August 30, 2019

Wachtell Lipton Outline: Board Update Regarding Stakeholder Governance

In light of the Business Roundtable's statement on the purpose of a corporation, which was issued last week and signed by 181 public company CEOs endorsing stakeholder governance, we thought you might be interested in the attached briefing outline. It provides a short overview of the context and implications of stakeholder governance as well as the shift away from shareholder primacy, which may be useful to you and your colleagues in interpreting these recent developments, responding to questions from your Board or management team, and considering any next steps that may be appropriate.

Outline of Board Update
Regarding Stakeholder Governance

This illustrative outline provides a brief overview regarding the recent endorsement of stakeholder governance by the Business Roundtable and what it means for management and boards of directors of U.S. public companies. This outline may contain more points than are appropriate for a particular company, and is designed such that sections may be deleted.

I. The Shareholder Primacy Paradigm

a. For several decades, there has been a prevailing assumption among many CEOs, directors, scholars, investors, asset managers and others that the sole purpose of corporations is to maximize value for shareholders.

   i. Milton Friedman, the Nobel Prize-winning economist, argued in 1970 that the sole purpose of corporations is to maximize profits for shareholders: "There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."

   ii. In 1986, the Delaware Supreme Court decided the *Revlon* case, which held that the board must attempt to achieve the highest value reasonably available to shareholders – but only in certain change-in-control situations after the board has determined to sell control of the company. *Revlon*'s emphasis on maximizing short-term shareholder value, however, has since served as a convenient slogan for advocates of shareholder primacy outside the sale-of-control context, even though that clearly was not intended by the court.

b. This exclusive focus on shareholder wealth maximization has exacerbated pressure on corporations to take actions to maintain or boost near-term stock price.

   i. Corporate raiders, activist hedge funds and others with relatively short-term investment horizons have exploited the shareholder primacy paradigm to push for cost-cutting, special dividends, stock buybacks, M&A transactions and other actions that could have more immediate benefits for shareholders and the company's current stock price, regardless of the consequences for the company's long-term health and value.

   ii. Data from the U.S. Bureau of Economic Analysis's Integrated Macroeconomic Accounts show that nonfinancial corporate businesses have increasingly accumulated financial assets relative to nonfinancial assets. In the United States, the ratio of corporate investment to profits has declined substantially since 2000.[1]

II. The Evolution of ESG and Stakeholder Governance

a. Recently, there has been increasing concern about the negative consequences of shareholder primacy and the short-termism it has facilitated, as well as the longer-term impact on broader socioeconomic and sustainability issues.

i. There have been many prominent examples of corporations that have boosted short-term market value at the expense of the long-term sustainability of the enterprise and key stakeholders, have neglected adverse impacts on their stakeholders to the detriment of the corporation's health and reputation or have experienced risk-related crises that have substantially harmed the corporation.

ii. Multiple statistical studies reveal a widening income disparity in the United States. For example, census family income data from the Congressional Budget Office show that from the late 1940s to the early 1970s, incomes across the income distribution grew at nearly the same pace; however, beginning in 1970, incomes at the top began to grow much faster than incomes at the middle or bottom, a trend that has only increased. Data from the Federal Reserve's Survey of Consumer Finances show that the share of wealth held by the top 1% rose from just under 30% in 1989 to 38.6% in 2016, while the share held by the bottom 90% fell from 33.2% in 1989 to 22.8% in 2016.[2]

iii. A study published by the Yale Program on Climate Change Communication revealed that, in 2018, six in ten Americans were either "Alarmed" or "Concerned" about global warming, and the proportion of "Alarmed" more than doubled from 2013 to 2018.[3]

iv. The investing world has recently seen a rise of ESG-oriented funds.

---

[1] Source: "Corporate surpluses are contributing to the savings glut," Martin Wolf, November 17, 2015, *The Financial Times* (https://www.ft.com/content/b2df748e-8a3f-11e5-90de-f44762bf9896).

[2] Source: "A Guide to Statistics on Historical Trends in Income Inequality," Chad Stone, Danilo Trisi, Arloc Sherman and Roderick Taylor, August 21, 2019, *Center on Budget and Policy Priorities* (https://www.cbpp.org/research/poverty-and-inequality/a-guide-to-statistics-on-historical-trends-in-income-inequality).

[3] Source: "Americans are Increasingly 'Alarmed' About Global Warming," Abel Gustafson, Anthony Leiserowitz and Edward Maibach, February 12, 2019, *Yale Program on Climate Change Communication* (https://climatecommunication.yale.edu/publications/americans-are-increasingly-alarmed-about-global-warming/).

1. Previously a small, niche segment of the investment community, data from last year suggest ESG-oriented funds managed almost $23 trillion, with around half of all assets managed in Europe and more than a third in the United States.[4]

2. Even beyond these specialized funds, ESG has become a focus of a broad range of traditional investment funds and institutional investors. For example, BlackRock and State Street both offer their investors products that specifically focus on ESG-oriented topics like climate change and impact investing – investing with an intention of generating a specific social or environmental outcome alongside financial returns. As the *Financial Times* recently reported, "[e]thical investing has reached a tipping point."[5]

v. Boards and management teams should now recognize that stakeholder considerations and sustainability as a whole has become a major, mainstream governance topic that encompasses a wide range of issues, including a company's long-term durability as a successful enterprise, climate change and other environmental risks and impacts, systemic financial stability, management of human capital, labor standards, resource management and consumer and product safety.

b. Legislative reforms in the United Kingdom and Europe have expressly incorporated consideration of other stakeholder interests in the fiduciary duty framework. In the United States, proposals like Senator Elizabeth Warren's "Accountable Capitalism Act" also advocate a legislative solution, and the position paper by Senator Marco Rubio in 2019 outlined the problems of shareholder capitalism and the merits of industrial policy.

i. However, regulatory approaches may result in relatively blunt, one-size-fits-all reforms that can potentially do more harm than good in creating value for the corporation and its stakeholders.

c. There has been real traction toward meaningful private sector reforms that embrace ESG principles and stakeholder governance.

i. **Corporations**. Last week, the Business Roundtable (BRT) departed from its long-standing endorsement of shareholder primacy and embraced stakeholder corporate governance.

---

[4] Source: "Sustainable Investing is Moving Mainstream," April 20, 2018, J.P. Morgan (https://www.jpmorgan.com/global/research/esg).
[5] Source: "Ethical Investing Has Reached a Tipping Point," Gillian Tett, June 18, 2019, *Financial Times* (https://www.ft.com/content/7d64d1d8-91a6-11e9-b7ea-60e35ef678d2).

1. The BRT released its statement on the purpose of a corporation, which was signed by 181 CEOs.

    a. The BRT emphasized the shared fundamental commitment of its members to all stakeholders – including customers, employees, suppliers and communities.

    b. The BRT's statement reflects the organization's recognition that its principles had fallen behind the views of most of its members regarding concern for all stakeholders and taking into account ESG principles when determining business strategy.

2. While the BRT's statement reflects a growing consensus around the need for a pivot away from the shareholder primacy paradigm, it has not been without controversy. The Council of Institutional Investors (CII) immediately registered its disagreement with the BRT's Statement. Shortly afterwards, however, the CII quickly walked back from its initial position by issuing a revised statement emphasizing its belief that boards and managers must focus on long-term shareholder value – a model that is essentially consistent with the BRT's consideration of other stakeholder interests, but with a stronger emphasis on shareholders as the principal focus in allocating among stakeholders.

3. In 2016 and 2018, respectively, over 20 prominent executives of some of the largest companies, pension funds and investment firms in the United States, including Jamie Dimon, chairman of the BRT since 2017, endorsed the *Commonsense Principles of Corporate Governance* and *Commonsense Principles 2.0*, which set forth a framework of corporate governance focused on long-term, sustainable value creation.

ii. **Investors**. Investors and asset managers have also been embracing ESG principles and a reconceptualization of the purpose of corporations that goes beyond a simplistic maximization of profits and shareholder wealth.

1. Larry Fink (CEO of BlackRock), in his 2019 Letter to CEOs, envisioned corporate purpose as not just the pursuit of profits, but rather "the company's fundamental reason for being – what it does every day to create value for its stakeholders." He suggested that purpose helps to sustain long-term financial return for shareholders, but also "unifies management, employees and

communities. It drives ethical behavior and creates an essential check on actions that go against the best interests of stakeholders."

2. This followed Larry Fink's important 2018 Letter to CEOs, which stated: "Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate. Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders…."[6]

3. In January 2018, the Investor Stewardship Group adopted stewardship principles for institutional investors and corporate governance principles for U.S.-listed companies aimed at incorporating ESG principles and long-term sustainability into investment decisions of institutional investors and strategies of boards and management.

d. On the academic front, in a widely acclaimed 2017 article in the Harvard Business Review, "The Error at the Heart of Corporate Leadership," Harvard Business School Professors Joseph Bower and Lynn Paine rejected shareholder primacy and made a compelling case for director-centric stakeholder governance:

> Don't misunderstand: We are capitalists to the core. We believe that widespread participation in the economy through the ownership of stock in publicly traded companies is important to the social fabric, and that strong protections for shareholders are essential. But the health of the economic system depends on getting the role of shareholders right. The agency model's extreme version of shareholder centricity is flawed in its assumptions, confused as a matter of law, and damaging in practice. A better model would recognize the critical role of shareholders but also take

---

[6] The full text of this key paragraph from Larry Fink's 2018 Letter to CEOs is as follows: "Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate. Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education."

seriously the idea that corporations are independent entities serving multiple purposes and endowed by law with the potential to endure over time. And it would acknowledge accepted legal principles holding that directors and managers have duties to the corporation as well as to shareholders. In other words, a better model would be more company centered.

e. At the request of the World Economic Forum, Wachtell Lipton developed *The New Paradigm*, which provides a roadmap for corporations, investors and other stakeholders to combine these various initiatives into a partnership for meaningful change. In effect, *The New Paradigm* seeks to recalibrate the myopic focus on near-term shareholder value to instead foster a more long-term, holistic approach to value creation that benefits shareholders as well as other stakeholders, while also embracing principles of accountability for corporations and stewardship for investors.

III. The Board's Legal Obligations

a. The Board's ultimate fiduciary duty is to promote the long-term value of the corporation – not to maximize shareholder wealth.

   i. In fulfilling its fiduciary duty, the Board should and must use its business judgment to reconcile the competing interests of the corporation's stakeholders for the long-term benefit of the enterprise.

      1. In considering stakeholder interests, potential increases in value as well as potential losses for stakeholders should be taken into account in seeking to promote the long-term value of the company.

      2. If directors are not conflicted and use due care in reconciling these competing interests, and in doing so seek to promote the long-term value of the corporation, the Board will have the full protection of the business judgment rule.

   ii. The Board's ability to consider other stakeholder interests is not only uncontroversial – it is a matter of basic common sense and a fundamental component of both risk management and strategic planning. In seeking to act on an informed, good-faith basis to properly manage a company's risk profile, due consideration should be given to ESG principles and the interests of other stakeholders that impact the corporation's business, reputation, strategy and sustainability.

1. As a case in point, in the recent *Bluebell* case, the Delaware Supreme Court suggested that the directors had failed to meet their fiduciary duties by not properly considering food safety issues where a multistate outbreak of listeria was linked to the company's facilities.

2. Responsible boards of directors will recognize an affirmative obligation to evaluate long-term enterprise-level physical, business and liability risks that principally relate to non-shareholder interests, including risks resulting from climate change, changes in labor markets, income disparity and related social dislocation.

IV. Our Approach to Stakeholder Governance *[<u>Note</u>: This is a company-specific section that should be tailored accordingly – the concept would be that following the presentation and review of the above key landscape issues, company representatives would review with the board the company's current approach to key stakeholders whose interests are relevant to the corporation's sustained success.]*

a. The principles articulated by the BRT and stakeholder governance are ones that we have always embraced and acted on as a company.

b. Consistent with the BRT's principles, we focus on:

   i. Delivering value to our customers. For example:

      1. [*Insert specific examples*]

   ii. Investing in our employees. For example:

      1. [*Insert specific examples*]

   iii. Dealing fairly and ethically with our suppliers. For example:

      1. [*Insert specific examples*]

   iv. Supporting the communities in which we work. For example:

      1. [*Insert specific examples*]

c. [*<u>Note</u>: While the BRT's statement outlines particular stakeholders that are of general relevance to public companies, the stakeholders that matter most to any given company are often company-specific. Therefore, you may wish to consider whether management should work with the Board to identify which stakeholders are most critical to the long-term success and health of the company. For example, as part of the company's annual review of strategy, management could include a presentation to the Board outlining: which stakeholders are most relevant; the company's strategy and approach with respect to each important* *stakeholder; and how management is anticipating or dealing with areas of risk, conflict, concern or opportunity as to the company's most important stakeholders.*]

d. As we continue our practice of taking into account the interests of various stakeholders, we will endeavor to keep you regularly apprised of what our company is doing, the impact of our actions with respect to our customers, employees, suppliers and communities, and how our strategies appropriately balance the interests of all stakeholders to achieve the goal of promoting the long-term success and value of the company.

e. We will also continue to hone best practices, such as documenting board-level deliberations with respect to risk management, ESG principles and the consideration of all stakeholder interests.