

From the Experts: Inside Job

Governance lessons from the News of the World controversy.

By **Michael Peregrine** – September 14, 2011



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The controversy surrounding the shuttered U.K. newspaper The News of the World—so prominent in the press this summer—offers general counsel a unique governance “teachable moment” with their board of directors.

It’s not about who is right and who is wrong; about which allegations are true and which are false. For our purposes, it doesn’t really matter and, besides, it’s best to leave those issues to the courts. Rather, it is from behind the salacious headlines that the truly valuable core governance themes emerge: those relating to director independence; reputation preservation; compliance effectiveness; and responsible corporate officer liability.

Not every corporation is going to find itself in a front-page-worthy scandal that embroils political and law-enforcement leaders. That’s not the point. Chances are, however, that many corporations will nevertheless become involved, to one degree or another, in a highly public controversy implicating many of the same governance issues. This recent “Murdoch Melodrama” serves as a vivid and irresistibly interesting example of how corporate governance issues are often found at the core of organizational scandal. And that’s a “board-education gift” to the general counsel.

The most practical News of the World governance lessons include the following:

The Importance of Independence

Criticism of News Corporation’s board composition underscores the value attributed to preserving governance control in directors who are independent, in all meaningful respects.

According to media reports, nine of News Corp’s 16 directors are considered independent in accordance with applicable NASDAQ standards. The specific criticism has centered on the number of independent board members who are allegedly beholden to the Murdochs, in one form or another (e.g., personal friends, business acquaintances, and former employees).

So, while there is no question that the company satisfies applicable independence standards, it is nevertheless challenged as to the level of independent oversight actually provided by the board. This speaks loudly to the importance placed on assuring board control in independent directors who are not predisposed to be deferential to executive management. General counsel should thus remind the board of the importance of the “optics” of independence. Board independence is more than simply meeting statutory or self-regulatory agency standards. It also involves “going the extra mile” to ensure true separation from management.

Independence issues may also affect the perceived integrity of an internal board review process. For example, there has been substantial public criticism of the News Corp board’s investigating committee, because it allegedly reports to the board through a senior corporate executive (who is also a board member) to an independent director.

The governance concern in this instance is the perceived loss of objectivity if the committee reports to the board through an executive (thus potentially beholden to the chief executive/major shareholder), as opposed to outside counsel. This notwithstanding the fact that outside counsel is involved, that the executive is a highly regarded former public official, and that both he and the independent director to whom he reports are former U.S. Department of Justice officials.

RCOD Realities

Public calls for the Murdochs to “take the fall” for the hacking scandal mirror increased government use in the U.S. of “responsible corporate officer” (RCOD)-based strict liability theories of enforcement.

The Murdochs have denied any knowledge of wrongdoing in connection with the scandal, with Rupert Murdoch famously noting that as head of a global enterprise with over 53,000 employees, he can hardly be expected to be aware of every decision made at each of his affiliates. Fair enough, yes? But the responsible corporate officer doctrine seeks to hold corporate leadership responsible for organizational noncompliance—regardless of whether the officer or director had any involvement with, or knowledge of, the challenged conduct. RCOD use reflects government interest in “following the conduct” to identify individuals who can be held responsible—whether they are in the field, executive suite, or boardroom. Historically, RCOD enforcement has been used to prosecute officers and directors for misdemeanor violations of “public welfare”-type statutes. The pharmaceutical, medical device, and hospital industries have been particular targets.

However, general counsel should be increasingly aware of the application of RCOD-based theories beyond the public-welfare context—in part because they appeal to a “frontier justice” mentality that has a certain political/media appeal. While defenses to RCOD enforcement are limited, certain proactive steps can be undertaken by the general counsel to better position organizational officers and directors for such a challenge (e.g., demonstration that the officers and directors had taken “extraordinary care” to prevent noncompliant corporate behavior).

Corporate Compliance

There is also a compliance oversight lesson to the scandal. General counsel might fairly ask: What is the compliance risk equivalent of phone hacking for his or her company? Does the compliance plan cover those kinds of risks? Should it? After all, Caremark doesn’t require perfection from a compliance plan, but rather that it be reasonably designed to identify and address compliance risks.

The News of the World scandal should prompt the general counsel to check whether the plan effectively covers the range of compliance risks reasonably facing the company—and whether the company’s reporting systems truly encourage employees to report related concerns. You know, that whole “culture of compliance” thing.

Along the same lines, the scandal provides a great opportunity to remind officers and directors of their duty to make reasonable inquiry. Caremark requires directors to act when suspicions are aroused, or should be aroused. Compare this to the criticism of James Murdoch for allegedly failing to comprehend the compliance significance of what has been described as an unusually large settlement the company paid to settle litigation with hacking-related implications.

The Reliance Factor

Another News of the World lesson arises from the controversy between the company and a former law firm with respect to the scope of the firm’s engagement and its advice. According to media reports, the firm strongly disputed the Murdochs’ characterization of its engagement as a “broad ranging internal

investigation” of the hacking scandal, and the board’s ability to rely on the advice to conclude that no credible evidence existed of a broader scandal.

The law firm was allegedly pressured to rephrase its findings to be more supportive of the company. This dispute provides general counsel with an opening to review with their boards the extent to which they may rely on the opinions of outside experts and the importance attributed to understanding what the advice says—and doesn’t say.

Reputation

Of course, the end result is that News of the World was shut down. Jobs are lost. Careers cratered. Lives forever altered. As such, the scandal allows the general counsel to remind the board that part of its core fiduciary duties is to help preserve the reputation of the organization, its assets, and its mission. And, as some regulators have interpreted this duty, it may mean making the connection between board action and oversight, and the impact thereof on the organization’s reputation.

Conclusion

In the end, much of what we understand about News of the World is not based on fact, but rather on allegations, opinions and inferences contained in multiple media reports. Yet whether fact or fiction, the scandal as reported provides general counsel with a near-law-school-perfect governance hypothetical, tailor-made for board education purposes. Not only is it riveting, but the issues are universal —and instructive whether the company is publicly traded, private/closely held, or nonprofit.

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