Board directors' duties and ESG considerations in decision-making

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ACKNOWLEDGMENTS:

WBCSD is delighted to partner with Baker McKenzie, a leading global law firm that places sustainability at the core of its purpose, and is committed to partnering with like-minded organizations and clients to address some of the biggest challenges facing the world.

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1 Introduction

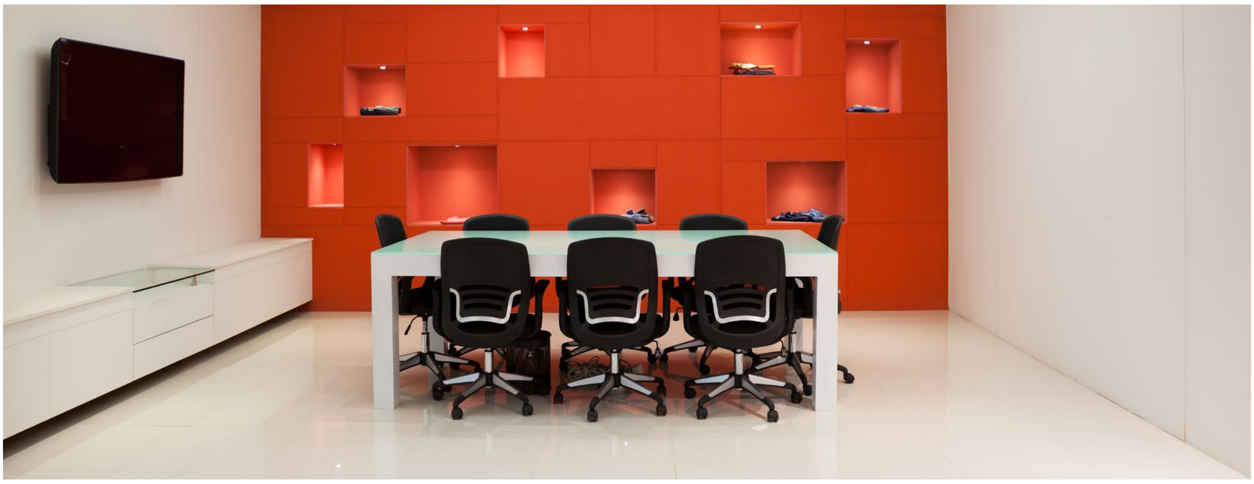
For many leading companies, sustainability and long-term success has been front of mind for many years, for those who are just beginning their journey or not yet engaged in the sustainable development agenda the events of 2020 are likely to shift that mindset.

The COVID-19 pandemic has certainly had an impact on corporates' sustainability agendas. It has shone a light beyond climate change and environmental degradation to other critical matters such as culture, workplace wellbeing, the fragility of supply chains and inequality, especially racial discrimination. The double-headed health and financial crisis has accelerated the growing focus on both the purpose of the corporation and the role of the board in overseeing and leading the corporation in ways that promote sustainable business success.

The push by investors has moved from talking purely of share price and returns to asking about resilience and long-term value creation. Society is forcing companies to focus on the link between values and value. Good stakeholder governance is now an operational and strategic imperative, at the heart of a corporation's ability to compete and succeed in the long term.

In this report, which draws primarily upon perspectives and insights from UK and US legal and regulatory structures, we seek to explain why sustainability matters and why it should be included by boards on their agendas as a matter within their remit. We consider how boards should address sustainability in the context of their company's strategic objectives and business model.

We challenge directors to assess whether they are taking all relevant steps in the boardroom to ensure the company not only properly assesses and mitigates sustainability risks but also understands the opportunities that sustainability considerations can bring to the company. Addressing sustainability is no longer a "nice to have", it is a critical business issue that should be rolled into the broader corporate governance, risk management, disclosure and accountability frameworks of the company. At the heart of good corporate governance is good decision-making, both in the boardroom and across the company. Decisions that do not take account of the voice of key stakeholders and societal concerns could be later proven bad decisions.



② Challenges for directors

So, why does sustainability matter for directors?

As an overarching reason, because directors owe fiduciary and other duties to act in the company's best interests, by implication the company's long-term sustainable success. Some other considerations are because:

1. There is increasing regulation that requires companies and directors to take sustainability issues into account in their business operations, decision-making and reporting, respectively.

2. There is a risk of litigation should directors fall short in the duties they owe the companies they oversee or should the company breach regulation or incorrectly report what it is or isn't doing.[1]

3. There is the risk of damage to reputation if a company falls short of what the public expects, via the court of public opinion (the so-called "clicktivists"),[2] which can be active both externally (for example, potential future employees, customers, suppliers, communities) and internally (the workforce).

4. Important stakeholders, such as customers and employees, are increasingly focused on sustainability issues.

5. Increasingly companies are publicly committing to sustainability via best practice statements and, there is a global effort to standardize the myriad of voluntary reporting frameworks and metrics that currently exist, the expectation being that many of these will become mandatory in the near future (for example, reporting in accordance with the Task Force on Climate-related Financial Disclosure (TCFD) recommendations is likely to become mandatory for premium listed companies in the UK).[3]

3 Fiduciary duties

Turning to fiduciary duties, directors need to be aware of their legal responsibilities as members of the board.

Good corporate governance is all about understanding roles, responsibilities and accountability across the company; it is also about good decision-making. In the words of Lord Cadbury in his report of 1992, "*Governance is the system of rules, procedures and processes by which a company is directed and controlled. Specifically, it is a framework by which various stakeholder interests are balanced and efficiently and professionally managed*".[4] At the heart of directors' responsibilities and what should be their guiding star is the fact that directors are fiduciaries of the company, of its enterprise.

To attempt to describe fiduciary duty concisely and in a way that would be strictly correct regardless of the jurisdiction in which the company is incorporated, is challenging. There are varied descriptions of director duties in the varied laws of the varied jurisdictions in which global business undertakings operate, so arguably one definition of fiduciary duty will not fit each and every director's circumstances.

By looking at civil and Anglo-Saxon laws, respectively, we will try to define the key concepts attaching to fiduciary and other duties that all directors should be conscious of when acting on boards of global companies.

The origins of the duty are different in the Anglo-Saxon world and under the civil law. In the former, the concept arose out of equitable principles and case law whilst in the latter it was developed in civil codes (essentially through contract law). Although the legal concept of "fiduciary duties" is perhaps most clearly established in the common law legal systems (such as Australia, Canada, India the UK and USA), many jurisdictions incorporate, to some degree, analogous concepts into various areas of law. Certain civil law jurisdictions (such as Germany, the Netherlands) codify these duties, in part, because of general obligations to act reasonably, in good faith or with reasonable care; other such jurisdictions (such as Japan, Switzerland) appear to focus more specifically on relationships where one person owes another a duty of care or is entrusted with managing another person's affairs.

French and German laws have developed concepts equivalent to fiduciary duties, arguably, by recognizing a duty of loyalty and fidelity and a duty of care and the contract laws of both countries recognize the concept of good faith, which is imposed on contracting parties in their dealings with each other. French law has recently gone further, with the introduction of the so-called PACTE ("raison d'etre") and the "vigilance" laws.[5]

Applying a broader lens, the behavior is expected of a director under both systems of law is very similar: as between a director and the company, there is a relationship of trust and confidence, a need to act in good faith, where there is a loyalty and fidelity. This in turn implies other duties such as the need to account for any profits, the duty of confidentiality, the need to avoid conflicts of interest and the need to act with a certain duty of care. In all the jurisdictions we have surveyed, there is one clear communality - directors owe their duties to the company, they are required to act in its best interests. They do not owe their duties to shareholders (with the exception of the USA, described in more detail below).

In the UK, director duties evolved through case law and were first codified in the Companies Act of 2006.[6] Briefly, director fiduciary duties in the UK cover the following:

- To promote the success of the company - the principle of "enlightened shareholder value",
- To act within powers for proper purpose,
- To exercise independent judgment,
- Not to accept benefits from third parties,
- To avoid conflicts of interest, and
- To declare interests in proposed transactions with the company.

Other duties are:

- To exercise reasonable care, skill and diligence,
- A duty of confidentiality, and
- To consider the interests of creditors when a company becomes insolvent.

We would note that directors' duties are owed separately by each director, each of whom has a separate duty to exercise independent judgement and each director could be pursued separately for breach of duty even when taking part in a collective decision-making process.

In section 4, Shifting duties – a greater focus on stakeholder governance, we look at directors' fiduciary duty to promote the success of the company and in section 5, Duty of Care expected by directors, their duty to exercise reasonable care, skill and diligence.

In the USA, fiduciary duties have evolved in Delaware and other US states primarily through case law and comprise the duties of care and loyalty, including the subsidiary duties of good faith, oversight and disclosure. Unlike the UK concept of enlightened shareholder value, US law generally embraces the principle of "shareholder primacy" under which directors have a fiduciary duty to make their decisions looking solely to the best interests of shareholders. As a practical matter, the US model of shareholder primacy does not require that directors completely disregard sustainability or environmental, social and governance (ESG)-specific issues as part of their decision-making process. Directors are required, however, to ensure that consideration of those issues has a sufficient nexus to shareholder welfare and value maximization.

In this respect, company boards increasingly have devoted consideration to sustainability and wider stakeholder perspectives. This development has resulted not from a change in law but rather from the growing significance of sustainability and extended stakeholder interests in affecting market opportunity and demand, valuation and financial returns. In short, while the law has not changed, the perception and impact of ESG considerations has given rise to its rapidly expanding review and evaluation within the framework of shareholder primacy. In light of the potential enormity of ESG issues, in particular for certain industries, the failure to take into account ESG-related risks and opportunities potentially could be viewed as breach of fiduciary duty even under the shareholder primacy principle.

④ Shifting duties - a greater focus on stakeholder governance

There is one area where the laws of various countries are beginning to converge and that is because of the recognition of the importance of stakeholder governance for business success and longevity.

This might be through investor stewardship codes, transparency or other means. Directors are required to act in a way that is most likely to promote the success of the company for the benefit of its shareholders as a whole; in doing so they are increasingly required (or expected) to take into account the interests of the company's other stakeholders. Stakeholders are any parties interested in or affected by the operations of the company. In addition to shareholders, those generally listed are employees, customers, suppliers, the community and the environment. Failure to address stakeholder governance can seriously threaten a company's license to operate.

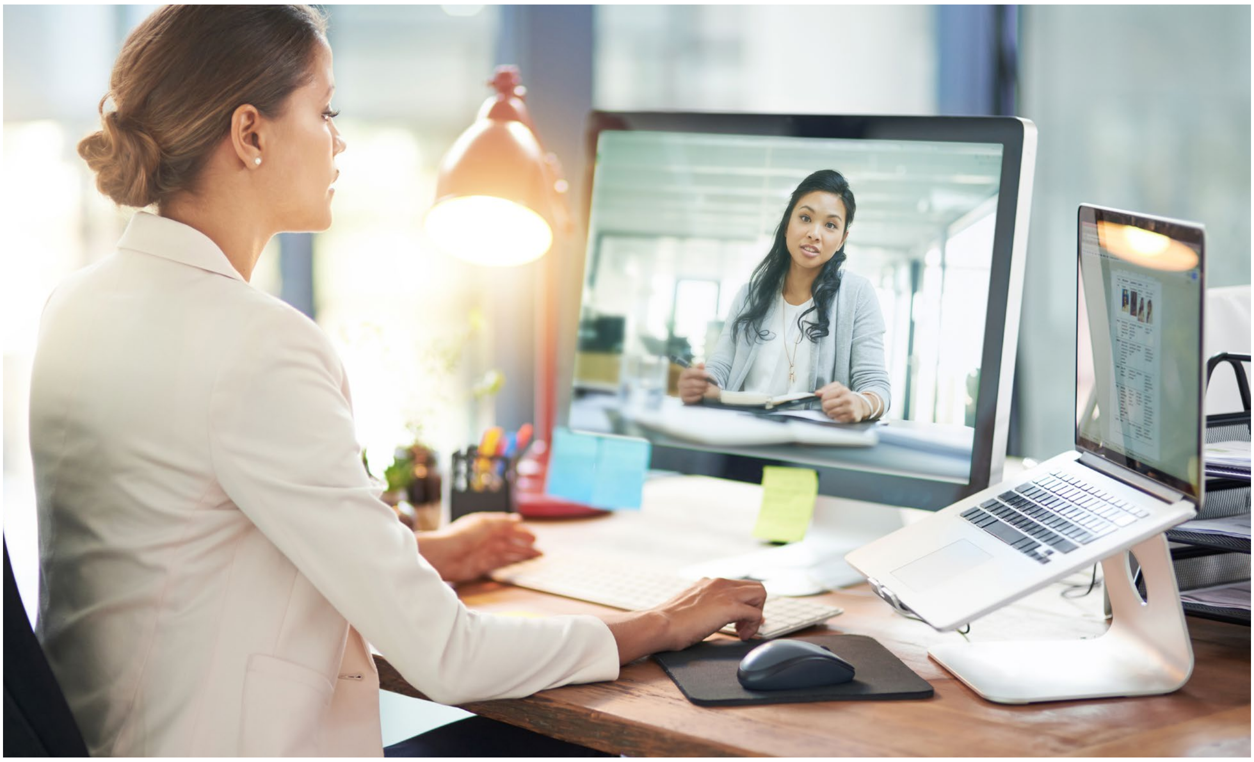
Acting in a way that promotes the success of the company is generally accepted to mean securing its long-term financial success or increase in value. This is because boards are required to consider present and future shareholders, so they must at all times seek appropriately to balance short- and long-term interests.

It is largely up to directors to determine how success can be achieved and indeed how to define success (subject of course to shareholders' specific instructions and the company's constitutional documents). In most companies, strategies to achieve financial success for shareholders will include addressing ESG matters and integrating them into the company's strategy and business model. The UK's corporate law mandates directors to take account of a non-exhaustive list of stakeholders in their decision making when exercising their fiduciary duty of acting in the best interests of the company with a view to creating long-term shareholder value. This list of stakeholders and factors to be considered includes employees, customers, suppliers, the impact of operations on the community and the environment, the desirability of maintaining a reputation for high standards of business conduct, all of which are relevant when considering ESG matters.

Furthermore, directors in the UK will not be judged using hindsight - they will be judged by what they, or a reasonable director with their knowledge and experience, should have known. If a director is of the opinion that any particular regulatory risk or likely change in the business environment poses a risk to or provides an opportunity for the company's future success, that director should take that factor into account in his or her decision making to take, or indeed not take, action. It does not matter whether the factor in question might affect the success of the company in the short, medium or long term. Directors should take into account externalities that do not immediately affect the company if they believe they might affect them in the future; hence, for example, the need to consider the risks and opportunities presented by climate change today, even though they may not immediately come to pass.

Domestic listed public companies in the USA are required to adhere to certain corporate governance standards, including having majority independent boards and independent board committees, under the listing rules of the New York Stock Exchange and the Nasdaq Stock Market. Corporate boards are not, however, otherwise affirmatively required to consider ESG matters or the interests of non-shareholders.

In August 2019, the Business Roundtable in the United States announced the release of a new Statement on the Purpose of a Corporation signed by 181 Chief Executive Officers who committed to lead their companies for the benefit of all stakeholders – customers, employees, suppliers, communities and stakeholders.[7] While the Business Roundtable statement included a commitment to generating long-term value for shareholders, it did not directly address the question of how the signatory companies intended to pursue their goal of benefitting all stakeholders within the existing US legal model of shareholder primacy.



5 Duty of Care expected of directors

In the UK, directors also have a duty to act with the care, skill and diligence that would be exercised by a reasonably diligent person with both (i) the general knowledge, skill and experience to be expected of a director and (ii) the general knowledge, skill and experience that the director has.

The standard is often referred to as that of the "reasonable director" and a director will be assumed to have the knowledge, skill and experience to be expected of a director in that role. In addition, a director with additional or more specialized knowledge (such as financial, technology or human resources qualifications or experience) will be held to the standard of a reasonable director with that knowledge. It should be noted that there is no "business judgement rule" built into the UK's statutory duty of care.

Reference to "good faith" allows directors freedom to exercise commercial judgment without being subject to second-guessing by the courts. However, the court will apply the reasonable director standard and will be more likely to be persuaded that a decision is taken in good faith if it is a decision a reasonable and intelligent director could have concluded would promote the success of company. Judges will not apply hindsight in assessing director compliance with this duty of care. The courts expect boards to maintain sufficient knowledge and understanding of the company's business to enable them to discharge their duties. This implies that directors should have access to information regarding risks and opportunities for the company and, although they can delegate authority to deal with particular risks, they should put in place and be satisfied with systems allowing them to have oversight over any authorities they have delegated.

In the USA, the duty of care requires informed, deliberative decision-making based on all material information reasonably available. Directors are entitled to rely in good faith on company records and on information, opinions, reports or statements presented to the board by the company's officers, employees or board committees, or by other parties as to matters the director reasonably believes are within the parties' professional or expert competence and who have been selected for the company with reasonable care.

In reviewing business decisions by corporate boards, the courts in Delaware and other US states will, in the first instance, normally apply a "business judgment rule." The business judgment rule is a rebuttable presumption that in making decisions directors acted in accordance with their fiduciary duties. To rebut this presumption, a plaintiff has the burden of demonstrating that directors were grossly negligent in not becoming adequately informed or put their own interests above those of the company and its stockholders. If a plaintiff is unable to rebut this presumption, a court will defer to the decision of the board unless it determines that no rational basis exists for the board's actions.

Commentators have noted that director decisions relating to ESG matters and the interests of non-shareholders, if challenged, are likely to be entitled to judicial deference under the business judgment rule on the same basis as other business decisions. Therefore, although the US may continue in principle to adhere to model of shareholder primacy, in practice it may be difficult for shareholders to challenge board decisions regarding these matters that are undertaken with reasonable care and without director conflict of interest.

6 Conclusion

In any case, debates and scrutiny of how fiduciary and other duties of corporate boards apply in the context of ESG considerations, in particular climate change have increased, with a focus on the duties of directors of companies which operate in 'high risk' sectors as well as directors of insurance companies, banks and trustees of pension funds.

With regard to directors' duties, directors must approach ESG matters in the same way they would approach any other financial risk, especially as, in the case of climate change in particular, its impacts have evolved from a non-financial, purely environmental, ethical matter to one that presents foreseeable and often material, financial risks and opportunities for companies. Legislators, regulators and investors acknowledge this. It is therefore incumbent upon directors to set aside their personal views and ensure that decisions are made based on a comprehensive assessment of the relevant facts and circumstances, including under appropriate circumstances challenging the evidence and assumptions provided by management.

At the time of writing, developments on stakeholder governance, fiduciary duties and the role of the board continue to evolve.

For example, the European Commission has issued a 'Study on directors' duties and sustainable corporate governance'[8] and a consultation on Sustainable Corporate Governance. The responses to this consultation will help to shape the European Commission's legislative proposals in 2021.[9] Additionally, in the US B Lab and The Shareholder Commons have issued a White Paper proposing a reform to US fiduciary duties, and we expect their continued debate around what constitutes good governance.[10]

It is thus imperative that directors understand the nature of their fiduciary duties and take advice in circumstances where they are in doubt. It is clear that good stakeholder governance is not only an imperative from a legal risk perspective, but also from a societal perspective. Shareholders, employees, customers and society have increasingly higher expectations of companies with regards to sustainable business practices - those boards that ignore this do so at the risk of losing their licence to operate.

Endnotes

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Chemin Eugène-Rigot 2B
CP 2075, 1211 Geneva 1
Switzerland
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