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Environmental, Social & Governance And The Duty Of Oversight: A Trojan Horse Attack On The Business Judgment Rule

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A TROJAN HORSE ATTACK ON THE BUSINESS JUDGMENT RULE

Over the past decade, businesses and investors have widely incorporated environmental, social, and governance ("ESG") considerations into their decision making process. At the same time, corporate law continues to evolve such that some have advocated that not only do Boards of Directors have an affirmative obligation to factor ESG considerations into their decision making process, but they also have an explicit duty of oversight to implement internal reporting and control systems related to ESG risks. In this view, the duty of oversight would be fully extended from its classic formulation of director oversight of legal compliance to the more nebulous concept of oversight of business risks. Such a result, however, could expose directors to expanded personal liability, have serious, deleterious consequences for how Boards function and, ultimately, how companies perform.

If a duty of oversight over ESG risks is found for directors of corporations, the still amorphous nature of ESG and the challenges inherent in deciding whether, in retrospect, Boards were adequately overseeing ESG risks would combine to undermine the business judgment rule. Boards weary of litigation risk will end up devoting more time to documenting compliance with ESG principles, and in so doing would likely impair the entrepreneurial principles foundational to modern corporate law. Meanwhile, the role of ESG in the decision making of fiduciaries has become front and center in our political debate, as evidenced by President Biden recently using his veto pen for the first time on the subject, and as a result Boards may prefer to avoid the issue altogether—but would be precluded from doing so if they owed a duty to oversee ESG risks. Accordingly, instead of extending the duty of oversight to encompass business risks associated with ESG, the more proper course—and one consistent with well-settled principles of corporate law—is to ground the decision to adopt ESG strategies and to manage ESG risks firmly within the rubric of the business judgment rule, and not the duty of oversight.[1]

The Current State of ESG and the Duty of Oversight

To understand the challenges Boards would face if confronted with an explicit fiduciary duty to oversee ESG risks, one needs to understand both the current state of ESG and the duty of oversight.

<u>The Different Varieties of ESG in Corporate Governance</u>

Despite over a decade of robust debate, what ESG means and how it fits within the established corporate decision making process and existing fiduciary duties remains unsettled.

The term ESG can mean different things to different people. For some, ESG reflects a set of values, including achieving climate or societal goals, that companies and executives can and should incorporate into their business decisions. For others, ESG is a tool for making strategic decisions, whether that includes identifying opportunities or risks for the enterprise. For a third, more skeptical group, ESG is an effort to accomplish through businesses progressive political goals that have not been achieved through the democratic process. The second school of thought has grown in prominence, and likely dominates, within corporate governance circles and within many board rooms today.

How ESG should be implemented by corporate fiduciaries is the subject of greater debate. Here, advocates in favor of ESG can fall within a spectrum, ranging from a view that Boards must consider ESG matters and do so coextensive with stockholder interests, to a view that Boards have discretion as to whether they incorporate ESG into their decision making process. Within this last group are advocates who believe that Boards should not incorporate ESG considerations at all, and focus instead solely on financial results.

First, one group has advocated that Boards must consider stakeholder interests, and that Boards can consider stakeholder interests coextensive with stockholder interests. This form of "Strong ESG" is inconsistent with the model of stockholder governance that has been the dominant model of corporate law in the United States for over a century, which has held that Boards owe their duties to maximize the value of the organization solely for the benefit of stockholders. Instead, business leaders would "share a fundamental commitment to all of our stakeholders,"[2] where "[t]he purpose of a company is to engage all its stakeholders in shared and sustained value creation."[3] As a result, some in the corporate governance sphere have advocated that ESG considerations related to "long-term sustainability and value-creation . . . **must be considered and balanced** (along with and against all other factors and policies, practices, and risks that are material) by companies and boards."[4] Under this model, if there were a tie between stakeholder and stockholder interests, a Board would be free to break the tie in favor of the stakeholders if the Board believed that was in the best interests of the corporation.

Second, others have argued that Boards must consider ESG factors in their decision making process, but Boards must still place stockholder interests above stakeholder interests. This form of "Semi-Strong ESG" accepts the more traditional model of stockholder primacy rejected by the advocates for Strong ESG. In this model, ESG factors are used to assess enterprise risk and opportunities, but furthering stakeholder interests must ultimately be for the benefit of stockholders. For Semi-Strong ESG, the tie between stakeholders and stockholders must go to the stockholders.

Third, the last group argues that Boards have absolute discretion to determine which ESG considerations to factor into their deliberations, subject to compliance with legal requirements. This form of "Weak ESG" recognizes that "[t]he fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals,"[5] and that some corporate goals may be on truncated time horizons inconsistent with long-term ESG considerations. Indeed, many investors are not focused on the long-term horizon that achievement of certain ESG goals may entail. Under Weak ESG, the Board can decide that there is no tie between stakeholders and stockholders because the Board can determine that ESG factors are not even relevant to the decision at hand.

Different state corporate laws may compel different results for how Boards implement the above framework of ESG decision making. For example, the default rule governing for-profit organizations in Delaware is that Boards must act solely on behalf of stockholder interests, and that stakeholder interests could be considered only in furtherance of stockholder interests.[6] This view could be compatible with

Weak ESG or, in certain circumstances, Semi-Strong ESG.

On the other hand, approximately thirty-two states have adopted "constituency statutes" requiring or permitting directors to consider various stakeholder interests in their decision making process, including, among others, jurisdictions where significant public companies are incorporated such as Nevada and Pennsylvania.[7] Delaware also has adopted a version of a constituency statute, [8] Del. C. § 361, *et seq.*, that allows the creation of a "public benefit corporation" with the purpose of having a "positive effect" on a variety of communities or interests, including artistic, environmental, or scientific interests.[8] These state provisions would conform to Strong ESG in that under these statutes Boards can favor the interests of other stakeholders, including society at large, in their decision making process even if such a decision will not ultimately benefit the stockholders.

While there remains continued debate about how directors should incorporate ESG into their decision making process, the above debate begs another question that has of late garnered increased focus within the corporate governance community: are directors obligated as part of their duties to monitor business risks related to ESG, even when a Board is not confronted with a specific business decision to which the above framework would apply? Before answering that question, it is necessary to review the history of and recent developments for the duty of oversight. In short, the duty of oversight has historically focused on the duty of a Board to monitor for potential legal violations, though in recent years there has been discussion about expanding the duty to oversight to encompass business risks such as ESG.

<u>The Uncertain Status of the Duty to Oversee Business Risks</u>

For decades, Delaware courts have recognized that Boards have a fiduciary duty of oversight, which is a specific application of the duty of loyalty's requirement to act in good faith. The duty of oversight has been often tested when directors allegedly failed to prevent the corporation from violating the law. Recently, Delaware courts have begun grappling with the question of whether directors also owe an explicit duty to oversee business risk to avoid losses to the corporation that might be foreseeable.

The Court of Chancery framed the duty of oversight in the seminal decision *In re Caremark International Inc. Derivative Litigation.*[9] There, Chancellor Allen explained that a Board's duty of oversight was not simply reactive, but required the Board to make a good-faith effort to assure that:

a corporation information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.[10]

Chancellor Allen explained that directors could be liable for a breach of their duty of oversight only where "a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."[11] Pointedly, oversight liability pursuant to *Caremark* is premised on unconsidered action by the Board, and thus is not based on a Board decision that would be protected by the business judgment rule.[12]

A decade later, the Supreme Court of Delaware affirmed *Caremark*, holding that to plead and prove a failure of oversight a plaintiff must establish either: (a) directors "utterly failed to implement any reporting or information system or controls"; or (b) "having implemented such a system of controls, [the director] consciously failed to monitor or oversee its operations," thus ignoring the risks or problems requiring their attention.[13] And recently in *Marchand v. Barnhill*, the Supreme Court of Delaware emphasized the first part of the *Stone* test, faulting directors who allegedly failed to "make a good faith effort to put in place a reasonable system of monitoring and reporting about the corporation's central [i.e., mission critical] compliance risks."[14]

More recently, in *In re Boeing Co. Derivative Litigation*, a case brought in the aftermath of two passenger plane crashes, the Court of Chancery found plaintiffs sufficiently pled that Boeing's board of directors had failed in its duty of oversight by, among other things, having no committee charged with direct responsibility to monitor airplane safety, and failing to monitor, discuss, or address airplane safety on a regular basis.[15] The Court also found that *ad hoc* reports, mostly focusing on curated positive feedback, were insufficient to support a pleading stage inference that the Board acted in good faith to implement a reporting system about a mission-critical risk.[16] The *Boeing* decision was significant, as the Boeing Board made at least some efforts to improve airplane safety. And yet, the Court found that those efforts were insufficient to obtain a pleading stage dismissal. Following *Boeing*, Boards had more reason to be concerned that their oversight efforts for at least mission critical risks may be deemed unreasonable or insufficient in the aftermath of a major disaster or significant loss to the corporation.

Most recently, in late 2022, the Court of Chancery considered in *Construction Industry Laborers Pension Fund v. Bingle* whether "oversight liability may be established . . . in the absence of" a violation of established law, such as legislation, code, or regulation.[17] The plaintiffs in *Bingle* asked the Court "to find that oversight liability may attach to the Company's alleged failure to sufficiently oversee risks related to efforts to avoid cybercrime by third parties—that is, business risk."[18] Although it did not squarely answer the question, the Court noted that "it is possible . . . to envision an extreme hypothetical involving liability for bad faith actions of directors leading to such [oversight] liability" for a failure to monitor business risk.[19]

To avoid liability for a failure of oversight, Boards have in the past adopted a number of onerous processes to demonstrate their compliance with the duty to oversee legal compliance. Should there be an equal duty to monitor ESG risks, one would expect Boards to employ similar procedures, though covering far more varied conduct given the breadth of ESG risks an organization may face. First, Boards and management would need to identify the critical ESG risks for the organization, which will change over time. Second, Boards would ensure that mechanisms exist to channel reports about those ESG risks from within the organization to the Board or a Board-level committee. Third, a Board or a committee would monitor those reporting channels, including being alerted to warning flags about a potential ESG risk, receiving management reports about the ESG risks, and, in some cases, engaging outside counsel and other advisors to investigate and make recommendations to address any reported risk.

The Dangers of Requiring a Duty to Oversee ESG Risks

With the differing views as to Boards' obligation to implement ESG principles and the recent evolution of the law of the duty of oversight, it is not surprising that some—especially in the Strong ESG camp—have argued that Boards' duty of oversight should encompass the duty to oversee ESG risks. For example, a global law firm has expressly advised that the "[i]ntegration of ESG risks and potential issues into the board's oversight of risk and compliance programming . . . benefits the company from the perspective of good governance as well as a potential reduction in liability should one of those risks become reality."[20] Other firms have likewise warned Boards of their duty to oversee ESG risks.[21] We caution, however, that extending the duty of oversight in this way would be a mistake that likely would have unintended consequences. Among other things, such an extension would undermine the precepts giving rise to the business judgment rule, would create new and significant challenges for Boards, and would challenge well-established law on fiduciary duties applicable to directors.

Extending the duty of oversight to encompass ESG risks unrelated to legal compliance is likely to subvert the substantial benefits of the business judgment rule. The business judgment rule has evolved as part of long standing common law in many jurisdictions, such as Delaware, and has been codified into law in many jurisdictions, such as California, Nevada, and Pennsylvania.[22] The business judgment rule is grounded in the broad discretion Boards have to manage the business and affairs of the corporation.[23] To protect that discretion, the rule "creates a presumption that in making a business decision, the directors of a corporation acted on an informed basis [i.e., with due care], in good faith and in the honest belief that the action taken was in the best interest of the company."[24] If a plaintiff fails to overcome that presumption, "the business judgment rule, as a substantive rule of law, will attach to protect the directors and the decisions they make."[25] The business judgment rule thus promotes entrepreneurial decision making by Boards, even when the decision turned out, in hindsight, to be wrong.[26] However, unless a court were to read the rule into a claim that directors failed to oversee business risk, the business judgment rule would likely not apply to such a claim because a failure of the duty of oversight is based on unconsidered Board action.[27]

Moreover, courts will be challenged in clearly delineating between a wrong business decision protected by the business judgment rule and a failure to monitor for or address ESG risks. The absence of monitoring for risk can just as equally reflect a decision, whether or not documented, to discount that risk. And looking back with hindsight, especially toward a black swan event that causes a massive corporate loss, the discount of an ESG risk could appear wrong. If the business judgment rule applied to that decision, it is unlikely that directors would face liability, whereas a claim for a failure to oversee constantly evolving ESG risks would be more likely to proceed. It is in this ambiguity that creating a duty to oversee the variety of ESG risks which would make Board service even more perilous because, "[t]o the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions."[28] A duty to oversee ESG risks thus threatens the protection that has long been afforded directors by, and undermines the principles of, the business judgment rule.

Boards weary of litigation would have good reason to be concerned if they owed a duty to oversee ESG risks beyond compliance with law. Similar to *Boeing*, should a particularly pernicious risk materialize resulting in significant corporate loss, a Board could face a claim that it did not do enough to oversee a material risk that came to fruition. As a result, Boards would need to dedicate more of their limited time to monitoring the panoply of ESG risks, receiving reports from management and consultants on those risks, and documenting those discussions. Directors serving on Boards, however, are already taxed with fulfilling their existing obligations. The likely result of imposing an affirmative duty to oversee ESG risks would be to divert valuable corporate resources to ESG compliance rather than developing and implementing business strategy. Such a result is the antithesis of directors' entrepreneurial freedom that the business judgment rule is intended to preserve.

Imposing a duty of oversight for ESG risks also creates significant challenges for the legal regime governing directors' fiduciary duties. Courts have noted the difficulty such a task would pose.[29] For many ESG risks, such as those posed by climate change, that difficulty is magnified as the factors that could contribute to an adverse company event could accrue over many years, if not decades. Attempting to assign liability and damages for such an event would strain the equitable principles animating fiduciary law.

In addition, the existence of constituency statues cuts against a duty to oversee ESG risks. Delaware's public benefit corporation statute, for example, provides for deference to directors in how a Board balances the social purpose of the organization as against the interests of stockholders.[30] Imposing an ESG oversight regime on Boards of for-profit enterprises could ironically result in exposing for-profit directors to greater risk of liability than the directors of public benefit corporations, and make it more risky to be a director in a state that does not have a constituency statute applicable to for-profit corporations, such as Delaware, than other states.

As a consequence of the change in Board behavior likely to flow from an express duty to oversee ESG risks, such a duty also could limit investor choice. A duty to oversee ESG risks would require Boards to factor ESG considerations into their decision making process so as to minimize the risk of personal legal liability. Investors may thus be deprived of the opportunity for investing in corporations that eschew ESG principles and would instead pursue value maximizing goals through other, lawful means. Such a result would be inconsistent with the private ordering of stockholder goals that corporate law has traditionally favored.

Last, imposing a duty to oversee ESG risks would thrust companies even more into political crosshairs. Within the United States, there is growing political debate over companies adopting ESG principles. For example, the Congress and the President recently engaged in a tug of war over whether ESG considerations should trump investor returns for pension managers. GOP governors with supposed aspirations of higher office have conducted their own public relations and legislative campaigns against ESG. As the country has become more politically polarized, one can expect the debate over ESG to become more heated. In light of the greater political attention to the role of ESG at corporations, Boards may instead prefer to avoid the controversial issue altogether by focusing solely on maximizing value for stockholders. Imposing a duty to oversee ESG risks beyond compliance with law would deprive Boards of that choice.

Instead of Imposing a Duty to Oversee ESG Risks, Boards Should Retain the Discretion to Adopt or Reject ESG Strategies Pursuant to the Business Judgment Rule

Given the potential for eroding director discretion, Courts should pause before imposing an explicit duty on directors to oversee ESG risks beyond the existing obligation to oversee legal compliance. The better course would be to reaffirm that a Board's consideration of ESG risks (including all matters attendant to that consideration) resides solely within the confines of the business judgment rule, with a Court presuming that a Board's adoption or rejection of a business strategy is made in good faith, with due care, and in furtherance of the interests of stockholders. Doing so will preserve the discretion of directors, and avoid a system that makes one-size fits all ESG mandatory for Boards who may otherwise see no business reason for adopting its precepts.

Footnotes

[1] This article focuses on the Boards of operating companies chartered and listed within the United States, and does not address the obligations of Boards of foreign domiciled companies or of investment funds.

[2] *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans,'* Bus. Roundtable (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

[3] *Davos Manifesto 2020: The Universal Purpose of a Company in the Fourth Industrial Revolution,* World Econ. F. (Dec. 2, 2019), https://www.weforum.org/agenda/2019/12/davos-manifesto-2020-the-universal-purpose-of-a-company-in-the-fourth-industrial-revolution/.

[4] Marty Lipton, *Understanding the Role of ESG and Stakeholder Governance within the Framework of Fiduciary Duties,* Harv. L. Sch. F. on Corp. Governance (Nov. 29, 2022), https://corpgov.law.harvard.edu/2022/11/29/understanding-the-role-of-esg-and-stakeholder-governance-within-the-framework-of-fiduciary-duties/ (emphasis added).

[5] *Paramount Commc'ns, Inc. v. Time Inc.,* 571 A.2d 1140, 1154 (Del. Ch. 1989).

[6] *Allen v. El Paso Pipeline Gp. Co.,* 113 A.3d 167, 180 (Del. Ch. 2014); *see also N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla,* 930 A.2d 92, 1010 (Del. 2007); *eBay Domestic Holdings, Inc. v. Newmark,* 16 A.3d 1, 89 (Del. Ch. 2010); *accord Dodge v. Ford Motor Co.,* 204 Mich. 459, 507-08 (1919).

[7] *See* NRS § 78.138.4-5 and Pa. Bus. Corp. Law § 1715.

[8] 8 Del. C. §§ 361, 362(a) & (b).

[9] 698 A.2d 959 (Del. Ch. 1996).

[10] *Id.* at 970.

[11] *Id.* at 971.

[12] *Id.* at 968-69.

[13] *Stone ex rel. AmSouth Bancorp. v. Ritter,* 911 A.2d 362, 370 (Del. 2006).

[14] 212 A.3d 805, 824 (Del. 2019).

[15] 2021 WL 4059934, at *26, 27 (Del. Ch. Sept. 7, 2021).

[16] *Id.* at *31.

[17] 2022 WL 4102492, at *7 (Del. Ch. Sept. 6, 2022).

[18] *Id.*

[19] *Id.*

[20] Katie LaVoy, *A Board's Guide to Oversight of ESG, Harv. L. Sch. F. on Corp. Governance* (July 22, 2022), https://corpgov.law.harvard.edu/2022/07/22/a-boards-guide-to-oversight-of-esg/.

[21] *See, e.g.,* Marty Lipton, *On the Debate Regarding ESG, Stakeholder Governance, and Corporate Purpose,* Harv. L. Sch. F. on Corp. Governance (Mar. 14, 2023), https://corpgov.law.harvard.edu/2023/03/14/on-the-debate-regarding-esg-stakeholder-governance-and-corporate-purpose/ ("As we have stated, the complex stakeholder issues that companies face today are integral to corporate sustainability, responsible risk management and value creation; indeed, *addressing these risks is consistent with directors' fiduciary duty of care and the board's legal obligation under Caremark to implement and monitor systems to identify material risks and to address risks once identified."* (emphasis added)); Carolyn Frantz et al., *ESG and Regulatory Enforcement Action,* Harv. L. Sch. F. on Corp. Governance (Mar. 19, 2023), https://corpgov.law.harvard.edu/2023/03/19/esg-litigation-and-regulatory-enforcement-action ("Given the increased focus on Caremark-type claims alleging that boards failed to appropriately oversee and manage risks, ***we expect a steady increase in derivative claims alleging board oversight failures where ESG-related risks manifest to the detriment of an issuer."*** (emphasis added)).

[22] *See* Cal. Corp. Code § 309(c); NRS § 78.138.3; Pa. Bus. Corp. Law § 1712(d).

²³ *Citron v. Fairchild Camera & Instr. Corp.,* 569 A.2d 53, 65 (Del. 1989).

[24] *Id.*

[25] *Id.*

[26] *Caremark,* 698 A.2d at 698.

[27] *See, e.g., id.* at 968-69.

[28] *In re Citigroup S'holder Deriv. Litig.,* 964 A. 2d 106, 126 (Del. Ch. 2009).

[29] *Caremark,* 698 A.2d at 970 n.27 (noting the challenges of proving proximate causation).

[30] 8 Del. C. s. 365(b).

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