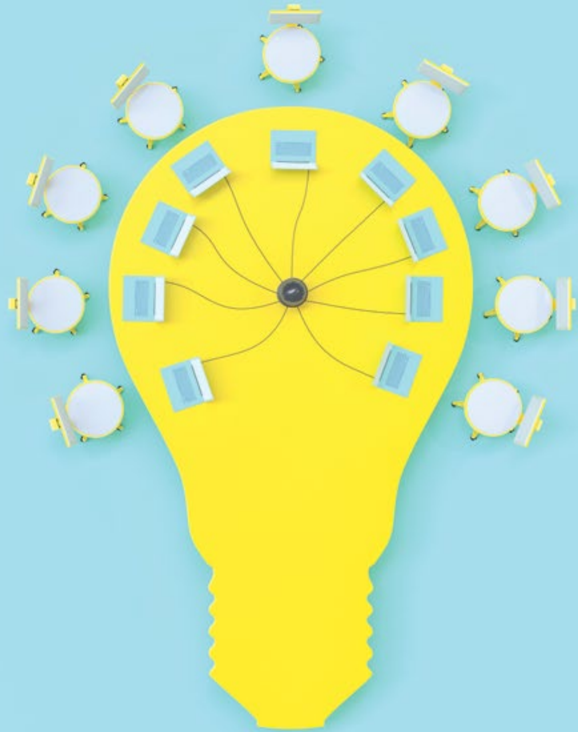

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Considering the Corporate Purpose

In his regular column, Frank Aquila drafts a memo to a board identifying key issues to consider in connection with corporate purpose.

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MEMORANDUM

TO: The Board of Directors
FROM: Frank Aquila
RE: Considering the Corporate Purpose

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As we have discussed, the Board will consider the recent public discourse on corporate purpose at its upcoming meeting. The Board's primary focus at this stage should be to ensure that the Company has a view of its corporate purpose that is cohesive, carefully considered, and consistent with the Board's responsibilities and goals for the Company, its shareholders, and other stakeholders. To do so, the Board must understand the relationship between corporate purpose and fundamental principles of corporate law, especially the fiduciary duties of Board members under Delaware law, where the Company is incorporated.

This memorandum provides a high-level overview of key legal and practical issues for the Board to consider in connection with a discussion of corporate purpose, including:

- The recent public discourse on corporate purpose and related investor and legislative efforts.
- The general principle of shareholder primacy under Delaware law and how the Board may consider corporate purpose under this framework.
- Special fiduciary duties that apply in the context of a sale or break-up of a company, which limit the extent to which a board may consider the interests of stakeholders other than shareholders or any factors other than maximizing short-term shareholder value.
- Challenges that may arise from competing stakeholder interests.
- Strategies for effective communication of corporate purpose.
- The need to monitor legal developments.

1. PUBLIC DISCOURSE AND RELATED DEVELOPMENTS

The focus on corporate purpose has increased since August 2019, when the Business Roundtable (BRT) released its Statement on the Purpose of a Corporation, available at *businessroundtable.org*. The CEOs of some of the largest US companies and institutional investors signed the BRT's purpose statement, which presents the view that corporations "play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services." Specifically, the signatories expressed their support of a fundamental commitment to shareholders and a variety of other stakeholders, including customers, employees, suppliers, and local communities, "to deliver value to all of them, for the future success of our companies, our communities and our country." In connection with delivering value to all stakeholders, in addition to focusing on long-term value creation for shareholders, the BRT's purpose statement highlighted the importance of fair compensation, workplace diversity and inclusion, ethical dealing with suppliers, and environmentally sustainable practices.

Although the debate over the role and responsibilities of for-profit corporations in modern society has intensified, the view that corporations should serve purposes beyond maximizing short-term financial returns for their shareholders is not new. This sentiment has become increasingly prevalent over the last decade in the boardrooms of US public companies, and in interactions between these companies and their shareholders on issues including environmental, social, and governance (ESG) oversight and corporate social responsibilities (for more information, search Memorandum to Board: Issues to Consider When Preparing for Shareholder Engagement on Sensitive Social Issues on Practical Law).

Besides signing the BRT's purpose statement, large institutional shareholders, such as BlackRock and Vanguard, which hold a meaningful percentage of the shares of most US public companies, have also adopted stand-alone public statements or policies that highlight their emphasis on corporate sustainability, workplace equality, human rights, and other ESG issues. US public companies are also engaging with shareholders more frequently on ESG issues in the context of annual meeting shareholder proposals. The 2019 proxy season marked the third consecutive year in which the number of shareholder proposals demanding that US S&P 1500 companies adopt measures to improve their environmental, social, or political impact or disclosure surpassed all other topics. (See Sullivan & Cromwell LLP, 2019 Proxy Season Review: Part 1: Rule 14a-8 Shareholder Proposals (July 12, 2019), available at *sullcrom.com*.)

Recent legislative efforts and the 2020 presidential election are amplifying the discussions on the purpose of US corporations. For example, Senator Elizabeth Warren introduced the Accountable Capitalism Act (S. 3348) in August 2018, which, if adopted, would:

- Permit directors at companies with over $1 billion in annual gross receipts to consider, in addition to shareholder value, the short- and long-term impacts of corporate actions on employees, customers, local communities, the environment, and society.
- Require that 40% of the board of qualifying companies be elected by employees.

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Although the Accountable Capitalism Act has not gone farther than the Senate Committee on Commerce, Science, and Transportation, the adoption of even a watered-down version of this legislation would substantially shift boardroom dynamics and the relationship between a company's directors and its employees.

On the other side of the corporate purpose debate, some shareholders, advocacy groups, and lawmakers have decried certain companies' decisions to define a corporate purpose that includes benefitting non-shareholder constituencies as inappropriate, unethical, or even unlawful. Some of them have publicly denounced directors of corporations for adopting initiatives such as promoting workplace diversity or environmental sustainability, claiming that these directors are diverting corporate funds for personal causes or political reasons. Others have argued that the corporate purpose described in the BRT's purpose statement is inimical to the fundamental principles of corporate law, including directors' fiduciary duty to promote shareholder value.

2. DELAWARE LAW FRAMEWORK

Delaware is not one of the 44 US states with constituency statutes, which permit directors to consider the interests of non-shareholder constituencies (typically only in the M&A context). Except with respect to public benefit corporations (for more information, search Public Benefit Corporations (DE) on Practical Law), current Delaware law mandates that "stockholders' best interest must always, within legal limits, be the end" of business decisions made by directors of a Delaware corporation. (*In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 37 (Del. Ch. 2013)). This idea that shareholder interests should be the principal focus of directors' corporate decisions (known as shareholder primacy), is a central tenet of Delaware law.

However, shareholder primacy does not prohibit directors from considering the interests of constituencies other than shareholders, but those "[o]ther constituencies may be considered only instrumentally to advance [shareholders' best interests]" (*In re Trados*, 73 A.3d at 37). Therefore, under Delaware law, it is crucial for the Board to begin any discussion of corporate purpose by asking not only why the interests of the Company's various stakeholders should be considered, but also how benefitting a non-shareholder constituency ultimately impacts shareholder value.

Actions that benefit a non-shareholder constituency and may also promote long-term shareholder value include:

- **Increasing employee wages.** This enables a company to attract and retain a talented and motivated workforce, which can help the company outcompete industry peers, sustain or grow market shares, and deliver sustainable financial results and shareholder returns that improve over time.
- **Allocating resources to diversity and inclusion initiatives.** This promotes respect and dignity in the workplace and is likely to improve a company's desirability as an employer. In addition, a commitment to workplace diversity may expand the company's customer base by appealing to new demographics that support the company's values, create a positive work culture that contributes to customer satisfaction, improve the goodwill associated with the corporate brand, decrease the potential for human capital mismanagement issues, and reduce the likelihood of negative publicity and resulting value destruction.
- **Offering fair terms to small, local suppliers.** A positive relationship between the company and these suppliers may alleviate risks and costs associated with supplier consolidation and supply chain disruption.
- **Giving back to, and conscientiously engaging with, local communities.** This may improve the company's reputation, publicity, and role in the community, and reduce the risk of operational disruptions and protracted litigation.
- **Adopting environmentally sustainable measures.** This may increase goodwill and customer loyalty associated with the corporate brand and help the company avoid penalties and enforcement costs arising from any violations of current and future environmental laws and regulations.

Generally, as long as a board has made an informed and non-conflicted decision that a corporate action, even one that may decrease the corporation's short-term profitability, will benefit the corporation and its shareholders in the long term, Delaware courts will not second-guess the directors' decision. Instead, Delaware courts have held that the deferential standard of review under the business judgment rule applies to directors' "rational judgments about how promoting non-stockholder 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" (*eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 33 (Del. Ch. 2010)). Accordingly, when approving an action that furthers the interests of a non-shareholder constituency, the Board should consult with management

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and external advisors as needed, so that each director is prepared to reach an informed decision. The Board should consider documenting its decision-making process in a way that protects the Board against claims that directors improperly allocated corporate resources to advance individual altruistic goals at the expense of shareholder value.

3. SPECIAL FIDUCIARY DUTIES

The Board should be aware that the fiduciary duties of Delaware directors change meaningfully in the context of a sale or change of control of the company. If a company is seeking to sell itself or effectuate a break-up, whether as part of an active bidding process initiated by the company or in response to an unsolicited bid, or a board is considering whether to approve a change of control (such as a stock-for-stock merger where a controlling shareholder will exist post-merger, or a sale of a non-controlled company for at least 50% cash consideration), Delaware courts will apply the heightened standard of review under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). (*Revlon* duties generally do not apply in the context of a stock-for-stock merger between two non-controlled companies.)

During the sale of a Delaware company, if a break-up becomes inevitable or a transaction will result in a change of control, *Revlon* requires directors to shift their focus from preserving the long-term value of the corporation, including efforts to generate value for other constituencies, to realizing the highest immediate value for shareholders. These requirements differentiate Delaware from most US states, where constituency statutes allow a board to consider the interests of non-shareholder stakeholders in an M&A context. Under *Revlon*, it is unclear to what extent a board may validly consider any factors other than short-term shareholder value in a sale, break-up, or change of control, and given the highly fact-specific analysis required to determine whether a board has met its *Revlon* duties, the Board should have a detailed discussion with its legal advisors at the appropriate time.

In connection with the Board's conversation on corporate purpose, it is important to note that the duty to maximize shareholder value under *Revlon* is not solely based on maximizing sale price. A board may also consider, among other factors, the legality of various aspects of an offer, deal certainty, and the impact of a particular bidder's prior actions and future business plans on the company's shareholders. Within this framework, a board might meet its *Revlon* duties by considering how a bidder's reputation as a corporate raider, or actual plans to eliminate jobs and close plants, could destabilize the workforce and local community, if these considerations factor into the board's overall analysis of deal certainty (for example, if negative press attracts government interference) or the company's ultimate sale price (for example, in the event that the company fails to complete a deal with the original bidder).

Search Fiduciary Duties of the Board of Directors and Fiduciary Duties in M&A Transactions for more on directors' fiduciary duties.

4. COMPETING STAKEHOLDER INTERESTS

Perhaps the most challenging aspect of committing to serve all stakeholders, per the BRT's purpose statement, is balancing the conflicting interests of different constituencies. For example, if production is outsourced to a country with lower labor costs and lax environmental and labor regulation, consumers may benefit from the resulting lower prices, but the local workforce, community, and environment may suffer. If a company switches to clean energy solutions that protect the environment, it may pass the costs of implementation on to customers and may significantly impact the business of its previous energy suppliers.

The same stakeholders may have competing interests as well. For example, if a board is considering whether selling a company to one bidder versus another will achieve the highest shareholder value, it should balance the two offer prices with factors such as financing or regulatory certainty, as well as other concerns that could make the highest-priced offer fall through in ways that may harm the company's ultimate sale price.

This type of cost-benefit analysis is likely already a component of the Board's oversight process. The BRT's purpose statement simply emphasizes the importance of carefully evaluating the consequences that corporate actions are likely to have on each relevant constituency. Weighing the impact of these consequences on long-term shareholder value (or shareholder value in the context of a sale or change

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of control transaction) will be especially difficult, and especially important, in the face of shareholder activism or a hostile bid. Depending on the issues involved in a particular decision, the Board may wish to consult with financial, legal, public relations, and investor relations advisors to better evaluate the impact of an activist's demand on various stakeholders, including shareholders.

Given the difficulties of predicting the impact of competing interests on shareholder value, it is often helpful for a board to solicit input from its institutional shareholders. In addition to providing helpful insight, these investors' meaningful holdings in most US public companies make them important allies if an activist challenges a company's board for failing to maximize shareholder value. The Company's proactive engagement with its institutional shareholders on corporate purpose and how to balance various constituencies' interests will increase these investors' buy-in with respect to the decisions of the Board and management, making them more likely to stand by the Company in the event of a challenge.

5. EFFECTIVE COMMUNICATION

Many leading US companies are engaging with their shareholders and making public disclosures on corporate purpose. Considering the spotlight on this topic and the fact that some of the most prominent institutional investors have signed the BRT's purpose statement, the Board should expect and be prepared for engagement with shareholders on corporate purpose and its relationship to shareholder value. Working with management and advisors, the Board should understand the key issues for various stakeholders and the risks that these issues present to the Company's long-term viability, and consider whether the Company's public disclosures should be enhanced to better reflect the Company's efforts to manage these risks and generate sustainable value. Given that the key issues for the Company's stakeholders are subject to change, in some cases rapidly due to sociopolitical or legal developments, or company- or industry-specific events, the Board should make sure that the Company evaluates and updates its engagement policies and communication strategy on an ongoing basis. Including experienced external advisors in these discussions can assist the Board and management in benchmarking the company's disclosure practices against those of its industry peers, so that the Company remains up to date on current trends and best practices (for more information, search What's Market: Corporate Social Responsibility and Corporate Sustainability Disclosures on Practical Law).

The Board should assess the Company's channels for responding to stakeholder feedback. Proactive discussions with institutional investors, other shareholders, and key stakeholders (including surveys of major suppliers, customer focus groups, or employee town halls) will assist the Company in creating a clear framework for evaluating, discussing, and implementing its corporate purpose, and in articulating how the Company generates value for its shareholders and other stakeholders. The Company's investor relations team can support the Board in considering whether the Company's disclosures are responsive to concerns raised by the Company's shareholders (particularly its institutional shareholders), for example, in one-on-one sessions and on investor calls, as well as topics highlighted in shareholders' public statements and voting guidelines.

Reporting requirements under US federal securities laws largely focus on the disclosure of information that is material from a financial perspective. Therefore, shareholders and other stakeholders may have only a narrow window into a board's ESG strategy and oversight in the absence of voluntary disclosure. To address this, institutional investors representing more than $5 trillion in assets under management recently petitioned the SEC to adopt a framework to require disclosure of ESG information, arguing that ESG issues are material to a broad range of investors and that companies often struggle in consistently disclosing reliable ESG information to investors (Rulemaking Petition File No. 4-730 (Oct. 1, 2018), available at *sec.gov*). Although the SEC has not broadly adopted ESG disclosure requirements, a substantial portion of the shareholder proposals from the 2019 proxy season sought voluntary disclosure from US S&P 1500 companies on environmental, political contribution, human rights, pay equity, and other non-financial issues. As the topic of corporate purpose continues to attract attention from shareholders and other constituencies, clear and transparent disclosures will be increasingly important to the effectiveness of the Company's public relations and investor relations efforts.

A company's public statements on corporate purpose may be conveyed through:

- **Press releases and other website posts.** Press releases and website posts are the typical channels for companies to highlight their ESG achievements and commitment to their stakeholders, as well as to host ESG-related content, such as sustainability reports. Having a well-established and well-managed forum where shareholders and other stakeholders can expect to see this type of content is particularly

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valuable when a corporate controversy or an activist challenge arises, because the company can use it to tell its side of the story to stakeholders. In contrast, in the context of a sale or merger, instead of making public statements, companies generally issue private communications to employees, key suppliers, and customers to reiterate their commitment to "business as usual" in the transition period.

- **Annual and periodic reports.** Due to the legal liability associated with information disclosed in an SEC filing, most US public companies tend not to include extensive ESG discussions in their reports on Form 10-K or 10-Q. However, depending on the industry and the circumstances, many US public companies currently include more fulsome risk factors outlining the interconnections between the well-being of key non-shareholder stakeholders and the company's financial performance or the success of post-M&A business integration.
- **Proxy statements.** US public companies must distribute proxy materials that provide sufficient disclosure on matters to be addressed at a shareholder meeting (for example, director elections, shareholder proposals, or a proposed sale of all or substantially all of a company) so shareholders are able to vote in an informed manner. While disclosure on corporate purpose is not necessarily required, many US public companies currently highlight their ESG oversight frameworks or recent ESG achievements in their proxy statements, including ESG expertise represented on the board or executive team.
- **Social media.** Social media is a powerful tool for communicating with stakeholders, including on ESG issues. Given the unique challenges of this tool, the Company's social media team must understand the audiences on the various platforms, avoid content that is susceptible to misunderstanding, and remedy misunderstandings that arise. As with SEC filings and press releases, the Board should make sure that the Company has adequate internal controls over social media posts.
- **Advertising.** A company should carefully consider whether and how to use advertising to comment on its purpose. Many US companies have faced backlash from stakeholders as a result of advertising campaigns involving polarizing social or political issues, which in some cases have harmed the company's market performance and operations.

6. LEGAL DEVELOPMENTS

The Board should continue to monitor legal developments at the state and federal levels, especially developments that may impact the shareholder primacy principle under Delaware law or permit Delaware directors to consider non-shareholder constituencies in a sale context. Aside from the Accountable Capitalism Act and similar legislative efforts at the federal level, recent Delaware case law and commentary may signal shifts in Delaware judges' views on corporate responsibility to stakeholder constituents.

In recent years, Leo E. Strine Jr., the influential former Chief Justice of the Delaware Supreme Court, has publicly called for reform of the fiduciary duties of institutional shareholders that manage the income of "human investors," suggesting that these investors' interests as company employees make factors beyond corporate profits relevant. Relatedly, he has criticized activist hedge funds for their short-termism and its detrimental impact on human investors. (See Strine Jr., Leo E., Toward Fair and Sustainable Capitalism: A Comprehensive Proposal to Help American Workers, Restore Fair Gainsharing between Employees and Shareholders, and Increase American Competitiveness by Reorienting Our Corporate Governance System Toward Sustainable Long-Term Growth and Encouraging Investments in America's Future (Oct. 3, 2019), available at *papers.ssrn.com*.) Recent Delaware decisions reiterating the importance of long-term value creation over short-term economic gains (see *In re Rural Metro Corp.*, 88 A.3d 54, 80–81 (Del. Ch. 2014); *In re Trados*, 73 A.3d at 37) may also signal that directors of Delaware companies should consider non-shareholder stakeholders as part of the exercise of their fiduciary duties.

The undercurrent for many of these developments is a concern that US corporations no longer serve the societal purpose of generating a profit while gainsharing with their shareholders, employees, and other stakeholders. By remaining attentive to the concerns of its shareholders, customers, employees, suppliers, local communities, and other key constituencies, a company can build up goodwill while improving its ability to respond to legal developments in this area.

I look forward to discussing these issues at your convenience.

F.J.A.

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