Some Thoughts for Boards of Directors in 2022

Martin Lipton, Steven A. Rosenblum, Karessa L. Cain and Hannah Clark

December 27, 2021

Some Thoughts for Boards of Directors in 2022

The focus on climate change and other ESG issues, and on stakeholders generally, has been prompting boardroom deliberations around the recurring theme: "How do we take into account ESG and other stakeholder considerations, while at the same time addressing the expectations of our shareholders for robust financial results, stock price appreciation and dividends or other returns of capital? What is our legal responsibility?" Nearly every board-level corporate governance discussion we have had this past year has involved some version of these questions and the balancing act that they entail.

The proxy fight loss by Exxon earlier this year and the settlement of shareholder derivative litigation against the Boeing board are cogent illustrations of the significance of this challenge. Moreover, starting in 2016 with the publication by the World Economic Forum of The New Paradigm of corporate governance, and intensifying in 2019 with the shift away from shareholder primacy to stakeholder governance by the Business Roundtable, this has been the subject of intense discussion not only in boardrooms, but also in academia, the halls of legislators and regulators and by special interest groups.

The answer to this question when it was raised previously in the context of takeover defense, and the answer articulated more recently in the context of The New Paradigm of corporate governance, is that this is a classic business judgment question for the board of directors. The framework and guiding principles for a board's exercise of its business judgment are anchored in the purpose of the corporation, which provides actionable guideposts for corporate and fiduciary conduct and can be summarized as:

> The purpose of a corporation is to conduct a lawful, ethical, profitable and sustainable business in order to enable its success and increase in value over the long term. This requires consideration of all the stakeholders who are critical to its success (shareholders, employees, customers, suppliers and communities) as determined by the corporation and its board of directors using their business judgment and with regular engagement with its shareholders, who are essential partners in supporting the corporation's pursuit of its purpose. Fulfilling this purpose in this manner is fully consistent with the fiduciary duties of the board of directors, and the concomitant stewardship obligations of shareholders.

Viewed through this lens, the fundamental purpose of a for-profit corporation, and, accordingly, the decision-making calculus of boards, must include value-creation. However, corporations do not exist in a vacuum, but rather in a complex ecosystem of stakeholders. Every corporation relies on a multitude of stakeholder contributions and interests in order to operate effectively and create value. As with all business strategy, risk and operating decisions, it is essential to take into account the corporation's relationships with and the well-being of employees, customers, suppliers, communities and, more broadly, society and the environment at large.

Indeed, one takeaway from the ongoing Covid-19 pandemic has been the erosion of silos and the emphasis on the interconnectedness and co-dependencies of various constituents—for example, the far-reaching business and economic implications when the health and safety of employees are jeopardized, the ripple effect of bottlenecks and vulnerabilities in supply chain networks, and the sense of community that has been a motivating factor in the embrace of vaccines, masks and other behaviors aimed at reducing transmission rates. In this environment, many costs and risks that were previously viewed as externalities—including, but not limited to, climate change and environmental sustainability—are increasingly being taken into account by both corporations and investors as directly relevant to business strategy, risks and operations and financial results. The evaluation and weighing of these factors have also been facilitated by technological advances in processing and distilling large amounts of multi-dimensional data, so that increasingly attenuated linkages can be identified and quantified.

With all that said, the task and legal duty of a board of directors is fundamentally unchanged; it must use care and diligence and exercise its business judgment in weighing risks and opportunities to chart the path forward for the corporation. While the landscape of considerations that shareholders and other constituents expect directors to bear in mind has become increasingly broad and more complex, directors continue to be governed by the same legal duties.

In addition to the focus on ESG issues and stakeholder governance, the perennial themes of effective board functioning will be as important as ever—including with respect to board leadership, structure and composition, activism and defense preparedness, risk management, crisis management, succession planning and executive compensation. We recently highlighted these themes in our September 1, 2021 memo, Spotlight on Boards, which is attached.

September 1, 2021

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 ongoing coronavirus pandemic and resulting economic and social turbulence, combined with the wide embrace of ESG, stakeholder governance and sustainable long-term investment strategies, are propelling a decisive inflection point in the responsibilities of boards of directors. The 2016 and 2020 statements of corporate purpose by the World Economic Forum and the 2019 embrace of stakeholder capitalism by the Business Roundtable, together with current statements of policy by most of the leading corporations, institutional investors, asset managers and their organizations, as well as governments and regulators in and outside the United States, lead us to summarize the purpose of the corporation:

> The objective and purpose of a corporation is to conduct a lawful, ethical, profitable and sustainable business in order to ensure its success and grow its value over the long term. This requires consideration of, and regular engagement with, all the stakeholders that are critical to its success (shareholders, employees, customers, suppliers, communities and society at large) as determined by the corporation and its board of directors using their business judgment. Fulfilling this purpose in such a manner is fully consistent with the fiduciary duties of the management and the board of directors and the stewardship duties of shareholders (institutional investors and asset managers), who are essential partners in supporting the corporation's pursuit of its purpose.

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 commanded the attention of investment banks, public relations firms, investor relations firms, law firms, management consultants and other advisors. As a 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 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 have 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) responsible investor stewardship to further long-term, sustainable value creation.

Boards should:

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

- 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;

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

- 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;

- 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 warning of imminent risks, if and when they arise (see our memo, Risk Management and the Board of Directors);

- Determine the appropriate level of executive compensation and incentive structures with the basic objective of having and retaining the best management available, and with awareness of the potential impact of compensation structures on business priorities and risk-taking, taking into account ESG goals and current stakeholder, proxy advisor and public and political views on compensation;

- Be prepared to deal with crises, including 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;

- Oversee management's development of analyses and metrics to understand the impact of 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; keeping in mind that in performing this oversight function of balancing and allocating among all the stakeholder interests, directors are fully protected by the business judgment rule;

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

- 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, serve as a liaison between the independent directors and management, and assist management in engaging with investors, other stakeholders, their advisors like S&P, ISS, SASB and with regulators;

- 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;

- 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;

- 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 the corporation's 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; 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, compliance and ESG and stakeholder governance;
- Compensate directors commensurately with the time and effort that they are required to devote and the responsibility that they assume, taking into account the possible impact on the objective of long-term growth in value;
- Have directors who have knowledge of, and experience with, the corporation's businesses and the 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;
- 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 corporation'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.

Martin Lipton
Steven A. Rosenblum
Karessa L. Cain
Hannah Clark