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Spotlight on Boards

The ever-evolving challenges facing corporate boards prompt periodic updates to a snapshot of what is expected from the board of directors of a public company—not just the legal rules, or the principles published by institutional investors and various corporate and investor associations, but also the aspirational "best practices" that have come to have equivalent influence on board and company behavior. The coronavirus pandemic and resulting recession, combined with the wide embrace of ESG, stakeholder governance and sustainable long-term investment strategies by the Business Roundtable, the World Economic Forum, the British Academy, BlackRock, Vanguard, State Street and other investors and asset managers is a decisive inflection point in the responsibilities of the board of directors of companies. The statement of corporate purpose by the World Economic Forum is a concise and cogent reflection of the current thinking of most of the leading corporations, institutional investors, asset managers and their organizations, so too governments and regulators outside the United States:

> The purpose of a company is to engage all its stakeholders in shared and sustained value creation. In creating such value, a company serves not only its shareholders, but all its stakeholders – employees, customers, suppliers, local communities and society at large. The best way to understand and harmonize the divergent interests of all stakeholders is through a shared commitment to policies and decisions that strengthen the long-term prosperity of a company.

The focus on ESG and stakeholder governance has shifted the question of *whether* a board of directors should take into account the interests of stakeholders other than shareholders, to *how* a board should do so. Directors need to grapple with a host of questions about the practical implications of this new paradigm, such as adjusting existing board functioning to reflect stakeholder governance, defining corporate "purpose" and shaping its "culture," integrating ESG considerations into long-term business strategy and measuring and delivering sustainable value to all stakeholders. Directors are also facing questions about the contours of the board's legal obligations, and what, if any, modifications should be made to communications and engagement efforts with shareholders and other stakeholders. In addition, the current pandemic has heightened emphasis on effective and adaptive crisis management and events of recent weeks have shone a light on the role of all market participants in combatting social and racial inequality.

The legal rules as to directors' duties have not changed. What has changed are the expectations of investors and the other stakeholders, for (1) greater transparency, (2) deeper board engagement and oversight, (3) greater opportunity to engage with directors, and by stakeholders for (4) investors to exercise their stewardship of corporations to further the new paradigm that they both have embraced. See, *Fiduciary Duties in Times of Financial Distress*, *On the Purpose of the Corporation* and *Some Thoughts for Boards of Directors in 2020: A Mid-Year Update*.

Boards should:

- Recognize the heightened focus of investors, special interest organizations and the public on "purpose" and "culture" and an expanded notion of stakeholder interests that includes employees, customers, suppliers, communities, the economy and society as a whole, as well as shareholders;

- Relatedly, be aware that ESG and sustainability have become major mainstream governance topics that encompass a wide range of issues, such as climate change and other environmental risks; systemic financial stability; diversity; human capital management (*e.g.*, employee working conditions, wages, training, retraining, healthcare and retirement); supply chains; and consumer and product safety;

- Oversee management's development of analysis and metrics to understand the impact of these stakeholder interests on the value and strategy of the corporation, and oversee the integration and balancing of these interests to promote the long-term success of the corporation; in performing this oversight function, directors should recognize that balancing and allocating among all the stakeholder interests is fully protected by the business judgment rule, if there is compliance with the usual duties of care and loyalty to the corporation;

- Oversee corporate strategy (including purpose, culture and vision) and the communication of that strategy to investors, in light of investors' expectations and keeping in mind that investors want to be assured about not just current risks and problems, but also threats to long-term strategy from global, political, climate, social, economic and technological developments;

- Set the "tone at the top" to create a corporate culture that not only gives priority to ethical standards, professionalism, integrity and compliance in setting and implementing both operating and strategic goals, but that also is a reflection of, and a foundation for, the corporation's purpose;

- Oversee and understand the corporation's risk profile as well as its management of short-, medium- and long-term risks, including climate-related risks, and how risk is taken into account in the corporation's business decision-making, and respond to red flags if and when they arise;

- Choose the CEO, monitor the CEO's and management's performance and develop and keep current a succession plan that takes into account the general and special risks that the corporation faces;

- Have a lead independent director or a non-executive chair of the board with clearly defined duties and responsibilities who can facilitate the functioning of the board and assist management in engaging with investors and other stakeholders;

- Together with the lead independent director or the non-executive chair, determine the agendas for board and committee meetings and work with management to ensure that appropriate information and sufficient time are available for full consideration of all matters;

- Determine the appropriate level of executive compensation and incentive structures, with awareness of the potential impact of compensation structures on business priorities and risk-taking, as well as stakeholder, proxy advisor and public and political views on compensation;

- Consider executive compensation in the context of overall management of all aspects of ESG governance and especially human capital, including diversity, relative compensation of all employees, training and retraining, continuity of employment, healthcare and retirement income and benefits;

- Maintain a working partnership with the CEO and management and serve as a resource for management in charting the appropriate course for the corporation;

- Recognize that shareholder engagement has become a central component of corporate governance, and participate, as appropriate, in proactive outreach efforts to communicate with and listen to shareholders and other stakeholders;

- Recognize that investors (including activists) and certain proxy advisors are monitoring the board's oversight and responsiveness to ESG governance and comparing the company's performance on ESG to that of its peers;

- Work with management to anticipate possible takeover attempts and activist attacks and keep current response playbooks in order to be able to address them more effectively, if they should occur;

- Meet at least annually with the team of company executives and outside advisors that will advise the corporation in the event of a takeover proposal or an activist attack;

- Be open to management inviting a stakeholder or even an activist, under appropriate circumstances, to meet with the board to present the stakeholder's or activist's opinion of the strategy and management of the corporation;

- Evaluate the performance of individual directors, the board and board committees on a regular basis and consider the optimal board and committee composition and structure, including board refreshment, expertise and skill sets, independence and diversity;

- Review corporate governance guidelines, committee charters and workloads and tailor them to promote effective board and committee functioning;

- Be prepared to deal with crises, with special emphasis on macro events such as a pandemic, a natural disaster like an earthquake or hurricane, a liquidity squeeze, a long-term recession or a breakdown in international relations;

- Be prepared to take an active role in matters where the CEO may have a real or perceived conflict, including takeovers and attacks by activist hedge funds focused on the CEO; and

- Determine that appropriate records of the foregoing are timely created and maintained.

To meet these expectations, corporations should seek to:

- Have a sufficient number of directors to staff the requisite standing and special committees to meet investor and other stakeholder expectations for experience, expertise, diversity and periodic refreshment;

- Consider whether the corporation would benefit from the addition of management or board committees focused on finance, risk management and compliance, and especially ESG governance;

- Compensate directors commensurately with the time and effort that they are required to devote and the responsibility that they assume;

- Have directors who have knowledge of, and experience with, the corporation's businesses and key developments and drivers that impact those businesses, even if this results in the board having more than one director who is not "independent";

- Have directors who are able to devote sufficient time to preparing for and attending board and committee meetings and engaging with investors and other stakeholders;

- Have directors who recognize that institutional investors and other third-party ESG activists will monitor the composition of the board of directors for expertise on particular aspects of ESG (such as climate and diversity) and for presence on the board of known opponents of an ESG issue;

- Have directors who recognize that ESG activists may take secondary action to have the company pressure customers and suppliers with respect to an ESG issue and similarly to have customers and suppliers pressure the company;

- Provide directors with all the data that is necessary for making sound decisions regarding performance, strategy, compensation, ESG issues, financial stability, and stakeholder allocation;

- Provide directors with regular tutorials by internal and external experts as part of expanded director education and to ensure that directors have the information and expertise they need to respond to disruption, evaluate current strategy, strategize beyond the horizon and integrate and balance the interests of the stakeholders; and

- Maintain a collegial relationship among and between the company's senior executives and the members of the board that facilitates frank and vigorous discussion and enhances the board's role as strategic partner, evaluator and monitor.

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