An Alternative Paradigm to 'On the Purpose of the Corporation'

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Recently a definition of corporate purpose has been proposed and elaborated on in a memorandum captioned "On the Purpose of the Corporation" (the Corporate Purpose Memo). This note offers commentary on various aspects of the Corporate Purpose Memo, including **three key takeaways**:

- The Corporate Purpose Memo's proposed universal definition of corporate purpose for publicly traded business (for-profit) corporations — which rests on directors addressing ESG (environmental, social and governance) and stakeholder interests by "reasonably balanc[ing] the interests of all constituencies" without giving primacy to the shareholder constituency — rejects the basic fiduciary responsibility of directors of Delaware business corporations (and directors of corporations in other states that tend to follow Delaware law) under existing law to measure their actions by what is in the best interests of *shareholders* as a whole (the shareholder primacy governance model).
- Moreover, in reaching for this new corporate purpose definition — prompted by the perceived need to push back those who "advocate a narrow scope of corporate purpose that is focused exclusively on maximizing shareholder value" — the Corporate Purpose Memo ignores the reality that the shareholder primacy governance model as it has evolved in fact embraces the ability of directors of Delaware business corporations to consider a broad array of ESG/stakeholder issues.
- Directors of Delaware companies who chose to address ESG/stakeholder-oriented decisions pursuant to the stakeholder interests balancing act contemplated by the proposed new purpose definition — untethered from their overarching fiduciary responsibility to shareholders to act in their best interests — run the risk of losing the valuable protection of the business judgment rule.

Corporate Purpose Formulation

In the Corporate Purpose Memo, the authors offer their view of "the purpose of the corporation." They tie it directly to "stakeholder governance." They identify the archenemy as "a narrow view of corporate governance that is focused exclusively on maximizing shareholder value." To illustrate this dichotomy, they assert: "The Covid-19 pandemic has brought into sharp focus the inequality in our society that, in considerable measure, is attributable to maximizing shareholder value at the expense of employees and communities." They emphasize that, under their new corporate purpose definition, directors will have "latitude to make decisions that reasonably balance the interests of all constituencies." They make clear that they "continue to advise corporations and their boards that they may exercise their business judgment to manage for the benefit of all stakeholders over the long term." And they urge corporations and their shareholders to "recognize that ESG and stakeholder purpose are necessary elements of sustainable business success."

Finally, as a synthesized reflection of these perspectives, they offer "a simple formulation of corporate purpose":

> The purpose of a corporation is to conduct a lawful, ethical, profitable and sustainable business in order to create value over the long-term, which requires consideration of the stakeholders that are critical to its success (shareholders, employees, customers, suppliers, creditors and communities), as determined by the corporation and the board of directors using its business judgment and with regular engagement with shareholders, who are essential partners in supporting the corporation's pursuit of this mission.

We would like to offer a few comments.

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Overview Comments

- We do not quarrel with the view that there is an important role for publicly traded business corporations in addressing serious domestic and global issues (call them ESG/stakeholder issues) — although, as the survival imperative priority many companies face today due to the COVID-19 pandemic underscores, whether, to what extent and how to participate in ESG/stakeholder support activities are subject to changes in objectives and circumstances rather than permanent corporate decisions. We note, as well, that at some level this concept has long been embedded in the shareholder primacy governance model that prevails in Delaware (the dominant jurisdiction of incorporation of U.S. public companies) and in other states that look to Delaware corporate law (for example, corporate support of and funding for various not-for-profit organizations that promote communities in which corporations operate, as well as educational, health care, employee well-being and a wide range of other societally beneficial initiatives).
- At the same time, we believe it is critical — from the standpoint of guiding and protecting directors of public business corporations — to not let ESG/stakeholder objectives blur or undermine a clear-eyed vision by those directors of what their current responsibilities are, and to whom they are owed, under applicable law, which in Delaware and like-minded states continue to be grounded in their obligations as fiduciaries to shareholders. We believe that the corporate purpose formulation set forth above promotes that blurred vision risk as a core feature — by calling on directors to balance the interests of all stakeholders, including shareholders but without giving shareholders primacy status. Moreover, the Corporate Purpose Memo states: "[C]orporate action, taken against the backdrop of this view of corporate purpose, will be fully protected by the business judgment rule, so long as it reflects the decisions of unconflicted directors acting upon careful deliberation."[1] As explained below, we believe that applying the foregoing balancing act approach to board decision-making involves rejection of the basic fiduciary responsibility of directors to measure their actions by what is in the best interests of *shareholders*, and that such rejection will put at risk the directors' business judgment rule protection under current law.
- That said, we believe that the shareholder primacy governance model, in its currently evolved state, can, and does, accommodate a broad array of ESG/stakeholder objectives while avoiding the above-identified risk to directors that we believe inheres in the stakeholder governance model reflected in the corporate purpose formulation proffered in the Corporate Purpose Memo.
- Before elaborating on the above comments, we have one other. We completely agree that the promise of equality (of opportunity and of rights) is badly broken in our society and must be fixed — but characterizing this as "in considerable measure [ ] attributable to maximizing shareholder value at the expense of employees and communities" seems ill-conceived and very unbalanced rhetoric.

A Closer Look

- The ability of directors of Delaware business corporations to consider ESG/stakeholder interests is settled basic corporate law in Delaware. See "Putting To Rest the Debate Between Corporate Social Responsibility and Current Corporate Law" and "Social Responsibility and Enlightened Shareholder Primacy: Views From the Courtroom and Boardroom."
  - In a nutshell, the interests of non-shareholder stakeholders can be taken into account by boards in determining what is in the best interests of a company and its shareholders as a whole — at least in Delaware and in the states that follow its approach. And the best interests of a company and its shareholders as a whole are not confined to immediate, tangible, measurable economic benefit. Purposed corporate/shareholder self-interest (the Purposed Shareholder Primacy Paradigm) can encompass consideration of a broad array of ESG/stakeholder issues (including, for example, direct beneficial effects of adopting corporate environmental and sustainability policies on long-term costs, product quality and product availability, and indirect beneficial effects such as generating employee, customer, supplier, community and/or international recognition and goodwill) on a basis that is perfectly consistent with the shareholder primacy governance model.
  - What is essential in order for directors to retain the protection of the business judgment rule, and what is embedded in the Purposed Shareholder Primacy Paradigm, is that directors exercise their judgment on an independent, unconflicted and informed basis *in the best interests of the company and its shareholders as a whole*. Why is that critical? Because the business judgment rule is designed to protect directors *in properly exercising their fiduciary duties of care and loyalty* — which under Delaware law are *owed to residual shareholders* (and not to any other stakeholders).
  - If this sounds threatening to advocates of corporate board consideration of ESG/stakeholder concerns, it should not. And why is that? Because the Purposed Shareholder Primacy Paradigm does not predetermine a sole or narrow definition of "the best interests of the company and its shareholders," the components that may comprise it or the time frame over which that should be measured. To be sure, in the context of business/for-profit corporations, the fundamental touchstone

[1] The business judgment rule in Delaware is a rebuttable presumption that decisions by directors are taken on a basis consistent with their fiduciary duties of care and loyalty. Unless that presumption is rebutted, those directors' decisions will not be second-guessed by the courts unless found to be not rational.

must be enhancing or protecting "value" in some economic sense. But in what forms, over what time frames and how measured? The answers will be different for different companies. One logical source of insight into the answers to those questions is, not surprisingly, the shareholders of the company, including fiduciaries that act for managed money. As urged by the Corporate Purpose Memo, directors of publicly traded business corporations would be wise to engage on an ongoing basis with its shareholders to stay in tune with the interests of shareholders as a whole.

- So, have the Corporate Purpose Memo and the Purposed Shareholder Primacy Paradigm arrived at the same place? In short, no.
- The balancing act construct introduced by the Corporate Purpose Memo into directorial decision-making by Delaware business corporation boards also puts them at risk of losing the protection of the business judgment rule as it currently operates. The Corporate Purpose Memo concludes by stating:

> Directors will not be forced to act as if any one interest trumps all others, with potentially destructive consequences, but will instead have *latitude to make decisions that reasonably balance the interests of all constituencies* and operate to the benefit of the sustainable, long-term business success of the corporation as a whole. (Emphasis added.)

- This construct seems likely to have genuine appeal to the growing number of people, groups and entities (both as investors and as non-shareholder stakeholders) that believe public business corporations should have a significant role in helping to solve a long list of serious domestic and global problems weighing heavily on the present and future.
- However, quite apart from not providing directors with any guidance as to *how*, in practice, to do the weighing, the balancing act construct contemplated by the Corporate Purpose Memo introduces a decision-making process that appears to be completely untethered from "the best interests of shareholders as a whole." While it appears to distinguish between shareholder interests, on the one hand (which seems to be to what the Corporate Purpose Memo alludes when it states: "Directors will not be forced to act as if any one interest trumps all others, with potentially destructive consequences") and other constituencies' interests, on the other hand (when it states: "Directors ... will instead have latitude to make decisions that reasonably balance the interests of all constituencies"), it places them on equal footing for balancing purposes.
- As noted above, for directors to retain the protection of the business judgment rule they need to exercise their judgment on an independent, unconflicted and informed basis in furtherance of their fiduciary duties of care and loyalty, which means, in the end, *in the best interests of the company and its shareholders as a whole*. It would be problematic, for example, if the record of board deliberations reflects that the board carefully considered a wide range of stakeholder interests, but, on balance, decided to take a course of action that the directors themselves believed was not in the best interests of the company and its shareholders as a whole, but benefited other stakeholders. And even if the action turned out to be in the best interests of the company and its shareholders, if a plaintiff could point to the stakeholder interests balancing act process as the one applied by the board, that alone could expose the board to challenge.
- We believe that the Purposed Shareholder Primacy Paradigm, as described above, can more than adequately permit consideration of a wide range of impacts, involving multiple stakeholder interests, while continuing to maintain focus on what is in the best interests of the company and its shareholders as a whole and, in so doing, permit directors to continue to rely on the business judgment rule to protect their directorial decisions.
- The key point is that, in the board's independent, unconflicted and informed judgment, there is benefit to the company and shareholders as a whole in supporting interests that, at least traditionally, might not have been thought of as being or connecting to "shareholder interests," narrowly defined. Viewed through this Purposed Shareholder Primacy Paradigm lens, the shareholder primacy governance model accommodates the fundamental goal of stakeholder governance as contemplated by the Corporate Purpose Memo.
- To be sure, the Corporate Purpose Memo does tie the balancing act process to "operat[ing] to the benefit of the sustainable, long-term business success of the corporation as a whole." However, this statement does not speak to the interests of *shareholders*, much less their primacy. And it is ambiguous even as to the corporation — is it intended as a built-in limitation on what the board must determine, a prediction or aspirational statement of the outcome of the balancing act process, or something else? Whatever it is or is not, while, in a particular situation, the balancing act process might survive a challenge under Delaware law — and provide directors with the protection of the business judgment rule – alternatively, it might not.
- Delaware law does provide for a vehicle — the public benefit corporation — through which a board of directors could be tasked explicitly with balancing competing stakeholder interests without ultimately recognizing shareholder primacy as the touchstone for director decision-making. But, as we have discussed above, that is not current Delaware law applicable to for-profit corporations. Of course, the question may be asked: Is that what the law should be (or should for-profit corporations convert to public benefit corporations)? While worthy of

debate, we offer two preliminary observations. First, as we have discussed throughout this note, current Delaware law permits, and perhaps prudent decision-making may even require, where it ties to shareholder value, a board of directors of a for-profit corporation to consider and support a wide range of ESG/stakeholder interests. Providing this authorization and, if exercised, providing business judgment rule protection for the board's decision and decision-making process are critical features of the overall architecture of Delaware law as it stands today. Second, ultimately a corporate enterprise that does not produce sustainable financial value for its owners cannot, over time, create benefits for its other constituencies, such as employees, customers and the communities in which it operates.

- In sum, it seems prudent for directors of business/for-profit corporations to follow the Purposed Shareholder Primacy Paradigm route — based on a clear understanding (assuming Delaware law applies) that:
  - they are fiduciaries for (and only for) shareholders (and not for other stakeholders) — which requires them to act in the best interests of shareholders as a whole, and
  - in that capacity, they have broad decision-making latitude to identify, foster and support ESG/non-shareholder stakeholder interests if, in their independent, unconflicted and informed judgment the directors honestly believe that doing so will provide value (broadly defined) to the corporation and the shareholders who own it and will serve their best interests.