Navigating an Evolving Challenge: Role of the Board and the CEO in the Navigating Political and Social Issues

ESG and Director Fiduciary Duties

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Are principles of stockholder primacy and value maximization obstacles to acting on ESG Matters?

- Delaware corporate law has long ascribed to a principle of stockholder primacy, and corporate directors have a fiduciary duty to maximize stockholder value
- These principles, however, should not be an obstacle to corporate directors in properly considering and addressing environmental, social, and governance ("ESG") matters
  - Well settled principles of Delaware law provide directors considerable latitude in addressing such matters
  - A board's well-informed, good faith decisions on ESG matters should be protected business judgments and not subject directors to liability
  - But failing to consider and address ESG matters that affect the corporation's business could potentially be a breach of fiduciary duty

Directors have broad latitude under Delaware law to consider and act on ESG issues

- Fiduciary duties run to <u>the corporation and </u>the stockholders
- Long-term best interests of the corporation:
  - Directors are "obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon"
  - board's fiduciary obligation "includes the selection of a time frame for achievement of corporate goals."
  - No "per se duty to maximize shareholder value in the short term"

  (*Paramount Communications, Inc. v Time Inc.*, 571 A.2d 1140 (Del. 1990))
- Directors can consider the interests of other corporate constituencies (employees, customers, etc.) if rationally related to the best interests of the stockholders (*E.g.*, *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del.1986))
- Directors have a "fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source." *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985)

Could directors possibly face breach of fiduciary duty liability for ESG matters?

- Director liability seems unlikely if directors have informed themselves and consciously determined how to act (or not act) with respect to ESG matters
- Director liability arising from board decisions as to ESG issues seems unlikely due to the protections of the business judgment rule, the stringent gross negligence standard for due care claims, Section 102(b)(7) exculpatory provisions, and the fact such decisions ordinarily would not involve director conflicts of interest
  - Even a conscious decision not to take a stance or not to address particular aspects of ESG should be a protected business judgment if made in good faith on a fully informed basis
- Director liability could potentially result if the corporation is harmed by the board's failure to consider and monitor potential ESG-related risks to the corporation and its business – *i.e.*, oversight liability

Oversight obligations and ESG

- A board's oversight function involves monitoring the corporation's financial and operational performance, legal compliance, and risks to the corporation and its operations from whatever source
  - ESG issues can affect financial and operational performance, public image, and legal compliance
  - Significant overlap between certain ESG issues and aspects of legal and regulatory compliance
- The role of a board with respect to ESG is best understood as an extension of its oversight obligations and duty to implement and monitor compliance programs

(*See*, *e.g.*, Leo E. Strine, Jr. *et al.*, *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark and EESG Strategy* (2021))

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Could directors potentially be liable for breaching oversight obligations as to ESG matters?

- Failure of oversight liability is “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.” (*In re Caremark Int’l Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996))
- Under Delaware law, the conditions predicate for directors to be liable for breach of their fiduciary oversight obligations include:
  - An utter failure to implement reporting or information systems or controls; or
  - Having implemented such systems or controls, a conscious failure to monitor or oversee the corporation’s operations that disables directors from being informed of risks or problems that require their attention. (*Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006))
- If directors have systems in place to inform themselves and enable them to assess ESG issues of significance to the corporation, and they make conscious decisions in good faith as to ESG matters, the risk of liability for breach of fiduciary duty (under an oversight theory or otherwise) should be remote

ESG, stockholder primacy, and *Corwin*

- Fully informed, uncoerced approval of a transaction by disinterested stockholders results in the board's decision being protected under the business judgment rule (except in the context of conflicted controlling stockholder transactions)

  (*Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015))

- If stockholders value ESG considerations over price, *Corwin* suggests the board will be protected when acting in accordance with the will of the stockholders
- Even where the *Revlon* doctrine applies (and a board ordinarily is required to focus on short-term value maximization), a board's decision to accept a lower cash price for ESG-related reasons should be protected if the transaction receives fully informed, uncoerced stockholder approval

Public Benefit Corporations and ESG

- A public benefit corporation is a for-profit corporation intended to produce a public benefit while maintaining a responsible and sustainable operation
- When making decisions, directors of a public benefit corporation are statutorily required to balance stockholder pecuniary interests, the best interests of those materially affected by the corporation's conduct, and the public benefit or benefits identified in the certificate of incorporation
- Does the ability to organize as a public benefit corporation suggest that the directors of a corporation not so-organized do not need to consider (or should not consider) ESG matters?
  - No. Directors are obligated to act in the best interests of the corporation and its stockholders, understand issues and risks facing the corporation, and protect the corporation from harm, irrespective of its source
  - ESG issues can be significant to short and long-term financial and operational performance, corporate reputation, legal compliance, and long-term strategy and value maximization

Board approach to ESG: One size does not fit all

- Just as company-specific factors result in differences among companies in monitoring and compliance systems, company-specific factors will lead to different ways of addressing the approach to ESG
- ESG strategy and director oversight of that strategy should align with long-term business strategy
- Impractical to give every ESG-related matter equal priority or even to consider and evaluate every aspect of ESG
  - The board should implement systems to identify, understand, and assess ESG matters of significance to the corporation and the importance of those issues to various corporate constituencies (employees, consumers/customers, regulators, local community, etc.)
- No stance or response will satisfy all stockholders, let alone all stakeholders – that is the essence of business judgment
- Directors are often called upon to make difficult decisions that require them to balance competing interests, and ESG considerations are no exception

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