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Some Thoughts for Boards of Directors in 2020: A Mid-Year Update

The past six months have been marked by a profound upheaval that has accelerated the growing focus on both the purpose of the corporation and the role of the board in overseeing and leading the corporation in ways that promote sustainable business success. For a number of years, there has been a growing sense of urgency around issues such as climate change, environmental degradation, globalization, workplace inequality and the need to keep pace with rapidly evolving technologies. Then, in recent months, the COVID-19 pandemic prompted a systemic shock, which has been accompanied by a long overdue awakening regarding endemic racial injustice. The convergence of these events has accelerated the focus on environmental, social and governance (ESG) issues and stakeholder capitalism as operational and strategic imperatives that are core to corporations' abilities to compete and succeed. The well-being of employees and other stakeholders, and the ability to engage in more sustainable ways of doing business, are not a nice-to-have luxury or a branding exercise, but rather a basic building block of corporate value. There is an essential nexus between "value" and "values."

Attention is being focused not just on stock price and quarterly financial results, but also on understanding what is needed to manage through challenging business conditions, strengthen the business and ensure it is well-positioned to execute on strategic goals as conditions normalize. It is clear that value is not necessarily equivalent to stock price, particularly as the limitations of the stock market as the "all-things-considered" arbiter of value have been illustrated by seemingly capricious volatility, precipitous plunges and exuberant upward trajectories that, in some respects, have defied reality. A more holistic conception of value that is anchored not only in financial results and stock price, but also in a more nuanced understanding of a corporation's strengths and weaknesses that takes into account factors that are often difficult to quantify (such as corporate culture and employee well-being), goes hand-in-hand with stakeholder governance and the idea that a myopic focus on stock price and shareholder returns will ultimately limit, rather than enhance, the overall value of the corporation.

As directors work to maintain focus in these uncertain times, it is more important than ever to have a clear understanding of and conviction about the corporation's purpose. This is the anchor and compass that boards require to chart the path forward towards a new normal and is the bridge that reconciles value with values. As BlackRock CEO Larry Fink recently observed, "Companies and investors with a strong sense of purpose and a long-term approach will be better able to navigate this crisis and its aftermath."

In broad strokes, the purpose of the corporation is to achieve and conduct a lawful, ethical, profitable and sustainable business to create value over the long term. As applied to any given company, this requires a further articulation of the particular objectives and values that animate the company's business strategy: what are the products, services and other solutions that the company is seeking to offer that will enrich the lives of its customers, communities and the public at large, thereby capitalizing on opportunities to create profitable and sustainable business growth, and how is the company's pursuit of these goals driven by the values inherent in its corporate culture as well as broader societal values? So, for example, a company's purpose might be to provide reliable and affordable energy that increasingly draws from sustainable sources, to provide efficient technology platforms that connect and empower local businesses, or it may be aimed at developing and distributing innovative scientific solutions to address public health issues.

In giving shape to corporate purpose, directors must consider the interests of the various stakeholders in the company, the ways in which the company's success is dependent on their contributions, and the ways in which the company's relationships with these stakeholders provide opportunities for strengthening and growing the business. The skills and motivation of employees, the loyalty of customers and the support of local communities are not just a means to an end, but also reflect the company's values. The essence of stakeholder capitalism and corporate purpose is not enriching other stakeholders at the expense of shareholders; rather, the core idea is that to grow and thrive sustainably for the benefit of shareholders and all stakeholders, companies need to have a clear plan for how they will create value by providing products, services and innovations that make the world a better place and that are produced and distributed in a manner consistent with corporate and societal values.

While the challenges we face today are daunting, complex and systemic, the efforts of corporations are essential to effectuating meaningful change—to serve as engines of broad-based employment opportunities that can create prosperity for all socioeconomic groups, to be change agents that debunk racial and other stereotypes and foster a more just and inclusive culture, to develop vaccines and other medical weapons against pandemics and other threats to our health, and to develop more environmentally sustainable goods and services that will turn the tide on climate change, pollution and the erosion of our environment. Corporations that are animated by a clear sense of purpose that is both informed by and that capitalizes on values to create value will be better equipped to seize the opportunities that lie ahead.

Set out below are some key areas for companies and boards to consider as they seek to better understand and optimize the link between value and values, and as they assess how the current challenges present both risks and opportunities for the corporation's pursuit of its purpose.

Racial Justice.

The disproportionate impact of the COVID-19 pandemic on Black communities, as well as the senseless deaths of George Floyd, Ahmaud Arbery, Breonna Taylor and many other Black Americans, have brought salutary new focus on the continuing crisis of institutional racism. Black Americans have long faced discrimination in job searches, lower wages, higher levels of unemployment and lack of access to healthcare, education and social services as a result of systemic racism deeply rooted in many of our social institutions.

As we grapple with how to reform the structures that have historically excluded Black Americans and other people of color, CEOs of many major corporations have spoken out and announced commitments to racial equality, financial and otherwise. Bank of America, for example, announced a $1 billion, four-year commitment to address the racial and economic inequality exacerbated by the COVID-19 pandemic. Institutional investors and investor groups have also taken a stand with respect to companies in their portfolios. In announcing the creation of a Special Committee of the Business Roundtable Board of Directors to advance racial equity and justice solutions, Chairman Doug McMillon said: "Having spoken to many CEOs of America's leading businesses, I know they share my conviction that this is a time to act to address racial inequality. The pain our country is feeling should be turned into real change." The challenge for corporations, asset owners and asset managers in the months and years ahead will be to follow through on these commitments and maintain the current momentum in the drive to translate good intentions into actual results.

For example, as we suggested in our memo, "Using ESG Tools to Help Combat Systemic Racism and Injustice," companies should utilize ESG metrics to facilitate engagement with internal and external stakeholders on how best to foster inclusion and diversity in their day-to-day business and interactions. The Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI) and the consultation draft standards proposed by the International Business Council of the World Economic Forum include categories addressing diversity, inclusion, discrimination, human rights and social impact/vitality. Each of these frameworks provides for at least some measure of annual disclosure of percentages of management and other employees by gender and, where relevant, racial and ethnic status. A number of companies, including as a result of shareholder engagement efforts and proposals, have also begun disclosing pay disparity information by race, ethnicity and gender. As the country continues to have important conversations about systemic racism and inequality, expectations regarding disclosure of such metrics will increase.

Directors are uniquely positioned to work with management to drive meaningful change. The corporations they oversee have significant resources and cultural influence, and they are engines of opportunity creation. The "tone at the top" and values that boards embrace can have profound and far-reaching consequences. Boards should partner with management to ensure that the company's goals, culture and actions are consistent with the principles of inclusion and racial justice and consider ways in which the corporation can foster a more just and inclusive culture. For example, many companies already employ or consult with subject-matter experts who can assist in navigating issues of diversity and racial inclusion; if a company already has a diversity officer or team, the board should work with them to focus on the company's diversity and inclusivity performance.

Socioeconomic Inequality.

Economic inequality in the United States is at a fifty-year high. The wealth gap between the richest and poorest families in the country more than doubled between 1989 and 2016, and the middle class, which once comprised the clear majority of Americans, is shrinking. Not surprisingly, seventy percent of Americans say our economic system unfairly favors the rich and blame corporations for aggravating disparities in income and wealth. This trend has been abetted by multiple factors, including racial injustice, a misguided commitment to shareholder primacy, actions of corporate raiders and activist hedge funds, short-termism and the failure of corporations to properly manage and reward human capital. In recent weeks, the disparate impact of the COVID-19 pandemic has further exacerbated and shone a spotlight on socioeconomic inequality.

Corporations that ignore this trend, or discount the risks it is creating for their businesses, do so at their own peril and at the peril of shareholders who press for maximizing shareholder returns. Like climate change and other complex issues, socioeconomic inequality and the political and cultural unrest it is creating is reaching a tipping point where these consequences will have a boomerang effect—whether that materializes in the form of blunt regulatory reforms, deteriorating consumer confidence and spending levels, shortages of well-educated and highly-skilled employees, rising healthcare costs for employee populations, or other factors that correlate with broad-based prosperity or lack thereof.

Indeed, the codependencies and interconnectedness between stakeholder well-being and corporate well-being have been elucidated by the systemic shock from the COVID-19 pandemic. That shock has prompted not only an economic and social reset, but also a governance reset insofar as it has underscored the logic and benefits of ESG and stakeholder governance—not only in terms of reputational capital, but also in terms of the impact on operations, corporate culture, employee morale, customer and supplier relationships and other building blocks of corporate value.

Stakeholder Governance.

A strong and growing consensus of corporations, investors, academics and leading institutions—including the Business Roundtable, the British Academy and the World Economic Forum—have overwhelmingly embraced stakeholder governance. The consensus recognizes that directors should not be required to act as if any one stakeholder trumps all others, with potentially value-destructive consequences. Instead, they have latitude to make decisions that reasonably balance the interests of all constituencies and operate to promote sustainable, long-term business success of the corporation as a whole.

Stakeholder governance is fully consistent with well-established principles of corporate law and the existing fiduciary duty framework for directors. The directors of a corporation have a fiduciary duty to promote the success and value of the corporation, and the means and time horizon for achieving such goals are within the purview of the board's business judgment. Furthermore, the exercise of balancing competing interests and risks to pursue the best interests of the corporation is the very core of business judgment, and the decisions of unconflicted directors, acting upon careful deliberation, will be fully protected by the business judgment rule. As we have previously discussed, there is no rule of law that mandates the ideology of share-price maximization, or case law requiring directors to manage the ongoing business of a corporation with the paramount goal of maximizing share price.

For an example of how stakeholder governance could influence board decision-making, Yvan Allaire and Stéphane Rousseau have outlined a framework for corporate governance in a multi-stakeholder context that suggests that directors should (i) be explicit about how the decisions they make relate to the objective of maximizing the corporation's long-term value, (ii) adopt a rigorous and explicit decision-making process that involves identifying stakeholders and their level of relevance for the decision, (iii) consider the reasonable expectations of all stakeholders, including shareholders and (iv) finally, render fact-based business judgment as to the course of action that would best serve the long-term interests of the corporation. This framework recognizes the competing tensions between stakeholders, but also accounts for the differing relevance of stakeholders for certain decisions and focuses on the long-term interests of the corporation as the overarching goal. Boards and board committees that follow a similar framework will be fully protected by the business judgment rule.

It is important to note that not all investors, law professors and economists accept stakeholder governance. Some continue to insist on shareholder primacy from both a legal and economic policy standpoint. The law professor who has been most vocal and insistent, Lucian Bebchuk of Harvard Law School, acknowledges the needs of stakeholders other than shareholders, but argues that this is best left to government regulation. As pointed out in a recent *Financial Times* op-ed by the renowned Salomon Brothers economist Henry Kaufman, this is the road to unhealthy state corporatism. Maximizing shareholder returns at the expense of other stakeholders is not supported by the law, economic theory or plain common sense.

COVID-19 Pandemic.

The COVID-19 crisis has had an astonishing impact not only on the economy but on multiple facets of business operations—from factory floors to global supply networks to retail shops—as well as on society more broadly, and particularly communities of color. While some industries and companies have been facing more challenging conditions than others, nearly all companies have had to adjust their operations and strategy to mitigate risks and seize opportunities. As companies have been pressure-testing and recalibrating their businesses to address a range of stakeholder needs, many boards have correspondingly been adjusting their processes to implement what is effectively a stakeholder governance approach to decision-making.

In particular, employee health and safety has been a top priority, and considerations have included protective gear to limit COVID-19 exposure, sick pay for employees who fall ill, flexible work arrangements to accommodate external challenges such as school closures, medical and other employment benefits, and hazard pay and other financial assistance to employees. Employee concerns are a key component of the ESG rubric, prompting some to characterize it as "EESG" to underscore the importance of employee well-being. Indeed, while ESG has perhaps been most prominently associated with climate change and environmental sustainability issues, the pandemic may permanently enhance the focus on human capital.

In addition, considerable effort has been spent on communications and the need for heightened transparency with employees, investors, regulators and other stakeholders. The SEC, for example, has urged companies to provide disclosures that "enable an investor to understand how management and the board of directors are analyzing the current and expected impact of COVID-19 on the company's operations and financial condition, including liquidity and capital resources" and "to proactively revise and update disclosures as facts and circumstances change." Yet, the unprecedented uncertainty many companies now face complicates the directors' task in this environment, and many communications exercises have required thorny judgment calls not only about legal implications, but also business, reputational and relationship implications. For example, questions about whether to withdraw guidance and when to reissue guidance, and what modifications should be made to previously issued guidance, may be particularly challenging in this environment and require additional board-level discussions about key risks and assumptions.

Technology and Artificial Intelligence.

The move online amidst the COVID-19 pandemic has accelerated the ever-increasing dependence on technology that permeates all aspects of business and modern life. Artificial intelligence, cybersecurity and other technological developments continue to create game-changing opportunities and challenges for businesses. Corporations must continuously adapt to developments in information technology, digitalization, artificial intelligence and other disruptive innovations that are forging new markets and transforming the business landscape. Dealing with these disruptions often requires significant investments in research and development, capital assets and employee training that, while creating headwinds for near-term profitability, may be essential for long-term competitiveness and growth.

In this environment, cybersecurity and data privacy are top of mind. At the federal level, both the FTC and the SEC have been intensely focused on these issues. The SEC has observed that cybersecurity risks "pose grave threats to investors, our capital markets, and our country," and in line with that view, the SEC has called for more robust disclosures about cybersecurity risks, oversight responsibility and incident reporting. At the state level, California implemented at the start of this year the most expansive data privacy law in the country to date. The California Consumer Privacy Act imposes wide-ranging data obligations on companies doing business in the state, requiring increased data use transparency and the observance of novel consumer data rights. Internationally, the EU's General Data Protection Regulation has significantly increased data handling requirements for companies with even a minimal European nexus.

Given this changing and complex landscape, the monitoring of technology-related risks should be a priority. Companies should implement and evaluate comprehensive cybersecurity risk mitigation programs, execute data and system testing procedures, institute effective and regularly exercised cyber incident response plans and ensure that the board is vigilant in its cyber risk oversight. More generally, a company's risk management structure should include an ongoing effort to assess and analyze how technological developments may impact the company's profitability and prospects for sustainable, long-term value creation. A further discussion of the board's oversight of technology-related risks and other risks is available here.

Climate Change.

The reality of climate change has been increasingly manifested in rising sea levels, extreme temperatures and the increasing prevalence and intensity of hurricanes, wildfires, droughts, floods and other natural disasters. Mark Carney, the United Nations Special Envoy for Climate Action and Finance, has warned that companies that fail to adapt to climate change "will go bankrupt, without question," and former U.S. Treasury Secretary Hank Paulson has called climate change the "single biggest risk that exists to the economy today." Two hundred and fifteen of the world's largest companies have estimated that climate-related risks could collectively cost them $1 trillion—with the bulk of those costs to be borne in the next five years.

Recognizing these mounting threats, institutional investors have called for more robust disclosure of climate risk and corporate action on climate change. In his 2020 letter to CEOs, BlackRock's Larry Fink recognized climate change as a "defining factor in companies' long-term prospects." Because climate risk is an investment risk, Fink explained, BlackRock will be placing "sustainability at the center of [its] investment approach." Other investors, asset managers, companies and stakeholders have similarly pushed for standardized and accelerated sustainability disclosures and have indicated that this is a key area of focus. For example, in May, a shareholder proposal calling for J.P. Morgan to disclose whether and how it plans to bring its lending activity in line with the temperature goals of the Paris Climate Agreement narrowly missed passage.

Disclosure is just a start. Corporations have a critical role to play in contributing to society's broader response to the climate crisis and face massive potential liability and operational exposure if they fail in the task. Boards of directors should actively oversee the evaluation and management of climate-related risks and sustainability initiatives, implement appropriate monitoring procedures and record these efforts in corporate documents.

ESG Metrics.

As ESG is being increasingly incorporated into corporate decision-making as well as decision-making by institutional investors, there have been ongoing efforts to develop useful, standardized ESG reporting metrics—for example, data about environmental protection, greenhouse gas emissions, treatment of employees, anti-corruption matters, and board and employee diversity. Given the significant differences between industries and between companies within any given industry, a key challenge has been to articulate a framework that is appropriately tailored and flexible, but that can also facilitate some degree of comparability. Adjusting to the evolving expectations in this area has required considerable effort and engagement on the part of companies, including in identifying useful metrics, and then undertaking the information gathering and analysis to validate and disclose the relevant data.

The largest U.S. public companies that disclose this information often report against some portion or combination of the GRI, the SASB and the Task Force on Climate-related Financial Disclosures (TCFD) standards. Other frameworks have been developed by the International Integrated Reporting Council (IIRC), the UN Global Compact and related Reporting on the Sustainable Development Goals (SDGs), the CDP (formerly the Carbon Disclosure Project) and the Climate Disclosure Standards Board, among others. In addition, the International Business Council of the World Economic Forum recently produced a consultation draft that draws from existing frameworks to propose a common set of metrics and disclosures that, if widely adopted, could form the basis for generally accepted standards that are akin to an ESG version of GAAP.

In January, the SEC published guidance on key performance indicators and metrics in Management's Discussion and Analysis (MD&A) disclosures. While not aimed specifically at ESG, nor mandating new disclosures, the guidance references several ESG-type measures (such as employee turnover and energy consumption) that might be included in MD&A, and affirms that companies should identify and address "those key variables and other qualitative and quantitative factors that are peculiar to and necessary for an understanding and evaluation" of the business. More recently, the SEC's Investor Advisory Committee recommended that the SEC should work to update reporting requirements to include "material, decision-useful, ESG factors." While it did not endorse a particular disclosure framework, it did recognize the growing demand from investors for standardized, reliable ESG data, and called upon the SEC to begin outreach to investors, issuers and market participants to develop "well-constructed, principles-based reporting."

In addition, many institutional investors have published their own metrics and scorecards that they are using to assess the ESG strengths and weaknesses of the companies in which they invest, or have endorsed specific frameworks in an effort to push for a consensus approach. For example, BlackRock has endorsed both the industry-specific standards developed by SASB and the climate-specific framework developed by the TCFD as benchmark frameworks. State Street assigns companies an "R-Factor" score that measures the performance of the company's business operations and governance as it relates to financially material ESG issues facing its industry, and it announced earlier this year that it "will go beyond engagement and deploy its voting power in director elections to accelerate corporate action on ESG."

In short, it seems clear that companies will be expected and required to do and say more when it comes to tracking, reviewing and disclosing ESG data. While the number of alternative frameworks and publications, and lack of clear consensus, can be disorienting, it is important for companies to be actively engaged and contributing to these discussions so that they can shape the emerging "best practices" and steer them toward metrics that are meaningful and useful. In addition, it is clear that ESG is not just an operational issue, but also very much a governance issue that is being factored into board-level discussions and engagement with shareholders.

Corporate Raiders and Activist Attacks.

Stock price volatility surrounding the COVID-19 pandemic has made many companies vulnerable to attacks by corporate raiders and shareholder activists. As we have noted in prior memos linked here and here, opportunistic hedge funds have been quick to take advantage of this volatility to acquire high-quality assets at large discounts to their intrinsic value, and in many cases, they have continued to follow their typical playbook of seeking to pressure companies to make operational, governance and other changes to create quick profits. This unrelenting pursuit of stock price increases and other gains for shareholders is not just tone deaf; it is harmful to the ability of corporations to prioritize pressing challenges to the business—such as employee health and safety, supply chain disruptions and the acceleration of digital transformation initiatives.

As boards and management teams work to adjust and recover from the COVID-19 crisis, the power to protect long-term value and stave off attacks from opportunistic activists ultimately rests in the hands of institutional investors and asset managers. After having fought for several decades to tip the balance of power in investors' favor, they now have a responsibility to use this power to protect and defend companies in the pursuit of a corporate purpose that takes into account a broader range of stakeholder and societal interests and that looks beyond near-term profits.

One interesting counterpoint to the continued activism by hedge funds is the recent formation of Inclusive Capital Partners (ICP) by Jeff Ubben, the founder of ValueAct Capital, together with Lady Lynn Forester de Rothschild, founder of the Coalition for Inclusive Capitalism. ICP's mission statement calls out the harms of shareholder primacy, stating "the pendulum has swung too far to the short-term activist shareholder, causing societal and natural welfare to also implode." It further states that it will seek to partner with boards and management of companies whose core businesses seek to achieve the reversal of corporate harm, and "make capitalism part of the solution, rather than the source of some of the world's biggest problems." This includes not only smaller or earlier-stage companies that are focused on sustainability issues, but also so-called "legacy" companies that ESG funds tend to avoid (such as those involved in oil and gas, utilities, materials, chemicals and refineries, capital goods, food processing and food service and for-profit education) because those companies "have the customer relationships, technology, work force, capital, and scale to positively impact the transition to a healthier society and planet" and "show the greatest potential to become part of the solution and to be re-valued."

In responding to this new kind of activism, the traditional defense playbook of "thinking like an activist" will need to be reworked to consider, among other things, the company's position on ESG matters and whether those factors are being appropriately taken into account in identifying and addressing risks and opportunities for value-creation.

Class Action, Derivative and Mass Tort Litigation.

Directors and companies also face the prospect of increasing big-ticket class action and derivative litigation. Economic and social dislocation frequently generate litigation risk, and the present environment is especially ripe for exploitation by the class action plaintiffs' bar. Even before the pandemic, super-charged class actions like the Roundup pesticide cases and talc-related asbestos cases subjected corporations to the outsized risks of an undisciplined tort system. Furthermore, the inability of the legislative branches to forge political solutions to social crises has opened the door to policy-driven litigation in state and federal courts that seeks to hold corporations liable for the costs of social ills—even in the face of significant legal defenses, and even where a corporate defendant may be far removed from the liability-causing exposure.

A specific litigation risk in many sectors of the economy relates to climate change—where the class action bar appears to be readying a broad litigation campaign. Dozens of climate change suits against major corporations are already pending, many brought by municipalities (represented by class action attorneys) seeking billions of dollars to pay for structural responses to climate change. These suits invoke broad and flexible public nuisance theories that create liability risk across a range of industries. That risk has grown more acute in light of recent guidance from the Ninth Circuit that opens the door to actions against corporate defendants in state courts across the country. The class-action firms behind these suits are politically connected, public-relations savvy, well-capitalized and enormously incentivized by their typical contingency fee arrangements.

Exacerbating the litigation challenge more generally is the uptick in corporate governance litigation—especially *Caremark* claims attacking directors for a failure of oversight when a corporation suffers a financial trauma or bad publicity. While such claims remain very difficult to sustain, they have become a favored tool of the plaintiffs' bar. At the same time, the courts have not always applied derivative and class pleading standards strictly, with the result that some fiduciary breach claims that may have been dismissed at the threshold stage a decade ago are today more likely to survive an early motion and thereby acquire substantial settlement value.

One result of all this is growing turmoil in the insurance markets. Even pre-pandemic, major liability and D&O carriers were under substantial margin pressure, pushing even long-time clients to accept higher rates and retentions as well as more elaborate coverage exclusions. The demands on the insurance industry coming out of the COVID-19 crisis will only enhance the challenges in placing and renewing coverage.

But there are tools at hand to meet these litigation challenges. Companies and boards should invest in anticipating major enterprise-level liabilities early, to minimize exposure, enhance relevant reporting functions and consider structural defenses and settlement strategies well before the crisis comes calling. Active engagement with class suits is also critical: some situations require relentless defense in court; others are optimally addressed through complex settlements that can deliver global relief from claims by government and private plaintiffs. Government also has a role to play, by ensuring that social problems are not left to resolution in countless courtrooms but rather by the political branches. For much the same reason, companies should urge, and government should enact, mandatory claims administration programs to address liabilities associated with reopening the economy and other broad-sweeping social problems that may otherwise be unfairly charged as corporate liabilities. And boards should focus on insurance early, examining a wide range of risk management options, to avoid selecting from a range of inadequate options at renewal time.

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