

Some Thoughts for Boards of Directors in 2020

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Some Thoughts for Boards of Directors in 2020

In hindsight, 2019 may come to be viewed as a watershed year in the evolution of corporate governance. After years of growing alarm about endemic short-termism, the sustainability and competitiveness of businesses over a long-term horizon, and the role of corporate policies in contributing to socioeconomic inequality, there has been an emerging consensus that the prevailing corporate governance system is broken. Initially, in the aftermath of the financial crisis of 2008, this critique was focused on short-termism as a root cause of systemic destabilization and decay. In subsequent years, the concept of sustainability gained traction, and ESG (environmental, social and governance) principles were embraced by shareholders and corporations alike as the next frontier in corporate governance best practices. This in turn laid the foundation for the latest iteration of corporate governance modernization: the advent of stakeholder governance, and the realization that the pursuit of wealth maximization for shareholders as the sole *raison d'être* of corporate governance has been a principal accelerant of short-termism and socioeconomic inequality.

Perhaps remarkably, the key proponents of stakeholder governance – which posits that the fiduciary duty of management and the board of directors is to promote the long-term value of the corporation for the benefit of all its constituents and not solely to maximize shareholder wealth – have been a subset of institutional shareholders, namely, the major index funds such as BlackRock, State Street and Vanguard, as well as other shareholders with a long-term investment horizon. Their reasoning has generally been that, in order to thrive, corporations must focus not only on profitability but more broadly on their social purpose and sustainability, and in that regard, it is essential to consider the interests not only of shareholders but also those of employees, customers, suppliers, the environment, communities

and other constituencies who are critical to the success of the corporation.

In the last few months, several milestones have solidified this formulation of corporate governance. In August, the Business Roundtable embraced stakeholder governance in a statement signed by 181 high-profile CEOs: “[W]e share a fundamental commitment to all of our stakeholders.... Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.” In November, the British Academy echoed this theme in its “Principles for Purposeful Business,” and earlier this month, the World Economic Forum issued its “Davos Manifesto 2020: The Universal Purpose of a Company in the Fourth Industrial Revolution,” which 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.

At this point, much of the focus on stakeholder governance has shifted from the question of *whether* a board of directors should take into account the interests of other stakeholders, to *how* a board should do so. In the coming year, directors will need to grapple with a host of questions about the practical implications of this new paradigm – such as how to adjust existing board functioning to reflect stakeholder governance, 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 many respects, an embrace of stakeholder governance is best characterized as a recalibration rather than a sea change. The board's objective continues to be the long-term health and profitable success of the corporation, and it must continue to exercise its *business* judgment to achieve that outcome. To be clear, the essence of stakeholder governance is not about altruism, nor does it enable boards or companies to promote the interests of some stakeholders at the expense of others for reasons that are not squarely anchored in the best interests of the corporation. Indeed, shareholder concerns about the prospect of zero-sum trade-offs between shareholders and other stakeholder interests should be mitigated to a large extent by the fact that shareholders are the ultimate beneficiaries of the financial value of the corporation. Profits are not the sole objective of the corporation, but they are one of the objectives that a well-functioning corporate governance regime must seek to achieve.

In addition, the exercise of considering multiple stakeholder interests, and the risks and opportunities they entail for the corporation and its business plan, is hardly a novel endeavor for boards. The core function of the board remains the same: it is tasked with overseeing the evaluation and synthesis of varying objectives and interests, and concomitant risks and opportunities, while contributing the perspectives and experiences of directors to formulate a strategy and then determine the steps to execute that strategy.

Nor is stakeholder governance inconsistent with well-established principles of corporate law and the existing fiduciary duty framework for directors. There is no legal impediment to embracing stakeholder governance. Instead, the board has a fiduciary duty to promote the best interests of the corporation, and in fulfilling that duty, directors must exercise their business judgment in considering and reconciling the interests of various stakeholders and their impact on the

business of the corporation. Moreover, in exercising their duties of care and loyalty, directors are afforded the safe harbor of the business judgment rule in seeking to promote sustainable long-term investment and ESG principles in a manner designed to enhance the long-term value of the corporation. Indeed, the special genius of Delaware law in particular, and one of the primary reasons why it has become the indisputably preeminent jurisdictional choice of most U.S. public companies, is that it has been animated by a fundamental sense of pragmatism and its fiduciary duty framework has afforded corporations the breathing room they need to address evolving business challenges as well as expectations of shareholders.

In other respects, however, the shift toward stakeholder governance may be subtle but profound. A focus on the corporation and its co-dependencies with varying stakeholders, rather than more narrowly only on shareholder interests, should broaden the lens and sharpen the focus on the corporation's purpose and long-term strategy across multiple dimensions. For example, instead of concentrating on the quarterly financial results and financial outlook of the company, a consideration of broader stakeholder interests may prompt a more nuanced, multifaceted assessment of value that includes assets and liabilities that are impactful but, in some ways, outside the four corners of the company's balance sheet – like the caliber of employee skillsets in the face of rapidly evolving technology, or the suitability of the company's production processes and facilities to stay ahead of the curve in anticipating customers' needs.

Among the critics of stakeholder governance, a common mantra has been that “accountability to all is accountability to none.” Yet, the practical reality is that asset managers and institutional investors continue to be uniquely situated to exert tremendous influence and pressure on public corporations, and accordingly,

the viability of stakeholder governance hinges on their support. Shareholders are the only corporate stakeholders who have the right to elect directors, and, in particular, the “big three” asset managers – BlackRock, State Street and Vanguard – collectively own approximately 20% of the S&P 500 companies. In order for this new paradigm to work for all stakeholders, the major asset managers and institutional investors must demonstrate real conviction not only in the tone of their policy statements but also in their voting decisions and engagement efforts. At the same time that boards of directors are considering the ways in which they must recalibrate their processes, mindset and culture to achieve the benefits of stakeholder governance, a similar exercise may be warranted for many institutional investors. They must refrain from insisting on short-term performance that discourages long-term strategies, and from investing in and outsourcing engagement to activist hedge funds. Instead, they must embrace the same purpose, culture, stakeholder, sustainability and ESG principles that are reflected in the statements of the Business Roundtable, the British Academy and the World Economic Forum and engage directly with companies to achieve the mutual understanding and support that is critical to a flourishing economy and a tranquil society.

If investors are successful in working together with companies to effectuate stakeholder governance, the result will be to *raise* rather than *lower* the bar – in effect, shareholders as well as other stakeholders are not watering down accountability, but rather they are demanding *more* from corporations. It is not enough to prop up the company’s stock price with a stock buyback program or substantial cost-cutting initiatives. Nor is it sufficient to produce good quarterly results unless those results are building blocks in a longer-term strategic plan. Value is not limited to stock price and dividends, and performance and success will

be measured using multiple types of metrics. Moreover, it is simplistic to suppose that these metrics will cancel each other out or obfuscate an objective review of the corporation's performance. Instead, a more multifaceted articulation of corporate purpose can be used to cultivate a richer, more thorough assessment and understanding – both by boards as well as shareholders and other stakeholders – of the corporation's ability to compete and succeed in growing its business, winning customers, cultivating and retaining a talented workforce, serving as an engine of prosperity in local communities and fostering a reputation with regulators as a best-in-class corporate citizen.

As we look forward to 2020 and beyond, it is clear that the shareholder-value maximization model of corporate governance is politically and commercially unsustainable in view of the acute challenges confronting this generation. Environmental and human capital risks, as well as the systemic instability generated by widespread economic inequality, are substantial and increasingly near-term risks for corporations operating in every business sector. Directors must meet this challenge by focusing not just on profits, but also on the corporation's broader purpose and role in the economic and societal ecosystem in order to build a sustainable and long-term value proposition.

With this background and context, in the coming year, boards will be expected to:

Recognize the heightened focus of investors, special interest organizations and the public on “purpose” and “culture” and an expanded notion of stakeholder interests that includes shareholders as well as employees, customers, suppliers, communities, the economy and society as a whole;

Relatedly, be aware that ESG and sustainability have become major, mainstream governance topics that encompass a wide range of issues, such as climate change and other environmental risks; systemic financial stability; worker wages, training,

retraining, healthcare and retirement; supply chain labor standards and consumer and product safety;

Oversee management's development of analysis and metrics to understand the impact of these 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, directors should recognize that balancing and allocating among all the stakeholder interests is protected by the business judgment rule if there is compliance with the usual duties of care and loyalty to the corporation;

Oversee corporate strategy (including purpose and culture) and the communication of that strategy to investors, in light of investors' expectations and keeping in mind that investors want to be assured not just about current risks and problems, but also threats to long-term strategy from global, political, social 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 risks, including how risk is taken into account in the corporation's business decision-making, and 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;

Have a lead independent director or a non-executive chair of the board who can facilitate the functioning of the board and assist management in engaging with investors;

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 investor and proxy advisor views on compensation;

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 efforts to communicate with and listen to shareholders;

Work with management to anticipate possible takeover attempts and activist attacks in order to be able to address them more effectively, if they should occur;

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 major shareholder or even an activist under appropriate circumstances to meet with the board to present the shareholder'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 skillsets, 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;

Be prepared to take an active role in matters where the CEO may have a real or perceived conflict, including takeovers and attacks by activist hedge funds focused on the CEO; and

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

To meet these expectations, corporations should seek to:

Have a sufficient number of directors to staff the requisite standing and special committees to meet investor 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; and ESG;

Compensate directors commensurate 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 with 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;

Provide directors with the data that is critical to making sound decisions regarding performance, strategy, compensation, ESG issues, capital allocation and stakeholder allocation;

Provide directors with regular tutorials by internal and external experts as part of expanded director education and to assure that directors have the information and expertise they need to respond to disruption, evaluate current strategy, strategize beyond the horizon and integrate and balance the interests of varying 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.