



# From Enron to Volkswagen and Companions: Where Were the Boards? The Importance of Governance, Culture, Compliance and Ethics.

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# INTRODUCTION

I would like to identify the root causes and share with you the conclusions of my review of some of the major corporate crises since 2000 involving corporate governance breakdowns, accounting irregularities, earnings restatements, violations of law, enforcement actions, financial failures, financial markets disruption, and other events such as those at BP, GM and Volkswagen.

These have continued through Theranos, Toyota, Yahoo and Uber.

Whether before Sarbanes Oxley, after Sarbanes Oxley, before Dodd Frank or after Dodd Frank, the reasons identified in the multiple public reports and investigations are strikingly similar.



# INTRODUCTION

My theme here is simple: you cannot legislate away bad behavior or bad judgment – but you can create sound governance that involves an ethical culture, independent risk management, and creates an environment where people do the right thing – but even then there will be mistakes and errors in judgment.

Let me start with a famous quote that I think highlights the importance of having a risk culture, an ethical culture and sound governance.

# INTRODUCTION



“When the music stops, in terms of liquidity, things will get complicated.  
**But as long as the music is playing, you’ve got to get up and dance.**  
**We’re still dancing.**”

The depth of the pools of liquidity is so much larger than it used to be that a disruptive event now needs to be much more disruptive than it used to be.

At some point, the disruptive event will be so significant that instead of liquidity filling in, the liquidity will go the other way. I don’t think we’re at that point.”

Chuck Prince, Citigroup CEO, “Citigroup chief stays bullish on buy-outs,” Financial Times, July 9, 2007.

# Introduction

## > Corporate Crises and Ethical Issues Can Arise in Different Kinds of Events

- Fraud
- Violations of law and compliance
- Excessive risk-taking
- External market or environmental events
- Financial markets disruption
- Product failures
- Environmental events
- Corporate governance breakdowns



# Introduction

> Major non-financial events that can create crises:

- BP
- Toyota
- News Corp
- Massey
- Chesapeake Energy
- Siemens
- GM
- Volkswagen
- Fox News

# Introduction

- > Major non-financial events that can create crises:
  - Wells Fargo
  - Theranos
  - News Corp
  - Toyota
  - Yahoo
  - Uber

# New Environment

- > Historically a headline event could lead to SEC, criminal and civil actions
- > New era now - - multiple Congressional hearings and investigations, intervention by the Executive Branch, actions by State AGs, public vilification, Federal and state political and governmental reactions, shareholder reaction, customer reaction, director resignations, compensation clawback, executive officer dismissals, employee reactions, whistle blowers and more.



# Velocity of and Politicization of Consequences

- > For example, a headline event in 2012 involving a major financial institution led to 14 consequences in the first 10 days of public reporting:
  - SEC investigation
  - DOJ investigation
  - FBI investigation
  - Civil class actions
  - Congressional hearings
  - Internal investigations



# Velocity and Politicization of Consequences

- Congressional legislative reaction
- Political reaction
- Shareholder activism – unsuccessful efforts to split CEO and Chairman
- Public vilification
- Executive officer dismissals

# Velocity and Politicization of Consequences

- Significant market cap loss
  - Fitch rating downgrade
  - CFTC investigation
- > One year later renewed controversy to split Chairman and CEO roles and a 1500 page Congressional Investigative Report.

# Velocity and Politicization of Consequences

- > The Wells Fargo cross-selling announcement resulted in 61 publicly reported consequences in the first 30 days following the announcement.
- > They included:
  - multiple Congressional investigations and hearings
  - executive officer dismissals
  - clawback of executive compensation
  - state and cities ceasing to do business with Wells Fargo
  - multiple employee and former employee class actions
  - multiple investigations
  - state attorney general actions
  - shareholder litigation
  - multiple regulatory actions
  - legislative reaction

# Velocity and Politicization of Consequences

- > These consequences continue through Senator Warren's recent demands that the Federal Reserve Board remove all of the members of the Wells Fargo Board.

AUGUST 4, 2017

## Wells Fargo Says It May Find 'Significantly' More Fake Accounts

The bank boosts its estimate of possible legal losses by \$1.3 billion and discloses a CFPB probe into freezing of accounts



Wells Fargo headquarters in San Francisco (Photo: AP)

Wells Fargo & Co., reeling from a scandal over fake accounts that erupted in September, said it's wrapping up an expanded review of that issue, while facing new probes and higher potential legal costs.

The bank must "go beyond what has been asked of us by our regulators by reviewing all of our operations -- leaving no stone unturned -- so we can be confident we have done all that we can do to build a better, stronger Wells Fargo," Chief Executive

Officer Tim Sloan said in a statement Friday.

The Consumer Financial Protection Bureau is looking at whether consumers were "unduly harmed" by the bank freezing and closing accounts that had suspected fraudulent activity.

# Why Do These Events Continue?

- > There are 23 Common Themes identified in the multiple investigations and reports of failures before Sarbanes-Oxley, after Sarbanes-Oxley, during the Financial Crises, after Dodd-Frank and continuing today.

# Why Do These Events Continue?

1. Breakdown of corporate governance - inadequate Board oversight, management reporting, and information flow.

# Why Do These Events Continue?

## 2. “Imperial Executive Leadership”

- > Kenneth Lay, Jeff Skilling, Andrew Faston (Enron)
- > Bernard Ebbers (WorldCom)
- > Ken Lewis (Bank of America)
- > Dennis Kozlowski (Tysons)
- > Richard Fuld (Lehman Brothers)
- > Jimmy Cayne (Bear Stearns)
- > Jon Corzine (MF Global)
- > Angelo Mozilo (Countrywide Financial)
- > Aubrey McClendon (Chesapeake Energy)
- > Roger Ailes, Rupert Murdoch (Fox News)
- > Travis Kalanick (Uber)
- > Elizabeth Holmes (Theranos)



# Why Do These Events Continue?

3. It can't happen here – arrogant suspension of belief.

# Suspending Disbelief – It Can Happen Here, Lehman

- > “At no point in time, until that Sunday, did I think it was a real possibility.....I did not think such a stupid decision could be made by intelligent people.”

Source: Lehman Lawyer, Corporate Counsel Magazine



# Why?

4. If it is too good to be true, it probably is not
  - > Inability to balance the relationship between risk and reward.



# Why?

## 5. No one expected the unexpected

- House prices to fall
- Commercial paper markets to shut down
- Conservatorship of Freddie Mac and Fannie Mae
- No government bailout of Lehman
- Well-head blowout
- Coal mine explosion
- Ignition switch problem
- Widespread manipulation of emissions testing
- Widespread abusive sales practices



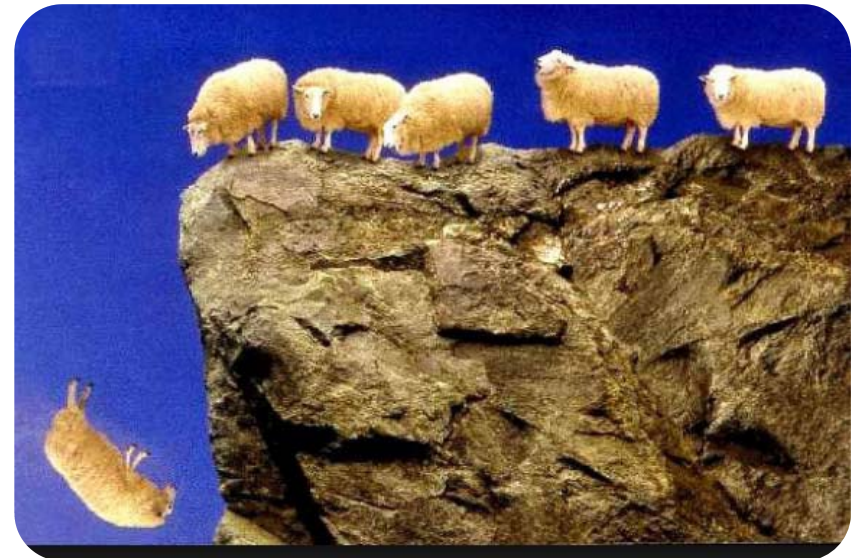
# Why?

6. Failure to escalate and report – attempts to cover up
  - “Doubling down” to avoid problems
  - It ain’t the crime – it’s the cover-up



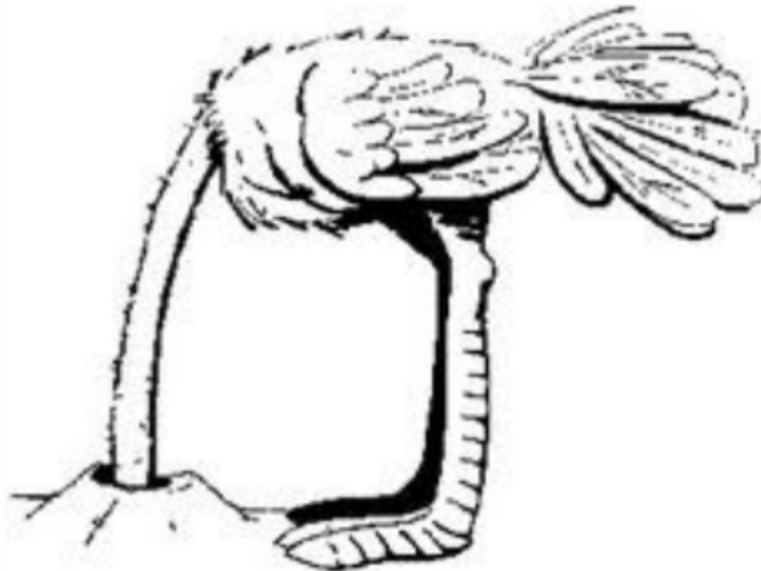
# Why?

7. As a General Counsel, this is my favorite..."everyone else is doing it"....
- Safety in numbers
  - Can't all be wrong
  - Competitive disadvantage
  - It is legal



# Why?

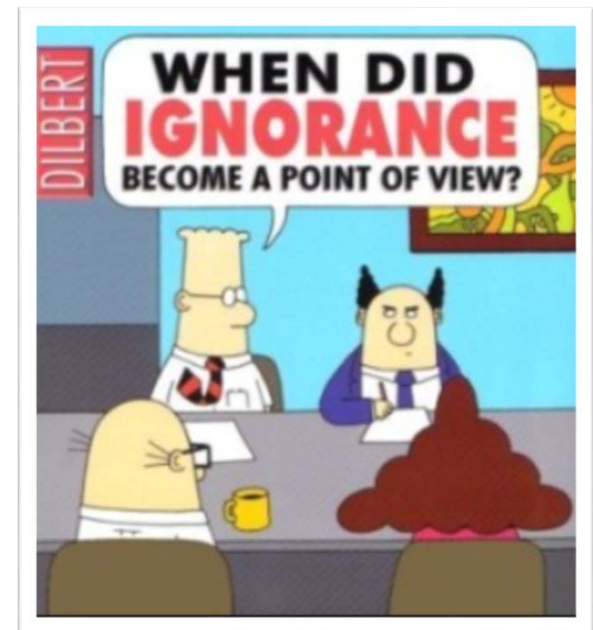
8. Absence of an effective Enterprise-Wide Risk Management System at Board and Management Levels to proactively identify, assess, prioritize and mitigate risk.



# Why?

## 9. NO RISK CULTURE

- > No emphasis on doing the right thing
- > Lack of awareness and priority
- > Complacency
- > Arrogance
- > Blind reliance on models
- > Suspension of belief
- > Lack of accountability
- > No escalation
- > No clear roles and responsibilities





# Why?

## 10. EPM and Compensation Systems

- > Rewarding the wrong behavior
- > Not incentivizing the right behavior

# Why?

## 11. Lack of Sensitivity

- > Stay sensitized
- > Constant “headline training” and awareness
- > Stay ever vigilant and mindful
- > Be skeptical
- > Constantly adjust risk-reward balance and risk tolerance
- > Trust but verify

# Why?

## Inadvertent vs. Advertent

### > Inadvertent

- Lack of sensitivity and awareness leads to “bad” decisions or no decisions.
- Business “justification” or “rationalization” clouds judgment – whether risk or violation of law or both.
- Formal and informal reminders – training, tone at the top, risk culture.

# Why?

- 12. Unachievable corporate stretch goals that encourage and incentivize illegal or inappropriate behavior
  - > Rewarding the wrong behavior
  - > Not incentivizing the right behavior

# Why?

## 13. Ignoring **Red Flags**

- Lack of sensitivity
- Not seeing
- Not believing what you are seeing
- Coming up with a business justification/rationalization



# Why?

## 14. Regulatory arrogance

- > Absence of regulatory and enforcement sensitivity – regulator is wrong and we are right.



# Why?

## 15. Long-Standing Behavior

- > Be aware of, and always self-assess, long-standing behavior and activity.
  - Libor rate setting
  - Market-timing cases
  - Off-shore tax havens
  - Sanctions and money-laundering
  - FCPA
  - Cultural norms and behavior

# Why?

## 16. Absence of Stress Testing

- > Absence of a sound stress testing and contingency plan to identify potential problems and risks, crisis management plans, and risk-adjusted analysis of business activities based on geography, lines of business, organization and governance.



# Why?

17. Absence of thinking forward with hindsight
  - > How will actions today be viewed with the benefit of hindsight.



# Why?

## 18. No harm – No foul

- > Acceptance/tolerance of de minimus violations of law because there is “no harm” and the business or individual is a key producer or part of management..

# Why?

## 19. Use of Independent Reviews

- > Failure to conduct periodic third party assessments before problems occur to ensure periodic, objective, unbiased assessments of governance and risk management practices and business practices.
- > Did not learn from mistakes
  - Root cause analysis of problems after they occur

# Why?

- 20. Management and Board indifference and tolerance of Internal Audit findings not being remediated

# Why?

## 21. Absence of INDEPENDENT internal control functions

- Legal
- Audit
- Compliance
- Risk
- Internal controls

# Why?

- 22. Ineffective internal controls and no ethical culture



**KNOW  
RISK!**

# Why?

- 23. Failure to focus on, identify and manage risk in significant business transformations

# What Should Lawyers be Doing!

- > Be a proactive and persuasive advisor to management and the Board.
- > Advise, counsel and persuade for the adoption of governance standards and a corporate culture that ensure independence, ethical behavior, and an informed independent Board.
- > Remember who your client is: the corporation acting through the Board of Directors.
- > Remember your ethical responsibilities when aware of violations of law and management fails to act.
- > Be aware of your role as the “gatekeeper” by the SEC and DOJ.



# What Should Lawyers be Doing!

- > Provide constant reminders of these 23 observations.
- > Make sure that Board is getting complete, accurate, reliable and timely information.
- > Be the devils' advocate – challenge “everybody’s doing it” justifications.
- > Educate and emphasize the importance of enterprise risk management to prevent and mitigate problems.
- > Motivate and advocate for the fostering and nurturing of an ethical culture.
- > Do the right thing: you are the conscience of the corporation.
- > Develop a crisis management plan and have it in place before the crisis.

# Lessons Learned

There are a number of lessons learned and governance challenges for a general counsel in a major corporate crisis:

1. Can't anticipate everything so have a plan in place.

# Lessons Learned

2. There are multiple simultaneous challenges involving:

- > Corporate public reputation
- > Customers
- > Vendors
- > Shareholders
- > Counter-parties
- > Regulators

# Lessons Learned

- > Employees
- > Media
- > The Administration
- > Congress
- > State AGs
- > SEC
- > Justice Department
- > State governmental authorities

# Lessons Learned

3. You need a holistic approach on a variety of fronts to minimize loss and manage litigation and investigations including:

- > Public Relations
- > Government Relations (Congressional)
- > Political
- > Clearly defined and articulated Board involvement and role

# Lessons Learned

- > Regulators
- > Enforcement agencies
- > Reputation
- > Shareholders
- > Management's role
- > Employees (how do you keep them going? Tired, demoralized, uncertain, scared, angry)
- > Customers
- > Counterparties

# Lessons Learned

4. From a legal perspective – need to be prepared for and develop a strategy for simultaneous investigations and actions:

- SEC
- DOJ
- Civil shareholder suits
- Internal investigations
- Congressional investigations
- Regulatory investigations
- State attorney general actions

## Lessons Learned

5. These events are like an iceberg, you can really only see the little part sticking out of the water but it is the mass of ice underneath that can do the most damage.
  - > When management and Boards think about a crisis that might result in an investigation or litigation, it is critical to be prepared to get on top of the issue quickly. In this environment, a headline grabbing event -- the tip of the ice berg -- results in simultaneous or rapid sequential civil litigation, governmental investigations by the SEC, DOJ, primary regulatory agency, congressional investigations, and actions by state Attorney Generals.



## Lessons Learned

6. The strategies for each are different and require an integrated, coordinated, holistic response. Managing conflicting views of multiple legal advisors who are myopically focused on their particular proceeding is a leadership challenge.

# Lessons Learned

7. Significant challenges regarding strategy, production of documents, consistency of multiple interviews and depositions:
  - > Production in one venue can be public for all proceedings.
  - > Productions to Congressional Committees may be posted on the Committee website.



## Lessons Learned

8. Developing a legal representation strategy for the large numbers of employees who may be interviewed – many of whom may not be officers and not technically entitled to indemnification.

# Lessons Learned

9. Misinformation or bad information can often times create more problems than the underlying facts.
  - > An immediate factual investigation is imperative.
  - > Information disclosure - advertent and inadvertent.
  - > The impact of these investigations and the facts for the company and the employees, and management, can be paralyzing and distracting. The political and public relations issues are overwhelming.
  - > Important to proactively monitor social media and blogs to gather intelligence on what is happening and what messaging is going on, including allegations or facts that may impact the investigative process.



# Lessons Learned

10. The consequences can go on indefinitely .

# Lessons Learned

11. Failure of boards and companies in responding can result in shareholders, creditors, suppliers and customers all acting irrationally. What are the proactive actions for boards that should be in place?

- > First, a predetermined list of advisors who know the company, and immediate fact-finding -- a careful, truthful, deliberate response is necessary no matter how painful. In particular, independent counsel.



## Lessons Learned

- > Second, conflicts can and will develop between Board counsel and company counsel – working together and partnering can be challenging.

## Lessons Learned

- > Third, from a governance perspective, the Board should decide ahead of time what its role will be -- how involved it will be. I believe that in this environment a Board, or a Board committee, must be intimately and actively involved with management. Communications and information flow to the Board is critical. There can be no surprises.



# Lessons Learned

12. What is the Board governance during the crisis – who, how much and how?

> Who?

- Entire Board
- Board Committee
- Special Committee
- Lead Director
- Non-Executive Chair
- Chair of Audit Committee

# Lessons Learned

## > How?

- Updates, Special meetings
- Timely information flow
- Input on key decisions, alternatives, implications

## Lessons Learned

13. Need to have a communications plan to all stakeholders and constituencies including shareholders, employees, vendors, customers, suppliers, regulators, Congress, the Administration -- is imperative. There must be confirmed, fact-based, open and honest communication.

# Lessons Learned

14. The identity of the public company spokesperson should be determined ahead of time.
- CEO
  - Chairman or Lead Director
  - Outside PR Firm
  - General Counsel



## Lessons Learned

15. Always do the right thing - - as lawyers you are the conscience of the corporation.

# Lessons Learned

16. You must maintain credibility, your reputation, and the trust of others - - including management, the Board, prosecutors, regulators and all employees and the public.

# Lessons Learned

17. Leadership: need to be a role model – you must inspire and lead your colleagues to work 24/7 for long periods of time under great stress and potential personal liability.



# Lessons Learned

18. Maintain relentless enthusiasm, dedication, commitment and professionalism.



## Lessons Learned

19. Most importantly, and I cannot emphasize this enough, say “thank you” – constantly show appreciations and respect for everyone.