

WALTER SCOTT

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ESG Commentary

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ESG Commentary

THIRD QUARTER 2019

COMMENTARY

How best to describe the now infamous global work space company WeWork? Office-space provider or work-lifestyle enabler? Talismanic leadership or an unduly financially conflicted CEO? From the drop of its IPO prospectus in August, the WeWork story became something of a soap opera for the financial press. Its mooted valuation fell from around \$50bn, to \$30bn, to \$20bn. The company delayed its IPO, then at the end of September it was withdrawn indefinitely.

Depending on your perspective, the cancellation of WeWork's IPO can be viewed as an example of how attitudes to corporate governance have changed, or just how far we still have to go in setting an acceptable bar in governance and corporate behaviour. That the process got as far as pitches to prospective institutional investors shows a worrying lack of concern for sound governance and minority shareholder rights. That the institutional investors' who were approached appear to have comprehensively spurned the company is far more encouraging. WeWork's proposition was rightly rejected; from its ownership structure, to remuneration, to the company's attachment to its audacious community-adjusted-EBITDA metric.



Culture is difficult to define, very difficult to test and all-too-easily dressed up

Beyond the specific instances of questionable financial arrangements, the question of corporate culture loomed large. Culture is difficult to define, very difficult to test and is all-too-easily dressed up in meaningless mission statements and corporate codes. But, it is critical. Regulators, employees, and potential employees, shareholders and customers rightly expect that a robust and respectful culture will frame future strategy and act as a backstop in difficult conditions.

Litigation risk and corporate culture

No business of any scale is free of litigation risk. Turn to the notes to any annual report and accounts and you will find multiple references to litigation risk, legal provisions and related contingent liabilities. These notes don't only detail material and one-off events but will reference the legal risks inherent in the ordinary course of business.

Comprehensive as these notes may be, in some senses they are of limited help in judging the integrity of a company. With a long-term outlook, we need to be assured that a company isn't culturally predisposed to such risk and that, in so far as possible, it conducts business in a sustainable and ethical way. In legal terminology, a bad actor, however profitable in the short-term, does not make a good long-term investment candidate.

To address that risk, we must gain confidence in a company's culture. We do that through engagement over time and constant re-assessment. With every report of litigation or legal threat we will test the investment thesis. With every new piece

of information, we will challenge our own thinking. We need to ask ourselves, have we got this wrong, is this a failing in corporate culture, is this company unacceptably accident-prone? We need to be sure that the investment thesis remains intact, the culture is robust and that trust in management remains unchanged.

We must then be confident that the company has the financial resource to meet a possible legal penalty or bear the burden of settlement.

And each time a new claim is reported or a settlement reached, we must re-group, adding that new information into our discussions and research, to then again challenge our thinking and test the investment case. It is an unavoidable, but vital part of the company research that underpins our long-term investment.

US opioid addiction and legal settlement

The statistics around opioid addiction and misuse are staggering in their magnitude and in the lack of immediate solutions. Reckitt Benckiser (RB) and Johnson & Johnson (J&J) are both regrettably embroiled in this tragedy facing legal issues in the US that have been prominently reported on this quarter.

In July, RB reached a US\$1.4bn opioid settlement with the US Department of Justice and Federal Trade Commission, without conceding to any wrongdoing. The settlement stems from a complaint that former prescription pharmaceuticals subsidiary, Indivior, had made unsubstantiated claims in marketing Suboxone Film, an anti-addiction drug. Indivior was demerged from Reckitt in 2014. The size of the penalty was determined by adding up the sales of Suboxone Film to patients on Medicaid and Medicare from 2010 to 2014 and fully absolved RB from all federal investigations. From the company's perspective, the settlement removes the uncertainty and overhang of this matter and the terms agreed protect its involvement in all ongoing US government drug programmes. Whilst in some regards settlement might seem an expensive and short-termist 'way out', it can often be the optimal route from a financial standpoint. However robust a defence, litigation can be drawn out for years and the non-financial cost in terms of management time and attention can be significant. The benefits of certainty and closure, and reasonable cost, will often justify settlement.

In regards J&J, the company has always held less than 1% of the opioid market through the sale of oral painkiller, Nucynta and fentanyl patch, Duragesic. Furthermore, Nucynta was designed so it could not be crushed or cooked, making it much less easy to abuse, and, J&J no longer markets either drug in the US and has not done so for a number of years.

What is considered by some to be more problematic, legally, is that the company held a 60% share of the raw materials market for legal opioid drugs. However, those production assets were sold in 2016 and more importantly from J&J's standpoint, the company had the approval of the Drug Enforcement Administration to produce and supply these raw

ESG Commentary

THIRD QUARTER 2019

materials. Federal law has to date protected those responsible for raw material production in such instances.



Pursue those with the deepest pockets

Regardless of the arguments around market share and raw material approvals, J&J could never avoid the inevitable legal actions to come as US governments understandably try to reclaim money spent on this crisis. Put simply, they must pursue those with the deepest pockets. J&J has a AAA credit rating, a solid balance sheet and generates around US\$20 billion in free cash flow annually.

In August, the company was fined US\$575m by a judge in Oklahoma in a public nuisance case that contested that J&J was responsible for the current opioid crisis in the state as a result of improper marketing practices. In its defence, J&J argued that it should not bear liability for the misuse of opioids also stressing the point that its market share has always been small. In the company's legal language, "neither facts nor law support this outcome" and it has since appealed. More recently, J&J reached a US\$20.4m settlement with two Ohio counties. Again, the company made clear that "the settlement is not an admission of liability" whilst adding that it "remains open to negotiating a viable, broader resolution to outstanding cases".

Amidst this uncertainty, what is clear is this issue will continue to run. There are now thought to be around 2,000 potential lawsuits waiting in the wings in multiple states based on allegations around misleading claims and aggressive marketing. As the lawsuits stem from states, cities and boroughs, rather than individuals suing on a product liability basis, the master settlement reached by tobacco companies back in 1998 is a relevant precedent when attempting to estimate a possible settlement cost.

The application of a similar methodology, and with unavoidable yet considerable assumptions baked in, implies something around a US\$20bn settlement. Of course, how such a charge would be split and who would be liable is another unknown. In other instances, financial apportionment has been based on who can pay rather than the degree to which an individual company is responsible.

Defending allegations that link talcum powder to cancer

J&J also faces increasingly high profile claims regarding its talcum powder products with 15,500, and rising, personal injury claims that talcum powder use caused ovarian cancer or mesothelioma.

Some of these cases involve women who allege that regular users of talcum powder products caused their ovarian cancer. In other cases the allegation is that some talcum powder contained traces of asbestos which in turn caused cancers, either mesothelioma or ovarian. There have also been claims that J&J was aware of asbestos contamination and failed to

disclose that knowledge. Again, the likely outcomes, and possible costs, are extremely difficult to gauge. Proving the link between talcum powder and cancer will likely be challenging where there is no asbestos link, while the company is categorical in its message that "thousands of tests over the past 40 years repeatedly confirm that our consumer talc products do not contain asbestos".



We must ensure that we are aware of the facts and the materiality of the associated risks

In all these instances, there is no certainty of outcome or of cost. What we must do is ensure that we are aware of the facts and the materiality of the associated risks. We must obviously be assured that any company has the financial means to meet the cost of any charge or settlement. However, speaking to company management is also an important part of our work in these kinds of situations. We will also speak to legal experts and try to engage with companies within the supply chain that have a perspective on behaviour and practices, and thereby a view on any change in those approaches. In doing so we are not only gathering or confirming information but also assessing the company's approach and culture.

In September, we met J&J representatives at the company's New Jersey headquarters. We had expected a fair but firm view on litigation risk but were struck by the confident tone. Relaxed but not complacent, might best sum up the impression that came across. We left reassured that the culture underpinning the company's legal efforts is appropriate and effective.

This is a company that has faced crisis before and reacted with success and respect to all stakeholders. J&J's actions regarding the Tylenol recall in the 1980s must rank as one of the most used case studies in business and marketing courses around the world; as an example of what a company should do. In that instance the company acted with speed recalling products and then introducing tamperproof packaging to ensure malicious tampering of its products when out with its control should not happen again.

J&J's corporate culture has been a primary focus of our discussions. We have researched and discussed the legal claims, litigation risks and possible outcomes. In turn, we have considered the financial implications and the capacity to meet potential costs. In that regard, it is possible to have a high degree of confidence. With an increasingly rare AAA credit rating, J&J's balance sheet is robust. What is much more difficult to quantify and prove is corporate culture. Accepting that litigation risk is an inherent and increasing risk for any pharmaceutical company, how can we be confident that risk is appropriate managed throughout an organisation? How can we be sure that an appropriate culture will deliver integrity across functions? It comes down to judgement, which in turn stems from extensive discussion amongst the team, and active

ESG Commentary

THIRD QUARTER 2019

engagement with the company. Our engagement with J&J dates back almost twenty years. Over that time we have met with different layers of management and particular experts within the company as well as management in overseas divisions.

This is a company that should certainly be on close watch given the number of high profile legal issues it currently faces. A good corporate culture doesn't exist in isolation. Any company must protect those values and management behaviour must be absolutely in line. From our perspective, our years of analysis and engagement underpin our confidence in the outlook for this company and the strength of its corporate culture.

OUTLOOK

Three members of the team attended the PRI's annual conference. For one this was a return visit, having attended in both 2011 and 2014. From that perspective, other than the increase in attendees, it was the call to report on the outcomes of ESG integration that stood out. Gone is the previous debate on whether these issues should even be considered.



In the absence of universal metrics we must continue to use our judgement

The debate, however, continues on how to measure risks, and opportunities, and report success, or otherwise. In the absence of universal metrics we must continue to use our judgement on what is material and relevant on a company-by-company basis.

There were over 1,700 delegates at the PRI event representing a signatory base that added over 400 new organisations in 2019, a striking increase of 22% year-on-year. Global challenges around the environment, social equality and rising standards of living for all are no longer niche subjects. Equally, the bar that investors of all types must meet to ensure that these opportunities and threats are an integral part of investment decisions continues to rise. We welcome that challenge.

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