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Stakeholder Capitalism and ESG as Tools for Sustainable Long-Term Value Creation

Recent high profile investigations into greenwashing, the ongoing war in Ukraine and soaring energy costs have prompted questions as to the purpose and value of ESG, and more broadly, stakeholder capitalism. Some have criticized stakeholder capitalism and ESG as "woke" politics, a threat to shareholder interests and a distraction for boards and management. Others have questioned whether stakeholder capitalism and ESG can straddle "doing good" and "doing well." Uncertainty also abounds as to what ESG truly means.

We believe stakeholder capitalism and ESG are fundamentally frameworks to enhance the sustainable long-term value of a corporation. Both are tools for boards and management to guide business strategy, risk management and capital allocation in a manner that best serves the financial well-being of a business, and in turn, the interests of shareholders. Time and again, stakeholder and ESG considerations have driven positive societal outcomes (climate and DEI being among the examples). But stakeholder capitalism and ESG, as we and many investors understand them, do not lead with a political or moral agenda. The north star of stakeholder capitalism and ESG is driving sustainable long-term value creation.

Stakeholder capitalism is neither new nor a niche view. Since the Great Recession, acceptance of and reliance on the Friedman doctrine of shareholder primacy has been widely eroded, as a growing consensus of business leaders, economists, investors, lawyers, policymakers and important parts of the academic community have embraced stakeholder capitalism as the key to sustainable, broad-based, long-term global prosperity.

Stakeholder capitalism recognizes that corporations do not exist in a vacuum, but rather each relies on a multitude of stakeholder contributions and interests from employees, customers, suppliers, communities and, more broadly, society and the environment at large in order to operate effectively and create value. Since the adoption by the International Business Council of the World Economic Forum of The New Paradigm of Corporate Governance in 2016, stakeholder capitalism has been adopted in the 2020 Davos Manifesto, the Business Roundtable, the British Academy's Future of the Corporation Project, the Enacting Purpose Initiative, the UK Financial Reporting Council and the Investor Stewardship Group.

To reiterate, we summarize stakeholder capitalism as follows:

> The 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 all the stakeholders that 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 shareholders, who are essential partners in supporting the corporation's pursuit of its purpose. Fulfilling this purpose in such manner is fully consistent with the fiduciary duties of the board of directors and the stewardship obligations of shareholders.

The pandemic and its economic and social impacts have only generated further debate on corporate purpose and accelerated the shift to stakeholder governance. More than two years on, we continue to be reminded that businesses exist in a symbiotic relationship with their key stakeholders: once largely invisible, suppliers and supply chains have revealed themselves as the backbone of the global economy, the competition for talent remains as heated as ever and carefully built reputations have crumbled in step with missteps in customer, employee and community relationships.

When viewed from the lens of promoting sustainable long-term value creation, ESG also becomes easier to define. Some companies have already publicly disclosed that they will find it increasingly challenging to sustain growth and outperform peers without addressing issues such as the risks associated with climate change, human capital pressures, ongoing supply chain risks and cybersecurity vulnerabilities—all of which have been commonly grouped as ESG issues, but which we believe are each separately worthy of board and management attention where they (along with other issues that do not ostensibly appear on the balance sheet) have the potential to materially impact the bottom line. Separately, many companies have recognized the importance of measuring and disclosing specific metrics intended to enable comparisons, by the companies themselves, mainstream investors and other constituencies, of performance on various ESG factors.

Different ESG issues will have different impacts on different companies. It is for these reasons that boards and management need to take the lead to identify which subset of issues is material to their business, including engaging the perspectives of their stakeholders. Stakeholder capitalism does not require every company to outperform on every ESG issue. Priorities should be identified, reflecting the long-term financial interests of the business. Corporate action that gives consideration to stakeholder interests and ESG issues, in our view, will be fully protected by the business judgment rule, so long as decisions are made by non-conflicted directors acting upon careful consideration and deliberation.

In these uncertain macroeconomic and geopolitical times, and in the face of growing societal divisions, stakeholder capitalism and ESG will be critical tools for value creation. Companies that adopt a more thorough and long-term perspective to value creation will be better positioned to unleash the full power and potential of free market capitalism.

Martin Lipton
David M. Silk
Carmen X. W. Lu