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Preserving Directors' Business Judgment Despite Encroaching Esg Mandates

Contributor

Dechert LLP

Richard Horvath

Partner | richard.horvath@dechert.com

Stephen Leitzell

Partner | stephen.leitzell@dechert.com

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PRESERVING DIRECTORS' BUSINESS JUDGMENT DESPITE ENCROACHING ESG MANDATES

Last year in our "Hot Topic" for the Legal 500 U.S. Country Comparative Guide on Environmental, Social and Governance (commonly referred to as "ESG"), we discussed how imposing a duty to monitor ESG business risks pursuant to the Duty of Oversight would be "A Trojan Horse Attack on the Business Judgment Rule." Specifically, we argued in these pages that if directors of corporations owe a duty to oversee ESG business risks, 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. We argued that Boards weary of litigation risk would 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. It is our view that 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—would be 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.

In the past year, ESG has continued to be front in center not only in the boardroom, but in our national political debate and in courtrooms across the country. Private litigants, "red state" attorneys general and other governmental officials in the United States have increasingly scrutinized ESG-related decisions of corporate Boards, investment managers, pension fiduciaries and funds, including through litigation filings in state and federal courts. Meanwhile, some investors, "blue state" officials, foreign governments and regulators continue to advocate for including ESG factors in business and investment decisions. Courts across the country, and in particular in Delaware, have continued to grapple with the very questions that we discussed in this piece last year, in particular whether a duty of oversight exists to monitor ESG and other similar business risks and, if so, how that duty should be applied.

Against this background, on March 6, 2024, the Securities and Exchange Commission (the "SEC") adopted its much anticipated final climate disclosure rules (the "Rules") which were two years in the making. The Rules set forth a comprehensive and uniform regulatory framework for climate-related disclosures by public companies in the United States. Although scaled back in scope from what the SEC originally proposed in 2022, the final Rules represent a major expansion of the SEC's disclosure regime. The headlines, of course, focused on new disclosure requirements such as the requirement for most public companies to disclose Scope 1 and Scope 2 greenhouse gas emissions and related financial disclosures. However, also included in the Rules are new disclosure requirements regarding, among many other things, Board management and oversight of climate-related risks and management's role in assessing and managing those risks. Of course, the SEC promulgated the Rules with an eye towards withstanding the expected legal challenges—which were promptly filed. However, we find it interesting to observe that with respect to the disclosure requirements regarding the corporate governance framework for managing climate-related risks, the SEC stopped short of its most aggressive proposals, and allowed for each Board to assess for itself the best way to manage climate related risks for its particular situation with the attendant disclosures to follow accordingly. One might even say the SEC left room for Boards to exercise their business judgment as to the right way for each company to manage its own climate-related risks.

Summary of the Different Views of ESG in Corporate Governance

As we outlined in this piece last year, advocates for 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,"[1] where "[t]he purpose of a company is to engage all its stakeholders in shared and sustained value creation."[2] 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."[3] 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,"[4] 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.

SEC Final Climate Disclosure Rules Which Impact Corporate Governance Practices

Before considering where the final SEC Rules might cause Boards to fall within this framework as they relate to corporate governance practices, it is first worth remembering that the SEC is a federal regulator of securities law, not state corporate law. However, there have been many examples in the past where the SEC has incentivized particular governance practices through required disclosures. For example, Item 407(d)(5)(i)(C) of Regulation S-K requires a registrant that does not have a financial expert serving on its Board's audit committee to explain why it does not, which has resulted in almost all public companies designating at least one of their Board members as an audit committee financial expert. Similarly, though the SEC itself does not mandate Board-diversity disclosures, the SEC in 2021 approved Nasdaq's Rule 5605(f) that requires Nasdaq-listed companies to have at least two diverse directors on their Board, or publicly disclose why they do not (the Nasdaq's Board-diversity rules are being challenged in the Fifth Circuit Court of Appeals). It is notable that, as described in more detail below, the Rules do not contain analogous disclosure obligations (although such disclosure obligations were proposed).

Regulation S-K Items 1501(a) and 1501(b) of the Rules will now require a registrant to disclose, as applicable, certain information regarding the Board's oversight of climate-related risks and management's role in assessing and managing those risks. This disclosure includes identifying any Board committee or subcommittee responsible for the oversight of climate-related risks (if a registrant has such a committee or subcommittee), describing whether and how the Board of directors oversees progress against disclosed climate-related targets, goals, or transition plans, and describing the processes by which the Board or any Board committee or subcommittee is informed about climate-related risks. The final Rules as adopted eliminated the requirement in the proposed rules to describe the frequency of these discussions, as well as the proposed requirements to disclose the identity of specific Board members responsible for climate-risk oversight and the expertise that any Board member has in climate-related risks. The final Rules also eliminated the proposed requirement to disclose whether and how the Board of directors establishes any final or interim targets or goals and other more prescriptive disclosure requirements regarding Board oversight.

Importantly, the SEC emphasized in the adopting release that the Rules are focused on disclosure only and do not require, and are not formulated to prompt, registrants to change their governance or other business practices.[5] As such, the Board-oversight disclosures provided for in the Rules are not required for registrants that do not oversee climate-related risks at the Board level. That the SEC takes no position for purposes of disclosure under the Rules on whether a company should or should not address climate-related risk at the Board level has no bearing on the Board's satisfaction of its fiduciary duties to its shareholders beyond ensuring compliance with the SEC rules.

The Rules contain more prescriptive disclosure requirements with respect to management than are required for the Board, such as disclosing what managers or management committees are responsible for monitoring climate-related risks, the managers' relevant expertise, and the processes by which they stay informed of climate-related risks and report on those risks to the Board or Board committee. However, the Rules limit this disclosure to material climate-related risks. Furthermore, as with the Board-oversight disclosure, the Rules do not impose any disclosure requirements on registrants that do not exercise any management oversight of climate-related risks.

In addition, Item 1503 of Regulation S-K now requires registrants to disclose any processes the registrant has for identifying, assessing, and managing material climate-related risks. If a registrant has not identified a material climate-related risk, no disclosure is required. The SEC declined to adopt several prescriptive elements from the proposed Item 1503 (for example, disclosures describing how the registrant determines the relative significance of climate-related risks compared to other risks, and how the registrant considers shifts in customer preferences in assessing potential transition risks). The Rules also include a materiality qualifier that the proposed rules had not. The SEC clarifies that when describing its processes for identifying, assessing, and managing material climate-related risks, a registrant will be able to determine which factors are most significant, and therefore should be addressed, based on its particular facts and circumstances.

While the walk-back from the proposed rules that attracted the most attention was the SEC not requiring the Scope 3 emissions disclosures, the differences between the proposed rules and the final Rules regarding how registrants oversee and manage climate-related risks are significant. Instead of imposing significant pressure on registrants to add directors with climate-related expertise, hold frequent meetings on the topic and set forth targets and goals for climate-related matters, the final Rules instead leave a significant amount of discretion to Boards to determine how to most appropriately oversee and manage these risks—like any other risks that Boards must consider. In many cases, if the Board determines those risks are not material to the registrant, then no disclosures will be required. Returning to the framework described above, while the proposed rules may be more consistent with the "Strong ESG" or "Semi-Strong ESG" outlook in that they set an expectation that Boards would be incentivized to prioritize climate related risks to avoid unwelcome disclosures, the final Rules seem to be more aligned with a "Weak ESG" point of view, which is that if the Board decides that managing climate related risk is not material to its investors and other stakeholders, then the SEC disclosure regime is not going to incentivize a change to that assessment.

ESG and the Duty of Oversight (2024 Version)

The SEC's Rules have shined a light on the debate that we focused on in these pages last year regarding how directors should incorporate ESG into their decision making process. 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 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.

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*.[6] 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.[7]

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."[8] 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.[9]

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.

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."[10] Other firms have likewise warned Boards of their duty to oversee ESG risks.[11] We cautioned in our "Hot Topic" last year however, and continue to caution, 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.

Had the SEC's climate disclosure rule been adopted in the form proposed in 2022, we believe advocates in the "Strong ESG" camp would have won a victory in their quest to solidify a duty to oversee EGS risks. The proposed rules would have, among other things, created in the law requirements for registrants to (i) identify any Board members or Board committees (whether a standalone committee or an existing one such as the audit or risk committee) responsible for the oversight of climate-related risks; (ii) describe in detail those Board members' expertise in managing climate-related risks; (iii) disclose how the Board is informed about climate-related risks and how frequently the Board considers them, as well has how the Board or Board committee considers these risks in the context of its business strategy, risk management and financial oversight; and (iv) disclose whether and how the Board sets climate-related targets and oversees progress against those targets, e.g., a target of net-zero carbon emissions by a particular year. The SEC explained in its adopting release that "[t]hese proposed disclosure items were intended to afford investors with transparency into how a registrant's Board considers climate-related risks and any relevant qualifications of Board members." However, the SEC also went on to explain that its proposal neither required nor encouraged any particular Board composition or Board practices, and was not intended to affect how a registrant operates, at any level, either through management or the Board of directors.[12]

While the SEC was clear to say that the proposed rules were not intended to shift governance behaviors, in practice if these rules had been adopted as proposed we have no doubt that Board composition and practice would have been profoundly impacted. Boards would have scrambled to bring on directors with expertise in climate-related risks to avoid embarrassing disclosures regarding the lack of such expertise on the Board. Pressure would have mounted to discuss climate-related risks with regularity at Board meetings, regardless of how material such risks were to an individual company or how those risks compared to the other business risks that company faces. Climate-related targets and goals would have been set, not necessarily for the benefit of investors or other stakeholders, but for the sake of being able to make a more favorable disclosure. Inevitably, the lack of affirmative disclosures of these matters would have drawn attention from proxy advisory firms, institutional investors and stakeholder advocacy groups who would have used the disclosures as an impetus to call for enhanced governance practices. Moreover, once that standard had been set in the federal securities laws, its not a far leap to then assume that the failure to meet these climate-related corporate governance benchmarks would have led to not only these embarrassing disclosures and pressure tactics, but ultimately to claims for the breach of the duty of oversight that the Strong ESG proponents are eager to impose upon directors.

The Continuing Debate in Delaware Over Extending Oversight Duties to Business Risks

Thankfully, in no small part due to numerous comments received, and in recognition that the SEC's role is not to create substantive corporate law which is instead the domain of the states, the SEC backed away from certain of its proposals when putting out the final Rules. But at the same time since we last addressed this topic in these pages, Delaware courts have continued to explore *Caremark* and the contours of the duty of oversight in ways that continue to confirm that the duty of oversight should not extent to purely business risks such as climate-related risks and other ESG matters.

For example, the Court of Chancery recently granted a motion to dismiss on December 14, 2023, in *Segway, Inc. vs. Cai* where the plaintiff, Segway Inc. ("Segway"), alleged a *Caremark* oversight claim against Judy Cai, the former president of the company.[13] In the Court's succinct memorandum opinion, Vice Chancellor Lori Will forcefully rejected Segway's theory that "everyday business problems" could give rise to a fiduciary's breach of the duty of oversight. Instead, the Court confirmed the "enduring principles" of the *Caremark* doctrine that "[l]iability can only attach in the rare case where fiduciaries knowingly disregard [their] oversight obligation and trauma ensues."[14] Indeed, the Court noted that Segway's allegations "are an ill fit for a Caremark claim," particularly because Segway failed to allege any "potential wrongdoing (much less within Cai's purview)."[15] For example, absent from the complaint were allegations that "Cai overlooked accounting improprieties, fraudulent business practices, or other material *legal violations*."[16] Accordingly, the accounts receivable issue constituted "generic financial matters [] far from the sort of red flags that could give rise to *Caremark* liability if deliberately ignored."[17]

Likewise, earlier in 2023 in *In re ProAssurance Corp. Stockholder Derivative Litigation*, Vice Chancellor Will drew a distinction between business risk and unlawful conduct, explaining that "[s]o long as the challenged conduct is lawful, directors have broad discretion to advance the corporation's interests as they see fit."[18]

The *Segway* and *ProAssurance* decisions are important additions to the ongoing debate in the Court of

Chancery that we highlighted last year over whether oversight claims extend from matters of legal compliance and to matters of business risk. The cases provide support that—even assuming oversight liability can arise from the failure to oversee business risk—the burden for a plaintiff to establish such liability should be substantial. As the Court explained in *Segway*, "[b]ad things can happen to corporations despite fiduciaries exercising the utmost good faith."[19] And as we explained in these pages a year ago, applying *Caremark* liability to matters of pure business risk (including ESG related matters), as opposed to legal risk, could undermine the important principles at the heart of the business judgment rule and the deference given to fiduciaries in running an entrepreneurial organization.

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

Developments over the past year have affirmed our arguments from a year ago in these pages. Given the potential for eroding director discretion, we continue to believe that both the SEC and courts should pause before imposing, either directly or indirectly through disclosure obligations, an explicit duty or expectation 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.

Footnote(s):

[1] *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.

[2] *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/.

[3] 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).

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

[5] The Enhancement and Standardization of Climate-Related Disclosures for Investors, Securities Act Release No. 33-11275, Exchange Act Release No. 34-99678, 89 Fed. Reg. 21668 (published Mar. 28, 2024) at 161.

[6] 698 A.2d 959 (Del. Ch. 1996).

[7] *Id.* at 970.

[8] *Id.* at 971.

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

[10] 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/.

[11] *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)).

[12] The Enhancement and Standardization of Climate-Related Disclosures for Investors, Securities Act Release No. 33-11275, Exchange Act Release No. 34-99678 at 160-61.

[13] 2023 WL 8643017 (Del. Ch. Dec. 14, 2023).

[14] *Id*. at *1, *5.

[15] *Id*. at *4.

[16] *Id*. (emphasis added).

[17] *Id*.

[18] 2023 WL 6426294, at *14 (Del. Ch. Oct. 2, 2023).

[19] *Segway*, 2023 WL 8643017, at *5.

Contributors

Richard Horvath
Partner
richard.horvath@dechert.com

Stephen Leitzell
Partner
stephen.leitzell@dechert.com