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PERSPECTIVE

Ethical lapses, illegal actions and corporate governance

By Scott M. Wornow

Recent indictments of well-known financial, legal and business persons accused of paying bribes to get their children into college raise significant corporate governance and fiduciary questions. Many of the individuals involved in the college admissions, aka "Varsity Blues," scandal served on corporate boards of directors or held high-level executive positions at the time that those bribes occurred. Some, according to press reports, have resigned from their positions, some have been terminated (with or without cause, it is unclear) and others apparently remain in limbo pending the outcome of the proceedings. Even at an early stage when charges of dishonesty and fraud have simply been levied, governance and fiduciary questions arise that demand immediate consideration, whether or not the alleged dishonest or fraudulent conduct had anything directly to do with the organization with which the accused was associated. Indeed, had the alleged inappropriate actions directly implicated the organization or its assets, a proper response would, one assumes (with all due respect to the world of politics), have been readily apparent, uncontroversial and prompt.

When allegedly unethical behavior is unrelated in any obvious way to an organization, what constitutes an appropriate response? Does general awareness of seemingly unrelated unethical, or illegal, behavior by a director, senior advisor or manager require a board to evaluate and investigate the accused's integrity, to assess the accused's candor, to consider the potential reputational effect that the alleged behavior may have on the company or even to initiate a formal, documented process (and go on the record) for determining whether to terminate, or not to terminate, the accused's association with the company? Can a board turn a blind eye if a senior executive has been indicted for financial fraud simply because that conduct doesn't have a direct connection to the corporation? Should a board have confidence, or just assume (at its own peril), that fraudulent or inappropriate personal conduct by a director or officer hasn't also infected that person's interactions with, or at, the company?

In a world drowning in social media, where brand, image, reputation, gossip and identity are amplified exponentially by Facebook, Twitter and Snapchat, how, if at all, can personal conduct remain disconnected from any organization with which a person is even tangentially linked? If connections, affiliations and associations among people and organizations are today readily known, easily traced and quickly exposed, a prudent and effective board must promptly assess the potentially broad implications arising from an awareness that an affiliated person's integrity and ethics are (justifiably or not) in doubt.

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Where to begin when confronted with allegations of unethical or illegal behavior by a director or senior executive that are apparently unrelated to the company? Are there contracts, like an employment letter, stock option agreement or confidentiality agreement that apply? Do quasi-contractual arrangements exist, such as corporate codes of conduct and governance policies, that establish an evaluative framework within which to judge the personal behavior? What, if any, fiduciary duties are implicated by the events? Is there a regulatory overlay that needs to be considered, which might affect the accused's ability to continue to serve or might create a fact pattern that potentially affects the company's regulatory status or disqualifies it from industry associations? Does the alleged behavior raise issues under directors and officers insurance policies? If these questions reflect legitimate concerns, waiting for the outcome of proceedings, or sitting idly by as others pursue the facts, cannot suffice. Proactive engagement with the matter is essential, whether or not the exercise results in removal of the affected individual from the company.

Contracts and Quasi-Contracts. What do corporate agreements and policies say about the personal conduct of employees or advisors? Any review must begin with the basics. Offer letters, employment agreements, stock option agreements and other agreements that legislate employment terms must be carefully considered. Corporate codes of conduct, governance and conflict of interest policies, which may be integrated into those offer letters and employment agreements, must be analyzed. Do any of these agreements and policies permit termination for misconduct, for conviction of a crime, or for no particular reason at all. Perhaps the individual is terminable at will, and maybe the real implication of termination is the nature and extent of severance compensation, including equity vesting, that may be owed. Is there a right of termination based on behavior prejudicial to the company's reputation? Does the "commission" of a wrongful act suffice? Or must the individual actually have been "convicted" of a crime? Words matter, and, unfortunately, there is no particular consistency to the specific contractual or quasi-contractual definitions, terms and phrases typically used in any of these agreements or policies. Each agreement may produce a different result even though based on the same facts.

Morals clauses have existed in the entertainment, media and sports industries for many years. They permit companies to terminate contracted talent if the talent acts in a reprehensible manner or engages in conduct that could adversely affect the employer's reputation, brand or image. The National Football League has a player misconduct policy. Player contracts may include provisions that permit player termination for any "form of conduct reasonably judged by the League Commissioner to be detrimental to the League or professional football" (Arian Foster, NFL Player Contract). While use of these clauses is understandable in the entertainment, media and sports industries, they are difficult to negotiate, difficult to interpret and subject to evolving cultural norms; for these reasons, they are somewhat rare in other sectors. And yet, with the pervasiveness of social media and the permanence of news content, instances of poor judgment and improper behavior exhibited in one's personal life, even when that conduct has nothing directly to do with an organization, are more likely than ever to affect the reputation, brand, image and internal morale of organizations. So, beyond just checking the agreements and policies to determine whether there is a basis for termination, and beyond

simply assessing the compensatory consequences that may result from that inquiry, boards must anticipate, and pre-emptively think about, the broader questions and policy implications that will arise from the seemingly unrelated, unethical personal conduct of an officer, director or employee. A reconsideration of morals clauses, or some derivation of the concepts underlying those clauses, may be necessary in today's hyper-connected world.

Fiduciary Considerations. Under Delaware law, corporate directors owe fiduciary duties to the corporation and its stockholders. These duties consist mainly of the duty of care and the duty of loyalty. There is no fiduciary duty to act ethically and morally in one's personal life. Due care requires a fiduciary to make informed decisions and to act as an ordinarily careful and prudent person would act in similar circumstances. The duty is focused on decisions affecting the company — the obligation to make informed decisions about company-related matters. It is difficult to perceive a breach by an accused of his duty of care predicated on unrelated personal conduct. The duty of loyalty seeks fundamentally to prevent self-dealing, requiring that directors act in good faith and in a manner they reasonably believe to be in the best interests of the corporation and its stockholders. Absent evidence that the unethical personal decision was intended to extract value for the accused from the corporate relationship, it may be difficult to establish a link between the duty to act loyally and unrelated unethical behavior. But, again, perhaps the swift reputational damage that social media can cause an organization demands reassessment. Indeed, in the extensive litigation that arose after Michael Ovitz was terminated by The Walt Disney Company, the Delaware Court noted that "the duty of loyalty ... imposes an affirmative obligation to protect and advance the interests of the corporation and mandates that [a director] absolutely refrain from any conduct that would harm the corporation. This duty has been consistently defined as broad and encompassing, demanding of a director the most scrupulous observance. To that end, a director may not allow his self-interest to jeopardize his unyielding obligations to the corporation and its shareholders." In re Walt Disney Co., 2004 WL 2050138, at *5 n.49 (Del. Ch. Sept. 10, 2004). That was 2004, and there can be little doubt today that personal misconduct, even if unrelated, can harm a corporation — that harm may be reputational or, in the era of the #MeToo Movement, it may undercut employee morale, adversely affect hiring, limit sponsorship opportunities and impose other negative externalities on the corporation. While claims of fiduciary breach may not appear self-evident, the underlying duty that a director or officer do no harm to corporate interests requires an informed board to undertake a critical evaluation. Whether that assessment should result, as a fiduciary matter, in termination of the accused individual or maybe just a reprimand or other form of rebuke, or no action at all, remains for consideration. Or, perhaps, it will require further elucidation of these duties under Delaware law. But one thing should be clear — failing to engage with the issue cannot, under any circumstances, represent an adequate attempt by a board itself to discharge its own fiduciary obligations.

Regulatory; Compliance and Risk Management. Does the individual serve a regulated company? Does the company sell insurance? Is it a bank or broker-dealer? Does it provide health care services? Is the company's Directors' & Officers' insurance policy up for renewal? If the organization with which the accused is affiliated operates in a heavily regulated sector, it may be necessary to evaluate whether an indictment, conviction or plea of nolo contendere could affect the company's status. The extent of the inquiry and the timing of any action taken by the board may depend on the industry and the specific nature of the allegations. If the felony conviction of a board member or senior executive will jeopardize a company's regulatory status or compliance posture, an effective board will need to have had a plan in place to address those possibilities before a conviction occurs. An informed board should presumably understand whether an indictment itself might have those effects and should have developed protocols and policies to manage those kinds of potential crises before, not after, they occur. Effective board governance requires proper planning and forethought; the regulatory, compliance and risk management implications of unrelated improper personal conduct by a director or officer should be addressed prophylactically by the board. It serves neither the corporation nor its stockholders well if a board is entirely reactive to these not unexpected possibilities.

Although the organizational response to unethical or fraudulent behavior by an officer or director involving corporate assets is fairly obvious, it is less clear when the inappropriate conduct is personal and does not directly implicate an individual's corporate role or function. With non-stop news cycles, and far reaching social media platforms, the potential adverse effects on an organization resulting from its association with a person accused of improper personal conduct are more significant, and immediate, than ever. Because of these realities, companies and boards must reconsider their practices and responses to these reasonably foreseeable situations, including the appropriateness of carefully crafted morals-like clauses in corporate agreements and governance policies. When a board becomes aware of allegations of unethical or illegal personal conduct by a director or officer, even if there is no obvious connection to the company, the board must undertake an expeditious, yet thorough, review of the matter to determine whether the improper behavior was indeed isolated from the company. If a parent has paid a bribe to obtain admission for their child to a college, is it unreasonable to question whether that parent may have also acquiesced to improper or questionable payments within the context of his corporate function or role? The board must also consider the implications, compensatory or otherwise, of that personal misconduct under employment-related agreements, corporate governance policies and practices, and regulatory and risk management standards. Is termination appropriate or permissible? Is a reprimand required? Should compensation be forfeited or prospectively adjusted? Is the company's regulatory status at risk? Will employee morale suffer significantly from ongoing corporate association with the accused? All these questions should be raised. And, in light of those questions, there can be little doubt that an effective board must actively assess, carefully consider and dutifully address the implications of personal misconduct by a director or officer on a corporation and its stakeholders, even when that misconduct is unrelated to the company.

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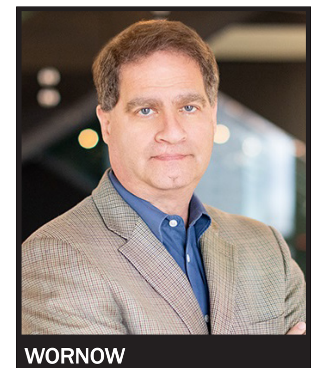
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