COVID-19 Places Corporate Social Responsibility in Sharp Relief

Sam Gandhi and Holly Gregory
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Sam Gandhi:
Corporate social responsibility in the COVID-19 era has taken on new significance. Investors in Delaware courts are focused on the board's role in both social responsibility and oversight, and courts are now allowing claims for failures in oversight to be litigated despite the uncertainty in the COVID-19 era. How has COVID affected these trends and how can boards prepare? We'll find out in today's podcast.

From the international law firm, Sidley Austin, this is the Sidley Podcast where we tackle cutting edge issues in the law and put them in perspective for business people today. I'm Sam Gandhi.

Hello, and welcome to this special edition of the Sidley Podcast, part of Sidley's ongoing efforts to help you stay on top of legal developments in the coronavirus crisis. You can find more information in our COVID-19 Resource Center at sidley.com.

Today we're focusing on two trends with significant implications for a company's governance and the risk for their board of directors in the age of COVID-19 and beyond. I'm joined by Sidley partner, Holly Gregory. Holly is co-chair of Sidley's Global Corporate Governance and Executive Compensation practice. She counsels publicly held, private, and not-for-profit corporations on the full range of governance issues and is frequently called on to advise boards regarding sensitive and unusual matters.

Holly just started a three-year term as the President to the American College of Governance Counsel and she's past-chair of the ABA's Corporate Governance Committee. Holly joins us from New Jersey. Holly, it's great to speak with you today.

Holly Gregory:
Great to speak with you as well, Sam.

Sam Gandhi:
Thanks. Before COVID-19 changed our world, boards were contending with complex social responsibility issues as significant institutional investors placed increasing importance on environmental, social, and governance factors and their investment and voting decisions.

And more recently, leading CEOs have articulated the importance of a defined corporate purpose and a commitment to a broad range of stakeholders.

So, Holly, as companies deal with the pandemic and its effect on their businesses, what's the impact on corporate responsibility and ESG, and do those corporate efforts to address ESG issues, do they become more or less important in the light of the COVID pandemic?

Holly Gregory:
Well, Sam, that's a great question. I think they become more important or it becomes more apparent how important they are, and let me explain.

The COVID pandemic really reminds us that corporations are sort of central to our well-being. They get the groceries on the shelf, they manufacture the toilet paper, they deliver health care and manufacture PPE, and innovate, develop vaccines. So, they really are innovators to help solve problems, make sure we have the goods and services we need, and they're very adept at quickly redeploying resources, and we're seeing that in very real time.

I think the pandemic also underscores the social, the S in ESG, the dimension around worker health and safety, worker support and motivation in a virtual workplace, hiring, retaining, retraining workers, and in some instances furloughing workers, and there are all kinds of social dimensions.

I think also the broader corporate social responsibility that corporations show in helping out communities, whether the pandemic dies, redeploying assets to help make PPE, manufacture ventilators when they never manufactured ventilators before. For example, we're seeing some of the auto companies shift gears, and that's a real socially responsible act.

I think also given the level of current social unrest these issues will prove to be even more important, but let's take it back to the business. How a company responds on these social issues is inextricably linked to business continuity, resilience, if you will, and to reputation and brand values so there's a business case.

The early data indicates that ESG focused investments really outperformed when the stock market was falling in that February/March timeframe in the first quarter, and we saw that ESG funds continued to attract inflows suggesting that many viewed them as a safer haven, if you will, and this all, as I said, suggests that ESG is linked to corporate resiliency potentially through a profession that has better risk management at these firms that score high on ESG measures.

I think there's really new research, partly anecdotal, but research nonetheless that indicates that firms that receive more positive media attention regarding to how they're responding on the human capital dimension, supply chain, and operational responses, those companies experienced a less negative impact to the stock market downturn, and I'm referring to research by State Street.

So, the COVID-19 pandemic appears in my mind to be strengthening rather than weakening the case or incorporating the ESG factors into investment decisions and business decisions, and may well accelerate the trend toward ESG investing, and so in my mind the corollary is that this is not the time to reduce our corporate focus on these types of issues.

Sam Gandhi:
I want to ask you a follow-up question on that which is that typically when we think about ESG investing there's been a more ... a larger emphasis on the E part, the environmental part, and now do you see a trend more towards the S part as opposed to the environmental part?

Holly Gregory:
Yeah, I think that the pandemic really highlights the S, as do the concerns that are rising in this country around social injustice and inequality, all of those issues, and corporations are going to need to be very attuned to that and very considerate in their response.

The environmental issues have been trending for a while and they won't go away, but I do think we have a new spotlight right now on the social issues.

Sam Gandhi:
And I want to just follow up on this. Given the issues of race, the unrest that we're seeing in the streets, how important is it for a board to refocus on diversity issues, issues of racism in the workplace, etc.? Do you see a greater trend of boards focusing on this given the fairly historical unrest that we're seeing lately?

Holly Gregory:
Great question, Sam. I can't speak to a trend because we're really talking about events that are occurring right now, but I think boards will be well served to really dig down on how the company is approaching issues of diversity, how it's ensuring that there is recognition of these issues, how are they training their employees to make sure that in their interactions with customers they're doing it in a way that will resonate well for the company.

These are going to be critical issues and as I said, it's really happening in real time. Boards have been focused on diversity on issues of opportunities. This is a moment in time to really take a good relook thinking about our training programs, our messaging, and emphasizing that commitment to diversity, equal opportunity is going to be critical.

Sam Gandhi:
There is a new reality for boards in the wake of the coronavirus. What in your view is the most pressing issue now for boards to focus on?

Holly Gregory:
So clearly, business continuity has to be front and center, and we've seen it in the early days of the crisis clearly focusing on issues of cash flow and revenue, employee health and safety, and supply chain concerns.

Now we're beginning to see that focus turn or pivot to the new normal. What does a reopened economy look like and what does that mean in the near term as we're planning for it and in the longer term?

I think boards should be exploring with management the plans for the pivot, and consider really what are the aspects of the business that are likely to be changed in a reopened economy and in the long term? What are the trends that will accelerate? We just talked about the ESG trend. That's clearly going to accelerate. There's a trend that was already there, but the spotlight really is going to make those forces grow.

But another example, when you think about the greater comfort that consumers have with a virtual marketplace and the greater experience that those companies and employees now have with a virtual workplace, how is that going to change things?

What aspects of that would be sticky and will endure? What are the opportunities and the risks that will emerge? What will the industry that the company is in look like and clearly, where are the opportunities for expansion through M&A? Where should the business potentially refocus and think about potentially exiting a business line through a spin-off revenue device?

To my mind, the board brings great value to these issues by prodding management about its assumptions and the alternatives that are under consideration and in helping to bring through that broader, bigger picture and longer-term focus to bear.

Sam Gandhi:
All boards are not necessarily going to be doing this and I imagine that some are somewhat skeptical of moving forward more on the social aspect of their business. What are the risks of a board that fails to address these ESG issues given how the virus's only intensified scrutiny of these issues?

Holly Gregory:
I think the risks are significant. There's clearly a risk of appearing tone deaf when the environment around you is changing, and this again both relates to the pandemic, but also relates to the social unrest that we're feeling at the moment.

There are risks of missing opportunities to develop greater traction with potential customers and employees who are becoming far more interested in associating with businesses that are socially and environmentally responsible. This really matters an awful lot. A lot of consumers were seeing that grow and I expect that will continue to grow.

And also among the employee base, these issues are becoming important. Employees want to work for companies that share their values and increasingly these are values that the employee population have.

There's also the risk that the company won't receive investment attention in the same degree from increasingly focused ESG investors. And so, clearly I think again as we set the asset, this really focuses a spotlight on ESG and the S in particular, and there are risks of not attending to these issues.

Sam Gandhi:
And so, let's pivot to how the investment community is really reacting. How has the conduct of institutional investors and their voting and engagement activities changed in response to this crisis?

Holly Gregory:
Interestingly, the investors really seem to be supporting management and directors generally, but they are continuing to engage. Very early on, a coalition of institutional investors that represent over $9 trillion in assets under management called on companies, and this is a quote, "to use their power as a force for tremendous growth," and their statement was they wanted to encourage companies to provide emergency pay leave to employees to support appropriate spouse isolation and prioritize employee health.

They wanted companies to, again quoting, "take every measure to retain workers so that the impact of large-spread unemployment would be limited and that when we do reopen operations can be resumed quickly."

They encouraged companies to pay the suppliers monthly to keep that cash flow moving through the economy, and also to work with customers who are facing financial challenges, and finally they asked companies to suspend share buybacks and to limit executive and senior management compensation. That's one aspect, for that early encouragement to think about the company's response.

We are also in the proxy season, and this year we expected another record year of social environmental shareholder proposals. It's too early in the proxy season to predict outcome, and it's here that companies had a lot of success in negotiating on shareholder proposals this year.

And so, it's unclear whether we will have a record number go to a vote and how we will fare, but the trends in the past several years at least have been through increased voter support for social and environmental proposals. In the past, it was the government's proposals that would pass and the environmental proposals and social proposals would routinely fail and that is shifting.

I do want to note that there's an organization called Principles for Responsible Investing, known as PRI, and they called on investors to tread lightly on boards and management this year to not distract them from being responsive to the crisis.

So again, I think investors want to support management and boards. They also want managements and boards to continue to focus on ESG issues, but it looks like they're given leeway at the moment and we won't know until the proxy season is over how the voting records come out.

Sam Gandhi:
Let me ask you a somewhat cynical question on this. Do you think institutional investors' behavior is going to change if we see a significant and longer-lasting downturn in the equity markets?

Holly Gregory:
Yeah, I think you'll see some changes, but I think the data that I'm most interested in is that early data that showed inflows into ESG-focused funds indicating that for many investors they view the companies that are representing those funds that some have safer, some have more resilience.

Sam Gandhi:
You're listening to the Sidley Podcast and we're speaking with Sidley partner, Holly Gregory, about the ESG-related challenges posed to businesses and their boards in our age of COVID-19.

Holly is the co-chair of Sidley's Global Corporate Governance and Executive Compensation practice and the new President of the American College of Governance Counsel, and she counsels publicly-held, private, and not-for-profit corporations on the full range of governance issues.

Holly, one other trend is an apparent shift in the willingness of Delaware courts to allow failure of oversight claims against directors to move forward to litigation, and in the past year we've seen Delaware courts have allowed three claims of oversight failure to go ahead and proceed to trial.

So, in light of these cases do Delaware directors face increased risk of COVID-related claims on the theory of failed oversight and what are the key takeaways that boards should understand from these cases?

Holly Gregory:
You're right, Sam. We've seen three cases out of Delaware in just the past year that allowed breach of fiduciary duty claims that were premised in a failure of board oversight to move past motions to dismiss, and this is highly unusual.

In the past, these kinds of claims were considered among the toughest to bring forward. The three cases are each unique, and they each have their own set of somewhat egregious facts.

The Marchand case involved an outbreak in listeria in an ice cream manufacturing plant where it appeared that management was put on notice for some time from testing that there was a problem and three people died, and significant financial problems for that company followed.

In the Clovis case there were disclosure of test results from clinical trials for a drug that was in development that did not follow the appropriate protocols, and the company had to retrack what looked like promising results with a significant impact on the value of the company.

And then most recent case just came out, a company with a history of restatement apparently didn't institute appropriate control resulting in yet another restatement.

These cases confirm the very serious nature of a director's oversight duties regarding compliance and risk, but especially in areas that are heavily regulated, and as you know food, drugs, and internal controls, audit processes in public companies are all heavily regulated.

It's interesting that in two of the cases, the listeria case and the drug development case, the products were the only products the company sold and therefore a serious problem from a regulatory standpoint was really mission-critical, and the cases highlighted the directors' need to be thinking about risks that are critical to the mission of the organization.

I think it's also important to remember that these are egregious circumstances, and in these kinds of circumstances courts find it much more difficult to give boards the benefit of the doubt, and so you could explain these cases to some degree on that level.

Now, while COVID-19 risks aren't the types of harm for risk and issue in these cases, I do think that an aggressive plaintiff's bar will be looking for an egregious set of facts that support a claim under the theories of these cases. I don't know that the claims will prevail. I think it depends on how highly regulated the issue was.

But let's just play for a moment. You know, there was a significant outbreak among workers coupled with public report of a failure to abide by regulatory standards about workplace safety and continued noncompliance followed by death. I think an aggressive plaintiff's firm would seek to get the books and records, including board minutes, and try to look and see what activities the board was engaged in to provide oversight in an effort to try to state a claim here, but the motion to dismiss depends on the factual record that developed.

Sam Gandhi:
In the COVID-19 crisis the two things that have emerged that are clear is, one, is that it's such a rapidly evolving crisis that it's difficult to pin down the cause, the means of prevention, etc. We're constantly getting new facts.

And the second thing is that there has been, while some helpful regulation and guidance from the government, there's not as much regulatory guidance on COVID given to businesses and individuals compared to say what you would typically see from OSHA in terms of workplace safety, etc.

Do you think courts look at that in that context and give boards more of a benefit of the doubt just given the fairly unique circumstances? There is a normal way of preventing listeria. There are ways of preventing E.coli in meat packing plants. It's very, very unclear how a company can really prevent COVID-19.

Holly Gregory:
I agree with that, Sam. I think that this is, you know, we're positing a hypothetical with very unique facts. Where there is great uncertainty, and there isn't a clear roadmap, it must be much more difficult to bring this kind of claim.

And you're right, the cases that the court has addressed in the past year all have pretty clear roadmaps for what would have avoided the problem. I agree with that point.

I think what I'm trying to emphasize is I wouldn't simply take great comfort from that if I were a director. I would be very cognizant that not only do we want to prevail on a claim, we would prefer that the claims are not brought, and so the aggressive plaintiff's firm will be asking, well, we'll find a shareholder who will ask for books and records, board minutes. The key was the board did or did not do.

And clearly, boards shouldn't be paying attention to COVID to avoid claims, they should be paying attention to it because it falls within the scope of their oversight responsibilities to understand how management is managing and mitigating the risks. So, whether or not they can be found liable it's a good thing to spend some time and attention on.

Sam Gandhi:
So, let's talk about some of those prudent practices that a board should be using to protect itself. You have this confluence of a very, a still yet unknown, complicated issue that's out there affecting a company, and you also have this greater scrutiny by the court.

So, what's a board ... what are the prudent practices that a board should be undertaking to protect itself?

Holly Gregory:
I think most of the boards that I'm aware of are certainly doing this. You know it's having discussions with management about management's efforts to identify the issues and risks around health and safety and certainly also the financial and operational risks that are prevented, so issues relating to sanitation protocols, what are we going to do when we reopen a workplace. Those kinds of issues should be front and center.

Courts should also be thinking about the other kinds of risks that are live in this type of a crisis. Clearly, these financial crises always give rise to increased level of fraud and cybersecurity, breach attempt, those kinds of issues.

So, if I were advising a director, I'd say really take a look at your risks again and think about how the crisis impacts those risks, and then ask management what they're doing to manage those risks and mitigate them, and make sure that you have the information that you need from management so that you can have reasonable assurance that they are on top of things.

But I want to emphasize the board needs to expect a plan that the risk posture of the company is changing. It's changing at this moment, and therefore having that discussion is really important.

I think also establishing with management very clear expectations about what information about changing risks and compliance issues in particular of management understand it is to bring to the board in fairly real time that a situation is developing.

So, those are some of the things that are very COVID-specific, if you will. I think in addition, any time you're dealing with compliance issues is important, but management is documenting the activities in the board minutes and other books and records of the corporation, and that directors are reviewing those minutes very promptly, because as I've said the shareholder plaintiffs will have access to books and records and will be looking to develop their case largely by what's not there.

Also, greater attention to corporate disclosures, changes in corporate disclosures is important at this time. And finally, I would say paying a little bit of extra attention to issues like lack of disclosure and insider trading is also prudent at the moment.

Sam Gandhi:
So, so much has changed in the way corporations conduct business since COVID-19 began wreaking havoc in the United States and around the world. On top of it, at the time that we're speaking today we've got tremendous social unrest in the country, the likes we haven't seen in probably 50 years.

So, if I'm on the board of a public company what are the key things that I need to be considering right now at the time as we move forward in this new reality?

Holly Gregory:
I think last year at this time I was advising the business roundtable on its statement on the purpose of the corporation, and I think that that statement is fairly prescient in that it really underscored that corporations need to focus and articulate how their particular purpose serves society.

In the light of the social unrest and the pandemic, there may be even greater forces to question the license that corporations have to do business and the justification. So, I think boards really need to be focused on articulating how the corporation that they are directing is providing more social needs by providing the goods and services that we all need.

I think they also need to be thinking about how the environment will change post COVID-19 and in the aftermath of the social unrest. What are the changes that will endure and where are those added risks and opportunities?

We spoke earlier about them paying attention to issues around diversity, equal opportunity. That's going to take a lot of focus, I think, as will the issues around real workplace changes endure. How will workers expect be kept safe in the work environment in the future? Will we all be working virtually? How is that virtual marketplace changing?

And I think the crisis is going to be demonstrating that companies need to be nimble. They need to be able to pivot to create entirely different types of products at times. They need to find that resiliency or that ability to shift tact and redeploy assets, and you know at the end of the day it's corporations that we're going to rely on to get us out of this pandemic because it's corporations that will invent and then deliver the vaccine that will get us there.

And I think also corporations will have a big role in helping us to shift and address the social unrest by working even harder on issues of equal opportunity, social justice, and diversity.

Sam Gandhi:
Great. We've been speaking with Sidley partner, Holly Gregory, about ESG concerns related to the coronavirus. And Holly, these are unusual times for businesses and boards of directors that are balancing environmental, social, and governance issues, and thanks for sharing your insights.

Holly Gregory:
Well, thank you for having me, Sam ... a real pleasure.

Sam Gandhi:
Before we wrap up, a word about Sidley Insights, the content section of our website. We've set up a special page with a COVID-19 Resource Center. You can read articles

related to various legal issues impacted by the coronavirus crisis, including the effects on mergers and acquisitions, securities disclosure, environmental law, and contract disputes, and we're going to be posting more in the coming days, and we're planning future podcasts too.

You can find our COVID-19 Resource Center by going to sidley.com.

You've been listening to the Sidley Podcast. I'm Sam Gandhi. Our Executive Producer is John Metaxas. You can hear more episodes at sidley.com/sidleypodcast or subscribe on Apple Podcast or wherever you get your podcasts.