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ESG, Stakeholder Governance, and the Duty of the Corporation

Recently, there has been much confusion and misinformation about (1) environmental, social, and governance (ESG) considerations, (2) the ways in which companies, boards, asset managers, investment funds, and other market participants can, do, and should factor such considerations into their decision-making processes, and (3) the need for companies to consider, balance, advance, and appropriately protect stakeholder interests in order to create value, generate sustainable returns, and guard against downside risks to value and corporate health. This cloud of confusion stems, in part, from nascent efforts to politicize ESG. Consider the Trump administration's proposed rulemaking in the Department of Labor that would have required fiduciaries of retirement plans making investment decisions to focus solely on "pecuniary" factors (and, in turn, would have burdened the ability of fiduciaries to appropriately take ESG factors into account in selecting investments and engaging in risk-return analyses). And consider the letter sent to BlackRock last month by 19 Republican attorneys general, accusing the asset manager of prioritizing its "climate agenda" over the interests of pensioners' investments. These developments unfortunately fail to appreciate that ESG, properly understood, is merely a collection of quite disparate risks that corporations face, from climate change to human capital to diversity to relations among the board, management, shareholders, and other stakeholders. We write to resituate the role of ESG and stakeholder governance within the well-established legal framework of corporate fiduciary duties.

Dating back to the 1932 law review exchange between Merrick Dodd and Adolf Berle, there has been a long-running debate over whether the purpose of the corporation is to maximize short-term profits for shareholders or, instead, to operate in the interest of all of its various stakeholders to promote the long-term value of the corporation. For several decades, the predominant view among corporate leaders, practitioners, academics, investors, and asset managers was that the role of the corporation was solely to maximize profits for shareholders. This theory, which came to be known as shareholder primacy, is epitomized by Milton Friedman's seminal 1970 essay, The Social Responsibility Of Business Is to Increase Its Profits, in which he argued that every corporation should seek solely to "increase its profits within the rules of the game." Friedman's shareholder-centric view of corporate purpose posited that a corporation that "takes seriously its responsibilities for providing employment, eliminating discrimination, avoiding pollution and whatever else may be the catchwords of the contemporary crop of reformers" would undermine "the basis of a free society."

We long have advocated for a broader view of corporate purpose than that espoused by Friedman — initially, as we wrote in 1979 in Takeover Bids in the Target's Boardroom, to empower boards to take into account the interests of all stakeholders, including the communities in which corporations operate, in repudiating takeover bids by opportunistic raiders; and later, to ensure that directors are encouraged to resist short-termist pressures and can exercise their business judgment to consider the variety of stakeholder interests essential to promoting sustainable success and growth in long-term corporate value. The 2008 financial crisis laid bare the dangers of the Friedman doctrine and marked the decline of shareholder primacy, exposing the reality that an exclusive focus on short-term maximization of shareholder value came at the expense of sustainable growth and innovation. Business leaders, policymakers, and investors have since increasingly advocated for a broader view of corporate purpose, one that promotes the long-term value of the corporation.

The growing acceptance of stakeholder corporate governance is captured by, among other developments, 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; the Davos Manifesto 2020 (see our prior memo here); and the Business Roundtable's 2019 rejection of the shareholder-centric view to which it had held firm over the prior two decades (see our prior memo here). Stakeholder corporate governance's acceptance is also seen in the many actions and investments by corporations intended to benefit stakeholders, including investors and non-investor constituencies, and to reduce negative externalities.

The term "ESG" was popularized in the early 2000s following the publication of the UN Global Compact's report, Who Cares Wins. Today, the concept of ESG is multifaceted: companies and boards take into account ESG and stakeholder considerations when developing and delivering products and services, making business decisions, managing risk, developing long-term strategy, recruiting and retaining talent and investing in the workforce, implementing compliance programs, and crafting public disclosures. Many major asset managers, including BlackRock, State Street, and Vanguard as well as actively managed funds, consider ESG issues in formulating investment strategies, serving their clients, and exercising their fiduciary responsibilities. This encompasses investors being able to exercise their professional judgment in considering ESG-related information when evaluating the risk *and* return profile of portfolio holdings. Certain ESG investment funds may also invest exclusively in companies that satisfy predetermined ESG standards. And regulators and enforcement authorities develop principles to promote consistency and reliability across ESG disclosures, and scrutinize such disclosures in companies' public filings.

The phenomenon of ESG is prevalent not only in the United States but around the world, as companies, policymakers, global leaders, academics, and investors debate how best to promote sustainability over the long term. ESG, properly understood, is not a unitary principle or even a collection of a fixed set of particular principles. Rather, ESG encapsulates the range of risks that all corporations must carefully balance, taking into account their specific circumstances, in seeking to achieve long-term, sustainable value. It is thus no surprise that asset managers and asset owners, too, are expecting well-run companies to incorporate ESG matters into their business decisions appropriately. Although the ESG moniker is relatively recent, corporate boards and management have long considered ESG factors and risks in setting and executing strategy. As Jeffrey Sonnenfeld recently pointed out, doing so is associated with superior financial results, and consistent with long-accepted norms as to the place of business in society.

To be sure, not all market participants embrace ESG principles. Recently, an anti-ESG movement has emerged, one opposed to consideration of ESG factors in investment decision-making in favor of a Friedmanist exclusive focus on shareholder primacy. This false dichotomy between ESG and shareholder value mirrors the confusion sewn by critics of stakeholder governance who pit shareholders against other stakeholders through the misleading allure of an existential conflict that requires directors to choose between value for one versus the other. But as we have previously explained here and here, the law of corporate fiduciary duties nowhere demands that choice — and opponents of stakeholder governance know it, as do critics of ESG. The purpose of a corporation is to conduct a lawful, ethical, profitable, and sustainable business in order to ensure the success and grow the value of the corporation over the long term. This requires consideration of all of the stakeholders critical to the success of the business (shareholders, employees, customers, suppliers, and communities), as determined by directors based on their business judgment and informed by regular engagement with shareholders. Such consideration includes ensuring that a company avoids ESG blindspots.

The first principle of corporate law is that a corporation must conduct lawful business by lawful means. To honor this axiom, the *Caremark* doctrine requires that companies have in place information and reporting systems reasonably designed to provide timely, accurate information to allow management and the board to reach informed judgments about the corporation's compliance with law and its business performance. The stakeholder governance model aligns closely with *Caremark* — for example, environmental risks have long been a core focus of compliance programs, and to the extent a company adequately addresses these risks through comprehensive compliance programs and operational adjustments, it will be well-positioned to meet the demands of the environmental component of ESG. As we recently wrote, it is important for companies to have high-quality risk management policies and processes, and for boards to oversee the monitoring and management of risk, to protect the long-term value of the company, and to fulfill *Caremark* duties. Risk management policies and oversight must reach ESG and sustainability-related risks that can damage and disrupt a company's strategies, business positioning, operations, and relations with stakeholders, including over the long term.

A holistic, stakeholder view of corporate purpose does not exalt ESG as the sole or weightiest consideration — to the contrary, it recognizes that the various elements of ESG are among numerous considerations that are essential to a company's sustainability and that must be carefully balanced by the board and management, in consultation with shareholders, to ensure the long-term health and prosperity of the business. One example, highlighted by BlackRock in its written response to the attorneys general, is the long-term risk to companies posed by climate change and the economic opportunities from the energy transition. By engaging with shareholders and thought leaders on these complex topics, management teams and boards can arm themselves with the knowledge necessary to understand the relevant risks and to develop strategies to support sustainable growth.

The unfortunate confusion that has entered the contemporary debate regarding ESG misunderstands the fundamental purpose of the corporation. We continue to believe it is essential that boards operate under a governance model that permits consideration of ESG principles and sustainable investment strategies, with the support of investors and asset managers, to promote long-term corporate value and to fortify the enterprise against relevant risks. There should be no doubt that the law in Delaware and in every other U.S. jurisdiction empowers boards to follow this course for responsible corporate stewardship and corporate success.

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