

AGENDA

Directors ‘Sitting Ducks’ for Reputational Damage Lawsuits

By Jennifer Williams-Alvarez July 8, 2019

Once rarely mentioned in court documents, reputational harm and the board’s related culpability are increasingly making their way into plaintiffs’ complaints. In fact, some 25 complaints were filed or amended in federal court that placed some responsibility at the feet of the board for a company’s reputational harm in the 12 months leading up to and including June 2019. By contrast, just six such cases were filed in the previous 12 months.

“Companies disclose that reputation is a vital asset, that reputation is a vital concern, and then nothing is being done to protect that reputation,” says **Nir Kossovsky**, CEO of **Steel City Re**, who first identified a similar uptick at the end of April. So when something happens that’s perceived to negatively impact a company’s standing, that’s pretty much the “setup” for these suits, he explains.

Consequently, according to Kossovsky, directors are “sitting ducks” for suits looking to hold board members accountable for reputational damage.

The change in filing patterns speaks to the underlying recognition that protecting reputation is pivotal for companies, sources say.

Reputational Risk-Related Lawsuits

July 2018 through June 2019

25

July 2017 through June 2018

6

Source: Agenda review of federal court filings using LexisNexis CourtLink. The review involved an initial search for filings responsive to various document text searches using terms such as “reputation,” “harm,” “risk,” “damage” and “directors,” followed by closer examination of each search result.

Directors have a critical role in mitigating reputational risks and overseeing culture, according to a panelist at the Society for Corporate Governance’s national conference last month. “As you can see in the headlines almost every day, sadly, [this] is a serious risk factor,” said panelist Dave Olsen, vice chairman of the board at nonprofit organization Providence St. Joseph Health and former senior vice

president of culture and leadership development at Starbucks. “[And it’s] one of the second-tier responsibilities of any board, so we’ve got to get it on the agenda.”

“Yes, it’s vague ... and changes from day to day, but it’s real and it’s important and we have to address that challenge,” Olsen said at the conference in San Diego.

Protecting Reputation

The series of suits, which were identified by *Agenda* using LexisNexis court records repository CourtLink, vary when it comes to the conduct that is alleged to have harmed a company’s reputation. What they all have in common, however, is the claim that oversight failures by directors exacerbated the problem.

For example, the allegations of sexual harassment by former Wynn Resorts CEO Steve Wynn, first reported by *The Wall Street Journal*, brought to light a purported decades-long pattern of systemic misconduct within the company. Among the resulting exposures for Wynn Resorts is the “billions of dollars” in damages to the company’s reputation and standing in the business community, according to a recently filed derivative suit.

And those responsible for the reputational harm, according to the March complaint filed in federal court, are current and former directors and officers who either allowed this behavior to persist or failed to take steps to prevent it.

For a variety of reasons, sources agree the court filings increase makes sense.

Board director Rajiv Gupta says he believes the uptick is due to the fact that potentially damaging issues are more often making their way into the public domain, and that plaintiff’s attorneys have seized upon a perceived opportunity.

While it’s true that frivolous suits remain prevalent, these cases still have an impact on the company, says Gupta, a director on a number of boards, including manufacturing company Arconic and global auto parts company Aptiv where he is chairman.

Indeed, companies have to decide whether to settle or take on the distraction and the expenses associated with prolonged court battles regardless of whether insiders feel the case has merit, he explains.

For Arthur Kohn, partner at Cleary Gottlieb Steen & Hamilton, it comes down to the severity of the potential fallout. Customers, investors and various other stakeholders are stressing the importance of a company’s reputation, he says.

At the same time, Kohn says, goodwill can be wiped out or severely damaged with one scandal.

With the #MeToo claims, for example, a business’s reputation can take a significant hit in a relatively short period of time for conduct that did not previously get such exacting attention, he

suggests. “The corporate scandals we’ve had in the last couple of years seem to have a bearing on a business’s reputation, where, let’s say, prior accounting scandals ... didn’t have the same impact.”

It’s no surprise then that the litigation increase coincides with sources’ perception that boardrooms are placing more emphasis on the health of a company’s reputation.

Gupta tells of three major reputation-related pain points facing companies at the moment: bad behavior, attempting to cover an issue up, and questions about the quality of goods, products or services provided by a business. While these are not necessarily new challenges for companies and boards, he says that in the current environment and because of social media platforms, dirty laundry is “going to surface,” which presents a reputational risk that did not previously exist.

Directors must ask how a company is thinking about reputational risk — for instance, by considering the way employee hotline issues are handled, how the audit committee is looking at fraud and what is being done to address #MeToo issues, he says.

Attorney Daniel Zinman says the heightened focus on reputational harm may stem from the broader understanding that companies need to protect their own image, and it may also, in fact, be driven by reputational harm–focused lawsuits, suggests Zinman, a litigation partner at law firm Richards Kibbe & Orbe whose practice includes defending companies, senior executives and board committees in litigation and regulatory proceedings.

“A derivative suit on its own is a reputational issue for the company and the board,” Zinman says. “[Those suits] are never good for the board.”

An 'Incremental Shift'

Beyond federal courts, a recent development in Delaware has further elevated directors’ role in risk management, as the Delaware Supreme Court reversed last month the Chancery Court’s dismissal of a suit claiming directors breached their Caremark duties, an historically difficult feat for plaintiffs.

The case — one of several — arose out of a 2015 listeria outbreak at ice cream manufacturer Blue Bell Creameries, which has been linked to three deaths. The company shut down production and recalled all products in the wake of the outbreak and ultimately laid off 37% of its workforce.

“The harm suffered by Blue Bell and its stockholders was catastrophic,” the August 2017 derivative complaint said. As alleged by plaintiffs, despite a history of substandard operations and warnings from employees about factory conditions, senior management disregarded contamination risks and board minutes indicate directors had no system in place that required reporting from management about food safety.

The Chancery Court dismissed the suit in the fall of 2018, which the Supreme Court reversed in June. There is a “reasonable inference that the Blue Bell board failed to implement any system to

monitor Blue Bell's food safety performance or compliance," and thus a viable claim exists that directors breached their Caremark duties, according to the opinion.

"Although Caremark may not require as much as some commentators wish, it does require that a board make a good faith effort to put in place a reasonable system of monitoring and reporting about the corporation's central compliance risks. In Blue Bell's case, food safety was essential and mission critical," the opinion reads.

Kohn says it's early yet to predict what the development in the Blue Bell case will mean for scrutiny of directors when Caremark claims are made. These are claims that are known to be among the hardest in which to prevail, he says, but it's also not difficult to imagine courts' being sympathetic when the stakes are as high as they were at Blue Bell.

And that could reach beyond food safety issues, Kohn says. For example, the consequences of #MeToo allegations have come to be acknowledged by society as more pervasive and destructive than previously recognized.

"I don't see a radical shift here," says Kohn. "I see an incremental shift. But incremental or marginal shifts can be important."