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Beyond #MeToo - The Board's Role in Crisis Management and Event-Driven Litigation

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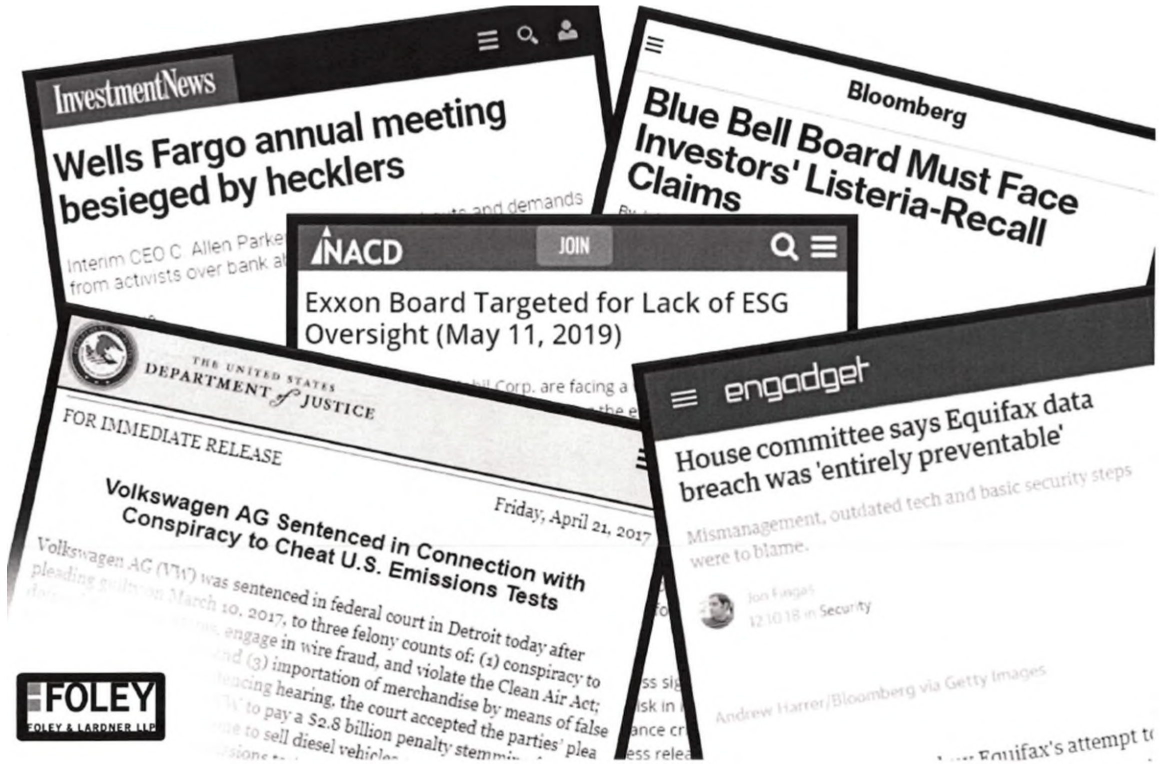

Increased Scrutiny of Risk Management

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Equifax Breach Prompted Privacy Culture Shift: Privacy Chief

By **Allison Grande**

Law360, Las Vegas (September 24, 2019, 11:07 PM EDT) -- Equifax's massive 2017 data breach marked a "once in a corporate lifetime event" that led the credit reporting giant to take a fresh look at and revamp how it handles personal data, the company's inaugural chief privacy officer revealed Tuesday.

During a solo presentation at the International Association of Privacy Professionals' Privacy. Security. Risk. conference in Las Vegas, Nicholas Oldham — who was tapped in December 2017 to serve as Equifax's first chief global privacy and data governance officer — detailed the "hodgepodge" privacy compliance structure that existed when he joined the company and how he has worked during the past two years to better align and standardize the company's data management approach.

"My story today ... is about how that incident was of such magnitude that it created a once in a corporate lifetime event where it allowed us to ... take a step back and look broader about how we were managing data and determine whether it was right," Oldham said.

He said that the company recognized that, given the growing privacy law landscape around the world and the increasing connectivity of data, it was in a different environment than ever before, and that the ultimate goal was to "look at our practice holistically" and build a framework that was able to adapt to this changing landscape.

Oldham took the reins roughly four months after Equifax revealed in September 2017 that it had been hit by hackers who exploited a website application vulnerability to gain access to names, Social Security numbers, addresses and other personal data belonging to what ended up being more than 148 million individuals.

Equifax's admitted failures to adequately identify and detect vulnerabilities, properly segment its databases and effectively manage password credentials led to a crush of legal and regulatory backlash, and the credit reporting giant in July announced a **landmark $700 million deal** to resolve a slew of federal, state and consumer claims that stemmed from the incident.

Then a partner at King & Spalding LLP, Oldham and his colleagues were retained by Equifax early in the process as part of an outside counsel team tasked with investigating the incident, with Oldham leading the internal probe, the forensic investigation and the data analysis.

"And then I think I ended up with Stockholm syndrome," Oldham said of his decision to go in-house just months later.

"So rather than outcome-determinative—you're either compliant or you're not—it's really based upon having operational processes that allow us to say we've done the right thing."

—Nicholas Oldham

Increased Scrutiny of Risk Management

- Prior *Caremark* standard:
  - ***"Only a <u>sustained or systematic failure</u> of the board to exercise oversight—such as an <u>utter failure to attempt to assure a reasonable information and reporting system exists</u>—will establish…liability"***
- This protective standard is fast eroding:
  - Shift to "inadequate risk disclosure" theories of liability. *See, e.g.,* VW emission standards, Equifax data breach, Wells Fargo account openings, etc. brought as securities class actions rather than solely as derivative actions
  - Important new DE decision *Marchand v. Barnhill*: ***directors "must make a good faith effort to implement an oversight system <u>and then monitor it</u>"***
  - *In re Clovis Oncology, Inc. Derivative Litig.*, the Court relied on *Marchland* that implementing an oversight system is not enough.

Increased Scrutiny of Risk Management Cont.

- *Marchand* Facts:
  - Blue Bell Creameries suffered deadly listeria outbreak; 3 consumers died. Massive recall and layoffs ensued. To stay afloat, new financing obtained, but under negative terms.
  - Management knew of reports raising major concerns about contamination risks, but didn't tell Board. Nonetheless, Board failed to ensure the adoption of a compliance system which effectively oversaw food safety issues, and did not proactively monitor management's response after the listeria outbreak.
- *Clovis* Facts:
  - Stockholders brought derivative suit against board for its failure to oversee pharmaceutical clinical trials.
  - Lack of monitoring included failure to correct management's inaccurate reporting of results from clinical trials—which the court found the Board was aware was inaccurate, and was "mission critical" to the company's success—to keep up with a competitor.

Key Takeaways…

- Now, courts are imposing an affirmative duty to:
  - (1) identify the key risks, (2) ask management to develop the right metrics to measure compliance so that the board can see those risks are adequately addressed, and (3) for publicly-traded companies, ensure the risks are fully disclosed in ’34 Act filings.
- Boards will now be asking Management:
  - What are the critical risks facing our company, considering our industry, our scope of operations, and our mix of products?
  - What key metrics do we need to hear from management on, in order to know these risks are being addressed?

Board's Response to Management in Trouble

<u>Before</u>: "We stand behind our CEO/Management"

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Board's Response to Management in Trouble

<u>Now</u>: "We're going to Get to the bottom of this."

Source and Types of Crises

- What is most likely to trigger a crisis communication?

Key findings

The legacy of long serving CEOs

Long-serving CEOs generally deliver higher shareholder returns than shorter-serving CEOs and are typically succeeded by insiders in a planned succession. However, we find that these successor CEOs significantly underperform and are much more likely to be forced out of office.

Turnover rate soars

Turnover among CEOs at the world's 2,500 largest companies soared to a record high of 17.5% in 2018 — 3 percentage points higher than the 14.5% rate in 2017 and above what has been the norm for the last decade.

Slow progress for women

The share of incoming women CEOs was 4.9% in 2018. This is down slightly from the all-time high of 6% in 2017, but it continues an upward trend from the low point of 1% in 2008.

Ethical lapses on the rise

The overall rate of forced turnovers was in line with recent trends, at 20%. But the reasons that CEOs were fired in 2018 were different. For the first time in the study's history, more CEOs were dismissed for ethical lapses than for financial performance or board struggles.

Last year – for the first time in the study's history – PwC reported ethical lapses were the No. 1 reason for removal of CEOs

CEO turnover in 2018

Turnover among CEOs at the world's 2,500 largest companies soared to a record high of 17.5 percent in 2018 — 3 percentage points higher than the 14.5 percent rate in 2017 and above what has been the norm for the last decade. Percentages of the types of turnovers — planned, forced, and M&A-related — remained in line with long-term trends. Planned successions continued to account for more than two-thirds of all turnovers (see "Tide still rising").

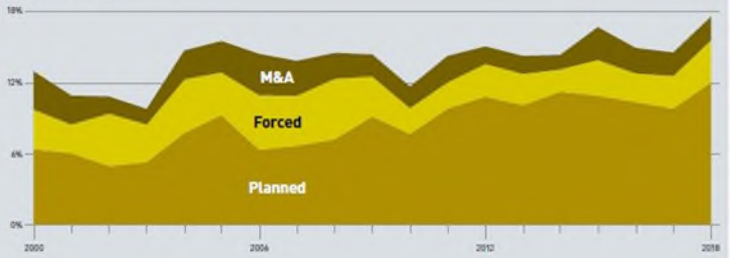
The overall rate of forced turnovers was in line with recent trends, at 20 percent. But the reasons that CEOs were fired in 2018 were different. For the first time in the study's history, more CEOs were dismissed for ethical lapses than for financial performance or board struggles. (We define dismissals for ethical lapses as the removal of the CEO as the result of a scandal or improper conduct by the CEO or other employees; examples include fraud, bribery, insider trading, environmental disasters, inflated resumes, and sexual indiscretions.) The rise in these kinds of dismissals reflects several societal and governance trends, including more aggressive intervention by regulatory and law enforcement authorities, new pressures for accountability about sexual harassment and sexual assault brought about by the rise of the "Me Too" movement, and the increasing propensity of boards of directors to adopt a zero-tolerance stance toward executive misconduct. (For background on this trend, see "Are CEOs Less Ethical Than in the Past?" *s+b*, May 15, 2017.) The growing presence and power of activist investors could also be a contributing factor to the higher rate of CEO turnover.

Regions, industries, and demographics

CEO turnover rose notably in every region in 2018 except China, and included a large increase in Western Europe. Turnover was highest in "other mature" economies (such as Australia, Chile, and Poland), at 21.9 percent, and nearly as high in Brazil, Russia, and India (21.6 percent). The next-highest turnover numbers were in Western Europe (19.8 percent), and the lowest were in North America (14.7 percent).

Tide still rising

CEO turnover rate, by succession reason



Setting the table

Culture has become the risk.

- Reputational and legal exposure from #MeToo issues are now seen as equivalent to cyber-security and other **enterprise-level risks**.
- **Customers, employees, and investors** expect companies to (1) share their values and (2) root out inappropriate conduct and implement policies and procedures to reflect those values.
- Number of never-been-seen before type issues.
- For example…employee activism
  - Nike
  - Wayfair

Culture - Why should Boards care?

- *Institutional investors* are asking for board oversight of both culture and HCM.
- *Employees* weigh workplace culture when choosing – and then remaining in –their jobs
  - Protracted low rates of unemployment have added fuel to the talent war.
- *Customers -* organizational culture reverberates across all aspects of business because it represents the *way* company does business. It's simultaneously the company's identity and image – i.e. determines how customers perceive Co.
- *Company/Management* - culture is a critical enabler of strategy.
  - Corporate culture directly impacts operations, the potential success of transformation programs and the integration of acquired companies and thus financial performance.

WHEN COMPANIES TAKE A STRONG STAND AGAINST SEXUAL HARASSMENT, EMPLOYEES ARE MORE LIKELY TO FEEL THEIR WORKPLACE IS SAFE AND RESPECTFUL

	SAFE WORKPLACE	RESPECTFUL WORKPLACE
When employees think senior leaders clearly communicate that there will be no tolerance for sexual harassment, employees are[39] . . .	2.0x more likely	1.6x more likely
When employees think that reporting sexual harassment to management would be effective and helpful, they are also[40] . . .	4.8x more likely	2.5x more likely
When employees think that top performers are held accountable if they violate the harassment policy, employees are[41] . . .	4.2x more likely	2.3x more likely
	. . . to say disrespectful behavior toward women is often quickly addressed at their company	. . . to say their company values the differences that people bring to the workplace

Board's Role in Avoiding Potential Crises

- Boards can be drivers of culture change.
  - With more tenure in the boardroom than in the C-suite, non-executive directors can insist management develops the right corporate culture and the leaders required to support Co.'s long-term sustainability.
- Directors who self-identified as having the most engaging, professional and productive cultures discuss corporate culture at more than half of all board meetings, and that they are confident the company culture reflects the desire of the board.
  - *See Russell Reynolds 2019 Global Board Culture and Director Behaviors Survey*

Board's Role in Avoiding Potential Crises

- Cultural disconnect—between Co. values and practices
  - Practices
  - Values
- Boards should <u>focus on the "how" of culture</u>, in addition to the "what" and "when" of strategy.
  - Ask management *how* they intend to achieve a particular goal since an understanding of the organization's culture is imbedded in the answer.
  - Then work with management to encourage clarity in articulating current and desired culture, and <u>why</u> evolving the culture is critical to success.

Board's Role in Avoiding Potential Crises

- Ways in which companies are now thinking very creatively about closing gap between practices and values.
  - Tools to monitor culture, compliance dept., values, etc.
  - E.g. Internal Audit function—expanded to include "cultural audits," with results reported directly to the Audit Committee
- Boards should encourage and assist in implementing ways to monitor and measure corporate culture
  - Establish oversight responsibilities at the board and committee level.
  - Identify which issues are within their purview and how the board will engage on the topic.
  - Then, look for *patterns* of poor behavior from such signals as high turnover, low morale, a culture that evidences of lack of respect and courtesy.

Cultural information-gathering

- Diversity and inclusion efforts (e.g., data and efforts from Employee Resource Groups)
- Employee engagement surveys
- Management versus rank-and-file employees
- Salaries/pay gaps/bonuses
- Promotion rates/voluntary and involuntary attrition/turnover
- New hire data and exit interviews

- Independent third-party data:
  - Social media, employer rating websites, and whistleblower/hotline reports were critical to spotting patterns of problems in the culture.
  - ESG advisor scores related to human and social capital metrics
  - Customer satisfaction surveys and focus group results

- Supplement with in-person visits: Enables directors to obtain first-hand insights about the alignment of internal and external messaging and behavior.
  - Site visits – meeting employees, convening small discussion groups with managers, and/or town halls.
  - Investor days and customer events – observe interactions between management, employees, investors, and customers.

Board's Response to a Complaint

- Shift in crisis management goals
  - Before: end the debate
  - Now: change the environment
- Focus: empathizing with victims and understanding that employees and customers expect a high level of ethical behavior

Board's Response to a Complaint

- **1st Cut: Complaint Against CEO? Or Senior Management??**
  - CEO/Officers – Board must be notified & participate/lead process
  - Sr. Mgmt. - ensure Board is notified/appropriate oversight
  - Other complaints - process should be led by management, but report to Board
- **How does the Board respond, when facts are less than clear??**
  - *Timing* of Response is Key
  - Stakeholders want to see companies move ***quickly*** and ***decisively***
- **Whether to conduct an Internal Investigation?**
  - Initial investigation should be undertaken by outside counsel:
    1. Maintain attorney-client privilege (to the extent possible);
    2. Ensure an objective third-party reviews the facts;
    3. Provide basis for determining appropriate remedial actions; and
    4. Keep the investigation moving forward on a timely basis.
  - Even if decide to terminate, consider whether to continue investigation post-termination

Range of Responses:	
Paid Admin Leave	Unpaid Admin Leave
Term. W/O Cause	Term. With Cause
Claw-back Salary, Bonus, and Stock	Review and (unpublicized) discipline taken
Nothing	20

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How to issue a meaningful apology…without triggering further exposure to liability.

- Stakeholders expect straightforward and prompt communication about misconduct allegations.
  - Aim for clarity & transparency (to extent possible)
- Be prepared and coordinated.
  - Choose internal crisis and communications team and spokesperson and confer on plan of engagement and decision-makers
  - Know who will manage the investigation
  - Prepare a checklist of external parties for consultation or contact such as call centers, insurance brokers, outside counsel, and forensics companies

Other Practical Considerations

- **Review employment contracts with current and future senior management**
  - Review “for cause” provisions closely – do they include violation of anti-harassment policies?
  - Consider whether to include a “morals clause”
  - Consider strengthening claw-back and indemnification provisions:
    - Should Exec. be required to indemnify Co. if claims are proven?
    - Can Co. claw-back payments previously made to the executive?
  - Consider inclusion of restrictions on shareholder voting rights
- **Review Employment Practices Liability Insurance**
- **M&A Implications for buyer’s due diligence review**
  - Add review of sexual harassment complaints against management to DD checklist
- **Increased focus on succession planning**
  - In case CEO or senior management forced to resign on short notice

Examples—What worked/What did not work

- When and how “bad actors” are terminated matters
  - Increasingly, corporate constituencies are reacting negatively when senior level executives are terminated for bad behavior and then receive huge severance payments—*e.g.*, the Google employees’ walkout

CBS Board—A Cautionary Tale


CBS

The New York Times

CBS Report on Moonves Shows Epic Failure of Corporate Governance |

December 4, 2018

Board member knowledge of bad behavior unreported for years: News reports reveal that a board member with close ties to Redstone and Moonves was aware of assault and harassment allegations before he joined the board, over ten years ago, but never disclosed the information.

Initial outside investigation run by longtime corporate counsel: Per the NYT, in light of media Moonves rumors, two board members asked a corporate lawyer (not a seasoned investigations attorney) to investigate, and he reported mere “rebuffed advances” and the company “had nothing to worry about.”

Fox News Board—Cautionary Tale

- Investors claimed board breached fiduciary duties in failing to oversee compliance with Code of Ethics and to conduct good faith investigation into known violations of laws and ethics violations re sexual harassment and discrimination.

Pre-hiring, Board was aware of Ailes' "well known reputation for being awful to women."

- But, Board allowed Ailes to "run Fox News as an independent fiefdom" essentially, allowing hostile work environment.

Result - ***$90 million settlement*** & "Fox News Workplace Professionalism and Inclusion Council" (First-of-its-kind board watchdog)

Protecting Privilege

- (Gen.) legal basis for protecting communications with communications consultant ("CC"):
  - Communications consultant is like an employee of the client; *or*
  - The communications consultant is hired to assist legal counsel in providing legal advice
- Because there are holes in each of these theories, client should assume communications with its CC are NOT privileged
- What to do in order to increase the likelihood of having CC communications privileged:
  - Have counsel (not the client) hire the CC from the start
  - Implement a litigation hold at the same time the CC is hired, so that Work Product privilege can potentially attach
  - Include counsel on CC communications, and include counsel in all strategic CC decisions

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