ACC Association of Corporate Counsel

GREATER PHILADELPHIA

ESG, Sustainability, Benefit Corporations, and the Great Stakeholder Versus Stockholder Debate

September 11, 2019

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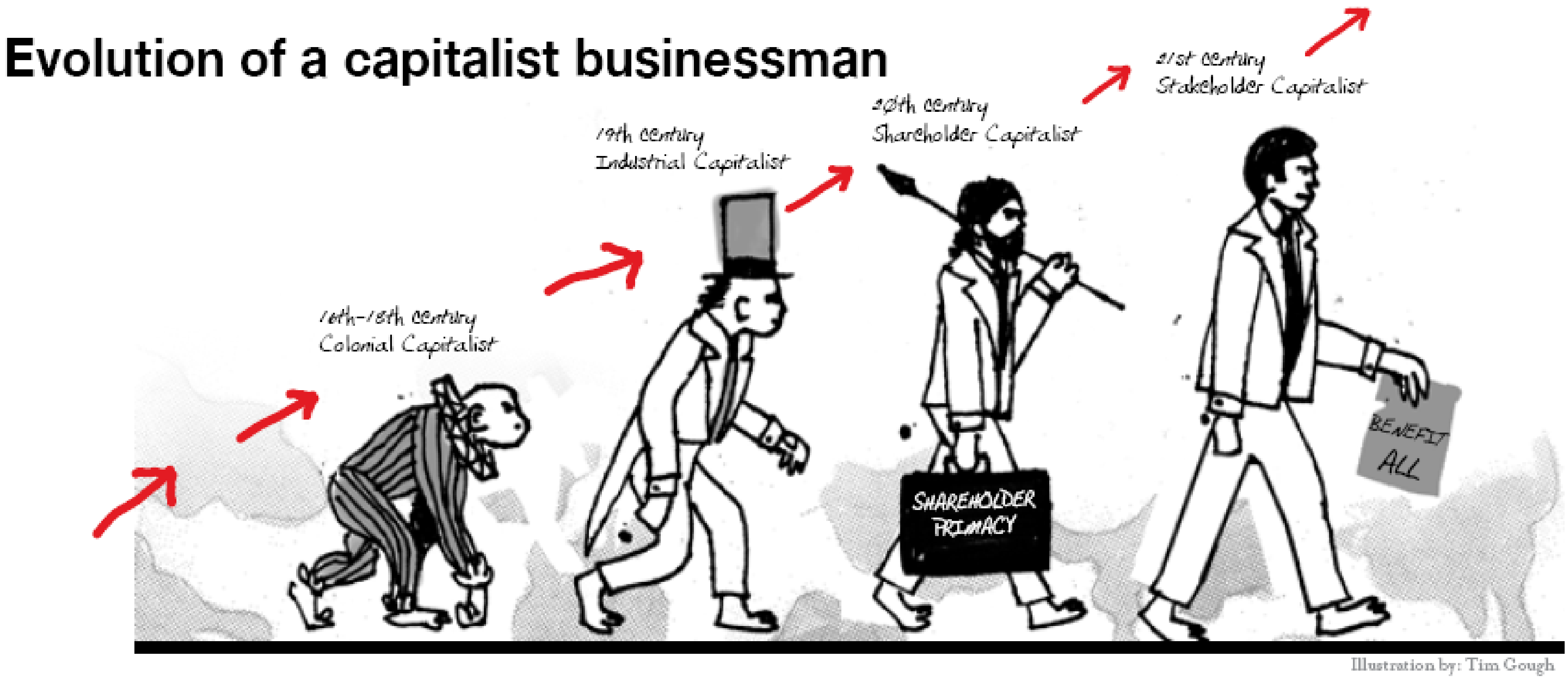
Presenters:

- William H. Clark, Jr., Drinker Biddle & Reath LLP
- Frederick H. (Rick) Alexander, The Shareholder Commons
- Leo Karwejna, PFM Asset Management LLC

Agenda

- Historical Perspective
- Benefit Corporations
- Investor Considerations

A Brief History of Corporations



History Cont’d

- The corporation is a medieval construct that has evolved to serve the needs of society
- Corporations were the agents of empire in the Age of Exploration
  - Dutch East India Company
  - Hudson’s Bay Company

- America inherited English common law and concept of a corporation in 1776
  - Creating corporation required an act of legislature – thus legislature as external oversight
  - Very few in America before 1800

History Cont'd

- First widespread use of corporations in America came during the Age of Westward Expansion when they were used to organize public utilities
- The corporation became the agent of the Age of Industry in the later 1800s as the checks and balances of external legislative oversight were removed:
    - free incorporation
    - limitations on state power to revoke charter
    - adoption of concept of limited liability for officers, directors and shareholders
    - courts impose common law of fiduciary duties upon directors to prevent abuse of shareholders by directors

History Cont’d

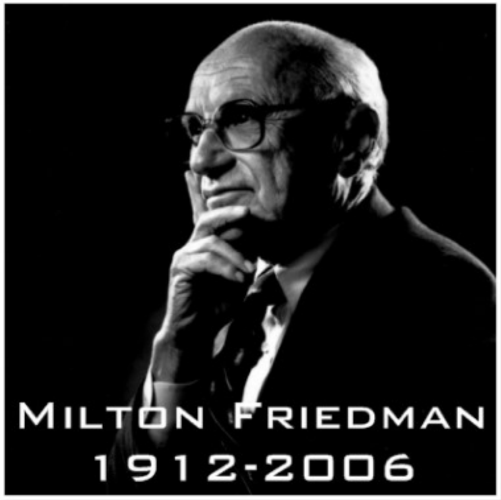
- 20th Century Corporation – Shareholder Value Maximization

“A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.”

- Dodge v. Ford (Mich. 1919)

History Cont'd

"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." (1970)



PA & DE Law Today: Fiduciary Duties Generally

PaBCL

- Directors must act in the best interests of the *corporation*. (§1712)
- Directors may consider all pertinent factors, including effects on shareholders, employees and communities, and short and long-term interests of the corporation.
- No particular interest must be considered controlling.

DGCL

- Directors must act in the best interests of the *stockholders*.
- When there is a threat to corporate policy and effectiveness, an intermediate standard applies (*e.g.*, *Unocal*, *Unitrin*). The applicable test involves assessing whether board responses are reasonable in relation to the threat posed by a reasonably perceived threat.

PA & DE Law Today: Fiduciary Duties in Change of Control Context

PaBCL

- PaBCL § 1715 provides that the ordinary business judgment rule applies to director actions in a change of control situation (*i.e.*, rejects *Revlon*).
- Any act relating to a change of control that is approved by a majority of disinterested directors is presumed to satisfy the standard of care unless it is proven by clear and convincing evidence that the disinterested directors did not assent to such act in good faith after reasonable investigation.
- "Disinterested" has a special and favorable definition in this context.

DGCL

- When there is a possible change of control situation, the short-term interests of stockholders predominate.
- In an "auction" or "sale" of the corporation, the sole obligation of the directors is to obtain the best price reasonably available for the corporation's shares.

Chief Justice Strine on the Law's Parameters

- "If we wish to make the corporation more socially responsible, therefore, we must do it the proper way. We must address the duties and the incentives of the stockholders themselves, who are often agents of others – human beings who have a strong interest in durable wealth creation."

- "If we believe that other constituencies should be given more protection within corporation law itself, then statutes should be adopted giving them enforceable rights that they can wield. The benefit corporation is a modest, but genuine, example of that kind of step forward."

- "But advocates for corporate responsibility are most likely to achieve it by dealing with the world as it is, and not as they wish it was or think it should be."

The Rise of Benefit Corporations

- Purpose
  - to create general public benefit (defined as “a material positive impact on society and the environment, taken as a whole, as measured by a third party standard, from the business and operations of the corporation”)
  - may create specific public benefit (defined by the company as a specific intent of the company; does not supersede creating general public benefit)
- Accountability
  - directors and officers must consider interests of stakeholders
  - shareholders and directors have right of action (no third parties)
- Transparency
  - publish annual Benefit Report in accordance with independent, transparent, third-party standards for defining, reporting, and assessing social and environmental performance
  - must distribute Benefit Report to all shareholders and make available on website

Benefit Corporations Create Long-Term Value

Traditional Corporations

- Strictly managed to produce value for shareholders
- Precludes corporate commitment to other interests in order to create sustainable long-term value for shareholders

Benefit Corporations

- For-profit corporations designed to create long-term value through broad commitment to sustainable growth

The Company Advantage

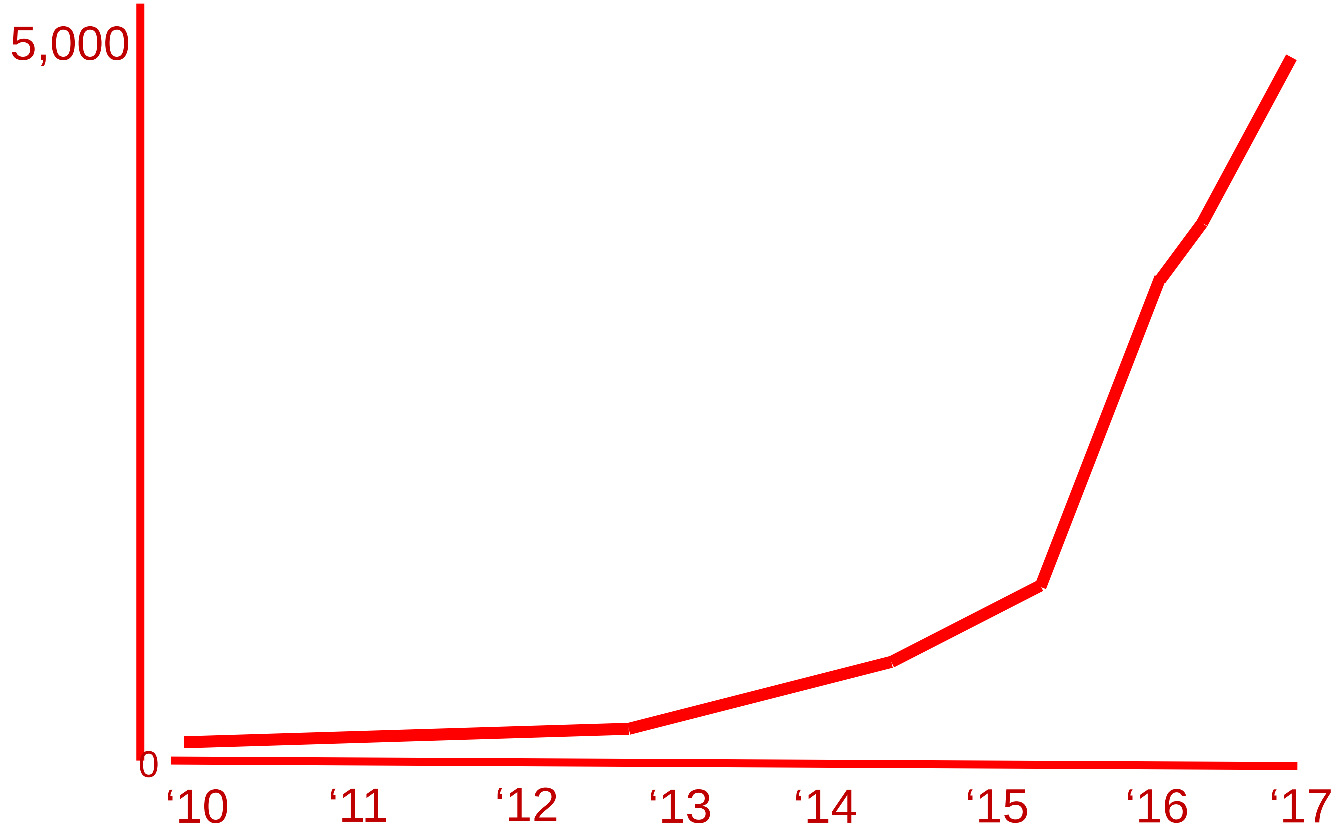
Benefit corporation governance allows full integration by committing to future sustainable performance

Full integration permits the creation of durable wealth with stakeholders

The System's Advantage - Creating Value Across Portfolio

- All investments are embedded in systems (environmental, social, economic) that bear brunt of externalized costs
- Universal investors rely on market return for almost all of their financial return

Rapid Growth in Number of Benefit Corporations



8500+

Benefit Corporations

37+

States

Case Studies: Mainstream Venture Capital Investors

data.world preview

Total raised = $32.7 Million

Forerunner Ventures, BFV, Greycroft

alt school

Total raised = $173 Million

Andreessen Horowitz, First Round Capital, LearnCapital, Founders Fund

Case Studies: $100M VC Investments in Benefit Corporations

ripple™

Total raised = $110 Million

Euclidean Capital

khosla ventures

Goldman Sachs

COLLABORATIVE Fund

Lemonade™

Total raised = $180 Million

SEQUOIA

General Catalyst Partners

GV

THRIVE CAPITAL

Case Study: Unicorn Valuation of Delaware PBC

allbirds

Total raised = $77 Million at **$1.5B valuation**

TIGERGLOBAL

Invest With Confidence T.RowePrice

LERER HIPPEAU

Fidelity INVESTMENTS

We founded Allbirds as a Public Benefit Corporation. This injection of capital will help us bring our sustainable products to more people...demonstrating that comfort, design and sustainability don't have to live exclusive of each other." - Joey Zwillinger, Co-founder

Public Company Subsidiaries

Campbell's

United Therapeutics CORPORATION

CONCHA Y TORO

DANONE

Plum organics

LUNG BIOTECHNOLOGY WE BREATHE LIFE

FETZER VINEYARDS

Happy FAMILY ORGANICS

SC Johnson

method

NEW CHAPTER

P&G

Public Company Subsidiary: Danone Creates World's Largest Benefit Corporation

Acquisition

In July 2016, Danone, a publicly traded company with a $45B billion market cap, announced that it had acquired WhiteWave Foods for approximately $12.5B. WhiteWave was combined with Danone's North American operations, creating an enterprise with $6B in revenue, 6,000 employees, 900M costumers and representing 20% of Danone's global business.

Incorporation & Certification

In April of 2017, Danone North America was converted into the world's largest benefit corporation.

In 2018, Danone announced that Danone North America had Certified as a B Corp.

Danone has Certified many of its subsidiaries and plans to Certify the entirety of its global business by 2030.

Reduced Cost of Capital

Partnered with 12 leading global banks on a €2B syndicated credit facility linking the margin payable to ESG performance data, including B Corp certification

Syndicate led by BNP Paribas; included Société Générale, Credit Agricole, Natixis, HSBC, Citibank, JPMorgan, Barclays, ING, NatWest, MUFG, and Santander

IPO of Laureate Education

Sponsor

Private equity backed

Bankers

Credit Suisse; Morgan Stanley; Barclays; J.P. Morgan; Macquarie, BMO Capital Markets; Citigroup; Goldman Sachs & Co.

Lawyers

DLA Piper / Simpson Thacher

Profile

$4.2 billion 2016 revenue
70 campuses/online schools
Operations in 25 countries

Funding

Pre-IPO round: $400 million

IPO: Raised $490M; priced at $14.00 February 1, 2017; (closed at $18.48 on 6/28/17)

LAUREATE EDUCATION INC®

M&A Activity – Natura & Avon

- Natura acquires Avon in stock for stock deal
- Avon shareholders will get Natura ADRs that trade on NYSE
- First “conversion” of publicly traded US company

Benefit Corporations are Congruent with Evolving Investment Standards

All constituencies need co-operate on developing a system of integrated accounting **so that corporations stop having incentive to pursue societally destructive practices**, and shareholders and customers stop being enablers of conduct that they personally deplore.

~Robert Monks June 2015 speech, ICGN Conference

CalPERS may engage investee companies and external managers on their governance and sustainability issues, including . . . [h]uman capital practices, including but not limited to **fair labor practices, health and safety, responsible contracting and diversity [and]** environmental practices, including but not limited to **climate change and natural resource availability.**

~California Public Employees' Retirement System, Investment Beliefs

Investment practices that foster intergenerational transfers of risk and wealth raise duty of impartiality concerns for long-term investors. Changes in understanding of systemic risk, and related investment management practices among global peers, demonstrate an ongoing evolution in the prudence standards against which the conduct of fiduciaries is judged.

~BlackRock/Ceres 21st Century Engagement

PBC Status Signals a Long-Term Perspective

“We had activists come into our stock… they wanted to force us into a sale…Boy oh boy oh boy, did I wish we were a B Corp…I would have loved to have tested the idea of shareholder activists versus the legal form of a benefit corporation.”

~John Mackey, CEO of Whole Foods

Beyond Benefit Corporations

Accountable Capitalism Act

- Proposed in August 2018
- Imposes benefit corporation principles on all companies in the U.S. with over $1 billion in revenues
- Requires such businesses
  - to create a general public benefit
  - to consider the effect of a proposed action on all stakeholders who are materially affected—not just the shareholders

- Effect on board accountability?

Business Roundtable

Statement on the Purpose of a Corporation

Americans deserve an economy that allows each person to succeed through hard work and creativity and to lead a life of meaning and dignity. We believe the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all.

Businesses play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services. Businesses make and sell consumer products; manufacture equipment and vehicles; support the national defense; grow and produce food; provide health care; generate and deliver energy; and offer financial, communications and other services that underpin economic growth.

While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:

- Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.
- Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.
- Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.
- Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.
- Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.

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.

August 2019

Assessment

- **90% of ~2200 studies show non-negative relationship between ESG criteria and Corporate Financial Performance:**
  - Positive relationship: 48%
  - Neutral relationship: 23%
  - Negative relationship: 10%
  - Mixed relationship: 18%

Journal of Sustainable Finance & Investment, 2015
Vol. 5, No. 4, 210–233, http://dx.doi.org/10.1080/20430795.2015.1118917
Taylor & Francis
Taylor & Francis Group

ESG and financial performance: aggregated evidence from more than 2000 empirical studies

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(*Received 22 October 2015; accepted 9 November 2015*)

- **Correlation:** averages between ESG performance and financial returns across studies: 0.108
  - “While [such] overall correlation averages…could be considered rather ‘small’, they reflect common effect sizes in social sciences and, notably, might have relatively high relevance for competitive global securities markets.” (page 225)
- **Conclusion:** “The orientation toward long-term responsible investing should be important for all kinds of rational investors in order to fulfill their fiduciary duties and may better align investors’ interests with the broader objectives of society. This requires a detailed and profound understanding of how to integrate ESG criteria into investment processes in order to havest the full potential of value-enhancing ESG factors.” (page 227)

Source: https://www.tandfonline.com/doi/pdf/10.1080/20430795.2015.1118917

Market Demand

Regional Share, by Asset Weight, in Global Use of Strategies

	Impact/ community investing	Sustainability themed investing	Positive/ best-in-class screening	Norms-based screening	Corporate engagement and shareholder action	ESG integration	Negative/ exclusionary screening
Japan	3.2%	2.6%	2.4%	0.9%	3.5%	**1.2%**	0.1%
Asia ex-Japan	0.0%	1.9%	0.1%	0.0%	0.0%	**0.2%**	0.1%
Australia/NZ	1.1%	5.2%	0.0%	0.3%	0.0%	**4.6%**	0.0%
Canada	2.7%	20.3%	21.3%	9.5%	10.3%	**10.1%**	2.3%
United States	49.8%	22.2%	24.0%	0.0%	30.6%	**56.0%**	23.8%
Europe	43.2%	47.9%	52.2%	89.3%	55.6%	**27.8%**	73.6%

Growth of Strategies 2014-2016 ($ billions)

Strategy	2014	2016	Growth	CAGR
Impact/community investing	$101	$248	146%	56.8%
Sustainability themed investing	$137	$331	140%	55.1%
Positive/best-in-class-screening	$890	$1,030	16%	7.6%
Norms-based screening	$4,385	$6,210	42%	19.0%
Corporate engagement and shareholder action	$5,919	$8,365	41%	18.9%
ESG integration	**$7,527**	**$10,369**	**38%**	**17.4%**
Negative/exclusionary screening	$12,046	$15,023	25%	11.7%

Source: Global Sustainable Investment Review

Asset Manager Implementation

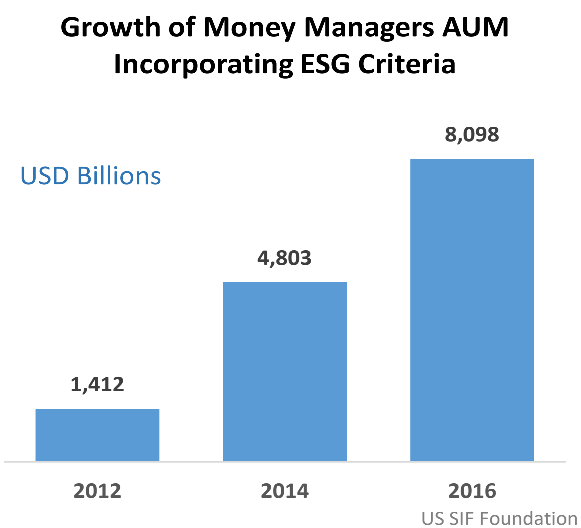
General Overview of asset manager adoption in the U.S.

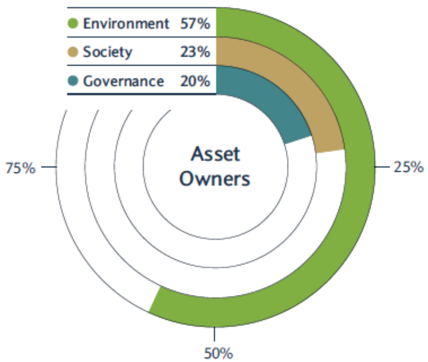
Based on discussions with asset managers and owners, generally found a fairly consistent implementation approach *(with few exceptions)*:	
Reason for Implementation	Most firms chose to implement ESG strategies due to client pressure- mostly Eurocentric, however, with small but steadily increasing US importance.
Investment Philosophy:	Most firms employ an overlay investment strategy where ESG metrics, provided by ESG professionals working with PMs, are used in every investment decision; however, discretion remains with each PM. Additionally, thematic portfolios are created- either customized at a client's request, or as a separate investment product.
ESG Governance Structure:	Centralized. Firms have dedicated ESG personal that work with PMs but report up to (or are part of) an ESG committee.
Return Experience:	Generally not specifically measured, however, all stated their expectation of slightly increased alpha with lower volatility. In addition, all mentioned the importance of ESG to retain and grow their client base (European and US).
Approach to Research:	Most began using MSCI and/or Sustainalytics data and scores (more reliance on MSCI) and gravitated to building their own proprietary models using MSCI, Sustainalytics and other 3rd party data providers (not scores)
Future Goals:	Increased ESG staff is likely as proprietary models are built and increased client demand add pressure for pro-active management and new products.

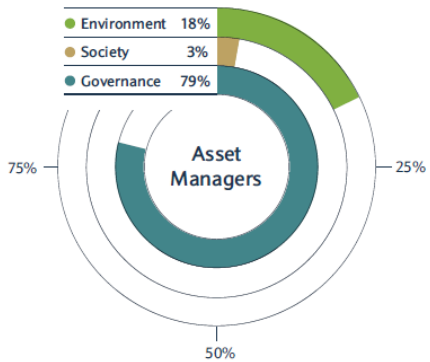
Asset Manager Adoption

Asset managers are increasingly incorporating ESG metrics into their portfolio construction

- U.S. Money managers & financial institutions incorporated ESG criteria in investment portfolio decisions encompassing $8.1 trillion in 2016[1]
- Heavy emphasis is being placed on Environmental scores, where clients have the most concern *(as opposed to governance, where managers are most focused)*
- Smart beta strategies are being adopted by several large institutional investors and their managers

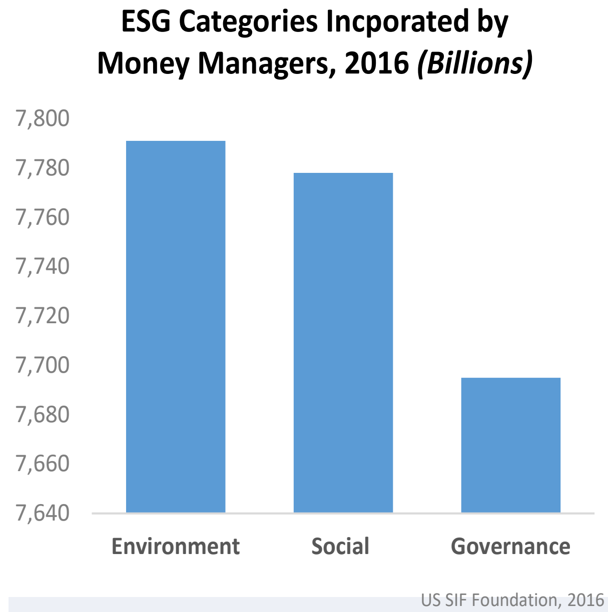






"Even if asset owners are smaller in size, they still have the ability to change their manager should the manager be reluctant to implement ESG policies." "If your money manager won't do it, there are other manager out there who would"

-Mark Thompson, CIO, HSBC Pension Schemes



1. US SIF Foundation, 2016 Trends Report

UN PRI: United Nations Principles for Responsible Investment

Investors ***voluntarily*** commit to an ***aspirational*** set of six investment principles (emphasis added):

1. We will ***incorporate ESG issues into investment analysis*** and decision-making processes.
2. We will be ***active owners*** and incorporate ESG issues into our ownership policies and practices.
3. We will ***seek appropriate disclosure*** on ESG issues by the entities in which we invest.
4. We will ***promote*** acceptance and implementation of the Principles within the investment industry.
5. We will ***work together*** to enhance our effectiveness in implementing the Principles.
6. We will each ***report on*** our activities and progress towards implementing the Principles.

PRI Principles for Responsible Investment

- **Presupposes ESG materiality** – "ESG issues can affect the performance of investment portfolios"
- **Entirely consistent with fiduciary duty** – apply the principles "where consistent with out fiduciary duties"
- **1994 signatories and counting** – incl. BlackRock, Goldman Sachs, State Street, Morgan Stanley, Vanguard, etc.
- **Cost** – $18k annually + 1 to 5 days of staff time
- **Benefits** – Opens up new market share + prevents automatic proposal disqualification + resources / network

PRI Signatory Text

"As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. ***In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios*** (to varying degrees across companies, sectors, regions, asset classes and through time).

We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, ***where consistent with our fiduciary responsibilities***, we commit to the following:

1. We will ***incorporate ESG issues into investment analysis*** and decision-making processes.
2. We will be ***active owners*** and incorporate ESG issues into our ownership policies and practices.
3. We will ***seek appropriate disclosure*** on ESG issues by the entities in which we invest.
4. We will ***promote*** acceptance and implementation of the Principles within the investment industry.
5. We will ***work together*** to enhance our effectiveness in implementing the Principles.
6. We will each ***report on*** our activities and progress towards implementing the Principles.

The Principles for Responsible Investment were developed by an international group of institutional investors reflecting the increasing relevance of environmental, social and corporate governance issues to investment practices. The process was convened by the United Nations Secretary-General.

In signing the Principles, we as investors publicly commit to adopt and implement them, where consistent with our fiduciary responsibilities. We also commit to evaluate the effectiveness and improve the content of the Principles over time. We believe this will improve our ability to meet commitments to beneficiaries as well as better align our investment activities with the broader interests of society.

We encourage other investors to adopt the Principles."

Note: emphasis added in bold / italics

Asset Manager Implementation

Approach of select asset managers and owners

	BlackRock	Aberdeen	Brandywine	CalSTRS	Calvert	State Street
ESG Structure	Centralized *(sustainable investing group)*	Centralized *(ESG Stewardship team)*	Centralized *(ESG Counsel)*	Centralized (3 separate committees)	Centralized *(research review committee)*	Centralized *(ESG Advisory Group)*
Rational	*Believe ESG enhances long term, risk adjusted returns*	*Early sustainable focus- their clients pushed them towards a inclusionary, ESG style*	*Customer driven decision (mostly Europe) but are increasingly receiving US client requests*	*fiduciary responsibility to require corp.'s to meet high standard of conduct & strive for sustainability*	*Core to mission*	*"Mainly in response to incoming client demands and specifications"*
Implementation	Overlay Incorporated in every investment decision	Overlay Incorporated in every investment decision- but no set rules	Overlay Fully incorporated into every in every investment decision	Overlay It's expected that all AM's abide by their 21 risk standards	Overlay Incorporated in every investment decision with set thresholds	Overlay Generally applied across all active portfolios but no set metrics
% AUM Applied	100%	100%	100%	100% ($2.5B to low carbon specific)	100%	~75% ($210B in dedicated funds)
Economic Benefit	Not measured believed to "improve investment outcomes"	Not measured results in true "financial scores" that leads to excess returns	Not measured too early to measure but unlikely to track	Not measured believed to increase alpha with a ~.25% tracking error	Not measured believed to "improve investment outcomes"	Not measured *believe associated costs are largely outweighed by the benefits*
PRI Signatory	Yes	Yes	Yes	Yes	Yes	Yes

Benefits to Investors | Improved Outcomes

INVESTMENT PERFORMANCE

The ESG Investing Thesis

Non-financial issues can have financial impacts on issuers. Therefore, incorporating non-financial data into the investment process can provide a clearer and more comprehensive picture of the current and future financial health of each issuer, alerting investors to material risks and opportunities that may be hidden from traditional financial analysis.

- Mitigate portfolio risk
- Reduce portfolio volatility
- Enhance long-term portfolio returns & performance
- Consistent with fiduciary duty

Table 2. Why Consider ESG Issues?

Survey Response	Respondents (%)
To help manage investment risks	63
Clients/investors demand it	44
ESG performance is a proxy for management quality	38
It's my fiduciary duty	37
To help identify investment opportunities	37
My firm derives reputational benefit	30
Regulation requires it	7
Other	5

In the words of Larry Fink

“A company’s ability to manage environmental, social, and governance matters demonstrates the leadership and good governance that is so essential to sustainable growth, which is why we are increasingly integrating these issues into our investment process.” (2018 Letter to CEOs)

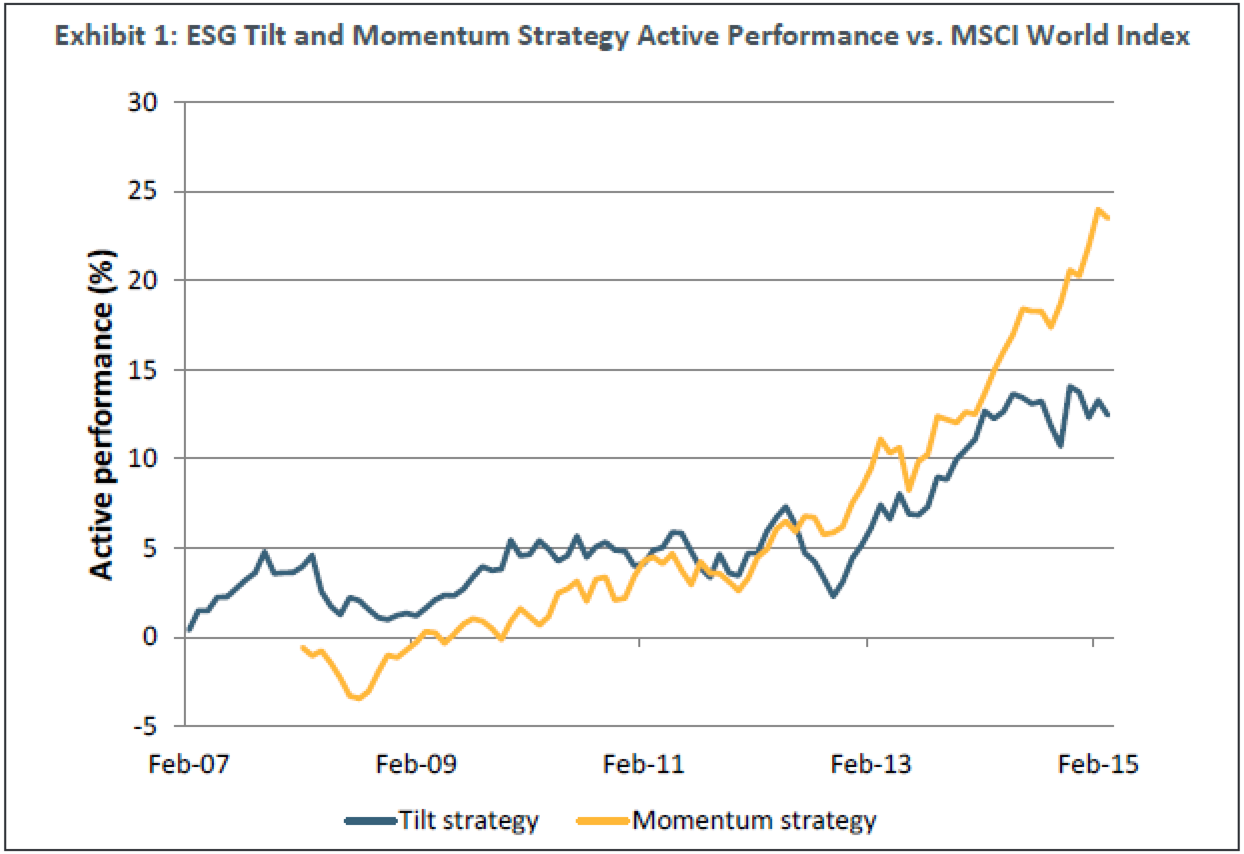
On Fiduciary Duty – DOL

“Fiduciaries should appropriately consider factors that potentially influence risk and return. Environmental, social, and governance issues may have a direct relationship to the economic value of the plan’s investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices.”

1 https://www.gpo.gov/fdsys/pkg/FR-2015-10-26/pdf/2015-27146.pdf
Table source: “Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals” CFA Institute, 2015, page 11

Benefits to Investors | Improved Outcomes

INVESTMENT PERFORMANCE



Source: “Can ESG Add Alpha?” MSCI, 2015. Page 26

MSCI

Backtests show ESG outperformance relative to benchmarks

- ESG Tilt – assumes ESG quality is linked to future stock performance (longer term)

  Annualized active return vs. MSCI World: 1.1%

- ESG Momentum – assumes *change* in ESG quality is linked to future stock performance (shorter term)

  Annualized active return vs. MSCI World: 2.2%

Benefits to Investors | Improved Outcomes

INVESTMENT PERFORMANCE

We believe companies that effectively manage ESG risks and opportunities perform better over time

MSCI found that companies with strong ESG profiles exhibit the following characteristics:

Stronger cash flows

- They are ***more competitive*** than their peers because they more efficiently use their resources, and/or have better human capital management as well as better manage long term business plans.
- This leads to ***higher profitability*** and ***higher dividends***.

Less idiosyncratic risk

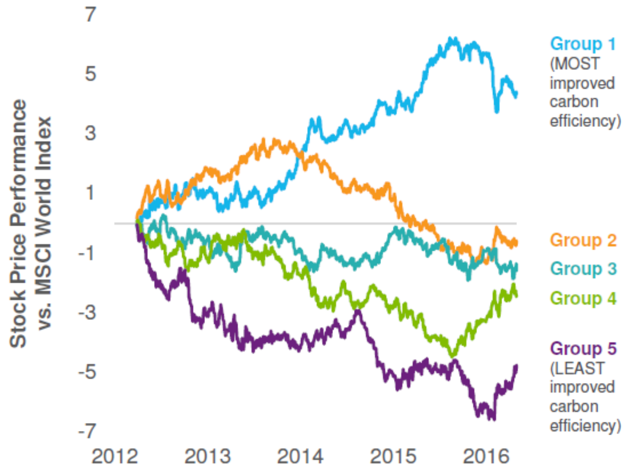
- They have ***better risk control*** and compliance standards.
- Better risk control leads to **fewer negative incidents** and ***less stock-specific downside or tail risk*** in the company's stock price.

Higher valuations

- They are ***less vulnerable to systematic market shocks*** and therefore show lower systematic risk.
- Lower systematic risk means a lower beta, which translate to **lower cost of capital** and a ***higher valuation***. Further valuation is increased through the ***increased size of investor base***.

BlackRock found that companies who reduce their carbon footprint also have stronger equity performance

Efficiency Improvement:
Equity Performance by Carbon Intensity 2012-2016



MSCI: "Foundations of ESG Investing, Part 1: How ESG affects Equity Valuation, Risk and Performance," 2017. Giese, Guido, Lee, Melas, Nagy, Nishik

Sources: BlackRock Investment Institute, ASSET4 and MSCI, July 2016. Notes: The analysis above calculates the carbon intensity of all MSCI World companies by dividing their annual carbon emissions by annual sales. Companies are ranked and bucketed in five quintiles based on their year-over-year change in carbon intensity. We then analyze each quintile's stock price performance versus the MSCI World Index. Most improved means the 20% of companies that posted the greatest annual decline in carbon intensity. Data are from March 2012 through April 2016. The example is for illustrative purposes only. Past performance is no indication of future results.

BLACKROCK® FOR USE WITH INSTITUTIONAL INVESTORS ONLY - NOT FOR FURTHER DISTRIBUTION MAS0418U-475921-1506313 3

BlackRock

Found that companies who reduce their carbon footprint have stronger equity performance

Source: BlackRock Sustainable Investing, p4

Integration: Challenges

- Evolving standards for definition of E, S and G factors
- Inconsistency across different ‘rating’ providers.
- Ratings are at the firm level and may not have any issue specific ratings:
  - These ratings cannot be incorporated at issue level.
  - ESG ratings cannot be applied towards Treasuries or ABS, which is an impediment to running a ESG specific product
- Lack of disclosures across the universe of publicly listed companies.
  - Lack of disclosure is penalized as lack of ESG effort, which could lead to throwing baby with bath water situation
- All of the above are being refined and are challenges faced by various practitioners in the space. As a result, some have created internal ESG teams to identify and rank companies based on various ESG factors as deemed fit within the scope of their investment philosophy.

Practical Recommendations and Legal Considerations

- Pay and Incentives
- Ownership and Governance
- Taxes and Lobbying
- Procurement of Local Goods and Services
- Investment
- Products and Pricing
- Reporting Obligations
- Metrics

A reminder about the benefits of ACC membership…

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- Networking meetings
- Special events
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- **For more information or to refer a new member, see your hosts today or contact Chapter Administrator, Chris Stewart, at ChrisStewart@ACCglobal.com.**

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Appendix A

"Is It Only About Profits?" by Doug Raymond

Is It Only About Profits?

The corporations-should-care-about-society movement reaches a crescendo with Elizabeth Warren's proposed bill.

BY DOUG RAYMOND

There's a growing and important debate about corporate governance, particularly viewed against the backdrop of significant criticism of recent corporate action (or inaction) around social media issues, the #metoo movement and other current controversies.

Sitting at the center of this is Sen. Elizabeth Warren, who recently introduced legislation (the Accountable Capitalism Act) requiring any U.S. company that has more than $1 billion in annual revenue to obtain a newly created federal charter.

Elizabeth Warren

The charter would be in addition to its state constituent documents (e.g., articles and bylaws) and would mandate significant changes in corporate governance.

In many jurisdictions, including Delaware, the board's primary obligation is to manage the business of the corporation "in the best interests of the stockholders." However, some jurisdictions take a more expansive view of the board's obligations and are expressly permitted to consider factors other than shareholder value in discharging their fiduciary duties.

For example, in Pennsylvania the board instead must act in the "best interests of the corporation," and may (but does not need to) take into account all "pertinent factors," including the interests of shareholders, but also the interests of customers, employees, suppliers, creditors and the communities in which the corporation operates. Pennsylvania also emphasizes a principle that has been judicially recognized in many jurisdictions — that short-term interests are not necessarily more important than long-term interests. Importantly, the board does not need to treat the shareholders' interest as paramount.

The Accountable Capitalism Act would impose benefit corporation principles on all large companies, requiring businesses to create a general public benefit, and to consider the effect of a proposed action on all stakeholders who are materially affected – not just the shareholders.

These broader "constituency" statutes were originally adopted largely to assist boards in resisting hostile takeovers, but more recently have been cited to authorize a greater scope of corporate responsibility outside of the takeover context. An expanded version of this approach is reflected in the "benefit corporation," a relatively new form of business organization for which enabling legislation has been adopted in 34 states. *(See related BCorp article on page 34.)*

The benefit corporation concept reflects the perspective that businesses affect more than just their owners and have extensive impacts on other interests, including employees, customers, communities and the environment. These include environmental, social and political impacts that are not reflected in the costs typically recognized in running the business — for example, air or water pollution, work-related illnesses not covered by their employers, or the utilization of a social media platform for nondemocratic or repugnant messaging. The managers of a business, it is argued, must take into account the external, as well as internal, impacts when making decisions.

In most jurisdictions where benefit corporations have been authorized, the corporation must have a corporate purpose of creating a material positive impact on society and the environment. Its directors are not permitted merely to consider the interests of constituencies other than the shareholders. On the contrary, they are required to also consider the interests of other groups, without giving priority to the interests of any one group. These other groups include employees, customers, suppliers and communities where the corporation conducts business, and also "community and societal considerations, the local and global environment, and the ability of the benefit corporation to achieve its general and any specific public benefit purpose."

The Accountable Capitalism Act would impose some of these benefit corporation principles on all large companies, requiring businesses to create a general public benefit, and to consider the effect of a proposed action on all stakeholders who are materially affected, which include all the groups identified in the benefits corporation legislation, and is not limited to the interests of shareholders. (This legislation contains other interesting provisions, including restrictions on political spending and a prohibition on management selling shares for five years after they have been acquired from the company, or for three years following a corporate stock buyback. The bill also would give employees the right to elect no less than 40% of the directors.)

The broader "stakeholder" approach reflected in this legislation and in the growing benefit corporation movement has been criticized on the basis that if the directors are allowed to consider "all pertinent factors" their decisions are essentially unreviewable. These critics argue that in order to have accountability, there must be clear guidelines for reviewing board action, and as the shareholders own the business, why aren't they the best group to provide the measure? Moreover, say these critics, it is the shareholders who elect (and remove) the directors, not the employees or suppliers, so shouldn't their interests be paramount?

This criticism may miss the mark.

Unless the corporation is being sold or a director or a controlling stockholder has a conflict of interest (when very specific rules come into play in most jurisdictions), the board — even of a Delaware corporation — has significant flexibility when deciding what action is in the best interest of the stockholders. And the business judgment rule affords broad discretion to the board, and makes such decisions, if thoughtfully made, essentially unreviewable (except in a shareholder vote).

Because most boards already have this inherently broad discretion, the Accountable Capitalism Act and the discussion it provokes can serve as an important jumping off point for a board to consider and articulate the criteria directors will use in making significant decisions, including whether near-term profits should be paramount.

This discussion is particularly relevant in the current environment of intense public interest in and criticism of corporations' impact on climate change and commitment to sustainability; the role they are playing in political discourse and elections; pricing decisions for pharmaceuticals and other products; and the extent to which these businesses have been perceived as perpetuating sexual or racial harassment and discrimination.

Boards should, if challenged, be prepared to explain the basis on which they have made a controversial choice. This kind of discussion can help prepare the directors to make, and to justify, those difficult decisions. ■

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Appendix B

“Weighing ESG Against Directors’ Fiduciary Duty” by Doug Raymond

Weighing ESG Against Directors' Fiduciary Duty

A focus on environmental, social and governance benefits should be framed by the lens of business benefits.

BY DOUG RAYMOND

The directors of a Delaware corporation have a fiduciary duty to manage the corporation, in good faith, in the best interests of the stockholders. Under Delaware law, this means, in general, that the board has a fiduciary obligation to maximize the profits of the firm for the benefit of its owners.

Of course, this does not mean that short-term profits outweigh all other considerations. Directors can, and should, consider both short- and long-term interests of the shareholders. (The principal exception, which is recognized in Delaware but not in certain other jurisdictions, is when the sale or break-up of the company is inevitable, in which case there really is no longer a long-term interest to consider.) As a consequence, boards can take into account all the factors that reasonably could contribute to the long-term health of the business, including impacts on employees, local communities etc.

Other jurisdictions take a more expansive view, looking beyond just share owners to other constituencies.

For example, in Pennsylvania, the board's obligations run to the corporation, not the shareholders, and a director is required to perform his (or her) duties "in good faith, in a manner he reasonably believes to be in the best interests of the corporation..."

Since a corporation is an inanimate concept, and cannot be said to really have any particular interests at all, the Pennsylvania corporation law helpfully adds a laundry list of stakeholders whom the board can consider when deciding whether an act is, or is not, in the corporation's "best interests." These include, among others, employees, customers, suppliers, creditors and communities where the business operates. But, in Pennsylvania, unlike Delaware, the interests of these other constituencies are not subordinate to the interests of the shareholders, and so can outweigh a focus on the shareholders.

But what if boards want to increase their focus on long- and short-term environmental, social and governance impacts of the corporation?

> While the law, and in particular the business judgement rule, will afford directors with substantial deference in determining how to act in the best interests of the corporation, boards should be careful how that discussion is framed, and make sure that the corporate records tie the board's actions to their assessment of what is in the best interest of the corporation's owners (or other permitted constituencies).

The directors' duty to act in the best interests of the corporation (or its shareholders/stakeholders) is known as the duty of loyalty. Directors also have a fiduciary duty of care, to act on an informed basis and with reasonable care. The directors have the benefit of almost bulletproof protections against claims that they have breached their duty of care. These protections are primarily the strong presumption of the business judgement rule — that the actions of the board are appropriate — and the statutory protections that most corporations have adopted to limit the directors' liability for damages.

However, these protections generally do not extend to a breach of the duty of loyalty, which would be implicated by an assertion that directors subordinated the best interests of the corporation to some other interest, even an ostensibly socially useful other one.

While most lawsuits asserting a breach by the directors of their duty of loyalty have alleged conflicts of interest or self-dealing, the obligations of this fiduciary duty reach more broadly.

Indeed, the corporation laws of most jurisdictions, including Delaware and Pennsylvania, have provided express statutory authority for corporations to make contributions and donations for the public welfare or for charitable purposes. That the legislature considered such provisions as necessary suggests that there was a concern that without them, such charitable activities would not have been permissible.

In considering the role that a business corporation should play in promoting social welfare, justice, environmental stewardship and similar societal benefits, directors need to be mindful that they are fiduciaries for the businesses they control. While the law, and in particular the business judgement rule, will afford directors with substantial deference in determining how to act in the best interests of the corporation, boards should be careful how that discussion is framed, and make sure that the corporate records tie the board's actions to their assessment of what is in the best interest of the corporation's owners (or other permitted constituencies).

There are newer corporate frameworks, and proposed legislation, that more clearly authorize directors to exercise greater discretion when it comes to ESG (environmental, social and governance) issues.

Over the last decade the new structure of the benefit corporation, and more recently the federal version proposed by Senator Elizabeth Warren in her recently proposed Accountable Capitalism Act (which was the subject of this column in the first quarter's issue), present a new paradigm: the corporation is run not only for the benefit of its owners, but is also required to have a purpose of creating a material positive impact on society and/or the environment.

For these businesses, directors must consider not only the interests of shareholders, but also community and societal considerations, the local and global environment, and the corporation's ability to achieve its general and any specific public benefit purpose. The Accountable Capitalism Act, if adopted, would mandate this for all corporations with more than $1 billion in revenues.

Although the benefit corporation movement, and other aspects of the increased emphasis on ESG, have garnered much attention, fewer than 9,000 businesses have chosen to conduct themselves as a benefit corporation.

While the number of benefit corporations is expected to increase, some proponents of ESG argue that the existing corporate structure can — and should — incorporate ESG principles into their boardroom deliberations, on the basis that if it is good for society, or the planet, it must also be good for the corporation.

The debate is expected to continue over the proper role that corporations should play in promoting and protecting worthy societal objectives such as environmental impacts and social justice. As part of this, important constituencies are advocating for boards to take a more active role in such matters, and embrace the broader mandate of addressing at least some of the problems that we face as a society.

As boards consider how to respond to these advocates, they should realize that their discretion is not without limits. ■

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