Corporate Purpose, Human Capital and Compensation Considerations

Arthur Kohn
Partner
New York
akohn@cgsh.com

Caroline Hayday
Counsel
New York
chayday@cgsh.com

Allison McQueeney
Law Clerk
New York
amcqueeney@cgsh.com

Corporate Purpose

On August 19, 2019, the Business Roundtable released its latest Statement on the Purpose of a Corporation, emphasizing commitment to all stakeholders.[1] The Statement received a lot of attention in the press and focused attention on a simmering, somewhat academic, debate regarding "shareholder primacy"—i.e., the idea that the most important purpose of a corporation is to increase shareholder value, which should supersede other considerations cited in the Statement such as "supporting the communities in which we work" or "investing in our employees."

Since Milton Friedman's advocacy of the idea in the early 1970s, it has been an article of faith in most of the business community that, as he put it, "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits." Notably, there is reason to believe that many companies whose executives signed the Business Roundtable Statement did not do so on the basis of prior discussions with their boards.

Academics debate whether the law in Delaware reflects shareholder primacy or not; not surprisingly, there are statements in cases, old and new, that can be cited for either side—and some that can be, and are, cited by both sides. In the end, while there are important exceptions, the divide between the purists and others is in many circumstances easily bridged as a practical matter, since other corporate goals often tend to correlate in practice with shareholder value—e.g., doing good by employees can in most circumstances be justified as likely to benefit shareholders.

1 *See* Business Roundtable, Statement on the Purpose of a Corporation (August 2019), available here.

Our suggested takeaway for boards about the Business Roundtable Statement is that, while the dust is still settling, the Statement seems likely to resonate into 2020 and beyond in at least two important ways.

Human Capital Management

On August 8, 2019, just a few days before the Business Roundtable Statement, the SEC proposed an amendment to its rules that, if adopted, would require disclosure of certain material "human capital measures or objectives that management focuses on in managing the business." The SEC's proposal is in obvious alignment with the practical import of the Business Roundtable Statement discussed above.

While management's focus on human capital barely shows up in financial statements, the SEC's proposal is an acknowledgement that investors are now attuned to the fact that, for many companies, a well-managed workforce is imperative for success. This shift is a function both of tight labor markets in the US and the changing nature of work. As we mentioned in last year's memo, we continue to believe that coinciding with this shift in investor focus is an investor expectation that the board is overseeing carefully management's attention to measures indicative of the health of a company's human capital.

We recommend that boards allocate time and resources to ensuring that companies are prudently managing their workforce, with specific attention to two key issues:

— First, what are the indicators that the management/labor relationship is healthy and not being undermined by new models of employment—i.e., outsourcing, use of independent contractors, joint employers, etc.?

— Second, what are the indicators that the company's investment in its workforce is providing a healthy return on investment?

We provide some examples of key indicators and best practices below, but directors should recognize that this is a rapidly expanding area of investor interest and not assume that there is a one-size-fits-all approach.

Employee Satisfaction & Motivation

— Assess diversity, pay equity and representation of minorities and women in management by measuring performance against management's goals and improvement over prior years.

— Use company-wide employee surveys to measure employee engagement, including a "net promoter score" asking how likely an employee is to recommend the company as a place to work among friends and family.

— Monitor changes in the rate of discrimination and whistleblower claims, absenteeism and voluntary turnover, focusing on upticks over time.

Talent

— Consider the current workforce within the context of anticipated industry changes, assessing the ability of the current talent to meet new demands.

— Evaluate whether recruiting efforts are aligned to meet new demands, and whether current employee training programs will sufficiently prepare the workforce for new demands.

Culture

— Identify key cultural tenets for the organization, and evaluate how senior management embodies and communicates these tenets.

— Use employee surveys, internal cultural audits, whistleblower hotline reports, visits to corporate offices, social media and customer complaints to get a read on company culture, and compare it against the company's identified key cultural tenets.

While management's focus on human capital barely shows up in financial statements, the SEC's proposal is an acknowledgement that investors are now attuned to the fact that, for many companies, a well-managed workforce is imperative for success.

— Request quarterly reports by management to the board highlighting behavioral misconduct, allowing the board to contemplate cultural drivers of these infractions.

— Ensure that the leadership pipeline established through succession planning reflects cultural values.

As always, to drive effective management investment in the workforce, boards should consider whether cultural alignment and key human resources management performance indicators should impact incentive pay for senior executives. Boards should also remain cognizant of their fiduciary duties under Delaware law's *Caremark* standard to stay abreast of significant human capital management issues affecting their organization. As with as other important compliance issues, in many business sectors, the workforce is a key to shareholder value.[2]

Environmental and Social Metrics in Executive Incentive Plans

The Business Roundtable Statement's focus on stakeholder interests also calls attention to environmental and social concerns. Large-cap public companies have been increasingly adding environmental and social metrics to their executive incentive plans as a way to highlight their attention to these issues, incentivize management to achieve long-term shareholder value objectives and respond to the concerns of stakeholders. According to a 2019 analysis by compensation consulting firm FW Cook:[3]

— In a survey of large public companies, 62% of companies using a strategic performance measure (or 26% of all companies with formulaic annual incentive plans) disclose using at least one environmental, social or governance (ESG) goal as part of their strategic performance measure, either as a pre-defined objective or as a consideration in arriving at the strategic performance score (excluding companies that use ESG measures as an individual performance consideration).

— Of the largest 250 companies using ESG measures, 43% use human capital goals (e.g., diversity, employee engagement, company culture, customer satisfaction, etc.); 25% use health, safety or environmental sustainability goals; and 32% use both types of ESG goals.

— Companies in the utilities and energy sectors have the highest prevalence of ESG goals within their strategic performance measures (81% and 77%, respectively).

As companies begin to incorporate ESG goals into their business strategies, we recommend that boards consider whether ESG metrics should be incorporated into their executive incentive plans. While perhaps not right for all companies, boards should reflect on whether it would make sense for their companies and, if so, how to choose and measure the appropriate metrics.

2 Recent Delaware Supreme Court decisions suggest a renewed receptivity to claims by shareholders of fiduciary breaches by directors on the basis that they failed to sufficiently oversee risks central to a business. See *Marchand v. Barnhill*, No. 533, 208 (Del. June 18, 2019). In other words, a board's inaction can lead to extended litigation and potential liability. Because of the material risks to a business that inattention to human capital management can entail, and the rapidly changing rules and environment affecting management of the workforce, *Caremark* risk is relevant to board oversight of human capital.

3 *See* FW Cook 2019 Annual Incentive Plan Report (October 2019), available here.

Compensation Clawbacks and Advancement of Legal Fees

A perennial regret of companies that have disputes with their executives arising from alleged misconduct is the cost of paying the executives' legal fees to defend themselves. These costs arise from near-universal director and officer indemnification provisions in corporate articles of incorporation and by-laws. Typically, those provisions require companies to advance executives' legal fees to the fullest extent permitted by law. When boards have occasion to take a step back to think about the appropriateness of those broad protections, they almost always decide that the protections are appropriate, in the corporation's interest and necessary to attract and retain executives.

The courts in Delaware and many other jurisdictions permit the enforcement of such obligations in a very broad range of circumstances. Companies regularly challenge their obligation to advance legal fees—and they routinely lose.

One of those challenges occurred at the beginning of 2019 in the Delaware courts in a novel context. Hertz Corporation sought a clawback of the compensation of executives (and sought other damages, totaling about $270 million) arising from a financial restatement that dated back to the actions of an executive team that was subsequently terminated. The executives sought to have the company pay their legal fees to defend themselves. The Delaware Court of Chancery was, unsurprisingly, unmoved, forcing Hertz to pay the legal fees.

We highlight these issues because our experience suggests that many compensation committees that have adopted compensation clawback provisions over the past few years have not expressly considered whether they should advance legal fees to executives who contest the company's allegations that their conduct merits a clawback. In our view, most companies that do consider the issue will conclude that advance of legal fees is appropriate, but consideration of the issue would enhance the governance process. Any board considering these issues should consider how their corporate obligations dovetail with their directors and officers insurance protection in this context.