Emerging Standards for Protecting Reputation

by Nir Kossovsky

Experts project that boards can expect to face as many as 700 activist investor campaigns annually. To take some heat out of corporate governance controversies and promote long-term planning, many efforts are underway to establish common standards of conduct. If you are a manager of risk and have to choose governance, risk management and compliance standards by which your directors and officers will be judged, do you adopt standards generated by the management of leading firms and their investors (including activists), or adopt standards generated by legal board advisors, regulators, prosecutors and judges?

As first reported by the *Financial Times* in February, Jamie Dimon, chairman and chief executive of JPMorgan Chase, has led a months-long series of discussions to draw up a blueprint for how boards should conduct themselves and engage with shareholders. Investment groups such as Fidelity, Blackrock, Wellington Management, Vanguard and firms such as General Electric, General Motors and Verizon have all participated. Concurrently, the American Law Institute (ALI) has been developing its framework, titled "Compliance, Enforcement and Risk Management for Corporations, Nonprofits and Other Organizations." Members of the project's advisory committee include Fidelity, Goldman Sachs, HSBC and firms such as Google, Clorox and Avon. Other members comprise law firms offering governance advisory services, law schools, regulators including the Department of Justice, and representatives from a number of prominent courts.

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In early June, the *Financial Times* reported that both Fidelity and Wellington declined to sign on to Dimon's draft standards. "Every company has its own distinct business model, culture and values, and thus, we generally do not sign on to blanket industry documents," Fidelity explained. Notwithstanding such general aversions, Fidelity remains active with ALI's project that, according to the Institute, is likely to hold an authority nearly comparable to that accorded to judicial decisions. It is therefore an emerging blanket industry document that no board, advisor or manager of risk should ignore.

The work products of both groups remain well-protected secrets. Among the issues likely before the Dimon group are the merits of combining the roles of chairman and chief executive, pay policies and determining when shareholders should be allowed to nominate directors. ALI's project is broader in scope and will recommend standards and best practices on compliance, enforcement, risk management and governance.

Of particular interest to risk professionals is that signaling strategies to manage reputation risk permeates the work of both committees. For example, pay policies—specifically clawbacks—are the top reason compensation committee directors feel they are in the crosshairs of both the investment community and regulators. During a panel discussion on compensation committee disclosures at the 2015 National Association of Corporate Directors (NACD) Global Board Leaders' Summit, more time was

spent discussing the implications of clawbacks than on the other significant parts of the say-on-pay provisions of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.

As reported in the NACD's *Directorship* magazine earlier this year, activists often wage battle in the court of public opinion to garner support from the public at large when they mount an attack against a company. A director's reputation becomes collateral damage. Costs to a director's personal reputation include public humiliation and lost professional opportunities. At a presentation at the 2016 RIMS Annual Conference & Exhibition, the opportunity costs of public humiliation and its consequences were estimated to average $2 million per director.

ALI's project appears to be formally acknowledging in the mainstream legal community that adjudications of directors and officers in the court of public opinion have consequences. The insight came in the form of a description of ongoing committee work in *JOTWELL*, a review of legal scholarship sponsored by the University of Miami School of Law.

The article reviewed recent work by Veronica Root, associate professor of law at Notre Dame University, to incorporate monitorships into the ALI framework. These third-party, court-ordered corporate oversight mechanisms enforce compliance after breaches in areas such as ethics, safety, quality and other drivers of reputation value. Examples of modern-day monitorships include court-ordered events following the sexual abuse scandal that rocked Penn State, when Apple was found to have engaged in anti-competitive behavior, and when servicers like Bank of America improperly foreclosed upon hundreds of thousands of homeowners. According to Root, they signal to outsiders the efficacy of the tarnished organization's efforts to remediate misconduct. "The modern-day monitor, like a gatekeeper, may lend reputational capital to the wrongdoer, but in this context to facilitate rehabilitation or...(other) public relations benefit(s)," she wrote.

The legal community's recognition of the value of actions designed to send signals to stakeholders and impact reputation is a major sea change. It affirms that behavioral economic principles are becoming mainstream among lawyers working in the governance, risk and compliance focus area.

The implications for risk managers are material. The prior legal standard for risk/benefit calculations, called the BPL formula, was established in 1947 by a case of negligence, and it has been for many risk managers and CFOs a standard for calculating the value of insurance. In the BPL formula, B stands for burden of untaken precautions, P is probability of outcome, and L is severity of outcome. From 1947 to 1981, the law was unambiguous: If the expected harm exceeded the cost to take the precaution, then the company must take the precaution, whereas if the cost of harm was less, then it did not have to. A similar quantitative approach was used to determine whether risk transfer instruments were worth purchasing.

The BPL defense in the case of the exploding Ford Pinto—based on the strict financial assessment of the costs of replacing vulnerable gas tanks versus the costs of loss of life—led to Ford being pilloried in the press for insensitivity. And it led to severe reputation damage in the court of public opinion reflected in the behaviors of customers, employees, suppliers, creditors, equity investors and regulators.

Fast forward from 1981 to 2011. Since then, reputation risk has been a top-ranked board and risk management concern every year.

Traditional approaches to reputation risk management, informed by models such as BPL, are useless in the courts of public opinion. Conventional insurance is not designed to absorb the costs of public humiliation. Risk managers can expect to see standards emerging from the work of these committees that will test the creativity of the profession to find risk-based signaling solutions—call them warranties—that will supplement traditional liability insurances and become part of the mix of protections for directors and officers.

As *Directorship* noted earlier this year, "These reputation-based indemnification instruments, structured like a performance bond or warranty with indexed triggers, communicate the quality of governance, essentially absolving board members of damaging insinuations by activists."

Will such "warranty-like" instruments be worth precluding the personal costs to each director or the increased costs to companies from reputational damage? The new standard risk management solution will have to recognize the importance of signaling because, to paraphrase former Federal Reserve Chairman Alan Greenspan, in a system like governance that is based on trust, reputation has a significant economic value. ■

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