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The Duty of US Company Directors to Consider Relevant ESG Factors

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The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and, ultimately, of the environment and society as a whole.

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The Duty of US Company Directors to Consider Relevant ESG Factors

Introduction

There has been substantial discussion in recent years as to the extent to which directors of United States corporations must or should take into account environmental, social, and governance ("ESG") factors when making decisions.[1] This discussion subsists within a broader debate about whether maximization of stockholder value must be the sole objective of the corporation,[2] or whether directors could instead properly have other goals for the corporation, as well as whether directors (at least directors of solvent corporations)[3] must consider solely the interests of stockholders[4] or whether directors may also take into account the interests of non-stockholder constituencies, such as current and former employees, creditors, suppliers, and communities in which the corporation does business. Proponents of a duty of directors to consider ESG factors sometimes elide these questions by simply assuming that attention to ESG factors will inevitably increase long-term firm value for the benefit of stockholders.[5] In circumstances where attention to a specific ESG factor, or set of ESG factors, is manifestly in the long-term financial interests of stockholders, there is no question that the directors should take it into account. But, in some cases, the financial interests of stockholders in a given corporation, measured solely by the value of their investment in that corporation, may be at odds with broader societal goals,[6] and, indeed, with the overall long-term financial interests of those stockholders.[7]

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[1] *See, e.g.*, 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*, Research Paper No. 15-08 (University of Pennsylvania Law School Institute for Law and Economics, 2015) (arguing that it is "not only hollow but also injurious to social welfare to declare that directors can and should do the right thing by promoting interests other than stockholder interests" and that in order to make corporations socially responsible this must be done through external regulation.); *cf.* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U.L. Rev. 733, 763-769 (2005) (arguing that Delaware law gives corporate managers considerable explicit and implicit discretion to sacrifice profits in the public interest).

[2] *See, e.g.*, A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049 (1931) (directors must exercise corporate powers solely for the benefit of stockholders), A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 Harv. L. Rev 1365 (1932) (directors manage the corporation as trustees of the shareholders); *cf.* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 Harv. L. Rev. 1145 (1932) (law and public opinion may compel or approve of corporations recognizing responsibilities to persons other than their shareholders).

[3] In Delaware, creditors of an insolvent corporation have standing to bring derivative claims for directors' breach of fiduciary duties to the corporation. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla,* 930 A.2d at 103 (Del. 2007).

[4] The view that directors of corporations must consider solely the interests of shareholders, as residual claimants of the assets of the corporation, is known as shareholder primacy. The origins of shareholder primacy are often traced back to *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919) ("it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others, and no one will contend that if the avowed purpose of the defendant directors was to sacrifice the interests of shareholders it would not be the duty of the courts to interfere."); *but see* Lynn A. Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (2012). Although shareholder primacy is sometimes conflated with the idea that the sole duty of directors is to maximize value, this fails to acknowledge that shareholders may have interests that are not purely financial. For example, shareholders have an interest in preserving the environment that is not, strictly speaking, financial. Nevertheless, in June 2020, the U.S. Department of Labor proposed regulations that would prohibit ERISA plan fiduciaries from investing ESG vehicles that have a strategy of subordinating investment returns to achieve non-pecuniary objectives. Release No. 20-997-NAT, 85 FR 38113 (June 23, 2020). Such regulations, if adopted, would not affect the fiduciary duties of corporate directors.

[5] *See, e.g.*, "*Business Roundtable Redefined the Purpose of a Corporation to Promote 'An Economy That Serves All Americans"; Updated Statement Moves Away from Shareholder Primacy, Includes Commitment to All Stakeholders*" (Aug. 19, 2019) (quotation from Jamie Dimon, Chief Executive Officer of J.P. Morgan: "Major employers are investing in their workers and communities because they know it is the only way to be successful over the long term."); "*A Fundamental Reshaping of Finance: Larry Fink's 2020 Letter to CEOs*" ("Each company's prospects for growth are inextricable from its ability to operate sustainably and serve its full set of stakeholders.")

[6] This problem is compounded by the fact that most shareholders of both publicly traded and private equity-sponsored US corporations are in fact intermediaries, making the collective interests of the ultimate beneficiaries of ownership of shares, to some degree, unknowable. *See, e.g.*, Leo E. Strine, Jr., "*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*", Research Paper No. 19-39 (University of Pennsylvania Law School Institute for Law and Economics, 2019).

[7] The ultimate beneficiaries of investments in corporations often have diversified portfolios (e.g., though investment in index funds) which make each of their overall interests – financial and otherwise – potentially at odds with their interests in relation to any given corporation. *Id.*

In examining whether and to what extent US directors have a duty to consider ESG factors, it is necessary to consider the purposes for which corporations are formed and the role of directors in managing corporations, the possible sources of a duty to consider ESG factors, and the question of to whom directors owe fiduciary duties.

Most US corporations are incorporated under state law. This memorandum focuses on the law of the State of Delaware, where more publicly traded US corporations are incorporated than in any other state, and where many portfolio companies of private equity sponsors are incorporated. Readers are cautioned that standards for legal review of director conduct may differ in states other than Delaware. Moreover, many portfolio companies of private equity sponsors are organized not as corporations, but as limited liability companies, which have governance arrangements defined largely by contract. The governing agreements of limited liability companies can, and often do, contain provisions modifying or largely eliminating the fiduciary duties of members of their governing bodies. While this memorandum does not address the duties of members of the governing bodies of such alternative entities, it should be noted that to the extent such members are absolved of fiduciary duties, they are free to consider, or not consider, ESG matters without risk of liability to investors.[8]

The Purpose of the Corporation

Corporations may be incorporated under Delaware law "to conduct or promote any lawful business or purposes."[9] The Delaware statute further provides: "The business and affairs of every corporation … shall be managed by or under the direction of a board of directors".[10] Thus, the law imposes at least one limitation on the corporation's pursuit of value maximization: directors have an obligation to manage or direct the management of the corporation such that its business is *lawful*, whether or not that maximizes firm value for the benefit of stockholders.[11] Delaware case law recognizes this obligation as a *Caremark* duty – named for the Delaware Court of Chancery case enunciating it – requiring directors to use good faith efforts to implement legal compliance and monitoring systems.[12] While the existence of such a duty does not, of course, answer the question of how directors ought to think about ESG factors that have not been reduced to legal obligation, it is worth remembering that some ESG topics – such as environmental compliance, worker safety, anti-bribery laws, and supply chain integrity – are at least in part addressed legislatively. In cases where such legal obligations arise, directors should ensure that compliance and monitoring systems are in place.

Corporations can be organized for purposes beyond the pursuit of profit. Many states (including Delaware) allow formation of benefit corporations ("B corporations"). B corporations are for-profit companies that are expressly formed "to produce a public benefit … and to operate in a responsible and sustainable manner".[13] "Public benefit" is defined as a positive effect on persons, entities, communities or interests other than stockholders, including artistic, cultural, environmental, and scientific interests.[14] Directors of B corporations are meant to balance the

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[8] For a fuller discussion on this subject, including alternative approaches to the law, see Ahern, Deirdre M., *Nominee Directors' Duty to Promote the Success of the Company: Commercial Pragmatism and Legal Orthodoxy* (127 Law Quarterly Review, 118-146 (2011)).

[9] Del. Gen. Corp. L . § 101(b).

[10] Del. Gen. Corp. L . § 141(a).

[11] *Cf.* 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*", Research Paper No. 15-08 (University of Pennsylvania Law School Institute for Law and Economics, 2015) ("Even if §101(b) of the DGCL, which allows a corporation to pursue `any lawful purpose,' represented an expression of Delaware's commitment to a constituency-based approach, the provision does not exist in a vacuum, and the contention that it proves directors are free to promote interests other than those of the stockholders ignores the many ways in which the DGCL focuses corporate managers on stockholder welfare by allocating power only to a single constituency, the stockholders."). Strine has proposed to modify this state of affairs through the creation of incentives for companies and investors to emphasize the interests of workers. *Toward Fair and Sustainable Capitalism*, *supra* note 6.

[12] *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996). Cases holding directors liable for breaching their *Caremark* duty are rare, and *Caremark* has been called "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *Stone v. Ritter*, 911 A.2d 362, 372 (Del. 2006); see also *Marchand v. Barnhill,* 212 A.3d 805 (Del. 2019); *In re Clovis Oncology, Inc. Deriv. Litig.*, C.A. No. 2017-0222-JRS (Del. Ch. Oct. 1, 2019); *Hughes v. Hu*, C.A. No. 2019-0112-JTL (Del. Ch. Apr. 27, 2020).

[13] Del. Gen. Corp. L . § 362(a).

[14] Del. Gen. Corp. L . § 362(b).

pecuniary interests of the stockholders, the best interests of those affected by the corporation's conduct, and the specific public benefits identified in the corporation's charter.[15]

Let us now consider whether, putting aside the general obligation to comply with law and the possibility of altering corporate purpose through the use of a B corporation, the extent to which general fiduciary duties of directors may obligate directors to take ESG factors into account when making decisions.

Fiduciary Duties of Directors

Directors of Delaware corporations – including corporations that are portfolio companies of private equity sponsors – have two principal duties: a duty of care and a duty of loyalty.[16] Even though boards make decisions on a collective basis, the fiduciary duties of directors are evaluated by courts on an individual, director-by-director, basis.[17] This is necessitated by the fact that many factors relevant to evaluation of whether directors have complied with their fiduciary duties depend on the subjective beliefs and individual circumstances of each director, as described below.

The duty of care

The fiduciary duty of care requires directors to act on an informed basis, which, according to Delaware case law, means they must "consider all material information reasonably available" to them in making decisions.[18] The term "material" is used in this context "to mean relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decision making."[19] The directors' duty of care will not be violated unless their actions are determined to be at least "grossly negligent."[20]

To the extent that ESG factors present risks or opportunities that are material to the corporation, directors have an obligation to take them into account when making decisions. The corollary to this proposition, however, is that directors do not have a fiduciary duty to consider ESG factors that are not material to the corporation, even if they may be plainly material to society more broadly. Directors have substantial latitude in determining what they consider to be material to the corporation. In particular, directors are free to select any time horizon for the achievement of corporate goals.[21] A director could decide, for example, that the long-term implications of climate change posed a threat to the corporation that justified action, even if the director perceived no immediate threat to the corporation. But a director could also reach the opposite conclusion, if he or she, acting in good faith, considered the risk remote in likelihood or time, or believed that actions by the corporation to combat the risk were unlikely to have a material effect on the effects of that risk on the corporation.

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[15] Del. Gen. Corp. L . § 365(a). This balancing requirement on its face presents a serious challenge as to how directors are to weigh competing stakeholder interests. The statute addresses this in three ways. First, directors affirmatively have no duty to any person in relation to such person's interest in any public benefit identified in the B corporation's charter. Second, the certificate of incorporation of a B corporation can provide that disinterested failure of directors to satisfy this standard does not constitute a breach of duty of care or loyalty. Finally, the statute makes clear that a director's decision implicating the balancing of stakeholder interests will be deemed to satisfy a director's fiduciary duties as if the decision is both informed and disinterested and not such that no person of ordinary, sound judgment would approve. Del. Gen. Corp. L . §§ 365(b) and (c).

[16] *See, e.g.*, *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

[17] *See, e.g.*, *In re Cornerstone Therapeutics Inc. S'holder Litig.*, 115 A.3d 1173, 1182 (Del. 2015).

[18] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). *Cf.* the American Law Institute's *Principles of Corporate Governance*, which requires that a director be "informed … to the extent the director reasonably believes to be appropriate under the circumstances." ALI Principles, §4.01(c)(2).

[19] *Brehm v. Eisner*, 746 A.2d 244, 260 n.49 (Del. 2000).

[20] *See, e.g.*, *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985), quoting *Aronson*, 473 A.2d 805, 812 ("under the business judgment rule director liability is predicated upon concepts of gross negligence"). In *In re The Walt Disney Co. Deriv. Litig.*, the court stated that in the duty-of-care context, gross negligence means "reckless indifference to or a deliberate disregard of the whole body of stockholders' interests or actions which are without the bounds of reason." 907 A.2d 693, 750 & n.429 (Del. Ch. Apr. 28, 2005) (quoting *Tomczak v. Morton Thiokol, Inc.*, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990)).

[21] *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1989). The default for directors, however, is to consider the long-term interests of stockholders. *See, e.g.*, *The Frederick Hsu Living Trust v. ODN Holding Corp.*, C.A. No. 12108-VCL, 2017 WL 1437308 at *18 (Del. Ch. Apr. 14, 2017, *corrected* Apr. 24, 2017) ("the fiduciary relationship requires that the directors act prudently, loyally, and in good faith to maximize the value of the corporation over the long-term for the benefit of the providers of presumptively permanent equity capital, as warranted for an entity with a presumptively perpetual life in which the residual claimants have locked in their investment.").

This, in turn, raises the question of how directors are to determine whether ESG factors represent material risks or opportunities. Do they have a duty of inquiry? In practice, directors typically rely on the corporation's management to identify risks and opportunities for the board's consideration. In connection with the informational component of the duty of care, a director in the performance of his or her duties is "fully protected in relying in good faith upon … information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other persons as to matters [the director] reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation."[22] Nevertheless, directors may not consciously disregard a known material risk.[23]

The duty of loyalty

The fiduciary duty of loyalty requires directors, in making business decisions, not to have a material self-interest that differs from those of the corporation and its stockholders, or to lack independence in the decision, and to act in good faith.[24]

A disabling self-interest exists if a director personally receives a benefit (or suffers a detriment) as a result of a decision that is not generally shared by the stockholders of the corporation and that is of such subjective material significance to that particular director that it is reasonable to question whether the director objectively considered the advisability of the challenged action.[25] Second, a director is "interested" if the director stands on both sides of the challenged transaction. In this latter situation, a showing of materiality is not required.

On the separate question of "independence," according to the Delaware Supreme Court, "independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."[26] Such extraneous considerations or influences may exist when the challenged director is controlled by another.

In most instances, a directors' consideration of ESG factors – even ones that do not obviously translate into increased stockholder value – will not implicate the duty of loyalty because the director is unlikely to have a disabling conflict of interests or lack independence relative to the decision at hand. To present potential liability to the director for breach of the duty of loyalty in the absence of a conflict or lack of independence, the decision would need to have been made in bad faith – that is, an "intentional dereliction of duty, a conscious disregard for one's responsibilities".[27] As a practical matter, this high bar to liability means that that there is a high bar to a stockholder seeking to impose liability on a director for failing to take into account ESG factors. Conversely, directors have broad latitude to take into account ESG factors in making decisions without risking a finding that they breached their duty of loyalty.

The business judgment rule

The business judgment rule is a judicial presumption that directors act in good faith, on an informed basis, and in the honest belief that the action taken was in the best interests of the corporation – in sum, a presumption that directors comply with their fiduciary duties of care and loyalty.[28] As a corollary, the business judgment rule means that directors' decisions will not be second-guessed by the courts, and directors will not be liable for their decisions, if the decisions are made in good faith by disinterested and independent directors acting on an informed

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[22] Del. Gen. Corp. L. § 141(e).

[23] *See infra* note 39.

[24] *Orman v. Cullman*, 794 A.2d 5, 22 and n.55 (Del. Ch. 2002) (a director is interested where that director "continues to receive a benefit financial or otherwise, upon which the director is so dependent or is of such subject material importance to him that the threatened loss of that benefit might create a reason to question whether the director is able to consider the corporate merits of the challenged transaction objectively.")

[25] *Id*.

[26] *Aronson*, 473 A.2d 805, 816 (Del. 1984); *In re The Limited, Inc. S'holders Litig.*, C.A. No. 17148-NC, 2002 Del. Ch. LEXIS 28, at *15 (Del. Ch. March 27, 2002).

[27] *Disney*, 907 A.2d 693, 755 (Del. Ch. Apr. 28, 2005).

[28] *Aronson*, 473 A.2d 805, 812 (Del. 1984).

basis.[29] The outer limit of business judgment rule is *irrationality* – that is, a decision that cannot be attributed to "any rational business purpose".[30]

Beneficiaries of Fiduciary Duties

Fiduciary duties of directors of Delaware corporations are owed to the stockholders and to the corporation itself.[31] Does this mean that directors are forbidden from considering the interests of non-stockholder constituencies? Delaware case law provides some basis for concluding that directors may consider the interests of non-stockholder constituencies, with two important caveats.[32] First, those interests must be "rationally related" to benefits to stockholders.[33] Second, in the case of a sale of control or breakup of the corporation, directors are obligated to seek the best price reasonably available for stockholders.[34]

The "rationally related" requirement limits the extent to which Delaware directors can take into account non-stockholder interests when those interests are at odds with stockholder interests. In most instances, however, directors will not find it difficult to articulate a benefit to stockholders rationally related to the director's focus on ESG matters. At a minimum, corporations have a reputational interest in being viewed as responsible actors.

A majority of states – excluding Delaware – have adopted "constituency statutes" expressly authorizing directors to consider the interests of stakeholders other than stockholders.[35] These states provide broader latitude for directors to consider non-stockholder interests because they do not impose the Delaware requirement that those interests be rationally related to stockholder interests. However, even in states with constituency statutes, directors do not have a *duty* to consider non-stockholder interests. All of these statutes are permissive, not mandatory: they permit, but do not require, directors to consider the interests of non-stockholder constituencies.[36] And they do not confer any fiduciary duties in favor of non-stockholder constituencies.[37]

Enforcement of Fiduciary Duties

As noted above, directors of US corporations are obligated, rather than permitted, to take into account ESG factors in two circumstances: when ESG factors implicate material legal compliance issues for the corporation, or when they present material risks or opportunities to the corporation. Even in these circumstances, however, there are meaningful obstacles to the ability of stockholders to hold directors liable for failure to observe such a duty, even assuming that a claimant could prove that the corporation was damaged by the breach.

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[29] *Orman*, 794 A.2d 5, 19-20 (Del.Ch.2002).

[30] *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

[31] State law, in this respect and others, is not a monolith. While some states (including Delaware) provide that directors' duties are owed to the corporation and its stockholders, others (such as Maryland) provide that directors owe duties solely to the corporation.

[32] *Unocal v. Mesa Petroleum Co.* , 493 A.2d 946 (Del. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *TW Services, Inc. v. SWT Acquisition Corp.*, 700 F. Supp. 1323 (D. Del. 1988).

[33] *Revlon,* 506 A.2d 173, 182-83 (Del. 1986).

[34] *Id.*

[35] *See, e.g.*, Ohio G.C.L. 1701.59:

> a director, in determining what the director reasonably believes to be in the best interests of the corporation, shall consider the interests of the corporation's shareholders and, in the director's discretion, may consider any of the following:
>
> (1) The interests of the corporation's employees, suppliers, creditors, and customers;
>
> (2) The economy of the state and nation;
>
> (3) Community and societal considerations;
>
> (4) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.

[36] Connecticut at one time had a statute *obligating* directors to take into account non-stockholder constituencies. *See* Conn. Gen. Stat. § 33-756 (2009). However, Connecticut amended the statute in 2010 to make it permissive, presumably to avoid the difficult question of how directors are meant to weigh interests of stakeholders when they are in conflict. *See* 2010 Conn. Legis. Serv. P.A. 10-35 (H.B. 5530) (West).

[37] In August 2018, Senator Elizabeth Warren proposed legislation to require federal charters for corporations with more than $1 billion in annual revenue, which would require directors to consider interests of "all major stockholders" in making decisions. *See* Accountable Capitalism Act, 115th Congress (2017-2018), S. 3348. Such a statute, if enacted, would raise the same problem as the earlier Connecticut constituency statute: how are directors to weigh competing interests of stakeholders?

First, Delaware permits a corporation's certificate of incorporation to contain a provision exculpating directors from monetary liability for breach of the duty of care so long as their acts are in good faith.[38] Most Delaware corporations avail themselves of such a provision. As a result, as previously described, a claimant seeking to overcome such an exculpatory provision would need to prove that the director acted in bad faith – that is, that the director consciously disregarded his or her responsibilities.[39] Second, the business judgment rule creates a powerful presumption that directors comply with their fiduciary duties, putting the burden of proof on any potential claimant. Third, any claim based on a breach of the duty of care would be derivative in nature, meaning that, assuming that the directors were independent and disinterested, the board of the corporation could decide not to pursue the claim. Finally, to the extent the claim bears on the corporation's legal compliance, Delaware case law requires only that directors make good-faith efforts to implement reporting and compliance systems; courts do not judge the effectiveness of those systems.[40] As previously noted, cases finding liability under *Caremark* are exceedingly rare.[41]

Irrespective of legal obstacles, fiduciary duty claims are unlikely to be brought against private equity portfolio company directors for the simple reason that private equity sponsors, together with management, typically control the board of directors and are the only beneficiaries of those duties; unless the company also has other stockholders, there is no one to bring such claims.

Conclusion

The fiduciary duties of directors of US corporations require directors to take into account ESG factors when they bear on material legal compliance issues or when making decisions when those factors are directly material to the corporation. They permit directors to take into account those factors as long as they are rationally related to stockholder interests. Directors have broad latitude in deciding whether ESG factors are in fact material to the corporation, and they do not face a meaningful risk of liability for breach of fiduciary duty based on their decisions as to the extent to which they will take them into account.

38 Del. Gen. Corp. L. § 102(b)(7).

39 *Disney*, 907 A.2d 693, 755 (Del. Ch. Apr. 28, 2005).

40 *See In re Gen. Motors Co. Deriv. Litig.*, 2015 WL 3958724 (Del. Ch. June 26, 2015); *Marchand*, 212 A.3d 805, 821 (Del. 2019).

41 *See supra* note 12.