Bloomberg Law

Corporate Law & Accountability Report™

CORPORATE GOVERNANCE

''Power tends to corrupt, and absolute power corrupts absolutely.''

—John Emerich Edward Dalberg-Acton, 1st Baron Acton

Uber's Continuing Corporate Governance Crisis: Out of the Frying Pan and Into the Fire?

BY CHRISTOPHER J. HEWITT AND JAYNE E. JUVAN

Even with new CEO Dara Khosrowshahi at the helm, Uber, the privately held ridehailing company that disrupted the taxicab industry and is purportedly valued at $70 billion, cannot seem to stem the tide of negative press, lawsuits and regulatory actions. Most recently, the scandal-plagued company announced that hackers stole data from 57 million drivers and customers. According to media reports, not only did the company know about the breach for more than a year and fail to disclose it, the company even paid a $100,000 ransom and entered into non-disclosure agreements with the hackers to keep it quiet. Khosrowshahi, touted as the captain who would right the ship, disclosed the breach and the cover-up more than 60 days after he learned of it.

Christopher J. Hewitt is a partner, Corporate Governance Group Co-Chair, and M&A Group Chair at Tucker Ellis LLP. He can be reached at 216.696.2691 or christopher.hewitt@tuckerellis.com.

Jayne E. Juvan is a partner, Corporate Governance Group Co-Chair, and Private Equity Group Chair at Tucker Ellis LLP. She can be reached at 216.696.5677 or jayne.juvan@tuckerellis.com.

The list of Uber's alleged misdeeds under the leadership of co-founder and prior CEO Travis Kalanick is long and salacious and goes far beyond the recently disclosed data breach. Based on media reports, Uber has been accused of misclassifying employees as independent contractors, refusing to take responsibility when an Uber driver killed a six-year-old girl because the driver did not have a ride booked at the time, and creating a hostile work environment. Uber has also purportedly been negligent in conducting background checks on drivers, booked rides from competitors and then cancelled them, and effected surge pricing during crises such as Hurricane Sandy.

It will be difficult to complete a full turnaround at Uber until the board recognizes it has operated in a dysfunctional fashion.

Under pressure from investors, Kalanick ultimately resigned. But the company, its enigmatic co-founder and the new CEO brought in to replace him continue to draw attention, both for the company's aggressive workplace culture, begun in part due to Kalanick's larger-than-life personality, and its perceived—and ongoing—corporate governance failings. While Kalanick no doubt bears much responsibility for Uber's misdeeds, the board, given its oversight responsibility, cannot lay the blame solely on him. It will be difficult to complete a full turnaround at Uber until the board rec-

ognizes it has operated in a dysfunctional fashion in the past and instead adopts better practices.

Basic Principles of Corporate Governance

While the media has largely focused on Kalanick's behavior, under state corporate governance principles, much of the responsibility for Uber's missteps lies with its board.

Under Delaware General Corporation Law (which applies because Uber is incorporated in the state), the business and affairs of every corporation are to be managed by or under the direction of the board of directors. The Model Business Corporation Act (the ''Model Act'') and most corporate laws in other states have similar provisions. Stockholders have equity ownership interests and often have voting power over key issues, but the board has the responsibility for oversight and decision-making.

The Model Act and Delaware law both require an annual election of directors by the stockholders. A director holds office until her successor is elected by the stockholders at the next annual meeting. Directors may only be removed before the next annual meeting by the stockholders. In short, except in the very narrow circumstance where directors can fill vacancies on the board, stockholders exclusively elect directors.

Directors owe fiduciary duties to the corporation—namely, the duty of care and the duty of loyalty. Under the duty of loyalty, directors must act in the best interests of the corporation and avoid self-dealing. Pursuant to the duty of care, directors have the responsibility to carefully consider matters before acting.

Under the corporate governance framework established under Delaware law and the Model Act, the board of directors provides guidance and supervision to management, and management executes on the board-approved strategy. Pursuant to this authority, the board is responsible to select, evaluate, and monitor management, including the CEO. If the CEO is underperforming or engaging in misconduct, the board has a responsibility to take remedial action.

Uber's Corporate Governance Framework

As with many high-growth private companies, it is not unusual for a company's founder to serve in the dual capacity of director and CEO. Similarly, as the company raises capital and takes on investors, it is very natural for the board to grow, with the new investors appointing board members. It is also quite common at this stage of a company's life to add independent directors who are beholden to neither the founder nor the new investors. Uber followed this framework until June 21, when Kalanick resigned as CEO under pressure from several large venture capital and institutional investors. The following description of what then happened at Uber is from media reports.

Frustrated by the years of missteps and scandals, Benchmark Capital Partners, a venture capital investor in Uber, presented a request for Kalanick to resign on behalf of itself and other stockholders. Kalanick ultimately agreed to step aside and, within about six weeks of his resignation, Benchmark then took the unusual step of unilaterally suing Kalanick to remove him from the board. Given the additional dysfunction this move created, the lawsuit prompted several other of the company's stockholders to request that Benchmark surrender its own board seat and divest enough stock so that it no longer had the right to appoint a board member.

In late August, Khosrowshahi, the former CEO of Expedia, was selected as Uber's new CEO over more well-known candidates Jeff Immelt of General Electric and Meg Whitman of Hewlett Packard Enterprise. Incidentally, Khosrowshahi's appointment was leaked live from the boardroom, showing that the typical protocol of maintaining the confidentiality of board deliberations was not followed.

On Sept. 27, Khosrowshahi and Goldman Sachs, another Uber stockholder, presented a proposal to the Uber board that would, among other things, shift power on the board from Kalanick to Khosrowshahi. In particular, the plan gave the power to nominate candidates for three current directorships to Khosrowshahi if those directors resigned. It also allowed Kalanick to keep his board seat only if approved by Khosrowshahi, but divested Kalanick of two other board seats he controlled but had not filled. Softbank Group Corp. would fill one of those two board seats if it completed its approximately $10 billion investment in the company (comprising $1 billion to $1.25 billion in new money and cashing out existing investors), and the CEO of a Fortune 100 company would fill the other. Khowrowshahi had the right to approve this latter director candidate, and, if he rejected the proposed candidate three times, he could then designate someone for the directorship himself. In short, while stockholders ultimately have to elect his nominees, this plan effectively gave Khosrowshahi control of six of 11 board seats, including his own, meaning that he would have power over a majority of the board seats. The plan also proposed to cut the voting power on the shares held by Kalanick (and other stockholders) from ten votes per share to one vote per share, further diluting Kalanick's power over the board. The board was set to consider this proposal at a meeting on Oct. 3.

In response to the proposal, on Sept. 28, Kalanick used the authority the Goldman/Khosrowshahi plan sought to take away from him to increase the number of directors from nine to 11 and appoint Ursula Burns, the former CEO of Xerox, and John Thain, the former chief of Merrill Lynch, to the board without consulting the remaining board members. Kalanick reportedly exercised this authority because he believed the Goldman/Khowrowshahi plan demonstrated poor corporate governance and was intended to shift power away from the board to Khowrowshahi. Without question, the plan certainly shifted power away from Kalanick.

At the Oct. 3 board meeting, in lieu of the board changes proposed in the original Goldman/Khowrowshahi plan, the board voted unanimously to add six additional directors to the 11-person board, including an independent chairperson, three independent directors, and two directors to be nominated by Softbank. Kalanick also agreed to seek board approval of any future appointees for the three seats he controls, and Benchmark agreed to suspend its lawsuit against Kalanick. All of these governance changes are contingent upon SoftBank completing its investment, which is far from certain to occur.

Out of the Frying Pan and Into the Fire?

The Uber board was, at minimum, lax in fulfilling its oversight responsibilities as Uber used aggressive busi-

   ISSN 2330-6300

ness tactics to grow the company, while at the same time the corporate culture became toxic. Laying blame solely on Kalanick is insufficient, as the board had the responsibility to oversee his management of the company. The media scrutiny surrounding Uber's missteps, e.g., how it treats its drivers, employees, customers, and most recently, the data security breach, is clearly warranted even though Uber is a private company. These are societal issues that may also violate a myriad of laws. These repeated missteps demonstrate that the board undertook its oversight responsibilities poorly and indicate significant corporate governance failings. To their credit, however, stockholders eventually found the courage to force Kalanick's resignation as CEO, which can be difficult to effectuate when dealing with a company's founder.

Most, if not all, of Uber's problems stem from the fact that Kalanick operated largely as a ''one person show'' and, in so doing, exerted too much influence over the board. From the media accounts, it is apparent that the board neglected one of its primary functions and failed to properly supervise Kalanick as CEO. This result is not surprising given that Kalanick is not only a director, but had the authority to hand pick other directors, and served in the capacity as the CEO. The company effectively lost the inherent checks and balances that should occur in a paradigm in which management is accountable to the board and stockholders, and the board is accountable to the stockholders. In the Uber situation, Kalanick was accountable only to himself.

It is not unusual for private companies to operate in a cavalier manner.

That Uber neglected adherence to corporate governance ''best practices'' or even technical corporate law requirements is not surprising as Uber is a private company. It is not unusual for private companies to operate in a cavalier manner. These companies oftentimes do not hold meetings of stockholders to elect directors, and directors hold over from year to year. The board also may not be refreshed in a thoughtful fashion—board members often are replaced only when someone steps down for personal or other professional reasons, and the board fills the vacancy. Even when the company takes on investors, stockholders tend to have an agreement among themselves as to the number and appointment of directors. While this form of governance can become sloppy, this is the practical reality of how closely held companies often operate. Uber is still a private company, so, on the one hand, it is not surprising that it fell victim to careless practices. On the other hand, given its $70 billion valuation, the presence of more sophisticated, investor-nominated directors, and its corporate compliance risks, it certainly is not unreasonable to expect that Uber's board processes should have been further refined.

The stockholders and board seemingly recognized that the status quo was unsustainable and considered alternatives. Nevertheless, did the Uber board actually fix its corporate governance problems with the selection of Khosrowshahi or the governance changes it ultimately approved at the Oct. 3 meeting?

Under the original Goldman/Khowrowshahi plan, Khowrowshahi would have effectively controlled six of Uber's 11 board seats. Ironically, it was Kalanick's use of his authority to appoint two directors in addition to himself, a questionable corporate governance practice itself, that caused a revision to that plan. It is unclear from the media reports what, if any, control Khowrowshahi has over the four new board seats not filled by SoftBank. If Kalanick is correct that Khowrowshahi has control over any of these seats, the board may simply have perpetuated the dysfunctional controlling CEO model and the same problematic paradigm that existed when Kalanick was the CEO.

While, by all accounts, Khowrowshahi was an effective and successful CEO at Expedia, there are indications he may have some of the behavioral traits exhibited by Kalanick. At an Aug. 30 all-hands meeting, Khowrowshahi reportedly commented to employees, ''I love our board. They picked me. So, awesome.'' Similarly, in an email to employees after Kalanick appointed Thain and Burns, Khowrowshahi allegedly wrote, ''Travis appointed two new members to Uber's Board ***without discussing it with me*** or the Board of Directors more broadly.'' (emphasis added) These statements do not give the appearance that the new CEO is taking a more humble, thoughtful, and measured approach to leading the company.

And, as if to prove that nothing has changed at Uber, Khowrowshahi also seems to have bungled the response to the recently reported data breach. According to media reports, he was aware of the data breach that exposed 57 million riders and drivers' personal data at least two months before the breach was made public, which itself was over a year after the breach occurred. This is longer than state law often allows a company to report a breach upon initial finding—and Khowrowshahi had to have known that the company was already months and months delinquent on these breach notices. While the breach and the cover-up cannot be laid at Khowrowshahi's feet, sitting on the information two months himself before going public is clearly his responsibility.

A 17-member board is so large that it may ultimately be unwieldy and ineffective.

At the board level, the company reportedly has now approved 17 directors. A 17-member board is so large that it may ultimately be unwieldy and ineffective. Studies have shown that smaller boards are more nimble, lead to more robust and meaningful discussions among board members, and tend to be more collaborative. By contrast, larger boards tend to be more divisive and fragmented. This structure carries the risk that Uber's board will divide into factions and have difficulty achieving consensus, and the power of the board to supervise the CEO may ultimately become diluted. Furthermore, the large number of directors seems driven more by the desire of the current stockholders to maintain their board seats than adherence to good corporate governance practices. Given the dysfunction and fragmentation of the current board, it is not hard to envision that the situation could become even more dysfunc-

tional, especially considering that SoftBank, an incoming powerful investor, is most certainly going to bring another agenda to the table.

Continued dysfunction at Uber has the potential to cause further harm to employees, customers, and society as a whole. The dysfunction could also further embolden competitors and erode stockholder value. SoftBank has purportedly even threatened to throw its weight behind Lyft, a significant competitor in the space, if it is unable to complete its Uber investment.

Conclusion

Only time will tell if the Uber board will learn from its past mistakes. Perhaps Khowrowshahi, with the appropriate amount of board supervision, is the proper person to lead the company in a competent fashion and restore credibility. However, Khowrowshahi's early leadership of the company has been rocky at best, threatening not only shareholder value, but also the public at large. Time will tell whether a 17-person board will be able to carry out its oversight responsibilities effectively. Hopefully, the board will realize the benefit of having appropriate checks and balances in place and will tighten up its practices, and Khowrowshahi will not be given (or take) absolute power that has the potential to corrupt absolutely.

   ISSN 2330-6300