DOJ Strategy Shift Increases Directors' Vulnerability in Courts of Law and Public Opinion

By Nir Kossovsky

When the US Department of Justice (DOJ) detailed in a November 2018 memo that "pursuing individuals responsible for wrongdoing will be a top priority in every corporate investigation," its deeper message was unmistakable. In the gray zone of culpability for wrongdoing, companies could more easily shield themselves going forward, but at the expense of individual executives and board members. The DOJ's shift in corporate prosecution strategy necessitates board members' deployment of new and more effective defenses.

When a corporate misstep occurs—whether it's a failure of systems, processes, personnel, or leadership; whether the issue is a symptom of an enterprise-wide problem or a group of rogue employees; and whether the trigger was accidental or malicious—the DOJ's statement indicates that government prosecutors are going to look for individuals to blame, and will encourage companies to cooperate.

The policy employs economic, political, and social pressures to separate the dutiful from alleged miscreants. "Corporate cases," then US Deputy Attorney General Rod Rosenstein acknowledged, "often penalize innocent employees and shareholders without effectively punishing the human beings responsible for making corrupt decisions." Yet in attempting to reduce collateral damage to the company and its corporate stakeholders, the new policy incentivizes companies to sweep individual directors—including those potentially exculpable—into the pool of suspected or alleged offenders.

Rosenstein's value of cooperation memo, which updates the DOJ's 2015 policy written by then-Deputy Attorney General Sally Q. Yates, makes clear that "any company seeking cooperation credit in criminal cases must identify every individual who was substantially involved in or responsible for the criminal conduct." That includes identifying all wrongdoing by senior management and the board in civil cases, too. Finally, the new policy eliminates the requirement that government attorneys consider factors like ability to pay when deciding whether to sue individuals for their roles in corporate misconduct.

Those swept-up individuals who are innocent will nonetheless incur material reputational damage, for trial in the court of public opinion is a rocket docket with no rules of evidence. It therefore must be the goal of boards and their advisors to use the full force of their companies' enterprise reputation risk management apparatus to shield the innocent, mitigate the exposure of the marginally culpable, and for the sake of the other directors, protect the assets of the firm from the secondary impact of shareholder derivative litigation.

The DOJ's move comes at a time when directors and officers are already increasingly in the crosshairs of the public eye. We live in an age of greater access to corporate information, a general mood of anger and mistrust of institutions, a proliferation of weaponized social media, and instigators ranging from politicians to activist investors. NACD last year published the *Report of the NACD Blue Ribbon Commission on Adaptive Governance: Board Oversight of Disruptive Risk*. The report explores the board's challenges of sorting through how these disruptions impact their businesses, including unforeseen potential reputation risks—that is, the economic and political damage that could be caused by angry, disappointed stakeholders, for instance.

The tarnish caused to individual reputations by unseemly corporate events has significant impacts. Directors serving on multiple boards will earn millions of dollars over the course of their careers from those positions. But the moment a negative spotlight shines on them in connection with one company, they become less attractive to others—leading to a loss of opportunity to continue serving companies in good faith.

A case in point of the breadth of financial damage a reputational tornado can inflict on a company and its board is illustrated by Wells Fargo & Co. The anger and disappointment of stakeholders

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ranging from customers to regulators, from a number of scandals, have reduced revenues and increased costs in the company's retail banking, commercial and industrial loans, and pension fund management businesses. It has paid billions of dollars in fines. The net effect is that over the trailing 36 months, equity investors have seen essentially zero percent equity growth while the S&P 500 large bank index has risen by 55 percent. A back-of-the-envelope calculation points to an opportunity cost of about $130 billion.

In March, Wells Fargo's directors and officers' (D&O) insurer tentatively agreed to pay the company $240 million to settle a derivative suit in what is being called the largest insurance-paid settlement ever. The settlement, valued at $320 million less legal fees, included an additional $80 million in personal clawbacks and forgone compensation. In addition, board members have paid a significant personal go-forward cash price, with 10 board members losing seats on other prestigious boards and, on average, a total of $600,000 in annual board compensation.

Not only did former CEO and Chair John G. Stumpf surrender millions in earnings and bonuses when he stepped down in October 2016, but he also left the boards of Chevron Corp. and Target Corp., losing a combined $650,000 in annual compensation. President and CEO Timothy J. Sloan, who resigned in March, was not on any other public company boards. Of the 13 remaining board members, only four are still serving at Wells Fargo. The other nine who have departed are also no longer serving on 11 other public company boards. While it's difficult to prove causation definitively, companies with strong reputations don't see a 73 percent rate of board turnover. For companies in reputational crisis that cannot exculpate their board members, such turnover is commonplace.

The DOJ, which has made the pursuit of individuals a top priority since 2015, now has more tools to pry directors loose. When a legal crisis hits, every board member and member of the leadership team is going to have to ask themselves not only, "Did I do anything wrong?" but "Am I vulnerable?" Their legal exposure and, equally important, their reputational exposure, will depend on the answers to those questions. The importance of confidential discussions in the boardroom only makes clearing one's name through nonverbal substantive actions—ones that speak louder than words—that much more essential for effective exculpation.

These crises occur with such regularity that 9 of 10 S&P 500 companies now disclose that reputational risks, in addition to all the underlying operational risks, are material perils, according to Steel City Re's research. Consider businesses where trust and reputation are vital assets: health care, finance, academia, food, and pharmaceuticals. Well-known operational risks such as Medicare fraud, insider trading, Title IX and #MeToo, food safety compliance failures, and unethical pharmaceutical sales practices today hold increasing second- and third-order risks for individual directors.

Boards rightfully turn to insurance to help manage their risks, but in cases like these, traditional directors and officers (D&O) insurance coverage won't help them. While D&O coverage may insulate against direct litigation-related costs, it offers no protection for damage suffered as a result of sullied reputations. As commonplace as D&O coverage has become, it holds no sway in the court of public opinion.

To receive credit for cooperation from the DOJ when they are targeted for investigation, companies must meaningfully assist in the government's investigation and prove that an otherwise pristine corporate virtue was besmirched by subversive rogues, internal or external. Investigators will look at the actions of boards and determine whether adequate systems were in place to protect against the misbehavior in question. Companies that have not anticipated these exposures and deployed strategic solutions—solutions that will tell DOJ investigators a simple, easy-to-understand, and credible story—will not be able to give dutiful directors the full protection they deserve.

Strategically deployed third-party warranties and validation of a board's actions will go a long way toward establishing their credibility. Such actions demonstrate that the board had engaged objective outsiders to conduct analysis, and that those objective third parties had not only attested to the company's governance but backed their opinions with insurance products. Conversely, board members who have seen their companies mention reputational risk repeatedly in public filings and have failed to engage outside experts in this manner are at risk of having to raise their right hand and explain why.

These types of warranties also deter and protect against attacks on individual board members by activist investors, politicians, and regulators, who will recognize the difficulty in mounting attacks against individuals whose decisions and actions have already been vetted and deemed dutiful by third-party insurers.

In this new environment, where every piece of economic bad news seems to require a corporate villain, where politicians jump on any opportunity to harness public anger and direct it toward corporate leaders, where social media gives any protagonist the ability to launch a tornado-like whirlwind against virtually any target, board members are at risk—regardless of the skill and diligence with which they do their jobs. And unlike corporate reputations, in the absence of strategic solutions, personal reputations rarely recover.

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