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Social Responsibility and Enlightened Shareholder Primacy: Views from the Courtroom and Boardroom

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Editor's note: Peter Atkins, Marc Gerber and Edward Micheletti are partners at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on their Skadden memorandum. Related research from the Program on Corporate Governance includes Socially Responsible Firms by Alan Ferrell, Hao Liang, and Luc Renneboog (discussed on the Forum here).

There is an ongoing debate about the role that publicly traded for-profit business corporations should play in addressing a broad range of problems confronting our world today. Many issues fall under the ESG label—meaning they are environmental, social and/or governance-related in nature. Investors, as well as interest groups with varying agendas, have joined in this debate.

Although the motivations of ESG proponents may vary, many ESG proponents are investors and asset managers that believe appropriate company consideration of ESG matters, and the attendant board oversight, improve the long-term performance of the companies in which they are invested and reduce the risk in those investments.

The reaction of publicly traded for-profit corporations spans a wide spectrum. At one end are those corporations that appear to have largely embraced or at least accepted that ESG is part of their business landscape, adopting policies relating to various ESG topics and providing robust public disclosures regarding ESG. At the other end are corporations that may view many or most ESG topics as matters that are inappropriate concerns for their for-profit businesses. And many for-profit corporations are likely at various points along this spectrum, including those just beginning to consider how and whether ESG has relevance to their businesses and those not yet ready to engage in this analysis.

Particularly for those corporations at the early stages of considering ESG or for those debating whether to do so, this note is intended to provide some guardrails in the form of highlighting certain legal pathways, considerations and constraints, as well as offering some thoughts on processes that boards of directors may find helpful.

The Legal Framework: Shareholder Primacy

Approximately 60 percent of Fortune 500 companies are organized under Delaware corporate law. This post focuses on Delaware business corporations for that reason, and because the Delaware courts have a body of well-developed case law concerning the duties of directors of Delaware business corporations.

In Delaware, court decisions have clearly established that the shareholder primacy rule applies. In short, directors have a fiduciary duty to make their decisions looking solely to the best interests of shareholders. In other words, enhancing and protecting value for shareholders is the ultimate interest to be served. Delaware Supreme Court Chief Justice Leo E. Strine, Jr. has made clear where Delaware law stands on the subject:

> [A] clear-eyed look at the law of corporations in Delaware reveals that, within the limits of their discretion, directors must make stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare.[1]

Similarly, in a 2010 decision involving craigslist, rejecting a board's refusal to redeem a shareholder rights plan, then-Chancellor William B. Chandler III of the Delaware Court of Chancery wrote:

> The corporate form … is not an appropriate vehicle for purely philanthropic ends, at least not when there are other stockholders interested in realizing a return on its investment. … Having chosen a for-profit corporate form … directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of the stockholders. The "Inc." after the company name has to mean at least that. Thus, I cannot accept as valid … a corporate policy that specifically, clearly and admittedly seeks not to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders …[2]

Staying on the Shareholder Primacy Path

The shareholder primacy rule is the substantive judicial guard-rail. The path it requires is clear. *Importantly, in addressing issues often framed as matters of corporate social responsibility, the shareholder primacy path does not preclude a for-profit company from taking social issues into account in the conduct of its business. What is required to stay on the path is that the company's consideration of those social issues have a sufficient nexus to shareholder welfare and value maximization.*

How can a board of directors determine that a sufficient nexus exists and be comfortable making that determination? For Delaware business corporations, the basic answer should be familiar. The board should do what it does in making other decisions regarding oversight of the company's business: define the issue; gather all reasonably available material information; identify and weigh the pros and cons; consider alternatives; and make an independent, disinterested and informed business judgment in good faith, looking solely to the economic best interests of shareholders as a whole. No time frame is mandated, and building long-term value is the goal (absent a sale of control).

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[1] Leo E. Strine, Jr., "The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law," 50 *Wake Forest Law Review* 761,768 (2015).

[2] *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 34 (Del. Ch. 2010).

Of course, decisions by boards of Delaware for-profit corporations can be challenged by shareholders. Such a challenge may be brought under state law for breach of fiduciary duty—the duties being the duty of care and the duty of loyalty.

In general, Delaware courts evaluating decisions by boards of directors will, in the first instance, apply the business judgment rule. That rule is a rebuttable presumption that, in making the challenged decision, directors complied with their fiduciary duties—that they acted in an informed and deliberative manner and were motivated by the best interests of shareholders and not their own or other interests. To rebut the business judgment rule's presumption, a plaintiff shareholder would have to present factual evidence that directors acted without becoming adequately informed or had interests or were motivated by interests other than those of the company's shareholders as a whole. Notably, if the decision is approved by independent (for Delaware law purposes) and disinterested directors comprising a majority of the board, Delaware courts will give particular deference to that decision in evaluating the evidence challenging it.

If the threshold application of the business judgment rule is not rebutted, courts applying Delaware law will not second-guess the board's judgment unless the decision is found to be not rational. To make such a finding, a court would have to conclude that the board's decision cannot be attributed to any rational business purpose related to the company.

As Chancellor Chandler succinctly wrote in his *craigslist* opinion:

> When director decisions are reviewed under the business judgment rule, this Court will not question rational judgments about how promoting non-stock-holder interests—be it through making a charitable contribution, paying employees higher salaries and benefits, or more general norms like promoting a particular corporate culture—ultimately promote stockholder value. [3]

In addition to fiduciary duty challenges, stockholder arguments challenging ESG-related decisions could come in the form of "waste" claims. However, waste claims have been acknowledged to be very difficult to establish in Delaware, given that a board decision must be "so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interest." [4]

The obvious but, nonetheless, key takeaway is that in the board's decision-making relating to consideration of ESG matters, directors of Delaware for-profit companies need to be focused on the shareholder primacy path and be thoughtful, careful and well-advised, just as they are required to be with all of their business decisions. [5] While there are many other substantive and procedural rules and arrangements—including provisions of the Delaware General Corporation Law, the company's certificate of incorporation and its bylaws—that may affect the outcome of a litigation challenge to a board's ESG-related decision, they do not change that conclusion.

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[3] *Id.* at 33.

[4] *White v. Panic*, 783 A.2d 543, 554 n.36 (Del. 2001).

[5] In 2013, Delaware amended its corporation law, adding provisions permitting the formation of "public benefit corporations." Delaware General Corporation Law §§361-368. Many other states have adopted versions of public benefit corporation statutes. Delaware's specifically modifies the shareholder primacy principle by permitting directors to *balance* the pecuniary interests of shareholders, the interests of those materially affected by the corporation's conduct and the identified public benefits. Few publicly traded companies have been formed as or have converted to public benefit corporations.

The Boardroom

Today, most directors of publicly traded for-profit companies probably are aware of the growing pressure to factor into their business and strategic decision-making the broader social challenges impacting the business environment. Whether and how a company addresses these types of social issues may impact any number of aspects of its business, financial performance and posture in the investment community, including: relationships with current or potential customers, suppliers and strategic partners; competitive positioning; the ability to recruit and retain a necessary, talented and motivated workforce; the ability to attract capital; and investor interest in and support of the company's stock.

Those pressures are coming from diverse sources, including shareholders, asset managers, special interest groups, activist investors, private equity funds, ESG rating firms, consumer groups, trade groups, politicians, regulators, academics and others. The issues list is long and growing. [6]Pressure is exerted in a variety of ways, including: submission of shareholder proposals; "vote no" campaigns against directors at annual meetings; publicity campaigns; consumer boycotts; messaging by large investors in direct engagement meetings or written communications; investor threats to divest or actual divestiture of their stockholdings in the company; and exclusion of companies from exchange-traded funds and other investment pools.

The phenomenon is real, and boards today that have not done so—including boards of companies where these matters may be just emerging or still latent—are well advised to make an effort to understand it and how it affects their companies or may do so in the future. Anticipatory assessment is prudent not only to be better prepared with a resonant response if and when the ESG spotlight turns on the company, but equally—and perhaps more importantly—because ESG initiatives are being adopted and supported by many for-profit companies as affirmatively beneficial to their business strategies.

One early step a board might take when considering ESG matters is to adopt and disclose a brief overall position statement on corporate social responsibility. This might, for example, be part of a company's corporate governance guidelines, which set forth a company's approach to corporate governance. Such a statement might affirm the board's view that the company conducts its business in a socially responsible manner. In doing so, it could note business reasons supporting this approach and explain that particular ESG issues will be examined in light of enhancing the company's ability to succeed over the long term consistent with its pursuit of shareholder value. Such an action might help indicate the board's overall awareness and sensitivity to ESG issues. Of course, it might also attract attention and lead to ESG demands, and in any event should not be relied on to forestall such demands. However, if the board intends to focus on particular ESG initiatives, it may serve the company's interests to get out ahead of public demands.

[6] Environmental-related issues include: (1) climate change (*e.g.*, reporting on climate change, risks of climate change, greenhouse gas emissions goals), (2) sustainability reporting, and (3) energy-related (*e.g.*, hydraulic fracturing, renewable energy). Social/political issues include those regarding: (1) discrimination and diversity, (2) pay inequity, (3) human rights, (4) animal rights, (5) opioid crisis, (6) "fake news" dissemination, (7) gun control, (8) drug pricing, (9) political contributions, (10) lobbying, (11) charitable support, and (12) workforce retirement planning. Executive compensation and corporate governance-related issues continue to be on the list as well.

Board Consideration of a Specific Demand

On any particular ESG issue, the board will have to go back to basics and address it thoughtfully and carefully, with input from legal and other advisers, as an important exercise of business judgment. There is no formulaic response—the facts and circumstances of each situation will differ, as will many assessments and judgments. As a nonexclusive guide, the Annex below identifies certain important matters that a board considering a particular ESG initiative will need to address and presents a set of questions that relate to each.

Annex

Board Consideration of a Specific ESG Demand/Issue–Certain Relevant Topics and Questions

Are Any Directors Not Disinterested and Independent?

The board should inquire about this as a threshold matter in considering a specific ESG demand or issue. Questions include:

- Does any company director have a material business, personal or other interest or relationship (*e.g.*, as a director, significant contributor or public advocate) in or with a nonprofit organization advocating for the ESG issue, with which an alliance or to which a contribution is contemplated?
- Does any company director have a position regarding the ESG issue under consideration (whether in support of or in opposition to it) that would impair the director's ability to make a determination with respect to it, as a director, solely on the basis of what is in the best interests of the company's shareholders?
- Have the identified interests, relationships and positions, if any, of directors been disclosed to the board?
- Do any directors having any such interests or relationships control or dominate the board?

Note: Depending on the answers to the foregoing questions, it may be appropriate to consider recusing certain directors or delegating the primary responsibility for addressing decisions relating to the ESG issue under consideration to a standing or ad hoc board committee that is comprised of disinterested and independent directors (relative to that issue).

Gathering Information to Make an Informed Decision

Focus on the ESG issue under consideration and on the types and sources of information needed to address the issue. Questions include:

- Is the demand to (1) take action in support of combating an ESG issue, (2) memorialize action taken, (3) disclose action taken or (4) undertake some combination?
- Is the ESG issue one that has been confronted in the company's business sector or in the company's business itself, and is the board already familiar with it?

- What types and sources of information have other companies identified? (In many cases, there will be useful precedent.)
- Does the board need, or in any event would it be helpful for the board to hear from, outside experts on the ESG issue under consideration?
- What information will be needed to assess whether a “sufficient nexus” exists between the ESG-related action under consideration and the best interests of the company’s shareholders? (Precedent from within and outside the company’s industry and/or business may exist and be helpful.)

Ensuring a Nexus Between the ESG Issue at Hand and Shareholder Welfare

Focus on whether, how and to what extent the specific ESG matter under consideration supports the company achieving shareholder value on a net basis (Potential Benefits).

Questions include:

- Whether, and if so how and to what extent, the ESG issue under consideration will positively impact the company’s business, financial performance and/or posture in the investment community, including:
    - the company’s relationship with current or potential customers, suppliers and strategic partners;
    - the company’s competitive positioning;
    - the company’s ability to recruit and retain a necessary, talented and motivated workforce at all levels;
    - the company’s ability to attract capital; and
    - investor interest in and support for the company’s stock.
- To what extent are the Potential Benefits quantifiable?
- What costs/risks might be associated with achieving Potential Benefits (Potential Detriments), and to what extent are they quantifiable?
- Are there alternative or additional courses of conduct or approaches that might enhance the Potential Benefits sought or decrease the Potential Detriments?
- Have boards of other companies identified the same or similar Potential Benefits and/ or Potential Detriments associated with pursuing the ESG issue under consideration? If so, does that fact support the business judgment and rationality of the board if it were to pursue the same path?