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In Practice

Facebook's Crisis Points to ESG and Reputation Failures

By Paul F. Liebman and Nir Kossovsky

When Facebook whistleblower Frances Haugen testified before Congress that executives would begin to conduct "reputational reviews" before rolling out new products, it gave us pause. Could Facebook—not only a public company but one living squarely in the public eye—have been operating up to that point without a such a process?

Reputation is more than mere publicity. It is what a company means to all of its stakeholders, including its customers, employees, investors, and social-license holders. Reputation expresses itself in the collective expectations of these stakeholders; if a firm enjoys a reputation "premium," that premium exists only through trust earned every day. That's why, in the month following the *Wall Street Journal*'s initial reporting on Haugen's alleged catalogue of breaches of trust, Facebook both underperformed the market and shed 13 percent of its equity value. That's why, back in 2018, Facebook shed 33 percent of what was then its equity value when news outlets reported on the misuse of customer data obtained by Cambridge Analytica—a matter just now winding its way through derivative litigation.

Government regulators are also stakeholders, and they are angry. One could imagine a Facebook director being asked under oath about board oversight of the company's environmental, social, and governance (ESG) goals—related to sustainability, social impact, diversity, and more—displayed on Facebook's website. One could further imagine that director being asked to reconcile the board's role with the website's disclaimer that ESG-related statements "are not intended to be promises" and that "investors should not place undue reliance on them."

How Facebook's situation unfolds and recent developments affecting the company's reputational risk should be closely watched by directors and executives. In the realm of reputation gone awry, The Boeing Co.'s directors, who amid a stream of material safety issues are discovering that a new standard exists for board oversight failures, also bear watching. In this new world of *In re Caremark International Inc. Derivative Litigation* claims and the more expansive interpretation offered in *Marchand v. Barnhill* of boards' oversight responsibilities, Delaware Court of Chancery judge Morgan T. Zurn recently ruled that shareholders could pursue claims against Boeing, writing, "I conclude the stockholders have pled both sources of board liability."

The bottom line is that boards are now subject to much greater legal scrutiny of their oversight of mission-critical processes—the very processes that, when effective, mitigate risk, bolster reputation, and allow companies to reach their ESG goals.

Like the proverbial rotten apple in a barrel, reputation lost for one reason can cascade into multiple crises across an enterprise. Absent reputational resilience, the bad will undo the good. In June, for example, Apple rolled out a multiproduct and service privacy solution, thrilling privacy experts and other stakeholders. Only two months later, Apple shocked those same stakeholders when it disclosed that it was selectively violating that privacy pledge by scanning product owners' images for child pornography.

As Facebook continues to absorb media and political oxygen, Boeing board members proceed to defend against litigation, and Apple suffers a reversal of fortune among users and privacy experts, corporate boards need to ask themselves three key questions:

1. Does our company have appropriate enterprise-wide structures and processes in place to discover, review, and mitigate reputational risk with precision?
2. Are we meeting stakeholder expectations of our mission-critical operations and ESG pledges, managing expectations on targets we can't meet, or insuring the costs of disappointment?
3. Is our enterprise reputation risk management apparatus robust enough to successfully address unknown risks just over the horizon?

To understand a general framework for mitigating reputational crises, we offer a few vignettes that show how companies can succeed in achieving a reputation premium.

Break through corporate silos, establish effective controls, and disclose with transparency. During the criminal investigation from 2008 to 2009 into Dell's accounting practices, Dell redoubled its efforts to act responsibly—with integrity, transparency, and in compliance with laws. An interdepartmental team led by the legal department redrafted the company's code of conduct, rolled out an ethics education program for all employees, developed and funded a metrics-driven global compliance program, and voluntarily looked for ways to build sustainable business practices in the communities in which Dell operated. Among key stakeholders impressed by this publicly promoted effort were third-party compliance and ethics organizations that hailed Dell's program,

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government officials who reacted positively to the firm's commitment, and financial markets that rewarded Dell for its efforts.

Understand evolving stakeholder expectations and balance the interests of multiple competing parties. Over a decade ago, environmental groups began to express concerns to banks over the financing of businesses engaged in the extraction and consumption of fossil fuels. Some banks chose to engage stakeholders on these topics, which directly or indirectly resulted in reduced exposure to certain energy companies. Banks recognized how stakeholder interests and concerns, coupled with environmental risks, could translate into business risks. Yet competing stakeholder sensitivities remain challenging. While the Glasgow Financial Alliance for Net Zero has encouraged more than 40 financial institutions to achieve net-zero carbon emissions in their lending and investment portfolios by 2050, others have argued for penalizing banks that reduce their financial exposure to energy companies.

Provide equity markets with evidence of risk management and controls over critical processes and values. While there can be no guarantee of performance, we observe that equity markets usually reward (or punish) companies for ESG and reputational behaviors within 30 days. The following are examples relating to various ESG issues.

- **Environmental:** Only three days after disclosing that a global council would review hotel-environment safety amid the COVID-19 pandemic, Marriott International outperformed the market by 2.6 percent. Following public authentication of the work of its own initiative with the Mayo Clinic and Reckitt Benckiser, Hilton Worldwide Holdings outperformed the market by 7.5 percent.
- **Social and ethics:** As previously mentioned, Apple disclosed a comprehensive privacy initiative and outperformed Facebook and Google by 9 percent; then Apple disclosed exceptions to its privacy initiative and underperformed those peers by 3 percent. Meanwhile, Merck & Co. took decisive action on social justice after the 2017 Charlottesville, Virginia, riots and outperformed the market by 2.5 percent within 30 days. The Coca-Cola Co. struggled this year to articulate a clear position regarding controversial Georgia state legislation and underperformed by 2.2 percent within 30 days.
- **Governance:** Apollo Global Management publicly disclosed an ongoing upgrade to its governance of reputation risk management and within 30 days outperformed the market by 9.3 percent.
- **Quality:** Fastly rapidly contained an Internet outage and within 30 days outperformed the market by 9 percent.
- **Security:** Johnson & Johnson is often cited as a textbook example of effective reputation management and recovery from a crisis. Caught in the 1980s without mission-critical supply chain security controls as poison was discovered in its Tylenol brand, the company underperformed the market by 19 percent and was still underperforming by 15 percent 100 days after the poisoning had been made public. Following enhanced security controls that were publicly disclosed, and facing a second poisoning four years later, the business briefly underperformed the market by only 7 percent and then outperformed the market by 24 percent after 100 days. The premium of the authenticated risk management put in place by Johnson & Johnson is the difference in market response between the two events: 39 percent.

These cases—Facebook being the most recent and prominent—offer lessons that enable us to deploy enterprise-wide reputation risk management solutions. Below are guiding principles and strategies:

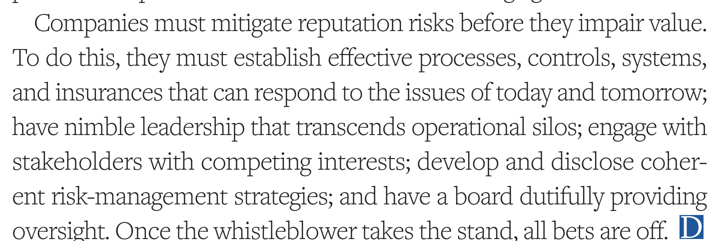
1. Reputation is mission-critical, and boards need to play an active oversight role. Reputation and ESG risk oversight processes should be managed on an operational level by chief legal officers, who can lead intelligence-gathering by stakeholder-owners across the enterprise, and who have the institutional authority and credibility to bring matters directly to the board while preserving attorney-client privilege and the work-product doctrine, where applicable.

LIKE THE PROVERBIAL ROTTEN APPLE IN A BARREL, REPUTATION LOST FOR ONE REASON CAN CASCADE INTO MULTIPLE CRISES.

2. Third-party support, validation, and risk-management authentication are crucial. Outside firms can provide objective metrics for assessing risks and potential damage using historical reference points, and can create standards that help companies to explain their actions in simple, convincing terms to sometimes divergent stakeholder groups.

3. In addition to being a financial backstop, insurance can be a strategic marketing instrument, showing that an objective third party has reviewed the governance processes for reputation risk management and that the business is putting its money where its mouth is. ESG insurance products, which are available to qualified companies, help company leadership, including directors, address the legal and reputational risks of failing to meet ESG expectations.

4. Even a *mea culpa* should be authenticated. Amid a reputational crisis, to regain stakeholders' trust, companies must communicate that they understand the reasons for their failures, have taken appropriate steps to remediate the damage, and have adopted authenticated new protocols to prevent those issues from ever arising again.



Companies must mitigate reputation risks before they impair value. To do this, they must establish effective processes, controls, systems, and insurances that can respond to the issues of today and tomorrow; have nimble leadership that transcends operational silos; engage with stakeholders with competing interests; develop and disclose coherent risk-management strategies; and have a board dutifully providing oversight. Once the whistleblower takes the stand, all bets are off. D

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