NEW DUE DILIGENCE NEEDS FOR A RAPIDLY EXPANDING RISK FACTOR LANDSCAPE…AND WHAT DILIGENCE TEAMS CAN DO

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Today's General Counsel

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Today, investors and their diligence teams face the new challenge of emerging socio-economic risk exposures. These risk factors are many, varied, and shifting… and are growing out of our divided cultural and business environment. This means that investors are now bringing new diligence demands to deals. Here's the background and a prescription for what legal and diligence teams can do to successfully address these new risks so deals can close smoothly for all sides.

Profit at all costs! We've come a long way from this single purpose mentality of the industrial revolution. Or have we?

For many years now, we've legislated against the abuses of businesses that devastate our environment and poison our people. Further, we continue the effort to enforce fairness and safety in the workplace. None of these baseline socio-economic remedies seem at odds with Milton Friedman's influential corporate mandate: "*the one and only social responsibility of business [is] to use its resources and engage in activities designed to increase its profits . . . .*".

At the time, Friedman was rejecting a growing perspective gaining broad acceptance, that corporate officials and labor leaders have a 'social responsibility' that goes beyond serving solely the interests of stockholders. But today, there's little doubt that this view, which Friedman found anathema, has gained greater momentum and broader acceptance — even when compared to the idealistic days of the 1960's when Friedman originally penned his views on business and freedom.

THE NEW FRONTIER OF SOCIO-ECONOMIC RISK

Today, businesses are being held to account by the media, consumers, and the market for perceived and real shortcomings and failures with their socio-economic obligations. The poster child is, of course, The Weinstein Company, which has seen its value reduced to a fraction of its former multi-billion dollar valuation, for grossly ignoring (and consequently enabling) the incorrigible conduct of its namesake. It now sits in bankruptcy.

Importantly, less obvious socio-economic failures can also result in a material negative impact on a business. Lapses in ethical labor policy anywhere in a supply chain, lack of sensitivity to issues of importance to a particular interest group, and publication and expression of political thought on social media can each result in media backlash, boycotts, and value loss in the market.

Look at Papa John's Pizza (NASD: PZZA). CEO and founder, John Schnatter, was run out of town for explaining that earnings had been hurt by the NFL: "The NFL has hurt us. And more importantly, by not resolving the current debacle to the players' and owners' satisfaction, NFL leadership has hurt Papa John's shareholders," Schnatter said during the company's third-quarter earnings call on November 1, 2017. The statement was roundly viewed as a criticism of the NFL player protests and led to a public alt-right endorsement of Papa John's. Share prices plummeted 15 percent across five days, wiping out $300 million in shareholder equity. Wasn't there a significant "risk" associated with this third-party marketing and business arrangement?

Yes (especially in the current socio-economically divided environment), but current disclosure requirements in the securities laws are insufficient for identifying these exposures and insulating investors against these types of socio-economic risk events. Indeed, The Investor Responsibility Research Center Institute (IRRCI) provides important background on this point. In their 2016 research study, The Corporate Risk Factor Disclosure Landscape, The IRRCI concludes: "…More important, there is an opportunity for companies to offer more insightful, company-specific (risk factor) information. For those risks that are particularly important, a company could enhance its disclosures by providing more descriptions of its risk mitigation efforts. Additional approaches that a company could take might include the greater use of company-specific detail; descriptions of how the nature, intensity and likelihood of key risks have changed or might change; and explanations of how significant risks can affect the company's business…".

INVESTORS' DEMAND IMPROVED SOCIO-ECONOMIC BUSINESS CONDUCT

Indeed, a recent survey conducted for Barron's by Sentieo, the financial research firm, showed that of 67,500 SEC filings sampled over the most recent 8-year period, only 167 10-K filings included any risk disclosures addressing "gender." That's only 0.2 percent. Sooner or later, the litigious consequences of this type of risk disclosure oversight are bound to show up on the radar of the plaintiff's bar.

To compound this issue, private investment does not have the benefit of public reporting and must rely on representations and warranties and covenants in private investment documentation. Customary documentation does not currently focus on these risks and even if it did, it would only create claims for damage against an already injured business.

While the business community is struggling to come to grips with the new reality of this muscular socio-economic advocacy, investors are also increasingly looking for opportunities with a proactive social impact, i.e., businesses that contribute positively to society. While renewable resources have been the darling of this new focus, investors are also looking for investments that can have positive societal impact. As Larry Fink, CEO of BlackRock, recently stated in his 2018 Annual Letter to CEOs: "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."

Even the activist investor, Barry Rosenstein of JANA Partners, has joined the party by demanding that Apple address the issue of children overusing its products, in order to set "an example about the obligations of technology companies to their youngest customers." JANA sponsors the related "Think Differently About Kids" website.

And Milton Friedman? Of course, there's no telling how he'd react to today's socio-economically aware business landscape, but surely he'd readily see the stark difference in business-conduct philosophies between now, and the 1960's.

THE PREREQUISITE OF SOCIO-ECONOMIC DILIGENCE

Fortunately, there are now emerging answers to these increasingly pressing questions:

- How do investors minimize or avoid the serious economic consequences of reputational or brand damage to businesses in which they invest?
- How do investors fulfill their goals of investing in businesses that are not only financially successful but which also provide meaningful socio-economic contributions to society?

While businesses scramble to preemptively address these risks and satisfy new investment criteria, investors should likewise task their investment due diligence teams to conduct detailed analyses of company and brand risk exposures to socio-economic issues.

The best approach? Empower management, legal counsel, and socio-economic risk and research analysis experts to do the necessary deep dive and implement an action plan that includes these important components:

1. Assess and even measure company exposure to socio-economic risk factors to help ensure there are no glaring exposures. Socio-economic risks can include numerous individual issues: immigration policy stance, economic inequity concerns, affirmative racial, gender and sexual preference policy management, ideological and political belief issue management, and much more. Many issues do not surface in responses to standard due diligence questionnaires (or, indeed, in disclosure schedules).
2. Verify that the company has taken, and continues to take, steps to identify particular risks (ranging from conventional risks to new emerging socio-economic exposures), has established coherent policies with respect to each risk category and actively monitors and enforces these policies. Implementation is key.
3. Look into the company history with previous risk events. This may require deep dives into company policies and implementation over extended periods. Issues long thought dead and buried can re-emerge in damaging ways.
4. Assess the company's risk identification and escalation process to ensure executive managers are involved and that appropriate accountability is in place. Small problems can quickly grow into big ones, and having senior people involved helps ensure effective company responses.
5. Require preparation and risk stress testing. Ensure the company has developed a response plan ahead of time, so that in the event of risk crisis, in-place plans can help guide company action.
6. Determine if a company is engaging in proactive steps that can impact all stakeholders positively. More than ever, investors are seeking targets delivering business results as well as delivering positive contributions to communities; the due diligence mandate is expanding to encompass these emerging imperatives. The legal profession has long encouraged societal contributions through extensive pro bono work, and more. Many investors are also seeking similar company behaviors. Traditional charity and

philanthropy are all good, and so are community building, environmental stewardship, workplace equity, and more.

7. Recommend that the company engage a third party socio-economic risk and analysis expert to identify, assess, and effectively address exposures. They can also implement market monitoring approaches to help identify emerging risks early.

The emerging challenge of socio-economic risk presents investors with a new dimension in due diligence needs. By following the steps outlined above, investors and their legal teams can be assured they're addressing current issues in the most through and effective manner available.

