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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 economic turbulence, combined with the wide embrace of ESG, stakeholder governance and sustainable long-term investment strategies, is propelling a decisive inflection point in the responsibilities of boards of directors. The 2020 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, as well as 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 salient question has shifted from *whether* a board of directors should take into account the interests of stakeholders other than shareholders, to *how* a board should do so. The focus of investors and organizations concerned with corporate social responsibility, ESG and sustainability is pervasive and intense. It has attracted the attention of investment banks, public relations firms, investor relations firms, law firms and management consulting firms. As a recently released advisory report from McKinsey notes, "A large spotlight is shining on corporate actions these days, and all stakeholders have growing expectations. A board's involvement in defining purpose helps meet those expectations."

In this environment, 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 corporate "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 the emphasis on effective and adaptive crisis management, and events of the past year 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 other stakeholders for (1) greater transparency, (2) deeper board engagement and oversight, (3) greater opportunity to engage with directors and (4) exercise of investor stewardship to further long-term, sustainable value creation.

Boards should:

- Recognize the heightened focus of investors, special interest groups, other 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;

- Recognize that ESG and sustainability are major mainstream governance topics that encompass a wide range of issues, such as climate change and other environmental risks; systemic financial stability; cyber security; cryptocurrency; racial justice; socioeconomic inequality; diversity; human capital management (*e.g.*, employee working conditions, wages, training, retraining, healthcare and retirement); supply chain management and related environmental and societal issues; and consumer and product safety;

- Oversee management's development of analyses and metrics to understand the impact of these ESG and 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 of balancing and allocating among all the stakeholder interests, directors are fully protected by the business judgment rule;

- Oversee corporate strategy (including purpose, culture and vision) and the communication of that strategy to investors, recognizing 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 strategic planning, and recognize that they have a duty to 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 human capital, including diversity, relative compensation of all employees, training and retraining, continuity of employment, healthcare and retirement income and benefits; and recognize that investors and proxy advisors are taking ESG into account in say-on-pay voting;

- 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 response playbooks up-to-date in order to be able to address these attempts or attacks more effectively, if they should occur; in this regard, it may be prudent to 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 in the context of takeovers and attacks by activist hedge funds focused on the CEO; and

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

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, or 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 provide directors with the information and expertise they need to respond to disruption, evaluate current strategy, strategize beyond the horizon and integrate and balance the interests of 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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