

# Corporate Scandals Near and Far: Governance Lessons Learned...?

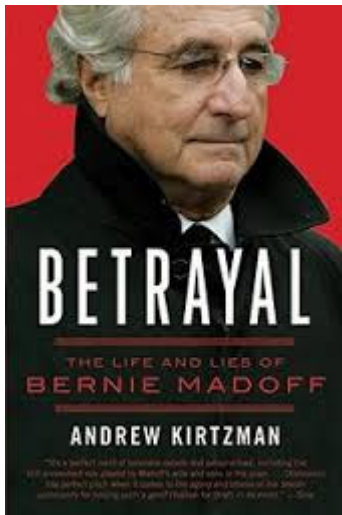
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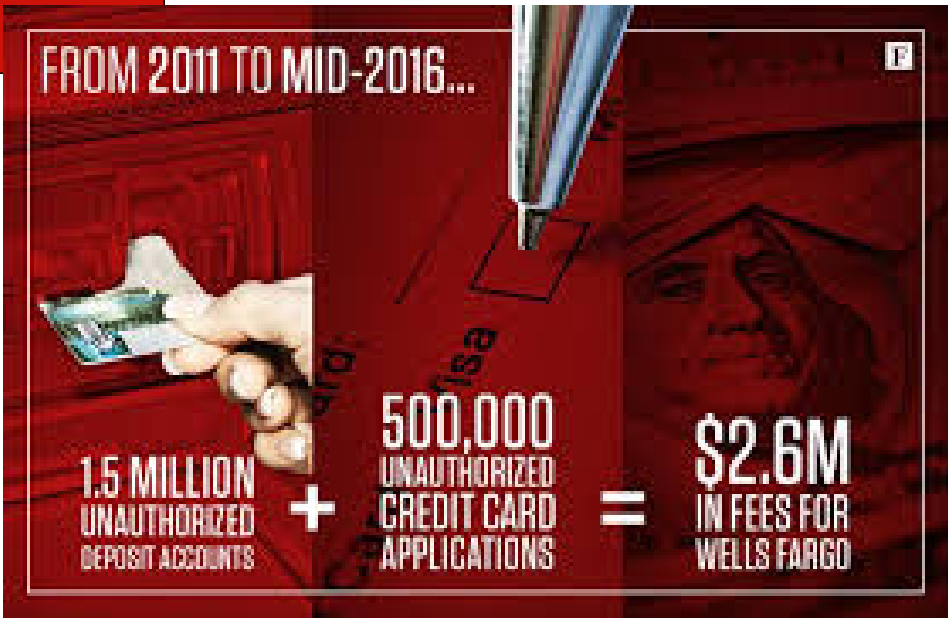


# Scandals?



# Wells Fargo Account Fraud

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# VW Diesel Scandal



## History of the VW Diesel Scandal

- May 2005: VW engineers reported it was impossible that its new engine could comply with US NOx emission standards using VW's technology.
- VW management initially agreed.
- New VW management reversed decision.
  - Directed design and installation of a “Defeat Device” software .
  - Software causes vehicle computers to run emissions control system to perform properly during emissions testing modes.
  - Software shuts down when vehicles are operating on streets and highways with vehicles emitting NOx up to 40x legal limits.

# History of the VW Diesel Scandal

- VW actively promotes “Clean Diesel” as alternative to Hybrid and EV:

**Efficiency. Now available without compromise.**

Hybrids aren't the only game in town. TDI® Clean Diesel engines offer up impressive efficiency numbers too. Take the Passat TDI for starters. It can go up to 814 miles uninterrupted. Now that's a game changer.

- Seven efficient models to choose from
- Efficiency from up to 29 to 46 hwy mpg
- Ranges from up to 594 to 814 hwy miles on a single tank of fuel

[View key fuel efficiency and range info](#)

A rear three-quarter view of a blue Volkswagen Golf TDI. The car is positioned on the right side of the advertisement. The rear features include the VW logo, 'GOLF' and 'TDI' badges, and a license plate that reads 'TEP 174'. The background is a light, neutral color.

- In Model Years 2009 through 2015, software is installed in 11 million diesel vehicles worldwide. 500,000 in the United States.
- Jetta, Beetle, Passat, A3, Golf, Audi Quattro and Porsche Cayenne.

## History of the VW Diesel Scandal

- 2014 International Council on Clean Transportation asks West Virginia University Center for Alternative Fuels Engines and Emissions (CAFEE) to help demonstrate benefits of US diesel technology.
  - CAFEE finds discrepancies showing poor on-road emissions. The researchers found that when tested on the road, some cars emitted almost **40 times** the permitted levels of nitrogen oxides.
  - The presentation of the testing results at a public forum and the publication of these results drew the attention of the EPA.
- 2014–2015 EPA repeats tests and contacts VW for explanation of poor real world NOx emissions.

## History of the VW Diesel Scandal

- September 18, 2015: EPA serves Notice of Violation alleging 482,000 automobiles equipped with 2.0 litre TDI engines sold in US since 2009 have "defeat device".
  - EPA states VW has admitted to the use of a so-called defeat device. Deputy Attorney General notes this is an "opening salvo."
- September 21, 2015: VW stock falls 20%.
- September 22, 2015: VW announces it will spend **\$7.3B** to cover the costs of the scandal; its stock price declines another 17%.
- September 23, 2015: CEO Winterkorn resigns.
- VW launches internal investigations by accountants and Jones Day.



## History of the VW Diesel Scandal

- October 8, 2015: Michael Horn, President and CEO of Volkswagen Group of America, in sworn testimony before the House Energy and Commerce Committee's oversight and investigations panel, stated:

“This was a **couple of software engineers** who put this in for whatever reason,” Michael Horn, VW's U.S. chief executive, told a House subcommittee hearing. “To my understanding, this **was not a corporate decision. This was something individuals did.**”

- December 2015: VW Chairman Dieter Hans Pötsch observed:  
“The key finding is that we are not talking of a one-off **error**, but a whole chain of **errors** that was not interrupted at any point along the timeline.”

## Aftermath of Scandal

- January 4, 2016: U.S. DOJ, on behalf of EPA, sues VW.
- March 9, 2016: VW US CEO Michael Horn resigns, citing a "mutual agreement" with the company.
- April 21, 2016: VW announces that it will offer its US customers "substantial compensation" and car buyback offers for nearly 500,000 2.0-liter vehicles.
- October 25, 2016: a US federal judge approves a **\$14.7B settlement** with 3 federal agencies for 2.0 liter engines:
  - \$10B allocated for buybacks of affected vehicles
  - \$2.7B allocated for environmental litigation
  - \$2B allocated for clean-emissions infrastructure
- December 21, 2016: VW reaches 2<sup>nd</sup> settlement for 3.0 liter engines.

## Aftermath of Scandal (Criminal & Civil Penalties)

- January 11, 2017: U.S. DOJ announces **\$4.3B** in penalties. Indicts 6 VW executives for connection with scandal.
  - Oliver Schmidt (Head of American regulatory compliance) charged with eleven felonies (including conspiracy to defraud United States), with maximum sentence of 169 years in prison.
- April 21, 2017: VW was officially sentenced and VW is ordered to pay a **\$2.8B** criminal fine.
- April 21, 2017: Canadian settlement reached for class action covering over 105,000 vehicles, requiring VW to pay **\$1.6B**.

## Aftermath of Scandal (Company Value and Reputation)

- Since September 18, 2015, more than  $\frac{1}{4}$  of VW's market cap has vanished. VW has abandoned its goal of becoming the world's largest automaker by 2018.



- Already 200+ civil lawsuits have been filed, claiming economic harm arising from VW's "Clean Diesel" marketing campaign and cars under EPA violation.
- June 2, 2017: German ministry demands that Audi recall some 24,000 diesel Audi models manufactured between 2009 and 2013

## What is the Scandal?

- The creation and insertion of the “Defeat Device”?
- The design and approval came from senior executives?
- Employees throughout the organization participated in the exercise?
- VW engaged in a cover-up for several years after the creation and installation?
- Once the cover-up was unearthed, executives tried to downplay the severity and engage in additional projects?
- VW lied to regulators, customers, vendors, and employees?
- VW failed to properly identify the problem in the financials?

## Common Threads Among the Scandals

- Senior management insist upon infeasible objectives with no tolerance for failure.
- Secrecy among staff/management.
- Dissenting views are not permitted (including intimidation).
- Lack of oversight.
- Lack of an ethical culture.
- Incentives for bad behavior.
- Absence of effective enterprise risk management systems.

## Take Aways

- Legislation Isn't Sufficient.
  - You can't eliminate bad behavior or bad judgement.
- Corporations (with counsel) need to promote sound governance that involves:
  - Creating and maintaining an ethical culture
  - Adopting appropriate risk management
  - Formulating a crisis management plan
  - Motivating people to do "right"
- Create the right incentives (including compensation) to reward good behavior and punish unethical conduct.
- Train people to understand the principles

## What Should We – as Lawyers – Do?

- Proactive Adviser to Senior Management and Boards of Directors
  - Ensure independence,
  - Promote ethical behavior, and
  - Provide accurate, reliable and timely information
- Stay Abreast of
  - Regulatory Changes,
  - Evolving corporate culture, and
  - Innovative Practices adopted by other companies and institutions
- Educate and Emphasize the Importance of Risk Management.



## What Should We – as Lawyers – Do?

- Don't Ignore Red Flags.
- Be Conscious about Acquiescing to Bad Behavior
- Don't Hide Violations of Law in the Absence of Harm
  - Post-Mortem “Cover-Ups” Only Make Problems Worse.
- Consider “Optics”
  - Public and Juries may view your company's actions or omissions much more harshly than colleagues
- Remember Your Client

## Board of Directors Responsibilities

- Fiduciaries Duties
  - Boards have Potential Liability for Breaches for not having exercised a reasonable degree of oversight and control.
- Oversee and Scrutinize Regulatory Concerns and Management
- Review Incentive Structures and Indemnity Arrangements
  - Executives, Employees and Board
- Explore Risk Portfolio and Downside Protection(s)
- Plan For Unexpected Challenges
  - Are there specific plans for security breaches, death of executives, financial mismanagement, environmental risks, employment disputes?

## Summary

- Scandals emerge not from a single mistake, but rather from Intentional, Willful, and Deliberate Actions.
  - Actions often occur in three phases: the initial action, the continuum of the practice, and cover-up.
- Minimize the Likelihood of Scandals by:
  - Create a Culture of Ethical Conduct
  - Practice What you Preach
  - Trust But Verify
  - Start at the Top (with the Board of Directors, as appropriate)
- Ways to Respond

## Speaker

Joshua Geffon is a strategic partner to entrepreneurs, executives and in-house legal teams, collaborating with innovative companies throughout their life-cycles, from nascent stage startups to billion dollar public corporations.

Joshua regularly advises emerging growth companies, conducts mergers and acquisitions for middle market and public corporations, and provides counsel and advice to boards of directors and senior management on corporate governance, intellectual property and technology transactions. Joshua's experience includes a significant number of purchase and sales transactions.

Joshua is the co-chair of the ABA Venture Capital Transactions Subcommittee and is a member of the ABA Mergers and Acquisitions and Legal Opinions Committees.

Joshua has been a Finalist for Corporate Counsel of the Year as identified by the Los Angeles Business Journal in 2015, and recognized as a Rising Star by Southern California Super Lawyers in 2017, 2014, 2013 and 2012.



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