Board of Directors Role in Corporate Compliance and Ethics

ACC Compliance and Ethics Committee Teleconference
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Board’s Role in Ethics and Compliance

• Company’s business and affairs are managed by or at the direction of the Board. Del. G.C.L § 141(a), giving rise to fiduciary duties

  – Establish compliance standards and procedures for employees and agents
  – Oversight by high-level personnel
  – Due Care in delegating substantial discretionary authority
  – Effective Communication to all levels of employees
  – Reasonable steps to achieve compliance, which include systems for monitoring, auditing, and reporting suspected wrongdoing without fear of reprisal
  – Consistent enforcement of compliance standards including disciplinary mechanisms
  – Reasonable steps to respond to and prevent further similar offenses upon detection of a violation
Board Must Establish Oversight

  - Board has an affirmative duty on board to create compliance mechanisms.
  - Stockholder must show a “sustained or systemic failure of the board to establish oversight.”
  - Directors utterly failed to implement any reporting or information system or controls; or
  - Directors failed to monitor or oversee operations so they disabled themselves from being informed of risks or problems requiring their attention.
  - In either case, imposition of liability requires a showing that Directors knew that they were not discharging their fiduciary obligations.
Best Practices Beyond Compliance Programs

• National Association of Corporate Directors (NACD) Best Practices Council
  – Tone at the Top
  – Director independence and meaningful equity ownership
  – Focus on fraud prevention
  – Open communication between and among the Board and management
Potential consequences of not exercising oversight

- Lose “business judgment rule” protection
- SEC investigations
- Director liability (MusclePharm)
- ISS “withhold” vote recommendations (Target cyber-security breach)
- Collapse (Enron, Tyco, WorldCom, Adelphia)
- Harsher criminal sentences
Documenting Director Oversight

• Board and Audit Committee minutes should document:
  – Ethics and Compliance Policy Review
  – Discussion of Conflicts of Interest
  – Discussion of Related Party Transactions (should be few in number)
  – That the Directors engaged in a reasonable diligent process by asking questions, seeking independent professional advice, etc.
  – When Enron’s CFO created venture equity companies to conduct business with the Company, the Board approved waiver of the conflicts with “little debate or independent inquiry.” The Role of the Board of Directors in Enron’s Collapse, S. Rep. No. 107-70, at 24 (2d Sess. 2002).

• Hot Line Reports
  – Audit Committee review of Hot Line Reports
  – Organize reports to help spot red flags (e.g., by geography or reporting structure)
Documenting Director Oversight

- Review of Code of Conduct
  - Enron Code provided that the CEO was allowed to waive the Code of Ethics!!!
  - Foreign languages
  - FCPA, AML, Cyber-security risks
- Review Related Party Transaction Policy
- Ethics and Compliance Training
  - Document employees and Directors participation
  - Annual certifications
Compensation Risks

• Balance between “pay for performance” and encouraging undue risk taking, proposed rule S-K Item 402(v), among other things, requires proxy disclosure of TSR vs. peer group

• *Amalgamated Bank v. Yahoo!, Inc.*, No. 10774-VCL at 42 (Del. Ch. Feb. 2, 2016) (“The directors’ involvement appears to have been tangential and episodic, and they seem to have accepted [the CEO’s] statements uncritically. A board cannot mindlessly swallow information, particularly in the area of executive compensation . . . .”).

• *In re Walt Disney Co. Deriv. Litig. (Disney III)*, 825 A.2d 275 (Del. Ch. 2003) (allowing claim where complaint alleged that “directors abdicated all responsibility to consider appropriately” a materially important hiring decision).

• Compensation Recovery (clawbacks), Section 304 of Sarbanes-Oxley and Section 954 of Dodd-Frank, Proposed Rule 10D-1
Reporting to the Board

- Private Audit Committee sessions with key management (CEO, CFO, GC, and Internal Audit)
- “Up the Ladder” reporting to CLO, CEO, Audit Committee and Board of material violations, Section 307 of Sarbanes-Oxley