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Legal and practical suggestions for boards as they navigate the crossroads of corporate governance and geopolitics

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Abstract

Recently, hundreds of multinational companies needed to make the same decision: to what extent should the company change the way it operates in Russia in response to the invasion of Ukraine? At first glance, the decision appears to concern geopolitical risk. This impact paper will explore what geopolitical risk is and is not, with suggestions on how company boards can better evaluate and manage such risk.

Keywords: corporate governance, board of directors, geopolitics, geopolitical risk

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Legal and practical suggestions for boards as they navigate the crossroads of corporate governance and geopolitics

Introduction and background

Recently, multinational enterprises based outside Russia, but with operations inside Russia, have needed to address the following question: to what extent should a company change the way it operates in Russia following the Russian invasion of Ukraine? With the whole world watching,[1] some companies have chosen to leave Russia entirely.[2] Other companies have suspended all activities temporarily, but without any permanent departure.[3] Still others have scaled back some activities while continuing to operate other activities as planned.[4] A similar option that some companies have chosen is to continue with all ongoing business commitments, scaling back none, while postponing future planned initiatives.[5] Finally, some companies are simply continuing to operate as usual.[6]

In most of these cases, the company decision on how to proceed in Russia was made by a board of directors. This kind of decision is made by the board of directors, and not by senior management, as strategy and risk management are among a board's principal missions.[7] Strategy and risk management are of course linked: companies generally adopt and then implement a strategy that takes into account various risks.

Board responsibilities regarding strategy and risk management cannot be fulfilled by one-shot decisions. Instead, boards need to continually monitor the risks that affect the company. They then need to consider updating the adopted strategy from time to time to take any shifting risks into account.[8]

When Russia invaded Ukraine, risks shifted in numerous ways for companies based outside Russia but with operations in the country. To better understand how the risks

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[1] See, for instance, Jeffrey Sonnenfeld and Steven Tian, *Some of the Biggest Brands Are Leaving Russia. Others Just Can't Quit Putin. Here's a List.* The New York Times, April 27, 2022 (https://www.nytimes.com/interactive/2022/04/07/opinion/companies-ukraine-boycott.html).

[2] "Companies totally halting Russian engagements or completely exiting Russia" run the alphabetical gamut from Belgium-based AB InBev and Ireland-based Accenture to Poland-based Zabka and Switzerland-based Zurich Insurance Company, according to the "Withdrawal" category in a database maintained by Jeffrey Sonnenfeld and a supporting team at Yale Management School (https://som.yale.edu/story/2022/almost-1000-companies-have-curtailed-operations-russia-some-remain, last consulted on June 3, 2022) (the "Yale Database").

[3] "Companies temporarily curtailing most or nearly all operations while keeping return options open" run the alphabetical gamut from US-based 3M and Sweden-based AAK to UK-based ZHA and US-based Zynga, according to the "Suspension" category in the Yale Database.

[4] "Companies that are scaling back some significant business operations but continuing others" run the alphabetical gamut from Switzerland-based ABB and US-based Activision Blizzard to Germany-based ZF Friedrichshafen and US-based Zoetis, according to the "Scaling Back" category in the Yale Database.

[5] "Companies postponing future planned investment/development/marketing while continuing substantive business" run the alphabetical gamut from Netherlands-based Aalberts and US-based Abbott Laboratories to US-based Young Living and France-based Yves Rocher, according to the "Buying Time" category in the Yale Database.

[6] "Companies that are just continuing business-as-usual in Russia" run the alphabetical gamut from Spain-based Acerinox and Austria-based Agrana to China-based ZTE and Hungary-based Zwack, according to the "Digging In" category in the Yale Database.

[7] The other main board missions relate to finance, ESG, leadership supervision, and regulatory compliance.

[8] A board can of course update an adopted strategy for other reasons too.

changed, we need to acknowledge the wide-ranging types of risk that a company board is supposed to monitor. These include economic risk, financial risk, compliance risk, security and fraud risk, reputational risk, operational risk, competition risk, and political risk. This last risk, *political* risk, becomes *geopolitical* risk when the political circumstances and events are outside the company's home country. For a multinational enterprise, geopolitical risks principally involve expropriation of foreign-owned assets, extraordinary regulatory burdens applied to foreign-owned businesses, and violence and civil unrest in areas where the company operates. Geopolitical risks may also include situations and events arising out of competition between states over such things as markets, natural resources, and strategic trade routes. Such competition can generate sanctions, embargoes, and other trade constraints, and in some cases is pursued through military means, in the form of armed conflict.

Purely domestic companies are not directly concerned by geopolitical risk as they have no foreign operations. They face political risk in their home country, of course, but the absence of operations abroad precludes them from having to confront geopolitical risk. Nonetheless, purely domestic companies can still be affected by geopolitical *developments*. If the supply chain or customer base extends beyond the company's home country, geopolitical developments clearly have the potential (the risk) to disrupt the company's trajectory. Even when the supply chain and customer base are solely domestic, the company can still be affected by geopolitical developments. For example, purely national companies in many countries have suddenly been faced with a steep rise in the cost of domestically supplied energy following the Russian invasion of Ukraine as even domestic energy is part of a worldwide energy market whose prices have gone up since the invasion.

A multinational enterprise might of course be similarly affected by geopolitical developments when there is no meaningful impact on geopolitical risk such as expropriation. Moreover, multinationals with operations in a location where a given geopolitical development has arisen may also experience a change in reputational risk.

Indeed, such a change in reputational risk is precisely what motivated many non-Russian multinationals to alter their strategy with respect to Russia. The companies changed their plans not because of a perception of increased geopolitical risk such as expropriation of company assets in Russia, or extraordinary regulatory burdens applied to foreign-owned businesses, or violence and civil unrest in the country. Nor did they fear a Ukrainian counter-invasion of Russia.[9] Instead, they were concerned about reputational risk, and the way their ongoing operations in Russia might prompt current and prospective customers, employees, suppliers, lenders, and shareholders, as well as government regulators, journalists, and analysts, to think less highly of the company. Put more simply, they feared damage to their reputation.[10]

[9] Armed conflict inside a foreign country where a company has operations can of course destroy company assets and disrupt its operations, but it can also expose employees in that country to mortal danger. Boards protect the interests of such employees more or less depending on how seriously they subscribe to stakeholder theory as opposed to shareholder primacy. In addition, in countries such as Germany, where the Codetermination Law of 1976 and related legislation provide for an employee's voice in selecting board members, the greater employee voice on the board might reasonably be expected to increase the board's protection of at-risk employees.

[10] In some cases there could be an additional non-risk reason, namely, distaste for doing business in a country whose leadership makes reprehensible choices.

Legal and practical influences on boards where geopolitical risk is concerned

As noted above, company boards must monitor risk, including economic risk, financial risk, compliance risk, security and fraud risk, reputational risk, operational risk, competition risk, and political risk. Political risk includes its subset, geopolitical risk.

Evaluating geopolitical risk is difficult.[11] Most corporate board members are ill-equipped to measure and evaluate geopolitical risk independently, even though some may have relevant experience and expertise. For that reason, board members rely—as typically permitted by the law[12]—on the advice of third-party experts, whether colleagues on the board, in-house staff, or outside consultants.[13]

Publicly traded companies in particular are obligated by law in some countries to go beyond merely monitoring risk. They also need to discuss risk, including applicable geopolitical risk, in their periodic reports filed with securities regulators.[14] Such public companies are specifically required to disclose material risk factors for the benefit of real and prospective investors, who can then work from such disclosures to make informed investment decisions. Misrepresentation of material risk factors is a leading source of securities-related litigation.[15] To protect themselves against securities fraud claims, companies tend to detail risks so extensively that the disclosures lose their usefulness,[16] but the duty to communicate the risk can nonetheless focus more attention on evaluating

[11] For a review of the legal and practical challenges that boards face in evaluating geopolitical risk in a context of armed conflict, see Nathalie Belhoste and Bastien Nivet, *Les entreprises et la guerre : vers la responsabilité géopolitique des entreprises?*, in Revue internationale et stratégique 2018/3 (N° 111), pages 16 to 25.

[12] Company laws vary, of course, but typically permit a board member to rely on information and advice provided by third parties, including company employees and third-party consultants to the company (including most visibly accounting firms that review financial statements, lawyers dealing with a broad range of corporate activities, compensation consultants advising on leadership team remuneration, and investment bankers handling transactions). An example of a company law provision authorizing such reliance can be found at Section 141(e) of the Delaware General Corporation Law (an influential state-specific company law in the United States)

[13] Third-party advice may be delivered to the board in several different forms, but are most commonly found in the executive summary of an expert's extensive written report; an expert's extensive written report; or an expert's in-person presentation at which the board can ask questions, followed by an extensive written report that includes the board's questions along with corresponding answers. The authors thank Willis Sparks of Eurasia Group and Mike Nowlis of the University of Cambridge for their help in understanding the deliverables of political risk consultancy firms.

[14] See, for instance, Item 105 of the American regulation implementing the Securities Act of 1933, the Securities Exchange Act of 1932, and the Energy Policy and Conservation Act of 1975, known as Regulation S-K, codified at 17 CFR § 229.105. Item 105 requires issuers of covered securities to discuss "material factors that make an investment in the registrant or offering speculative or risky. This discussion must be organized logically with relevant headings and each risk factor should be set forth under a subcaption that adequately describes the risk." Issuers must also "(c)oncisely explain how each risk affects the registrant or the securities being offered."

[15] When taken to its extreme, the need to disclose material risks transforms virtually every harm into securities fraud, a point made frequently by Bloomberg commentator Matt Levine. See, for instance, his 2019 article *Everything Everywhere Is Securities Fraud* at https://www.bloomberg.com/opinion/articles/2019-06-26/everything-everywhere-is-securities-fraud.

[16] See for instance the nearly 7700-word disclosure of risk by US-based Walmart Inc. in its 10-K annual report filed with the Securities and Exchange Commission for the fiscal year ended January 31, 2019 (https://www.sec.gov/Archives/edgar/data/104169/000010416919000016/wmtform10-kx1312019.htm#sBBC09961132151239331ED7A6E22065E).

it than might otherwise have been the case, and this attention can be important even if the communication itself is not always valuable.

We would like to add a psychological consideration: board members are susceptible to the same irrational tendencies exhibited by all human beings. One such irrational tendency, known as the Ellsberg paradox, involves decisions made in the face of risk: when given the choice, people generally prefer an option where the risk of success or failure is probabilistically known, and they generally avoid options where the risk of success or failure is unknowable, *even when doing so makes no rational sense when viewed strictly through the lens of probabilities*.[17] Concretely, when a board member examining risks in a company's entry or ongoing involvement in a country abroad perceives the risks of one option in probabilistically known terms, and the risks of a competing option in probabilistically unknown terms, he or she—like the vast majority of people—will tend to opt for the option where the risk is perceived in probabilistically known terms.

The last practical consideration we would like to raise is the common understanding of risk as the probability of a given negative outcome multiplied by the gravity of that negative outcome. In this understanding, a low-probability high-gravity risk and a high-probability low-gravity risk could be considered mathematically equal. A quasi-mathematical analysis would be ideal, but in the real world human bias tends to overvalue certain risk factors and undervalue others, undermining the reliability of estimations of probability and gravity.[18] And of course there are certain risks whose probability is unknown and even unknowable.

17 See Daniel Ellsberg, *Risk, Ambiguity, and Decision* (Garland, 2001), reviewed by Nicholas Leman, The Decision Theorist Who Leaked the Pentagon Papers, The New Yorker (November 4, 2002) (https://www.newyorker.com/magazine/2002/11/04/paper-tiger).

18 See, for instance, the numerous heuristics and biases described by, and in many cases discovered by, Daniel Kahneman in his book *Thinking Fast And Slow* (Farrar, Strauss and Giroux, 2011). For our purposes, the salience bias is probably the most relevant: people tend to focus on remarkable (salient) information while disregarding information lacking in prominence.

Tactics

Given the challenges identified above, company boards could benefit from specific tactics when they consider the general decision to enter a new country or exit an existing one, and the specific decision of how to enter or exit. We put forward four such tactics.

Periodic due diligence review of geopolitical risk

First, we propose a periodic "due diligence review" to examine geopolitical risk outside the usual transaction-oriented context. Due diligence is typically viewed as a pre-closing phase of a transaction during which the transacting parties perform a factual and legal investigation to ensure that the reality conforms with their assumptions, and any non-conformity can lead to a renegotiation or even termination of the transaction. We propose extending the concept of due diligence to the monitoring of geopolitical risk, periodically investigating the factual and legal underpinnings of geopolitical risk independently of any specific transaction. In particular, a company board should periodically perform such an investigation to ensure that the geopolitical reality in each region of relevance to the company is factually and legally as expected, consistent with the board members' assumptions. As with transaction-related due diligence, whether the information gathered confirms or invalidates the board's assumptions, it will ensure a better-informed consideration of the company's strategy with respect to the region under review (notably, whether and possibly how to enter or exit a country).[19]

In transaction-oriented due diligence, a board typically relies on third-party expertise. In non-transactional geopolitical risk-monitoring due diligence, a board should similarly rely on third-party expertise. Whether performed by in-house staff or consultants, or even fellow board members,[20] geopolitical risk analysis is a specialty that calls for expertise and experience. Moreover, if the board committee structure has no risk committee, then an existing committee should be tasked with risk monitoring.

Upstream consideration of geopolitical risk before making decisions

Second, we propose an internal board procedure to ensure that geopolitical risk has received the attention it deserves before the board makes any decisions. The internal procedure we envision would create no new legal duty to third parties, and therefore should not lead to any of the litigation that so often accompanies legally imposed obligations. The procedure would be no more formal than an internal "best practice" process.

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[19] A similar due diligence idea for human rights concerns as opposed to geopolitical risk is identified in Part 15(B) of the United Nations Guiding Principles on Business and Human Rights. In fact, human rights concerns and geopolitical risk concerns overlap one another, as with respect to armed conflict, for instance. See also the European Union's draft Mandatory Human Rights and Environmental Due Diligence Directive (summarized at https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1145); the OECD Due Diligence Guidance for Responsible Business Conduct adopted in 2018 (found at http://mneguidelines.oecd.org/OECD-Due-Diligence-Guidance-for-Responsible-Business-Conduct.pdf); and the French Loi n° 2017-399 du 27 mars 2017, a law that imposes a duty of vigilance on multinational companies (found at www.legifrance.gouv.fr/eli/loi/2017/3/27/ECFX1509096L/jo/texte).

[20] See our suggestion below to increase an internal board's capacity to evaluate geopolitical risk.

Our internal board procedure would consist of three parts. First, the board would periodically define a level of geopolitical risk that it found to be generally acceptable. For instance, it might adopt a perceived probability of less than 10% for significant negative geopolitical developments as its acceptable geopolitical risk standard. Second, for its own internal benefit, when the board occasionally makes a decision with possible vulnerability to geopolitical risk (such as entering or exiting a country), it should include an explicit finding that its decision is consistent with its previously approved geopolitical risk threshold. This finding should be based on the due diligence described above. Finally, if the board discovers that a desired decision would expose the company to a greater amount of geopolitical risk than the previously approved threshold, then it could either (1) explicitly decide to increase its threshold for acceptable geopolitical risk, or (2) explicitly find that the circumstances justify excessive geopolitical risk, with an internal explanation of the justifying factors, in either event still proceeding with the desired decision that would expose the company to more geopolitical risk than would formerly have been considered acceptable.

This upstream process would not legally prevent the board from reaching a decision. Similarly, it would not provide any prospective litigant with a possible legal claim. Nonetheless, such an internal non-law-based process would allow the board to better appreciate and manage geopolitical risk.[21] Furthermore, with this consideration of geopolitical risk just before a decision ('upstream" or "ex ante"), the board's geopolitical risk evaluation would necessarily be timely.

Recruiting board members with geopolitical risk expertise

Third, we suggest that multinational companies try to recruit individuals to the board with experience and expertise in evaluating geopolitical risk. Former diplomats,[22] other former high government officials,[23] international relations professionals, and geopolitical risk analysts (including former military analysts) can be exceptionally well qualified not only to evaluate geopolitical risk, but also to independently and critically evaluate the advice given to the board by third-party geopolitical risk experts. [24] We understand of course that board seats are limited in number and reserving a seat for a geopolitical risk expert would produce a zero-sum game, excluding other individuals with experience and expertise in other domains that could be valuable to the board. Hence, we are not saying that a board seat should be reserved for geopolitical risk experts. We simply suggest that the acumen of a geopolitical risk expert should be highly valued as boards go about attempting to fill seats with capable people.

21 This process takes its inspiration from the California Environmental Quality Act, codified at California Public Resources Code Sections 21000 *et seq*. This law, known as CEQA, compels a rejection of any discretionary public permit that could reasonably be expected to result in a significant negative environmental impact, unless the permitting body both makes an explicit finding of overriding considerations to justify permitting the project despite the risk, and imposes mitigation measures to limit the negative environmental impacts. Unlike CEQA, which is binding, our proposed process would be an optional internal process, a "best practice" that would not involve rights or duties, and would therefore not give rise to litigation.

22 See for instance former French Foreign Minister Hubert Védrine, a member of the board of French multinational LVMH.

23 See for instance former France President Nicolas Sarkozy, a member of the board of French multinational Accor.

24 To be clear, we support reliance on third-party experts where appropriate.

Moreover, any board member with geopolitical risk expertise should be a part of the board's geopolitical risk review process, serving on the risk committee (if one exists) or on whatever other committee may be tasked with reviewing geopolitical risk.

Adding geopolitical risk to non-financial reporting

Finally, in addition to the non-financial reporting that many multinational firms are already required to provide, we propose adding a reporting category specifically for geopolitical risk. This would simply be a marginal extension of existing non-financial reporting requirements, as several of the matters that companies are already required to report on overlap in practice with geopolitical risk. The European Union, for instance, requires some firms to report on environmental matters, social and employee-related matters, respect for human rights, and anti-corruption and bribery matters, issues that can help an observer to better appreciate geopolitical risk. Notably, the EU directive requires reporting firms to specifically describe the risks related to such reported-on matters.[25]

Conclusion

We put forward four solutions to help boards to better navigate geopolitical risk: a periodic due diligence review of geopolitical risk; a pre-decision-making upstream consideration of geopolitical risk; recruiting board members with geopolitical risk expertise; and adding geopolitical risk to non-financial reporting. Deciding whether and how to enter or exit a country may still be difficult, even if a board follows our proposals, but adopting such proposals would ensure effective and timely consideration of geopolitical risk as boards navigate the crossroads of corporate governance and geopolitics.

[25] See Directive 2014/95/EU of the European Parliament and the European Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups (found at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095).

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