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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