What To Do When Your Executive Bites Someone and Hurricanes

Featuring:

Harlan Tufford, *ESG Research, MSCI*

Katie Towey, *MSCI*

Mike Disabato: What's up everyone? And welcome to the weekly edition of ESG now, where we cover how the environment, our society and corporate governance affects and are affected by our economy. I'm your host, Mike Disabato, and this week we have two stories for you. First, we're going to discuss how company boards react to executive misconduct, and then we're going to discuss what companies are most at risk due to the increased intensity and prevalence of hurricanes. Thanks as always for joining us. Stay tuned.

One of the biggest governance questions of them all is how to deal with executives. Executives are the strategic guides of their companies. They're the ones that sit in the meetings all day and people ask, "Where are we going to go next? And how can this company continue to grow?" They are important conduits between the board and the company's employees. They are the public face of the organization. They are the ones that investors back to run the ship on their behalf. So what happens when an executive does something bad? What does the board do?

To help bring this to light, I'm going to give you two examples of some outrageous things that executives have done in this last month, in September. One is the COO of Beyond Meat allegedly bit a man on the nose, becoming the very thing he was trying to fight against. And then there was the former eBay executive that was sentenced to almost five years in prison for his Coen brother-esque scheme to terrorize the normie creators of an online newspaper that had insulted eBay, which included sending live spiders, cockroaches to their house, books on how to cope with the loss of a partner and other disturbing tactics. A scandal for which the CEO had stepped down in 2020 after the stalking scandal broke at eBay.

By the way, for more context on that eBay story, I highly recommend the New York Times story called Inside eBay's Cockroach Cult: The Ghastly Story of a Stalking Scandal that's written by David Streitfeld. I laughed, I cried. I marveled at the amassing of corporate power to take down, confuse, include this internet users and I worried about the state of humanity.

There are also some much more intense scandals that happened in September. For example, the JD.com's billionaire founder settled a rape lawsuit days before the planned US trial.

But when there is a executive scandal that happens at a company, from the bizarre to the criminal, the board needs to jump into action. Figuring out what to do and when is maybe their most important function, or so I was told by my colleague, Harlan Tufford, who covers Corporate Governance for us. He told me that this action by the board is maybe the number one reason that they exist.

Harlan Tufford: The only person who can fire the CEO is the board and worth remembering that. I think there's actually a very strong case to be made that basically everything the board does is either firing or hiring the CEO or some ancillary task related to hiring or firing the CEO.

The board's relationship with the CEO is the board's strongest relationship to management. The CEO is generally the only executive that the board actually hires directly, then the CEO goes on to hire people. So the hiring of the CEO is the board's expression of strategy. It's the board's expression of what it wants the company to be, really. And if you hire a CEO or the CEO hires someone else who starts eating other executives, that's a really big problem and reflects poorly on the company.

Mike Disabato: The board of eBay, for example, would have to look around in one to two things, is our executive team filled with individuals that as the United States attorney, Rachael S Rollins of Massachusetts noted, used the power of a Fortune 500 company to "Harass and intimidate a couple who did nothing, nothing other than blog." IE, the board will have to figure out if this is a systemic risk that has infected the company culture or is it a one-off? Is it a idiosyncratic risk? If it's an idiosyncratic risk, it is likely that the board would just distance itself from the executive, distance the company from the executive or try to get the CEO to do that. But if it's a scandal that seems deeply rooted, like if a number of employees came forward and said that the culture of the company allowed for these abuses to occur, then the board needs to do some serious digging.

Harlan Tufford: It's looking into, "What's the culture like in this company? How did we miss this? How did this happen?" It's a really tricky thing for a board to do because I think boards are actually, of all the people who interact with the company, probably the worst positioned to actually understand what a company's culture is like. They interact with the company in person at least once a quarter, twice a quarter. A lot of that time they're just talking to each other, rather than the other people at the company. The people that they interact with most at the company are senior executives who may or may not be reflective of the culture, or if they are, they'll still be on their best behavior. And you might not see the real culture per se.

When directors do actually try and experience that real culture and say, go to a site visit, it can often feel a bit like a royal visit. Everything will be freshly polished, everyone's smiling, it smells of fresh paint. And if you get a really enterprising director who does maybe do a surprise, I don't know, visits somewhere, to an office, that can actually, in a kind of quantum thing, you can change the outcome you're trying to measure and it can damage culture by feeling a bit like a pop quiz.

Mike Disabato: Well then what can you do? How can you avoid investing in a company that embroils itself into a scandal, because a scandal does long term damage not only to the company's value, but also to those people working at the company that were involved in the scandal, whether directly or not, just by association. Research from the Harvard Business School found that executives with scandal tainted companies on the resumes pay a penalty on the job market even if they clearly had nothing to do with the trouble. So what can one do? Well, the board itself can do a couple of things.

Harlan Tufford: Board that's monitoring culture like this would be wanting to regularly meet with the CEO in the boardroom, but also in more informal settings. A lot of boards will have a boardroom dinner before the actual meetings occur, the night before. That's a great opportunity to meet not just the CEO, but the other executives underneath the CEO and potentially even outside of the C-suite. Getting exposure to a broader group of employees is one way to give the board insight there.

Another way is to really leverage the work that the human resources committee can do. We often talk about the pay committee, the committee that sets pay, but more and more companies have committees that have a bit of a broader mandate to look at the overall human resources relationships at the company. For example, one activity that these committees can do is monitor formal complaints that are issued, monitor terminations of employees and look into the reasons why those happened and what they might say about the company's culture.

Mike Disabato: But what if you don't have access to those dinners? What if you're an investor and all you have is, for example, data? Well, Harlan has a couple metrics that might be helpful for, if not preventing a scandal because that might require a soothsayer or something, but at least knowing what types of boards would be good at piloting the ship through a scandalous storm.

Harlan Tufford: One is how many directors are overboard and overboard, the term of use, it means you basically sit on too many boards, you spread yourself thin. If you are overboarded, there's a good chance that when some kind of crisis like this breaks out, you may not be able to scale up your involvement in the company as rapidly, as substantially as circumstances might demand. You'd be in a situation where the board needs to strike a

special committee to investigate the CEO or after having made the decision to fire a CEO, the board then needs to strike a new committee to find a replacement CEO, this is tens of hours a month additionally that directors are going to have to find somewhere. And in some situations, once the CEO is fired, you may actually need an interim CEO from the board because it may be that there's no one on the management team ready or that the board necessarily trusts to step into the role.

Mike Disabato: I'm going to step in here and give some broader statistical context to help back up Harlan. I looked at a index that represents the broader global market, it has about 10,000 companies in it. And I found that the overboarded problem is a real one, around 2,200 or 2,220 to be exact, of companies in that index have an overboarded director on its board. That's nearly a quarter of the market that's dealing with this problem.

Harlan Tufford: Independence is another one that I would want to look at. If you are striking a committee to look into the investigation of executive misconduct, to look for a new CEO, you'd want to see a board that is independent in thought and in fact, in their ability to objectively assess the situations relating to the alleged misconduct and to ensure that investors' interest and the interest of other stakeholders are being represented in this process.

Mike Disabato: Ah, yes, independence. Now, out of the 10,000 companies, there are almost 18,000 of them that have boards with a less than 50% independent board. A majority of their boards are too close to the very managers that they're trying to oversee.

Harlan Tufford: I'd also be looking at long tenure directors. Directors who have served, for example, for more than 15 years on the board. That may not impact independence in the same way as having worked for the company, but I think it does raise some questions about that director's ability to really be objective in their ability to assess a CEO that they've worked with for the better part of two decades.

Mike Disabato: Okay, last stat here. There are nearly 3,700 companies with one director or more that have been on the board for more than 15 years. So this is all great, right? These are significant numbers. All we have to do is filter for these three factors and then we will be scandal-free. We don't have to deal with any of these companies. Well, that is where the problem lies. These are just factors that would be useful if there was a scandal at the company. These are just factors that would be useful if there was a scandal at the company. There's a difference between indicators that can show a board as, can spring into action if a scandal were to be committed. And those that can actually predict a man working for a company that is trying to lessen the consumption

of meat could allegedly bite the meaty nose of a motorist at a college football game in Arkansas, like our wayward Beyond Meat COO. Eat What You Love indeed.

Now, metrics can't really predict that, but we do have a metric called Executive Misconduct that flags a company if a board member or a senior executive has been dismissed or faced criminal or other prosecution for personal misconduct or misrepresentation or things like that. And as of today, there have only been 64 companies out of that, around 10,000 in the representative index I mentioned earlier that have been flagged for executive misconduct. The number changes so that 64 is just a snapshot in time, but that is the number as of today, as of this recording.

When you look at those three factors that Harlan mentioned, board independence, overboarding and board tenure, the metrics are all over the place for flagged companies. Half of them are overboarded, half of them aren't. Half have a majority independent board, half don't. It goes on like that. Actually, there's only one company that was both flagged for executive misconduct that had all three problematic governance indicators ticked. And that's Dongyue Group. It's a Chinese company that manufactures organic chemicals. I asked Harlan why this might be, why are so little companies dinged for executive misconduct, even though there are many with questionable corporate governance structures? "It's simple," he said.

Harlan Tufford: Directors want to do a good job. It doesn't reflect well on the board of directors if they or the people they've hired turn out to be criminals or cannibals or anything of the like, it is going to hurt their chances of getting on another board. It can hurt their social opportunities, it can hurt their reputation. Directors want to be good at being directors. And if that sounds like a simple explanation, I don't think that's because it's wrong.

Mike Disabato: It goes without saying that it costs a company a lot of money when an executive is scandal-ridden. By Harlan's estimate, it costs around two to three times the base salary of that executive to pay them to either get out or to get into litigation to get the money that was promised to that executive back or to get enough money to hire an executive that might help steer the company through what could be a systemic problem. It can get very messy. If it's a really bad problem, if it's a cultural problem, the company might have trouble hiring people. The company might have to deal with the fallout of, let's say, employees that saw these problems, reported these problems and nothing was done. And while we cannot predict where and when the next scandal might happen, we cannot at least understand better which companies are likely to address the scandal when it does occur and which companies are likely to maybe fall by the wayside. And sometimes that is all that one can hope for.

Last week, Cuba and Florida were hit by Hurricane Ian. After making landfall in Cuba on September 27th, the hurricane quickly turned into an extremely powerful storm and slammed into the West Coast of Florida on September 28th, bringing wind speeds of up to 241 kilometers per hour or 150 miles per hour. Hurricane Ian dealt damage and destruction to many vulnerable people in both Cuba and Florida. And in Florida the

damage is so extensive that according to Governor Ron DeSantis, it might take years to rebuild. Hurricane Ian became a category for a hurricane faster than anyone expected. And it needs to be said that that is because of climate change. While this pales a comparison to the destruction it brought to human lives and livelihoods, today we are going to talk about what extreme weather events like Hurricane Ian can do to the market value of companies, because some of our metrics use climate models to understand where the market impacts of these more intense tropical storms are likely to be and to whom it might affect most.

To talk about this, I have on the line with me, my colleague, Katie Towey, for a hot take on the effects of intensified tropical cyclones because she is both on the team that assesses physical risk to companies due to climate change, and she completed her doctorate in flooding related hazards produced by extra-tropical and tropical cyclones. And just so everyone knows, a hurricane is just a more powerful cyclone. So I asked Katie if she could first lay out the damage that tropical cyclones typically cause and why.

Katie Towey: With hurricanes, because they form over warm ocean waters, they carry a lot of moisture with them. So if they make landfall, typically, you can have very intense rainfall rates that can cause flooding inland. We saw with Hurricane Ian, some locations received up to 20 inches of precipitation and that caused significant inland flooding. But you can also have significant coastal flooding as well, and that is a result of storm surge. So the strong winds that are associated with the hurricane, as they make landfall or approach the coastline, the strong winds will have to push water towards the shore and that pileup of water will eventually push inland. So that generation of higher water levels makes it one of the more deadly hazards associated with hurricanes because the water being pushed on shore is just so much more powerful and more sudden to cause flooding near the coast.

Mike Disabato: Is there any misconception people have about hurricane risk?

Katie Towey: I do think storm surge is the forgotten hazard. People think of the strong winds destroying property and heavy precipitation and even tornadoes, but storm surge is really a hazard that is confined to areas along the coast, but that's where a lot of people live and work. And so it's very dependent on where you are, relative to the storm too. So we saw even with Hurricane Ian's forecasted track, areas in Tampa, they were under more of a forecast for high storm surge and then there was a slight shift in the forecasted track. And all of a sudden people in Fort Myers area were at more of a risk for higher storm surge values. So where storm surge occurs in terms of its magnitude is very dependent on the track of the storm, relative to what the coastal characteristics are. So the shelf, if it's more gradual or steep or if you're near a bay, for example, relative, that acts as a funnel to draw that water to come in towards the shore.

Mike Disabato: You pulled some data for this that looked at the long-term risk to companies' market value due to cyclone, hurricanes, tropical cyclones. What did you find? What did you see?

Katie Towey: We looked at the top 20 companies who are at most risk of tropical cyclones, and we found there are several of these in Japan and the Philippines, one in China Mainland, one in Hong Kong. A common feature here is that most of these are in Southeast Asia. And Southeast Asia is an area that is prone to tropical cyclones now and especially in the future. Some of the warmest sea surface temperatures, that really critical ingredient for tropical cyclones to develop and grow, are found in the Western Pacific Ocean. So where storms can form, there're more frequently and typically at higher intensities, they can track up along the Southeast Asia coastline as they then reach higher latitudes and recurve out to sea. So those areas along Eastern Asia that we mentioned before are at risk for feeling the impacts of tropical cyclones.

We also saw within the top 20 companies though, two that are in the United States as well, and they have assets that are along the coast of Florida. So these two real estate companies, Chatham Lodging Trust and CBL and Associates Properties both have these assets along the coast of Florida in which we just saw with the impacts from Hurricane Ian along the western coast of Florida that all it takes is one storm to come through and have these detrimental impacts, not just in terms of storm surge flooding, but also heavy precipitation and winds. These areas along the coast are most susceptible because that is where, so to speak, population and businesses are booming. And so you're putting more places at risk there for these storms that can happen now, but also might get worse in the future.

Mike Disabato: Right. And what you can see with this data is that the industries that are most at risk in Southeast Asia are energy utilities and real estate companies. And just to give you some extra detail on this data, what we do is we employ a climate model-based projection of the future frequency and intensity of tropical cyclones up to the year 2100. And the model we used for cyclones is called the [inaudible 00:20:49]. It's like Clamato but without A-D-A, [inaudible 00:20:54]. And it uses a stochastic tropical cyclone generator based on an extensive set of historical storm data and future models of likely storms. It says if warming were to continue, then the companies that we look at are at risk to either lose or gain. It's not just losses, a certain amount of market value due to tropical cyclones. And that's looked up to the year 2100 and then discounted back to the present day. The costs are discounted.

You might be thinking, well, obviously the costs are most at risk on the coasts, but many of these companies are giant, with assets all over the place. And what we can see with this data is where the risks are for certain assets and which companies have a concentration of assets in areas that are likely to be hit hardest by these much more intense, extreme weather events such as hurricanes.

That's it for the week. I want thank Katie and Harlan for talking to me about the news with an ESG twist. I want to thank you so much for listening. If you like what you heard, don't forget to rate and review us. That really helps. It pushes us up on podcast lists and more people can discover us. And if you like what you heard, also subscribe and you can hear me every week. I'll talk to you soon and have a good rest of the week.

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