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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

How Corporate Reputation Risk Is Exacerbating D&O Liability

By **Nir Kossovsky** (September 27, 2018, 1:51 PM EDT)

Nir Kossovsky

There is a centuries-old folk curse that says, "May you live in interesting times." For the directors and executives of public companies, these are exceedingly interesting social and political times. Culturally driven tolerance of sins in industry (#MeToo), sinful industries (#boycottNRA) and soul-selling industries (#deleteFacebook) have notably shifted over the past two years. As a result, the landscape of corporate risk is shifting rapidly, producing reputation risk tornadoes[1] that, for the #MeToo movement alone, have swept up more than 400 high-profile executives and employees as of June 2018.[2] Meanwhile, politically driven changes in the landscape of corporate risk have ranged from the market-moving shocks of presidential tweets,[3] director and officer civil suits for the social consequences of opioid addiction[4] and criminal indictments against officers for environmental crises arising from climate change.[5]

This intersection of business; social, political and cultural; and regulatory expectations of companies and their leadership — reputational risks[6] — comes at the same time that a slower evolution has been taking place in the fiduciary duty standards for public company boards. Broadly speaking, as first recognized by Chancellor William T. Allen in In re Caremark[7] and as developed in subsequent cases and endorsed by the Delaware Supreme Court in Stone v. Ritter,[8] boards are responsible for overseeing the core activities of management both in carrying out business and in safeguarding firms from risk. Board duties of care and "information" for the past two decades have been interpreted narrowly with respect to compliance with the law.

However, since 2014, the American Law Institute has been developing a framework titled "Compliance, Enforcement, and Risk Management for Corporations, Nonprofits, and Other Organizations."[9] The work products remain a well-protected secret, but based on the type of intelligence Kremlin watchers used to gather to discern Soviet-era intentions, it can be expected that the ALI standards will reflect the legal community's newly acquired recognition of the interactions between compliance, director and officer liabilities, economics, and cognitive sciences. Specifically, such governance standards will likely speak to the fact that while director and officer liability will be adjudicated in the courts of law, director and officer culpability will be adjudicated in the courts of public opinion.[10]

Also evolving are the boardrooms' own understanding of reputation and its risks. Back in 2005, when reputation risk was crowned the "risk of risks,"[11] only a handful of public companies disclosed its materiality. In a survey in 2008, only 7.5 percent of the S&P 500 companies even mentioned the word

“reputation” in their annual reports. In 2018, 90 percent of the companies were disclosing reputation as a key differentiator, and risks to reputation as material perils to their business strategy and financial position.[12] And for systemically important financial institutions, the Office of the Comptroller of the Currency, which recognizes reputation risk as one of eight named perils for which firms must disclose their risk management plans, the annual reports feature dedicated sections to the subject.[13]

The key question for the C-suite and the board at this time is how should this evolving landscape of duties, social and political considerations, and reputation risk inform risk governance today? Nor is the question academic. A derivative shareholder suit against Berkshire Hathaway already linked reputation damage to a breach of the duty of loyalty, complaining that “[Warren] Buffett’s inaction significantly impaired the reputation of Berkshire and constituted breaches of their duty of loyalty to Berkshire and its shareholders.”[14]

Reputation Risk: What Actually Is it, and What Should Management Be Doing About it?

To paraphrase Jane Austen, it is a truth universally acknowledged that a public company in possession of good prospects must be in want of a strong risk-management solution.[15] In other words, high-performing companies are distinguished not only by the success of their core business activities, but also by their intangible value as going concerns. Aon, a risk-focused professional services firm and broker, reported data that “showed companies could add 20% of value or lose up to 30% of value depending on their reputation risk preparedness, and management behaviour in the immediate aftermath of a crisis.”[16]

Good companies have good businesses, and they also operate those businesses well. The reputation of a firm is tied to both things. In order for a company to acquire strong reputational value, it has to be efficient and resilient. It also needs to be attractive as a counterparty to multiple stakeholders in the business environment. And, once attractive, it needs to meet the expectations it sets among its stakeholders. Thus, the reputation of the firm isn’t just about its branding or marketing (although these are surely important). Nor is it just about the success of the core business model (whatever that is), nor good investor relations, nor effective crisis management. Reputation is a product of all of those things, plus others, that manifests economically through the behavior of a firm’s stakeholders.

A firm has a good reputation when consumers want to buy from it, suppliers want to sell to it, lenders want to loan to it, employees want to work for it, investors want to own it, etc. To have all of those things is, by definition, to have a good reputation, and by implication, a strong reputation valuation.

Reputation risk, which is a threat to all that value, is the peril of economic harm from angry disappointed stakeholders. Which begs the question, how does management protect reputational value, once having created it?

It may be instructive to look to the example of compliance. In recent decades, the compliance mechanism within many firms has grown stronger. This has occurred partly because of legal and regulatory developments, such as the adoption of increasingly rigorous compliance program requirements under the Federal Sentencing Guidelines. But it’s also come about because of increasing recognition within the management community that a strong compliance function is needed to safeguard against operating risk. In the last two decades, a set of standards for effective compliance programs has become increasingly refined and widely accepted. A strong compliance program needs to be headed by an executive with an explicit mandate for this function, and one with appropriate resourcing and independence to carry the mandate out. Related responsibilities include risk assessment

and measurement, line reporting both to the C-suite and the board, and establishment of control mechanisms to detect and remediate any compliance problems that arise. More, the standards for compliance have also come to include a “softer” focus on corporate ethical culture, and on fostering a behavioral climate within the firm that can help to protect against misconduct, going beyond the simple enforcement of rules. All of these standards have helped to make the compliance function stronger. In turn, the corresponding responsibilities of boards and C-suites have also become more explicit: They, too, safeguard against compliance risk, in part by making sure that appropriate control mechanisms have been established within the firm.

In many ways, corporate reputation management today is arguably where compliance management was 20 years ago. The challenge for management is that unlike compliance where ambiguities are resolved over time through the courts of law, reputation and its risks are likely to strike with the speed and ferociousness of tornadoes. That only increases the challenges and uncertainty for boards overseeing its management.

How Does Corporate Reputation Risk Tie Back to the Board?

At a time when the materiality of corporate reputation risk is widely recognized, but institutional safeguards against that risk are not, what are the implications for a board of directors? The current state of play is not comforting as companies and boards scramble to anticipate stakeholder expectations before stakeholders become frightened, angry or disappointed.[17]

In the case of social ethical scandals, boards today are more likely to emulate Wynn Resorts[18] or Papa John’s Pizza[19] and jettison their chiefs, or even founders, than delay action and go the way of the Weinstein Company.[20] Both strategies are not without their own risks, as seen recently with Barnes & Noble,[21] and WPP.[22]

With respect to broad social issues underpinning reputation — ethics, innovation, safety, security, sustainability and quality[23] — boards appear to be more likely to be in the crosshairs. For example, Massachusetts in June became the first state to sue a drugmaker’s executives and directors and hold them responsible for the company’s alleged misrepresentation of the risks of addiction and death associated with the prolonged use of prescription opioids.[4] Similarly, in August, a Harris County, Texas, grand jury on Friday indicted a chemical company and two executives for the "reckless" release of toxic chemicals after the property flooded during Hurricane Harvey.[5] The company’s attorney noted, "It would set an ominous precedent if a company could be held criminally liable for impact suffered as a result of the historic flooding of Hurricane Harvey that no one, including Harris County itself, was prepared for."[24]

How can a board get in front of this kind of shadow liability problem in the face of a speculative duty to address a new form of risk? The answer basically resolves to, the board should take reasonable and intuitive steps to safeguard shareholders, in light of what they now know. When the C-suite identifies reputation as a material risk in corporate securities filings, then the board ought to ask management to review this issue with the board, and to explain what is being done to address it. If nothing else, that conversation should be documented, so that it’s clear that the board is not asleep at the switch. Meanwhile, where there are performance metrics available to help gauge reputational value and risk, boards and management ought to consider using them. And given that corporate reputational risk is now insurable, at least in part, management should also consider whether this can be useful as part of the strategy for mitigating risk. None of this is rocket science. It all resolves to the board recognizing that reputation is an issue on the table, engaging with management to discuss the issue, and understanding

what is being done by the firm to address it.

Discussion

Socrates famously wrote that the way to gain a good reputation is to strive to be what you wish to appear. This is deep advice for companies when it comes to managing reputation as a corporate asset. But it is also deep advice for boards when seeking to understand their own D&O risk in connection with corporate reputation. Rather than trying to anticipate future court cases about board governance failures, or parsing the technical boundaries of fiduciary duty, directors should be asking, "How do we do the reasonable and intuitive thing to protect shareholders?" In context, that means paying attention to reputation as an issue, asking management reasonable questions about reputational risk, and listening carefully to the answers that come back. Just by doing that, management will become more accountable for monitoring and managing reputation. Just by doing that, directors and boards will take a meaningful stride in protecting shareholders. D&O liability risk can be reduced as a result.

Nir Kossovsky is CEO of risk management firm Steel City Re.

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