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Understanding the Role of ESG and Stakeholder Governance Within the Framework of Fiduciary Duties

Over the past decade, investors, companies, and commentators have increasingly accepted and adopted stakeholder governance as the way to pursue the proper purpose of the corporation and have embraced consideration of environmental, social and governance (ESG) issues in corporate decision-making toward that end. But an emerging movement opposed to any consideration, at all, of ESG factors threatens to erase the gains that have been made over the past ten years and revert to the outdated view that the purpose of a company is solely to maximize short-term shareholder profits.

This debate is playing out very publicly, with politicians at the highest levels of state and federal government publicly staking out positions on ESG and the extent to which it should (or should not) be considered by asset managers; through regulation and law; and in boardrooms across the country and around the world. At one extreme, critics of ESG are dismissing any consideration of the long-term impact of environmental or social risk on a company as "woke" capitalism, to be condemned, if not outlawed. (See Bloomberg, Populist House Republicans Picking a Fight With US Business Over 'Woke Capitalism' (Nov. 27, 2022).) At the same time, attacks from the other end of the spectrum condemn board consideration of ESG in a stakeholder governance model as insufficiently prescriptive. Yet neither view, attempting to politicize the role of companies and their boards, grapples adequately with the real meaning of ESG and stakeholder governance and the role of these concepts in the decision-making process of corporate boards and management.

ESG, properly understood, is not a monolithic concept, but rather refers to the panoply of risks and policies that a company must carefully balance in seeking to achieve long-term, sustainable value. To be sure, political action may be necessary to meaningfully confront climate change and other environmental and social challenges to the long-term success of the U.S. economy and global prosperity. But separate and apart from that political will — and all the debate that should properly surround it — it remains incumbent upon and entirely within the purview of each board of directors to look beyond short-term shareholder profits and seek sustainable long-term value creation, taking into account all stakeholders, including those implicated by ESG matters. With this in mind, we write to correct recent misinformation about stakeholder governance and ESG, and to explain how the consideration of ESG, properly understood, as well as other stakeholder factors, is entirely consistent with the fiduciary duties owed by the board and management to the company and to shareholders, and indeed required if board and management are to act prudently.

Defining Stakeholder Governance and ESG

The long-running debate over whether the purpose of the corporation is to maximize short-term profits for shareholders or, alternatively, to operate in the interest of all stakeholders to promote long-term value, dates back to the 1932 law review exchange between Merrick Dodd (here) and Adolf Berle (here). Milton Friedman's 1970 essay, The Social Responsibility Of

Business Is to Increase Its Profits, epitomizes the former view, known as shareholder primacy, which posits that the sole role of the corporation is to maximize shareholder profits. In Friedman's words, "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits."

We have long advocated for a broader view of corporate purpose than Friedman's and the shareholder primacy theory: first, as described in 1979 in Takeover Bids in the Target's Boardroom, to empower boards to consider the interests of all stakeholders, including the communities in which corporations operate, in repudiating takeover bids by opportunistic raiders; and later, to encourage directors to resist short-term pressures and allow boards to exercise their business judgment to evaluate the variety of stakeholder interests that are essential to promoting sustainable success and growth in long-term corporate value.

Shareholder primacy dominated the thinking of corporate leaders, lawyers, academics, investors, and asset managers for the latter half of the twentieth century. The error and the dangers of strict adherence to this theory were plainly exposed by the 2008 financial crisis. The severity of the global economic recession laid bare the reality that exclusively focusing on short-term maximization of shareholder value comes at the cost of sustainable growth and innovation, and marked the beginning of the decline of the doctrine. In the years following the financial crisis, business leaders, policymakers, and investors increasingly advocated for a more expansive conception of corporate purpose, one that promotes growth in long-term corporate value.

The rejection of shareholder primacy and embrace of stakeholder governance is illustrated by, among other actions, the World Economic Forum's publication of The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth in 2016, the development of the British Academy's Future of the Corporation project beginning in 2018, and the issuance of the Davos Manifesto 2020.

On the corporate front, the Business Roundtable, whose membership consists of the chief executive officers of most of the major U.S. companies, in 2019 rejected the shareholder-centric view to which it had held firm over the prior two decades, instead recognizing that "[e]ach of our stakeholders is essential" and committing "to deliver value to all of them, for the future success of our companies, our communities and our country."

The major index fund managers, which collectively own a meaningful percentage of the shares of all U.S. public companies, have likewise embraced stakeholder governance. Larry Fink, CEO of BlackRock, stated in his January 2022 letter to CEOs (and expressed similar views in previous annual CEO letters dating to 2018) that "[i]n today's globally interconnected world, a company must create value for and be valued by its full range of stakeholders in order to deliver long-term value for its shareholders. It is through effective stakeholder capitalism that capital is efficiently allocated, companies achieve durable profitability, and value is created and sustained over the long-term." State Street, in its January 2022 letter to board members, similarly framed its comments starting from the premise that "strong, capable, independent boards exercising effective oversight are the linchpin to creat[ing] long-term shareholder value." Likewise, Vanguard in its 2021 Investment Stewardship Annual Report stated that they "are tireless advocates for the highest standards of corporate governance worldwide and the sustainable, long-term value of . . . shareholders' investments."

These developments illustrate how financial market participants — companies, boards, index funds, practitioners, and academics, among others — are moving beyond the short-term, shareholder-centric view that had dominated corporate law and policy since the 1970s and are embracing long-term, sustainable value creation as the proper objective of for-profit corporations. Widespread support for and adoption of this model is imperative to enable companies to drive socioeconomic prosperity not just today, but in the future.

Consistent with the increasing prominence of stakeholder governance, much attention has been paid to ESG principles in recent years. The term ESG was popularized in the early 2000s following the publication of the UN Global Compact's report Who Cares Wins, and is an acronym that refers to three categories of risks, practices, and policies — "environment," "social," and "governance" — that companies should consider. For example, the "environment" component of ESG could involve actions designed to reduce greenhouse gases, to recycle plastics or to treat waste to avoid polluting rivers; the "social" component could involve the health, safety, diversity or wages of employees, or it could involve the corporation's relationship to the communities and governments which the corporation impacts; and the "governance" component concerns the relationship between and among the corporation's shareholders, directors, and management. As we previously wrote in Risk Management and the Board of Directors, and as we explore in this memo, each of the policies, practices and actions embraced within the ESG components and sub-components represent risk that must be managed by the corporation, its management, and its board of directors, and the failure to oversee and address such risks may subject directors to potential liability, and the corporations that they oversee to grave danger of failure and destruction of shareholder value.

The increasing concern about the matters encompassed in ESG in the United States has coincided with greater focus on human capital issues and the treatment of employees in the workplace (in part arising out of the Covid-19 pandemic), widespread commitments to addressing systemic racism and injustice, emphasis on diversifying membership on corporate boards of directors (across numerous types of diversity, including gender and ethnic diversity as well as diversity of background and experience), and growing momentum to combat environmental degradation and climate change. The rise of concern about ESG matters in the United States mirrors the growth of similar movements in other countries around the world, which likewise are debating the complex questions about corporate purpose, social responsibility, long-term sustainability, and value creation that lie at the heart of stakeholder and ESG governance.

ESG, properly understood, is not a single principle or an assemblage of a fixed set of principles. To the contrary, ESG refers to a range of policies, practices, and risks that a company must carefully balance, taking into account its specific circumstances, in seeking to achieve long-term, sustainable growth in value. Consider climate change as one example: climate change poses significant risks to many companies, insofar as it has resulted in (and will continue to result in) physical impacts such as a rise in sea levels, more frequent and intense weather, and more severe wildfires, and likely will be the subject of future regulation and governmental policy. Embracing ESG does not mean that a company will make decisions exclusively with the goal of preventing climate change — it simply means that a company will consider whether and how to minimize the effect of these impacts and weigh potential future actions that could impact climate change against the corresponding risk and against other material considerations to arrive at the optimal outcome for the company. This is not only the socially responsible course of action, but also the one that best promotes long-term sustainability and value creation for the benefit of the shareholders and other stakeholders.

Each element of ESG stands alone and represents a different set of important issues that companies must carefully balance in order to ensure their viability and success over the long term. Although critics lump the three pillars of ESG into one category in service of their argument that ESG is simply a pretense to favor companies with liberal values, this misunderstands how companies can and must utilize ESG in practice, and entirely ignores the reality that management and boards have long considered ESG risks and factors in making decisions, whether or not explicitly doing so under the rubric of ESG.

Indeed, ESG considerations long have factored into corporate and investment decision-making in a number of ways: Companies and boards consider stakeholder and ESG issues when creating products and services; making business decisions; assessing and managing risk; developing long-term strategy; recruiting and retaining talent and investing in the workforce; implementing compliance programs; and crafting public disclosures. Pressure on ESG issues is commonly exerted on companies through the submission of shareholder proposals on ESG topics (which the SEC has made significantly easier), campaigns to vote against directors at annual meetings, messaging by large institutional investors in engagement meetings with company management, and as a key issue or critique advanced by activist shareholders. Major asset managers take ESG considerations into account when formulating investment strategies, exercising fiduciary responsibilities, and promoting the reduction of risk in their clients' investments, and they expect well-run companies to do the same. Certain ESG investment funds invest exclusively in companies that satisfy predetermined ESG standards. Regulators and enforcement authorities develop principles to promote consistency and reliability across ESG disclosures, scrutinize such disclosures in companies' public filings, and compel noncompliant companies to improve inadequate disclosures. The commitment to ESG by the public sector, the private sector, and regulators is for good reason — consideration of ESG factors and risks is associated with superior financial results and is critical to ensuring that the company is sustainable over the long term.

However, not all market participants embrace ESG principles. Recently, an anti-ESG movement opposed to consideration of ESG factors in corporate and investment decision-making has emerged and, unfortunately, caused great confusion about what ESG is, how it factors into decision-making, and the extent to which directors are legally permitted, or required, to consider such factors. This fast-growing movement has politicized ESG, detracted from what ESG, properly understood, means, and put companies, boards, and asset managers in the crosshairs of politicians using ESG as a divisive issue.

One cogent example of the politicization and polarization of ESG is the letter sent to BlackRock this past August by 19 Republican state attorneys general accusing BlackRock of prioritizing its "climate agenda" over the interests of pensioners' investments. BlackRock replied clarifying inaccuracies and reaffirming that its participation in ESG climate initiatives is entirely consistent with its fiduciary obligations. More recently, five Republican senators sent a letter to 51 law firms advising them to "preserve relevant documents" in anticipation of investigations into "institutionalized antitrust violations being committed in the name of ESG." In response to the Republican senators' letter, 17 Democratic state attorneys general wrote to the chairs and ranking members of the Senate Banking, Housing, and Urban Affairs Committee and the House Financial Services Committee arguing that public pension fund managers may, consistent with their fiduciary duties to maximize returns for beneficiaries, consider ESG factors, and refuting the claim in the Republican senators' letter that doing so may implicate liability under antitrust and competition laws.

The politicization of ESG has gone beyond political sparring — certain states with conservative leadership have taken concrete action in the form of divestment, legislation, and/or civil investigations to deter or prevent companies and fund managers from considering ESG issues. For example, Louisiana announced that it had withdrawn $560 million from BlackRock's funds in protest of BlackRock's anti-fossil fuel policies. Louisiana is not alone in deciding to divest from BlackRock in connection with the politicization of ESG matters — similar announcements have been made by states including Missouri (which announced in October that it pulled $500 million out of funds managed by BlackRock), South Carolina (which announced in October it would be divesting $200 million), Arkansas (which announced in March that it had divested $125 million), Utah (which announced in September it had divested $100 million), and West Virginia (which announced in January it was completely divesting from BlackRock). Although the divestments (both individually and in the aggregate) are a rounding error to the amount of funds managed by BlackRock, the symbolic impact is significant — the divestments have helped propel the anti-ESG movement and served as a call to arms for opponents of so-called "woke" capitalism.

Further, Texas enacted legislation requiring state pension funds and school funds to divest from financial institutions that the state determines "boycott energy companies," which list included BlackRock. The Florida State Board of Administration likewise passed a resolution specifying that investment decisions "must be based only on pecuniary factors [which] do not include the consideration of the furtherance of social, political, or ideological interests" (and which resolution was accompanied by a statement by Governor DeSantis emphatically stating that ESG considerations "will not be included in the state of Florida's pension investment management practices"). Finally, in October, a coalition of 19 state attorneys general announced an investigation into six major banks (Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, and Wells Fargo) regarding their involvement with the United Nations' Net-Zero Banking Alliance, in which member banks have committed to set emissions-reduction targets in their lending and investment portfolios to reach net zero by the year 2050.

These examples underscore precisely how politicized ESG has become in recent months, with actors on both sides of the political spectrum using ESG in aid of attacks on the other party, on companies, on banks, and on fund managers. But ESG, properly understood, is inherently apolitical — it merely refers to various types of policies, practices, and risks that are material to long-term sustainability and value-creation, and that must be considered and balanced (along with and against all other factors and policies, practices, and risks that are material) by companies and boards. ESG has, unfortunately, and wrongly, become a political lightning rod. But once ESG is properly defined and contextualized, it is abundantly clear that consideration of ESG principles is not only sensible business strategy, but also is necessary to ensure long-term sustainability and value-creation, and to fulfill the fiduciary duties owed by the board and management to the corporation and to shareholders.

Stakeholder Corporate Governance, ESG, and Fiduciary Duties

As we have previously explained here and here, the purpose of a corporation can be summarized simply, 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 objective of creating sustainable, long-term value recognizes that the purpose of for-profit corporations includes value creation for investors, but also recognizes that the interests of other constituents — namely employees, customers, suppliers, and communities — are inextricably linked to that very creation of long-term value. Vindicating this concept of corporate purpose necessarily requires consideration of ESG principles — failure to do so would undermine the long-term value and success of the enterprise.

In carrying out decision-making, corporate law imposes on boards a fiduciary duty of care to act on a reasonably informed basis after due consideration of relevant information and appropriate deliberation. This means that directors must take actions necessary to assure themselves that they have the information required to take, or refrain from taking, action; that they devote sufficient time to the consideration of such information; and that they obtain, where helpful, advice from appropriate experts. As we set out here, there should be no doubt: Long-term value maximization as the corporation's purpose and objective is entirely consistent with the board's fiduciary duty.

By ignoring or not taking into account the interests of stakeholders and ESG considerations, a corporation will not be able to sustain itself over the long term. Considering the interests of not only shareholders, but also all who are critical to the success of the company, is essential to ensuring long-term sustainability, and is consistent with the board's fiduciary obligation to inform itself of and consider ***all*** relevant information. To be sure, Delaware courts have long recognized and accepted that, outside of the context of a change-of-control transaction, corporate boards can and should take into account the interests of all relevant stakeholders in pursuing long-term value for the corporation. Doing so is consistent with the fiduciary duty of care, as well as with the board's obligation under the *Caremark* doctrine to implement and monitor systems to identify material risks, and to address risks once identified. It is imperative that companies oversee and address ESG and sustainability-related risks as such risks can damage and disrupt a corporation's strategies, business positioning, operations, and relations with stakeholders. Whether or not directors should face *Caremark* liability for failure to monitor ESG-related risks as a doctrinal matter, it is clear that directors may consider such issues in connection with their duty of care and, indeed, must do so to preserve and protect the long-term value of the company.

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In recent months, the concept of ESG has become fraught with political and legal implications as actors and lawmakers on both sides of the political spectrum and at all levels of government have seized on ESG and attempted to conflate it with progressive or liberal values. Asset managers are commonly the target of anti-ESG attacks, as are companies, boards and executives. These attacks and attempts to besmirch the ESG rubric misunderstand that the concept of ESG is as simple as it is uncontroversial: ESG is merely a collection of the risks and issues that all companies must carefully consider and balance, taking into account their own specific circumstances, in seeking to achieve sustainable, long-term value. The politicization of ESG does not alter or undermine the ability of boards and companies to consider stakeholder and ESG risks and issues.

Martin Lipton
Adam O. Emmerich
Kevin S. Schwartz
Sabastian V. Niles
Anna M. D'Ginto