.
- **Law 5: Vision.** When I think of the most important thing my organization aims to do, I feel a sense of pride.
- **Law 6: Communication.** In my organization I usually have the information I need to do my job—and

when I don't, I know I can get it without being dismissed or patronized.

- **Law 7: Conflict.** I can point to instances where the *best* ideas won—even though they weren't popular or endorsed by my organization's loudest or most prominent leaders.
- **Law 8: Humility.** My organization's leaders care more about doing what is right for its people, clients, and mission than they care about their own power and status.
- **Law 9: Negotiations.** Negotiations at my organization—whether between colleagues or with third parties—*rarely* leave people feeling taken advantage of.
- **Law 10: Breaches.** In our most trying or critical situations, I trust our leaders to make decisions that are in the organization's best interests, including responding promptly and fairly to any breaches of trust.

· ORGANIZATIONAL TRUST SCORECARD ·

Tallying the individual ratings will yield an assessment score of between 10 and 50:

< 25	26–35	26–45	46+
Below Average	Average	Above Average	Exceptional

· APPENDIX B ·

TWO CASES OF BETRAYAL

(WITH DISCUSSION QUESTIONS)

Both cases are works of fiction provided solely for illustrative purposes as a teaching device. All names, characters, and locations are fictitious. No identification with actual persons (living or deceased) should be inferred. Any resemblance to actual events, locales, or persons, living or dead, is coincidental.

CASE 1: A SHOWDOWN: MAIN STREET VS. WALL STREET

"Greed is a bottomless pit which exhausts the person
in an endless effort to satisfy the need without
ever reaching satisfaction."

—Eric Fromm

In December 2011, Alexandra ("Alex") Brennan (not her real name), managing partner of AB Partners, a fictional West Coast private-equity firm, caught a red-eye from LAX to JFK. She had scheduled two brief days of meetings, planning to then head home to enjoy the holidays with her family. A week later, however, still in NYC, she flipped on her television to see protesters only blocks from her Lower Manhattan hotel. Alex would soon have sympathy for the "Occupy Wall Street" movement, as she found herself caught in the Venus flytrap of one of Wall Street's most fearsome banks.

Hanalei Technologies (HanaTech), an enterprise software company in which AB Partners held a 9½ percent stake, had fallen under the influence of a large investment bank (the "Bank"). The Bank had failed to refinance $700 million of HanaTech's (the "Company's") debt, carrying an extremely high 15 percent coupon. This was debt the Bank had arranged in prior years and for which it was now the syndicate manager. The Bank blamed refinancing delays on "debt markets roiled by the European debt crisis." Alex was not surprised by the year-end delay; but she was bewildered by the proposed bridge financing.

In the days that followed, the Bank's multiple relationships with the Company would force the Company to the brink of insolvency in a gambit that to Alex looked every bit like the shakedown of a Main Street firm.

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The week prior to Alex's trip, the Bank—which also held a 24 percent ownership stake in HanaTech—had offered a "take it or pay the consequences" proposal to provide HanaTech with a $50 million bridge loan. According to the Bank, the new loan would need to be in place by the week before Christmas because of the specter of a technical default and bankers' vacation plans. For the holiday bridge loan, the Bank stood to receive a rate of return of more than 100 percent.

Alex had suggested that HanaTech simply raise the $50 million from its existing shareholders in the form of equity capital. HanaTech's core business had been performing well. And its investors were well-heeled. To her surprise, the Bank informed Alex that it had given an existing loan syndicate member (1) "blocking rights" on bringing any new equity capital into the Company, along with (2) a right to participate in 30 percent of any bridge financing. Furthermore, as the manager of the syndicate of lenders, the Bank had written into loan documents that it had a right to issue and take down the other 70 percent of any bridge loan. When the Bank failed in its agency assignment to refinance the Company's debt, it had fallen back on provisions it had written into loan documents.

When shareholders representing the other 76 percent of the ownership voiced objections (due to the loan's high cost and resulting economic dilution), the Bank responded that it might consider allocating up to 10 percent of the bridge loan to the other shareholders. However, the Bank now threatened that if other board-member shareholders failed to approve the terms of the bridge loan, the Bank would pounce from its perch as lender, put HanaTech into default, and seize control of the business.

To Alex, the threat was breathtaking. After all, the Bank was (1) a lender to HanaTech, (2) the manager of its debt syndicate, (3) a 24 percent shareholder (via its investments group), and (4) a member of HanaTech's board of directors. In two decades of service on various boards, Alex had never witnessed anything like the Bank's multiple control levers. In addition, she was stunned that HanaTech's reason for seeking new financing had been that it was groaning under 15 percent interest rates—the rate the Bank had arranged for the entirety of the Company's debt. The Bank's failure to refinance the Company's overpriced debt had created a moment of acute vulnerability for HanaTech. To Alex, it seemed that the Bank had manufactured the crisis for its own gain—a conflict of interest of the most treacherous kind.

Struggling to make sense of it, Alex learned that if HanaTech's board didn't accept the Bank's terms, the Bank would call the debt and foreclose on contracts put up as collateral and worth 150–175 percent of the outstanding debt. Although the lenders would easily be repaid in an orderly sale of the contracts, the Bank pointed out that "under the hammer," their value would be heavily discounted, putting shareholders at risk. And though the Bank was a shareholder, its net economic interest could be greatly enhanced from its perch as a debt holder.

HanaTech's worried executive team ("Management") had built an exceptional business that had garnered unsolicited offers to buy HanaTech at more than two times the value of its outstanding debt. Thus, in Alex's view, the debt was fully secured, and the creditors' risk of loss minimal.

To further sharpen its holiday ultimatum, the Bank reminded HanaTech of the debt covenants that allowed no time to cure any default, be it a cash-flow shortfall or a technical default as minor as a reporting delay. To demonstrate its resolve, the Bank announced that it had started monitoring currency exchange rates on a continuous basis because loan covenants were tied to the exchange rate between the US and Australian dollar. If rates moved in favor of the Australian dollar—even for a single second—the Bank threatened Management that the lenders could take over HanaTech, halt its operations, and liquidate its assets. Panicked, Management pleaded with the other shareholders to accept the Bank's Christmas demands.

Alex was especially unnerved by statements from the young associate the Bank had assigned to serve on HanaTech's board. Unmoved by shareholder objections, the associate threatened that the Bank's offer was what he called "take it or lose it" financing, bristling, "If you can bring $50 million to the table by Friday, the board will consider it; otherwise, the Bank's deal is the only one on the table."

With the clock ticking, Alex contacted the Bank's CEO to secure a meeting with the associate's boss, a senior Bank officer (the "Director").

· THE FIRST MEETING ·

Alex reached the Bank's CEO on Sunday afternoon to set up a 4:30 p.m. meeting the next day with the Director of the investments group supervising the relationship with HanaTech. The investments group was known both outside and inside the Bank as its shrewdest, most profitable unit.

Alex arrived thirty minutes early, eager to meet the person in charge of the Bank's relationship with HanaTech. She had three objectives:

1. To understand the Bank's proposal—was there a chance her concerns might be based on insufficient information?
2. To encourage the Bank to invite all shareholders to participate pro rata in any new financing—might there be a more equitable solution to HanaTech's needs?
3. To inform the Bank that she could not allow her Fund investors to be diluted by the nonmarket terms of the Bank's proposed bridge financing, when they were fully capable of funding the $50 million transaction themselves.

Alex planned to wait in the reception area. But there was no such area. The doors were all locked. And there was no indication that the offices were even part of the Bank.

After standing in the empty elevator lobby for several minutes, she hailed a young man, revealing to him whom she had come to see. He ushered her through an unmarked door into a vast landscaped office filled with desks at which young associates were seated shoulder to shoulder gazing into banks of glowing screens. He parked Alex in a conference room, and the Director arrived five minutes later.

After exchanging pleasantries, Alex asked how the interest rate on HanaTech's outstanding $700 million debt had ended up at 15 percent, roughly double the market rate. The Director replied: "Each time a new lender comes into our syndicate, the interest rate on the entire $700 million is ratcheted up to the rate required to cover the risk on the last dollar borrowed."

Incredulous, Alex asked: "How does that make any sense? Why wouldn't one simply create tranches of debt and price them according to the coverage provided by the underlying security?" (Typically, the more senior and less risky the security, the lower the return required by investors.) Only the last, least-secure dollar could conceivably have been priced at an interest rate approaching the 15 percent rate on the entire loan. The Director nodded: "It didn't make any sense to me, either; but this is what the Company agreed to."

Alex moved on to the next matter: "How about a rights offering to raise $50 million of equity from all existing shareholders on a pro rata basis?" Applying a non-dilutive formula for raising capital seemed to Alex the right way to protect all shareholders.

The Director's response was terse: "We need to be paid."

Alex responded: "The Bank will be paid—and handsomely—in a rights offering that treats all shareholders the same."

With its 24 percent stake as a shareholder, the Bank would receive nearly a quarter of any rights offering, in addition to a pro rata share of whatever the other shareholders declined to purchase. And since Management had already indicated it didn't have liquidity, the unsubscribed amounts related to its 40 percent ownership would be significant and would be allocated pro rata among the other shareholders, including the Bank.

Alex calculated aloud: "The Bank should end up with roughly $25 million of the $50 million offering. And at that participation level, it should make an extra $20 million profit in six months on a $25 million investment."

The Director shot back, "That's not enough."

In all of Alex's years of board service, she'd never known a board member to engineer what is known as a "cramdown" of other shareholders. She asked, "How can the Bank propose this, given the board's fiduciary duty to protect all shareholders?"

Before she could complete her question, the Director interjected: "We're not on the board."

"How could this be?" Alex wondered. The prior October all board members had signed a formal resolution to appoint a

Bank representative to the board. Furthermore, each board member had signed documents to appoint the young associate as the Bank's representative. And HanaTech's counsel had even sent confidential board materials to the Bank, who then joined the other Directors in appointing itself as agent to arrange the delayed refinancing that had triggered the Bank's ultimatum.

The Director informed Alex matter-of-factly that the Bank had never returned the document signed by all other board members to admit its young associate to the board. As a result, technically, the Bank was not on the board and was exempt from the legal standard of fiduciary duty owed by board members to shareholders.

This would make Gordon Gekko blush, Alex thought to herself. Was HanaTech the Bank's client, a counterparty, an investment—or all three?

Alex made a plea to the Director's sense of fairness: "What if we agreed that, since we [AB Partners] and the Bank are each capable of providing the capital for any bridge financing, our relative ownership percentages remain the same before and after the new issuance?"

Making sure he understood Alex's proposal, the Director responded: "So are you suggesting that if the ratio of the Bank's to AB Partners' net economics is now 80/20, that it remain the same after the offering?"

"Exactly," Alex replied, knowing this would produce a rights offering that would protect every shareholder. Alex then moved to her final point—alerting the Bank that under no circumstances would she permit her Fund's investors to wonder why they weren't invited to fund a pro rata share of the extremely expensive new financing. She summarized: "Even if [the Bank] has decided that it possesses no fiduciary duty to HanaTech's shareholders, I have a clear duty as a general partner to protect my limited partners' ["LPs'"] interests."

The Director demurred, promising to get back to Alex by the following morning. Sure enough, the next morning, Alex awoke to an email from the Director that read:

> "We are currently working with the intention of allowing AB Partners to invest their pro rata amount (9.5% of the $50mm bridge-loan issuance), in accordance with the preemptive rights afforded by the shareholder agreement (i.e., the $4.7 million that would protect them from dilution)."

Alex had achieved the objective of protecting her investors. However, she was disappointed that the Bank had rejected inviting all shareholders to participate pro rata.

· FOLLOW-UP ·

On the way to JFK, Alex received an urgent call on her cell phone from the CEO of HanaTech. In the back seat of a cab bouncing along Queens Boulevard, Alex sat stunned as the CEO accused her of interfering by calling on the Bank.

Alex explained, “I merely offered to take up to $10 million so they—or we—could offer all shareholders a chance to participate in the bridge loan.”

The CEO responded:

> “You don’t understand. The Bank will blow up HanaTech if it doesn’t get what it wants! By calling on the Bank directly, you got other shareholders mad, thinking they’re not getting a fair share of the bridge loan. I even had to tell a cofounder that he cannot sign up for ANY of this financing, just to keep the Bank happy. If you don’t limit your interest to the $4.7 million the Bank has offered your investors to protect them from dilution, you’ll tank HanaTech.”

Clearly, the Bank had relayed to the CEO that it had agreed to protect AB Partners from dilution by offering it a pro rata participation in the expensive bridge financing. Troubled by the CEO’s distress, Alex responded, “Doesn’t this tell you all you need to know about the predatory nature of this financing?”

Instead of examining her analysis, the stressed-out CEO responded: “I’m begging you not to blow up HanaTech. I’ll have to fire thousands of people on Monday unless you agree to limit your participation in the bridge loan to $4.7 million.”

Alex assured him that she had no interest in damaging HanaTech and would gladly accept the minimum investment allocation needed to protect her LPs. She also told him that she would rely on the board to do its duty to ensure every shareholder was given the same opportunity—a less-than-subtle reminder to the CEO of his own duty of care and loyalty to shareholders.

As soon as Alex landed in Los Angeles, she put her team to work. First, they prepared an alternative term sheet to the Bank's bridge financing, not only providing the board with more reasonable financing terms, but making participation in the financing available pro rata to all shareholders. Next, she and her team held an emergency Investment Committee meeting to arrange for up to $50 million of funding to be made available to support AB Partners' more attractive term sheet.

While preparing materials for her Investment Committee, Alex received an email from HanaTech's CEO marked: "Urgent Matter!" The CEO noted that the Bank had completed its allocation for existing shareholders and had agreed to increase from the 10 percent it presented in the face-to-face meeting in New York. Now it would allow those who owned 76 percent of HanaTech to participate in up to 17 percent ($8.5 million) of the $50 million bridge loan. Alex responded that she hoped this would satisfy any demand by other shareholders; and if it represented more than enough to satisfy demand from other shareholders, she wondered if it might represent a further pro rata opportunity for the AB Fund.

Knowing her Investment Committee's attitude, Alex said, "We're prepared to take the whole $8.5 million, go as low as

$4.7 million—simply to protect our LPs—or do anything in between." With this, Alex also informed the CEO that AB Partners would formally submit to the board an alternative term sheet to fund the entire $50 million bridge loan, giving Management an option.

Alex received no response from the CEO or the Bank.

· THE STING ·

Friday was the date of the board meeting at which HanaTech and Management would decide which bridge loan proposal to accept—the Bank's, or the cheaper one from AB Partners. As the deadline approached, Alex called the board to ask if she should be wiring money. To her surprise and disappointment, the board informed her that it had selected the Bank's more expensive term sheet. To her dismay, the Bank had also unilaterally reduced the allocation to AB Partners from the promised $4.7 million allocation to only $2 million.

The CEO asserted that "certainty of funding" had been the overriding factor in its decision. Furthermore, the CEO went on, the board had determined that AB Partners' approval wasn't required for the transaction, hence the sudden unilateral "haircut."

Alex stepped outside for some fresh air. It would be a long weekend.

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· TIME FOR HARDBALL ·

With little time left, Alex possessed but two options: accept the $2 million participation now offered, or fight for her LPs' interests as shareholders. With less than half of the participation needed to protect her investors, it became clear that any expression of the Bank's intentions that had come out of her face-to-face meeting in New York had been illusory. Out of options and out of time, Alex emailed HanaTech's board:

> "We don't see how we can participate at a $2 million level. Our LPs will never support what you've done, nor will they ever understand how you've gone about it."

Alex wondered how she would inform her LPs (who had offered to provide the entire financing on better terms) that the Bank had taken 83 percent of the financing, while allocating to her LPs just 4 percent, when their stake in HanaTech was 40 percent of the Bank's. Suddenly, the CEO called to report that the Bank had decided to delay funding—and might not even fund after all, warning ominously:

> "They might not fund the business unless you assure them you won't sue. I've never asked you for a favor. All I've ever done is create value. Don't destroy it now. Don't damage everyone else. You have to tell them you won't sue over this transaction or you will blow up the company."

Alex faced a daunting dilemma. Through an orderly sale of HanaTech, she calculated that the AB Partner Fund stood to receive more than $50 million, suddenly reduced by the Bank's seemingly predatory preference on an apparently carefully orchestrated bridge loan. Running the numbers for Alex, the CEO appealed to Alex's larger interest: "Your Fund will only lose $3 million of value due to the Bank's unfair bridge. So it's still in your interest to give the Bank what they need."

Recalling Falstaff's famous line from *Henry IV*—"the better part of valor is discretion"—Alex sent off an email to the Bank. To settle down the CEO, she assured the Director that she would not sue the Bank. Then she followed up with a phone call. But the Director was not in. So she left a voicemail, confirming she would not sue. Within moments, she received an email from the Director's assistant:

> "[The Director] will be out for the next two weeks and is totally unreachable."

Two members of the Bank's legal team called AB Partners' attorney, however, within minutes to say: "So, to be clear, AB Partners is *declining* to participate in the $4.7 million allocation that would have protected its LPs from dilution."

Alex's lawyer responded, "How could AB have declined what the Bank unilaterally withdrew?" With the lawyers' attempt to put words in Alex's mouth, the Director himself suddenly resurfaced from his heretofore "unreachable" two-week vacation, emailing Alex directly:

> "I'm sorry you decided not to participate in the deal. As you know, HanaTech had to balance many factors from multiple constituencies, and that process determined the amount available for existing investors."

Curiously, the Director had used exactly the same phrasing his lawyers had just used. And his so-called "balancing of many factors" had resulted in wildly skewed economics in favor of the Bank, with significant harm to all other shareholders.

Soon HanaTech's CEO called Alex to advance a new threat on behalf of the Bank. Because its lawyers had determined that Alex's email and voicemail assurances were inadequate, the Bank had determined that it would withhold funding altogether. It informed the now-panicked CEO that it would not fund unless it received a "full release" from Alex and from AB Partners. *So much for "certainty of funding,"* Alex thought.

The Bank's lawyers followed up with an expansive release form that protected the Bank from any and all liability, no matter what. Alex had her attorneys send it back unsigned, informing the Bank that she would sign an edited version—if HanaTech's CEO reimbursed her LPs for profits lost if their participation were reduced from what the Bank had offered when she was in New York.

The CEO called Alex to complain that it wasn't fair that he'd have to personally cover her LPs for what he now termed "the Bank's theft." And of course, he was right. In Alex's opinion, the Bank had betrayed everyone—the CEO, HanaTech, the board, and the shareholders. But Alex's only duty was to her LPs.

As the deadline approached, who would blink? Unless Alex signed the Bank's expansive release, or the Bank withdrew its threat to seize the company, Sunday would be HanaTech's penultimate day in business. Alex was becoming increasingly confident that the Bank's threats were bully and bluster. Indeed, she even wondered if the value of a shareholder suit might exceed the value of AB Partners' stake in HanaTech.

But Alex also began to second-guess herself. Had she put her LPs' ownership interest at risk if the Bank followed through on its threat to liquidate the company? Should she have signed the release presented "at gunpoint"? Was there any way to get the board to reconsider her term sheet that provided protection to all shareholders? And if so, could she quickly reassemble AB Partners' financing? Or should she just take a $3 million "haircut" on her investment because of the Bank's clout and willingness to play hardball?

Alex hastily sent an email to HanaTech's CEO:

> "The Bank is inappropriately leaning on you to pressure other shareholders. Please tell whoever at the Bank is having you do its bidding to call me directly from here on out. The problem at HanaTech is one of capital structure, in which the Bank has played the key role leading HanaTech into an artificial ditch. The fox is now in the henhouse preparing to feast on the chickens."

Frustrated with taking the blame for the Bank's betrayal of shareholders, Alex continued:

> "Let me be absolutely clear on this: We have done everything in our power to protect all shareholders at every moment in this awful process. We have been fully prepared to fund not only an amount that would have protected our LPs from dilution, but also to fund a pro rata share of any rights offering made to all shareholders. So the narrative that AB Partners is holding things up had better stop immediately. And the record had better be corrected, before anyone does any more damage to our reputation."

• A WAY OUT OF THE TRAP •

With her aggressive volley, Alex also offered the CEO a way out of the crisis by suggesting that the Bank:

1. Fund HanaTech as promised and correct the record with respect to any reputational damage to AB Partners.
2. Provide the math, methodology, and underlying principles the Bank followed in pricing and allocating the bridge loan financing to a leading litigation-support firm, where expert economists and financiers would quickly review and consent to

the validity of the transaction. This would provide the Bank with a way free and clear of litigation—if, in fact, its behavior had been fair, proper, and legal.

3. Provide shareholders with profits they would have received had they not been denied an opportunity to invest their pro rata share of the bridge-loan financing, which had been the Bank's proposed "intention."

· THE DENOUEMENT ·

Monday, the last day before the Bank's threatened foreclosure, came and went . . . almost. Just before 9:00 p.m., Alex received an email from the CEO:

> "I wanted to let you know that HanaTech is closing on the bridge financing tomorrow morning. The documents were revised over the weekend to allow HanaTech to sell up to $4.7 million of preferred shares to AB Partners on the same terms and conditions on which they were sold to other investors. The other investors in the financing were disappointed to learn that you were not initially offered your full pro rata share (as was their intention at the outset), and all parties have attempted to revise the financing to accommodate your investment. The Bank decreased its participation in this financing to make your participation possible."

Alex's relief was exceeded only by her shock at the revisionist email. She had protected her investors. However, the CEO's reframing of the Bank's conduct over the past week was stunning. The other investors had most certainly not been "disappointed to learn" that her investors had been taken advantage of, nor that the Bank's stated intent had been overlooked. And the "access to a full pro rata share" of the bridge loan had clearly not been made possible by the Bank's "decreased participation." Both were laughable claims. The Bank had reduced its participation by only $155,000. It was the other investors whose pro rata allocations had been reduced to allow AB Partner's LPs to take down its pro rata share of the bridge.

The bridge financing was funded the next day. Later that week, the Bank sent a formal notification to HanaTech's board reasserting its right to (re)install its junior associate on the board by returning the signed board approvals it had previously held back. Now the Bank was officially back on the board. And the crisis was over.

Having to spend a few days in the parallel universe of a Wall Street wolfpack nearly made Alex want to pitch her own tent in Zuccotti Park. The exercise of dealing with what Alex saw as the Bank's betrayal of shareholders required levels of legal advice and brinksmanship that were likely beyond the resources and experience of most businesspeople.

Alex reflected on what had unleashed a societal wave of anger at Wall Street and concluded that the human race had not necessarily come very far from Hobbes's description of most lives as solitary, poor, nasty, brutish, and short. As she recalled the "best and brightest" gazing into computer monitors in Manhattan skyscrapers, she thought they might well give world-class plunderers of past eras a run for their money.

· DISCUSSION QUESTIONS ·

1. Was the Bank, in fact, betraying shareholders, or was it merely being shrewd?
2. In an industry where the score is kept only by profit and loss, is there a role for ethics beyond what is imposed by law?
3. Was Alex a good steward when risking a lot ($50 million) for a little ($3 million)?
4. What other options might Alex have tried with the Bank, the CEO, and/or other shareholders?
5. Where did trust break down?
6. What could HanaTech, AB Partners, and Alex have done to guard against this betrayal?
7. What can they learn from this to better protect themselves in the future?

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CASE 2: A FIDUCIARY BREACH: MARIE JOHNSON VS. HER LAWYER

"Rather fail with honor than succeed by fraud."

—Sophocles

Before Bernie Madoff was found guilty of securities fraud and sentenced to one hundred and fifty years in prison for the largest Ponzi scheme in history, affinity fraud was a little-known term. Madoff preyed upon what the *New York Post* called "the Jewish circuit" of the well-heeled members of country clubs on Long Island and in Palm Beach. Drawing from an identifiable affinity group whose members tended to trust each other, Madoff took advantage of the trust bred by familiarity—be it derivative of religious affiliation, school ties, ethnicity, geography, or life circumstances.

Several years before Madoff was exposed, an Upper East Side couple who dodged Madoff's scam fell into a similar if less grandiose trap. After five years of relying on a young lawyer at a small Manhattan law firm, Sam and Marie Johnson (not their real names) hired Joe Cleveland (not his real name) to join them as full-time, in-house counsel. The Johnsons had come to know Joe on the board of a private school, where they, along with Joe, had a daughter attending. Sam and Marie attributed to their young lawyer all of the values of the school and the virtues of its philosophy about parenting and about life's priorities, especially where he spoke and wrote so convincingly about how he held those values, virtues, and priorities in the highest regard.

After Joe's five-year stint as the couple's personal lawyer, Sam and Marie were delighted to say yes when he asked for a job as their in-house counsel and fund manager. His frequent and solemn references to fiduciary duty—on top of years of faithful service as their personal attorney—made them comfortable in hiring the thirty-six-year-old. Their frequent mutual interactions with the neighborhood private school to which they all gave time and money added to their trust in Joe. Their plan was for Joe to set up an investment business the Johnsons would own, and from which Joe would receive a salary and performance incentives ("carried interests") above a preferred return to the couple for having put up all the money.

Alas, Joe was not the person they thought he was. And their misplaced trust in his character was partly their own fault, as they later learned when watching the Madoff affair unfold. In that sad case—as in their own—trustworthiness was attributed to someone by virtue of membership in a trusting affinity group.

· MARIE TRUSTS JOE LIKE FAMILY ·

In a note written soon after he was hired, Joe reassured the Johnsons that he *"always put the interests of the Johnson family* *ahead of his own."* So when he subsequently asked to be the only other signatory on Marie's personal bank account, she agreed. When he asked her for extensive power of attorney, she gave it. When he set himself up to be the sole manager of her separate assets, she was relieved, since her husband was preoccupied with out-of-state duties. Even when Joe wrote checks to himself out of Marie's personal bank account, she was unfazed. After all, she trusted him as her longtime legal counsel, as a friend, and as a representative to the parents' council of the private school their daughters attended.

Consistent with her unalloyed trust in Joe, Marie invited his wife to accompany her on an all-expenses-paid trip overseas. Marie loaned Joe $500,000 so he could coinvest in deals with her. With Joe's request for a bonus, Marie even forgave her half-million-dollar loan to him. (Unbeknownst to her, Joe then wrote a $1,000 check to himself from her bank account to pay himself for what he referred to as "legal work" in documenting her loan forgiveness. In a last-minute spasm of conscience, he voided the check, and Marie was none the wiser.) When Joe asked Marie to donate to a neighborhood charity and serve on its board, she agreed. And when she asked for legal advice on issues that arose with her duties at the school, he gave it.

· JOE BEGINS TO TEST THE WATERS ·

When an investment Joe made with the money Marie had loaned him began to falter, he quietly dumped it back into her account only months before writing it down by $12,500—all without a word to her. Thus, Joe came to realize that without any legal or financial training, Marie paid little attention to legal or financial matters. Indeed, she was busy raising a daughter, serving as president of an alumni group to which Joe belonged, and laboring in a humanitarian relief organization. And with Marie's husband frequently out of state, absorbed with his own projects and pursuing a significant nonbusiness career, Joe was free to manage Marie's assets however he saw fit. After all, that was his job—one of the main reasons Sam and Marie paid him. Before long—despite having brought no deals, no capital, and no track record to Johnson Capital—Joe began calling himself the founder of the couple's eponymous firm.

· JOE EXPANDS HIS ACTIVITIES TO SAM ·

After years of faithful service as a trusted fiduciary, Joe began to chafe. Learning that Sam would be in town for a few days, he drafted a transmittal memo to which he attached a legal document and a $300 personal check for his assistant to hand deliver to Sam. Within a sheaf of unrelated papers and documents for Sam's countersignature were the misleading transmittal memo, Joe's check, and a legal document referred to in Joe's memo. As usual, Joe attached a sticky note with his JC initials prominently displayed as "Reviewed and Approved," so Sam would know all legal documents were okay to sign.

This time, however, the system of blind trust was interrupted. As luck would have it, Sam had hired a new assistant who was unaware of the normal protocol by which Sam would sign whatever Joe placed in front of him with his initials on a "Reviewed and Approved" stamp. Rather than return the signed document directly to Joe's assistant, Sam's assistant ran it by Dave Parker, a recent hire at Johnson Capital. Dave quickly perceived that the legal document Sam had signed was different from the one Joe had identified in his transmittal instructions. Sensing that something was awry, Dave locked away the document for review with Sam when he returned.

In the meantime, Dave discovered that for his $300 check, Joe would have picked up a third of $2.5 million in cash on the Johnson Capital balance sheet. But that was only the tip of a large iceberg. Joe would also have ended up with a one-third ownership in the parent company to which the Johnsons had advanced millions of dollars when sponsoring third-party investment funds. Comparing the Johnsons' contribution with Joe's investment of $0, Dave couldn't understand why, for $300, Joe would, after more than a decade, suddenly own a one-third interest in the firm—much less why he'd acquire it by stealth.

When Dave alerted Sam that Joe was picking up a third of $2.5 million in exchange for a $300 personal check, Sam responded reflexively that Joe had to have made a mistake. Dave did a bit more sleuthing, however, and discovered that three years earlier, Joe had attempted to transfer to himself control of what he called a "worthless pass-through entity." At that time, when another employee had alerted Sam to Joe's undisclosed purchase, Sam had asked Joe how he could have thought it right to pick up an interest in any entity without talking with him about it first. Joe responded that it didn't really matter who owned the worthless entity, because "no economics flowed into it."

Sam had then instructed Joe never to assign ownerships—even worthless ones—without talking to him first. And suspecting nothing untoward, Sam had offered Joe an interest in the so-called worthless entity. But Joe had immediately transferred back to Sam all the ownership picked up clandestinely, as if it had been an inconsequential and innocent mistake. Thus Sam quickly forgot about the incident.

Sam now wondered if Joe's two attempts were related. Soon Dave confirmed that they both involved the same "worthless" entity. Joe had again attempted to transfer to himself an entity owned by Sam. This second time, rather than just assign the interests to himself without a word, Joe had written a false transmittal letter. Moreover, the entity in question was anything but "worthless." Not only did it possess millions in cash, but it was also the control entity for the fifteen-year-old firm the Johnsons had founded and funded from the beginning.

Now certain of Joe's betrayal, Sam confronted him, walked him to the elevator, and locked him out of his office. More from sadness than anger, Sam encouraged Joe to hire a good defense lawyer, offering him a fourteen-day standstill to allow him quietly to either settle up his accounts or prepare to defend himself in court. Joe quickly settled, and within a year was given an out-of-state assignment by an institution to which he and the Johnsons both belonged, making less awkward their occasional contact with other members of their common affinity group.

With Joe removed as longtime gatekeeper on all books, records, and electronic files, Dave was free to do an analysis of pending transactions. Soon he came across a written proposal Joe and his two lieutenants had put together, in which they'd made an offer to buy out the Small Business Administration's interests in investments in which Johnson Capital had been the sponsor. The offer was for $42,000. When Dave reported this value, Sam quizzed one of Joe's lieutenants, who responded, "We always 'sandbag' the numbers." Stunned, Sam researched the true value of the interests and soon contacted the SBA to offer more than $2.1 million for the Agency's interest—fifty times what Joe had presented as fair value.

This left Sam with little choice but to also terminate both of Joe's lieutenants who'd signed off on the manifestly phony value. This, too, was awkward, since they were both Upper East Side neighbors with multiple affinity connections. Not wanting to expose the embarrassing discovery within the affinity group, Sam presented them with the deal Joe had taken. Instead of agreeing to it, however, both contacted Joe, now out of state. And to Sam's surprise, both lieutenants filed specious preemptive lawsuits. One was quickly defeated in arbitration; but the other persisted, thanks to Joe's prescience—he had set up insurance to cover fiduciary breach claims. His lieutenant's cost-free attack would soon turn out to have great strategic value to Joe.

· MOVING $30 MILLION FROM THE JOHNSONS ·

The worst was yet to come. Marie soon discovered that Joe had hired David Smith, a partner in her estate-planning firm, to "represent" her in the transfer of her most valuable asset to Joe and his two lieutenants. Remarkably, Smith was a close friend of one of Joe's lieutenants whom he had long represented. Smith had never met—nor would ever meet—the Johnsons. When Marie finally sued Joe to recover the value of her transferred asset, Smith swore that he—not Joe—had "represented Mrs. Johnson" in what arbitrators would later rule had been an "unfair, interested-party transaction" that had represented a "breach of fiduciary duty."

Joe argued that Marie had had legitimate legal representation—however lousy—in the unfair transfer, so Joe was not liable for her remarkably unfair deal. Furthermore, Joe testified that though Marie thought Joe was her attorney, he wasn't including during all the years in which he'd transferred her assets to himself, sold failing assets back to her, and written checks to himself on her account.

In Joe's largest transfer to himself, he had moved Marie's most valuable asset over a weekend in her absence and prior to Sam's return from out of state. He'd documented the transfer by burying a false lowball value within a composite bookkeeping entry, camouflaged by four other assets transferred at current fair-market values (as required by law and in equity). By the time the Johnsons arrived five days after the transfer, Joe had already booked the interested-party transaction as a never-to-be-reviewed capital account credit.

Within the month, Joe and his lieutenants swore that the value of Marie's shares had ballooned in value from \$0.6 million to \$4.9 million. However, in discovery, Marie found a spreadsheet created by one of the insider director-transferees in which he'd calculated—*prior* to their transfer—an eight-times-higher \$4.9 million value for Marie's shares.

In an impressive display of sophistry, both Joe and his lieutenant then swore under oath—unchallenged by Marie's lawyer—that on the day of transfer, her shares were *"absolutely"* no longer worth the higher value the board itself had formally established nineteen days prior to transfer.

A transactional lawyer by training, Joe Cleveland took great precautions to keep his fingerprints off the fraudulent Sunday transfer, as follows:

1. He resigned abruptly as a director a week after a co-insider board member (and his lieutenant) showed Marie's shares to be worth \$4.9 million.
2. On the Friday *before* the Sunday transfer—suddenly no longer a Board member—Joe told Nate Smith, lawyer for the fund that owned

Marie's shares, that he would personally take over moving the fund's investments to another fund in which Joe's interests were higher (and where Nate was also fund counsel).

3. On transfer Sunday, Joe moved five assets (including Marie's vastly appreciated shares) into the new fund in which Joe and his lieutenants would instantaneously capture millions of dollars of concealed value.
4. On the Friday morning *after* the Sunday transfer, Joe retained David Smith from Marie's estate-planning law firm to pretend to represent her after he had just represented the largest transferee of her shares.
5. On the Friday afternoon after the Sunday transfer was complete, Joe caught the Johnsons en route to a wedding-anniversary celebration, asking the couple to drop by the office to sign a stack of documents, never letting on that:
   a. They were signing away millions in current value that he and his insider board-member lieutenants had hidden by using phony capital account credits.
   b. He had made the transfers himself and hired two conflicted affinity lawyers to pretend to represent (1) Marie and (2) the fund that owned her shares.

c. The conflicted affinity lawyers selected operated without engagement letters, conflict waivers, or any communication with their unwitting clients.

Less than two years later, the three insider directors (including Joe) pocketed over $30 million for having booked a $5 per share capital account credit for shares they now sold for $80 apiece.

Unsurprisingly, Joe moved to have Marie's case presented to arbitrators rather than to a jury. The judge overseeing arbitration had recently been an official in the same cozy affinity group where Joe was presently an officer. Consistent with the dense affinity network within which Joe operated, the judge did not recuse himself and, unsurprisingly, upheld the *only* defense arbitrators allowed—a technicality: The Johnsons had not caught Joe in time, given his fiduciary control over all books, records, electronic files, and the lieutenants who gave reports to the Johnsons.

· AFFINITY FRAUD ·

It seemed to Marie that cozy affinity connections had combined to betray her, playing a starring role in Joe's defense. Among the affinity-group members who either benefited from or helped to orchestrate, defend, and/or assist with what arbitrators ruled to have been an "unfair, interested-party transaction," were:

1. Marie's fund manager and longtime lawyer (Joe).
2. Both of Joe's lieutenants, who were insider directors of the company whose shares they transferred to themselves at a known false value.
3. Nate Smith, fund lawyer for both the transferor and the transferee fund.
4. David Smith, posing as Marie's counsel despite his roles as lawyer and close friend to the largest recipient of Marie's massively undervalued shares.
5. Joe's defense counsel, another affinity connection (belonging to the same affinity group as the conflicted lawyers and the supervising judge).
6. Joe's "expert witness," a high-ranking affinity-group member who provided a veneer of affinity approval (along with giving Joe a 60 percent discount on his fees).
7. The judge overseeing arbitration, who'd recently held the same official position in their common affinity group as Joe now held.

Joe's defense attorney (likewise a high-ranking affinity-group member) made a posttrial appeal to the arbitration firm to dump the panel chairman, whose questions made clear that he was troubled not only by Joe's manifest breach of fiduciary duty, but also by his destruction of evidence when contacted by counsel. Furthermore, the panel chairman was not part of Joe's affinity network. He was dumped from the panel after trial because Joe's defense attorney complained that he sat on a parent school board with one of Marie's sons-in-law. Somehow this served as justification enough for the arbitration firm (represented by another member of Joe's affinity group) to accede to the appeal to dismiss the panel chairman before he could participate in the panel's ruling.

Immediately prior to arbitration, the judge in whose court Joe's lieutenant's preemptive filing had been assigned, also came to Joe's rescue, ruling that the Johnsons' counterclaims (though later proven valid) were time-barred. Thus, mere days prior to Joe's arbitration, this judge issued a summary judgment dismissing the Johnsons' damages by virtue of the statute of limitations—even though time limits are normally tolled when dealing with fiduciaries.

What arbitrators ruled had been Joe's "only accepted defense" was a technicality that allowed him to keep the money he had taken when giving Marie a \$0.6 million bookkeeping credit for shares he and his lieutenants swore twenty-nine days later—under penalty of perjury—had a fair-market value (FMV) of \$4.9 million.

Delighted with all the help from his affinity network, Joe broadcast to affinity-group members that the verdict had been a "miracle of significant proportions," identifying "intercession" as the reason he'd kept his share of a \$30+ million interested-party transaction. Adding insult to injury, Joe trashed Marie to another affinity-group official as a "vengeful and vindictive woman" whose "claims could not be sustained." As soon as Joe returned from his out-of-state assignment, his lieutenant settled the suit he'd filed that had secured for Joe his "only accepted defense."

Marie discovered that the affinity group to which belonged (1) the beneficiaries of Marie's misfortune, (2) the lawyers who covered for them, and (3) the relevant judges, defense attorneys, and experts enjoyed a well-earned reputation for affinity fraud; she joined other trusting victims of those defrauded by members of the same group.

To put the affinity nightmare behind the Johnsons, Sam sent forgiveness letters to all who'd benefited from the adjudicated breach.

· DISCUSSION QUESTIONS ·

1. Should the Johnsons have pursued an appeal rather than send out forgiveness letters to those who had benefited from an adjudicated breach of fiduciary duty? Why or why not?
2. Should Marie have hired a lawyer to respond to Joe's report to group officials that she was "a vengeful and vindictive woman"?
3. Did the cozy affinity relationships between (1) Joe, (2) his lieutenants, and (3) the conflicted lawyers he retained make betrayal more or less likely? more or less easy to overcome?

4. If you were Marie and learned that shares your fund manager and lawyer sold for $80 apiece were ones he'd transferred from you on a Sunday in your absence by giving you a bookkeeping credit of $5 apiece, what would you have done?
5. Since Joe had made the unfair transfer on a Sunday with the help of conflicted affinity lawyers pretending to represent you, would you seek to recover damages from the law firms who also betrayed your interests?

CONCLUSION

Robert Louis Stevenson once observed, "Compromise is the best and cheapest lawyer." This is wise counsel to entrepreneurial leaders who hope to build their careers on high-trust relationships, yet end up in conflict or betrayal.

Having observed two litigators up close, I've been struck by the differences between the two regarding their competence, spirit, and quality. In the first instance, I came away with a high regard for litigators as honorable advocates. Though litigation was still a miserable experience, I could see that my attorney was smart, tough, honest, and determined. He gave a brilliant opening statement that nearly won the case on its own. His depositions were thorough, and his cross-examinations were devastating and done without regard to station. Moreover, he carefully disclosed conflicts and prior relationships. As a result, the judge and opposing counsel respected him. And by the end of the prosecution's presentation of its case-in-chief, the judge called everyone into chambers to urge settlement—even before my attorney had begun to present my case.

In the second instance, the lawyer barely gave an opening statement. What he said was perfunctory, incomplete, and forgettable. He protected a former client by allowing him to carve out vital evidence and give unchallenged testimony. As might be expected, opposing counsel and judges showed little respect for him, resulting in virtually every pretrial motion going against him. Predictably, he declined to appeal anything.

Both attorneys set up a mock trial to dry run the persuasiveness of their arguments and the strength of their evidence. In the case of my lawyer, his presentation was crisp, persuasive, and winning. In the case of the second lawyer, he was so disorganized that when an advisor to the plaintiff stepped in to present the vital information he had omitted, the mock judges reversed their ruling, deeming the defendant's actions not merely unethical but, in fact, criminal.

I summarize these wildly disparate litigation experiences so that entrepreneurial leaders may be aware of the wide range of competence and ethical behavior at work in the justice system. If entrepreneurs must hire litigation counsel, they should go with only the best. As Robert Frost noted, "A jury consists of twelve persons chosen to decide who has the better lawyer."

If you cannot settle a betrayal outside of litigation, the recommended course of action—for both economic and emotional reasons—is to find a smart, honest lawyer who is respected by the judiciary. Then buckle up for a long and miserable chapter of your life.