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Directors' Duties in an Evolving Risk and Governance Landscape

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The stakes for responsible corporate stewardship have never been higher.

Corporations today account for a greater proportion of our collective productivity than ever before. Of the 100 largest economies in the world, 71 are corporations, and only 29 are countries. U.S. corporations alone generated profits of $2.3 trillion in 2018—the highest in history. Reflecting their unprecedented scale, U.S. corporations have been blamed for accelerating environmental degradation and aggravating disparities in income and wealth. Calls for the exercise of corporate social responsibility have become increasingly urgent. Recognizing this urgency, the Business Roundtable last month embraced broad stakeholder governance and urged corporate leaders to focus on sustainable value creation. Yet, as directors of U.S. corporations seek to answer these calls, **they remain subject to countervailing market pressure** to deliver outsized stockholder returns in compressed time horizons.

To allow directors to mediate this challenge, and to facilitate responsible long-term corporate decision making, we have long supported a stakeholder-centered model of corporate governance and cautioned against rote application of the entrenched shareholder-primacy model. Recognizing that investors, and the asset managers who represent them, share with the rest of society an interest in sustainable prosperity, we have sponsored ***The New Paradigm***—a reconception of corporate governance as a collaboration among shareholders, managers, employees, customers, suppliers, and the communities in which corporations operate.

The New Paradigm thus offers an alternative to the shareholder-value maximization principle that has dominated corporate law thinking for some fifty years. **We question** the historical, doctrinal, and empirical underpinnings of that principle, which too easily justifies the pursuit of a short-term rise in stock price at the expense of long-term corporate value. Perhaps maximizing share price corresponds to greater overall corporate value as a matter of abstract economic theory premised on unrealistic simplifying assumptions. But destructive stock market bubbles, accumulating empirical evidence that share prices do not correlate with desirable macroeconomic outcomes, and the compelling lessons of behavioral economics all confirm that this theory does not work in the real world.

We therefore doubt that the shareholder-value maximization model of corporate governance remains politically or commercially viable in view of the challenges confronting this generation. Corporate law is in the midst of an evolution that we believe will eventually restore the broader social mission of the corporation. But directors are already—right now—faced with the task of managing massive risks to the environmental and human capital resources necessary to drive sustainable and equitable economic growth.

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The immediate challenge before corporate directors is the mitigation of unfamiliar risks in a developing governance context. The ESG (environmental, social, and governance) investing movement provides a useful starting point. ESG proponents urge corporations to adopt long-term policies for achieving sustainable growth that account for the environmental and social effects—including the costs to society—of corporate conduct. Some boards have sought to integrate ESG considerations into corporate policymaking; others have yet to address them.

But a corporation ignores environmental and social challenges at its own peril. Environmental and human capital risks are substantial and increasingly near-term risks for corporations operating in every sector of economic activity. Corporate boards are obligated to identify and address these risks as part of their essential fiduciary duty to protect the long-term value of the corporation itself. Attentive directors are already grappling with immediate environmental business risks, as climate change, soil erosion, and rising sea levels disrupt commercial relationships and supply chains. Changes to regulations and operating conditions, provoked by concerns about environmental degradation and widening income and wealth inequality, also create what analysts call "transition risks" for any entity that sells, finances, or insures anything—that is, nearly every business corporation.

Finally, and perhaps less well appreciated, the costs and dislocations caused by climate change and other instances of environmental degradation create liability risk across the economy. Natural resource companies are already responding to civil litigation alleging inadequate or inaccurate public disclosures regarding environment-related risks. This is only the beginning. Firms that extract resources from the environment or trade in products claimed to be pollutants must anticipate significant litigation risk over the coming decade. So must firms that manufacture, sell, or finance products that are implicated in environmental harm. Few sectors of the economy will be untouched. When significant costs to society from climate change and the depletion of resources are tallied, as they will be, an armada of regulators and plaintiffs' lawyers will appear. And as mass tort litigation over recent decades has shown, the legal system, when confronted with civil litigation claiming broad social injury, is often indiscriminate in extracting enormous damages from corporate defendants—even those far afield from the liability-creating conduct. Directors themselves, as we have **recently noted**, may be held accountable for corporate exposure if their efforts to implement and monitor board-level risk-management controls are adjudged insufficient in hindsight.

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To meet these challenges, directors have the ability, and in many instances the obligation, to use their reasoned business judgment to balance the interests of all corporate stakeholders—not just shareholders, but also employees, business partners, and national and local communities. There should be no uncertainty on this score. Some states have enacted constituency statutes that specifically reference stakeholder interests; others, including Delaware, have not. But the controlling legal rule is universal and rock-solid: in Delaware and every other U.S. jurisdiction, the business judgment rule will support board action that pursues ESG principles for the purpose of creating long-term corporate value.

That is just the floor. Properly informed directors are empowered to act to protect the corporate reputation; to pursue disclosure and engagement efforts designed to inform investors about global social and environmental developments that threaten long-term corporate health; to safeguard long-term global supply chain relationships; and to strengthen the ability to recruit and incentivize a skilled and motivated workforce. Moreover, boards have the affirmative obligation to identify business and liability risks and to articulate the strategy and the time horizon for mitigating them. Taken together, directors' duties not only permit boards to address the full range of risks that threaten the corporation's ability to deliver sustainable growth, but indeed require boards to address the most acute among them.

To be clear, then: the shareholder-value maximization model is no obstacle to full director commitment to corporate social responsibility. But it remains the elemental fact of U.S. corporate law that only shareholders elect directors. And so we return to *The New Paradigm*: effective governance requires effective partnership between boards and investors. The prospects for such a partnership are increasingly promising. Key institutional shareholders—notably including BlackRock, State Street and Vanguard—have recognized that companies must serve broader social purposes. Survey after survey of major investors confirms that they expect companies to articulate a socially and economically valuable purpose, to take public stands on ethical issues, and to formulate long-term corporate policy with the rising risks posed by income inequality and environmental deterioration in steady view.

The law empowers directors to address these new risks—and to capitalize on the attendant opportunities. An evolving shareholder landscape provides an opportunity for directors to do so with the support and counsel of the investment community. Well-advised boards, asset managers and shareholders will seize the opportunity as a matter of priority.