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2020 in Hindsight: Key Considerations for Directors in 2021

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As the stewards of American enterprise, Boards of Directors are rightly focused on helping their companies navigate through the challenges and opportunities the United States and the world face today. While vaccines offer the promise of normality, the pandemic continues to rage on. The political environment remains volatile and deeply divided. And we continue to struggle with fundamental racial, gender and economic equality and inclusion, as well as the path to a sustainable future. Crisis management often seems to be the order of the day. But directors must of course look beyond the current turmoil and ensure the company is well positioned to survive and thrive in the coming months and years. This Advisory elaborates on several key focus areas for Boards in the current environment.

Understanding the responsibilities that a seat on the Board bestows on you in the current context is critical. It is perhaps somewhat reassuring that, from a purely legal perspective, your fundamental fiduciary duties as directors remain largely unchanged. Your decisions as directors will be protected so long as made on an informed basis, in good faith, and in the honest belief that the decision was in the best interest of the company. That is not to say that directors needn't be concerned. While legal precepts haven't evolved significantly, the world in which your company operates, and mostly likely the way in which your company operates, have changed fundamentally in the past year. These changes require a rethinking of risk management, corporate strategy and the mission of the company. For example, under the *Caremark* line of cases, directors are responsible for ensuring that the company has in place information and reporting systems reasonably designed to provide the Board and senior management with timely, accurate information sufficient to support informed judgments about the risks facing the company. The tectonic shifts in the world over the past year—political, social and economic—have made it imperative for the Board to reassess the kind and degree of risks that the company's business faces presently and in the coming months and years, understand how those risks are being addressed at the company and ensure that appropriate, updated systems are in place to effectively monitor those current and emerging risks.

Corporate purpose and strategy are also in the spotlight. Directors face evolving standards of accountability from institutional investors and other key stakeholders on critical subjects such as climate change, and racial and gender diversity. These stakeholders have not stood still over the past year. Indeed, in many instances they have become more forceful in their standards and demands for accountability, and have been joined by legislators, regulators and other groups in

mandating change. Failing to address these demands head on opens the window to enhanced shareholder/stakeholder engagement and creates reputational and business risk. Addressing these critical subjects is not, of course, just about satisfying shareholder or other stakeholder demands. As the ultimate managers of the company, directors should understand and shape the company's mission and culture and its relationship to stakeholders, which are increasingly recognized as fundamentally interrelated to an effective corporate strategy, employee productivity and morale and value creation. In that role, directors are tasked with guiding the "best practices" of the corporation and setting, together with management, the tone at the top. Continuing to take the lead on these matters, and not treating them solely as risks or externally-imposed requirements, will serve directors and companies well.

Know Your COVID Scorecard

While positive news surrounding vaccine efficacy brings hope for tangible improvements in 2021, the world is of course far from done with the pandemic and the need for continued vigilance and crisis management. However, it is also important for Board and management teams to step back and review just how well, or poorly, the company has navigated the situation. This "COVID Scorecard" should illuminate the strengths and weaknesses of the company's handling of the challenges of the past year, and analyze the reasons, including business model, management performance, Board performance, employee contributions and other factors. An important aspect of this exercise is to understand how the company has performed relative to its peers and why it has over- or underperformed on a relative basis. Having weathered the storm may not be good enough if your key competitors have thrived in the same conditions.

Having a clear picture of the company's absolute and relative performance provides an actionable framework for understanding, and addressing, the strengths and weakness of the company and its resilience in the face of adversity. Clearly this requires a joint effort with management in reviewing the company's crisis performance. Having a frank and fulsome discussion is vital to understanding how effective all parties have been in these unprecedented times. For example, a recent survey involving more than 550 executives indicated that only 30% felt that their Board is able to respond well to a crisis, suggesting that a two-way dialogue with management could help the Board understand any perceived shortcoming it may have, just as the Board does with respect to its oversight of the company's management.

In addition to using this review for internal improvement, it should be expected that investors are conducting similar audits of portfolio investments, and will expect management, and the Board, to have a firm grasp on these factors and be able to explain how opportunities are being exploited and challenges being addressed. Board effectiveness rightfully continues to be a key focus of investors. Knowing your COVID Scorecard provides a basis for proactively engaging with key shareholders and having a ready and considered response to any shareholder concerns or questions.

Retune Your Company's Risk Oversight Systems

The extreme changes over the past year call for a ground-up reassessment of the key risks affecting the company. As a director, you are tasked with implementing information and reporting systems reasonably designed to provide the Board and senior management with timely, accurate information sufficient to support informed judgments about the risks facing the company and

monitoring the information and reports these systems provide. Those systems may well need to be retuned to account for changes both to the environment in which the company operates and to the company's business model brought on by the pandemic. This includes taking into account how the company's responses to the challenges of the pandemic and related shutdowns, however appropriate from a business perspective, may have created new or increased exposures. Such a comprehensive review requires engaging with management to take a fresh look at the key risks affecting the business today and in the near, medium and long-term. The results from the company's COVID Scorecard feed directly into this analysis.

Key examples of common changes to corporate risk profiles wrought by the pandemic include supply chain and technology. Shortages of basic consumer goods made supply chain a household word in 2020, but the risks exposed by the pandemic of course extend well beyond toilet paper and PPE. At the corporate level, the pandemic's effects on global production and trade, as well as geopolitical trade tensions, have drawn attention to the company's suppliers, clients and customers. Disruptions that rippled across the globe revealed how little insight many companies had into their supply chains and weaknesses in the various levels of suppliers. Understanding supply chain from raw input through end product has become a corporate imperative for many companies, and essential for a wide swath of industries, from food to public health, information technology to energy. The focus for many has shifted from efficiency to resiliency, including geographic and geopolitical diversification.

Moreover, heightened focus on responsible supply chains has led to increased scrutiny of and disclosure around corporate supply chains from an environmental, social and governance (ESG) perspective, including regarding labor practices, sustainability and ethical considerations. For example, Apple's announcement in 2020 that it will pursue total carbon neutrality, not just at the corporate level but throughout its manufacturing supply chain and product life cycle, underscores the importance for companies at all points of production and supply to understand both where they and their suppliers stand on factors such as climate impact, raw material use and sourcing, and fair and equitable treatment of employees. Both the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI) address supply chain disclosures. And additional considerations are coming to the fore, such as biodiversity and water waste, requiring constant updating of the framework for analyzing supply chain risks.

Failure of proper management and oversight of supply chains creates both business and reputation risk, including backlash from customers, clients, employees, and investors. And recent government actions underscore that supply chain will be a key area of focus for the Biden-Harris Administration, creating both risks and opportunities for companies.

Boards should work with management to understand, benchmark and monitor supply chain risks and exposures, and be prepared to discuss them with key stakeholders.

The truism that every company is a technology company became reality for many companies in 2020, often at a breakneck speed. Working from home, and having almost exclusively virtual interaction with customers and suppliers, accelerated the adoption of technology in mission-critical applications. In this environment, it is essential for Boards to understand and be on top of the current uses and risks of technology in the company's business. As technology becomes more central to the company's business, management of risks needs to evolve as well. The vulnerability of both sophisticated governmental and private sector participants in

the *Solarwinds* cyberattack is just one example of the risks associated with increased technology dependence. Dependence on the internet to conduct business means a company is reliant on an inherently unsafe medium for commerce and communication.

In addition to cybersecurity, with continued work from home requirements in place for many American businesses, and the potential for continued remote work even after the pandemic subsides, the Board should examine the impact of technology both in enabling remote collaboration and productivity as well as employee well-being. The average American workday has increased 40% during the pandemic, with the distinction between work and home breaking down, and adult mental health disorders have reportedly increased threefold during the same time. With many companies identifying employees as their greatest assets, the Board should focus on and track the impact of remote work, and technology, on those employees. Employee morale, retention and recruiting depend on it.

The Board should assess whether it has the right level of technology expertise among its members and if not, whether additional director candidates should be considered, including those inside the company. The Board should also assess its oversight function for cybersecurity and other technology risks. For some companies with higher exposure to technology risks, this could mean creating a separate Board committee that includes one or more directors steeped in technology (including company insiders) that is charged with overseeing this area in a more focused and sustained manner. In a recent survey, approximately three quarters of C-suite IT executives viewed their Board’s performance as fair or poor, compared to just one quarter of CEOs and CFOs, and when executives were asked to grade their Board’s subject matter expertise, IT/digital/data privacy and cyber risk expertise were at the bottom. While Boards are not accountable to management, responses such as these suggest that there is room for improvement for Boards of Directors in handling of the critical risks and opportunities that technology foists upon companies.

Lastly, there is increasing pressure for Boards and management to understand and monitor not only business operational risks, but also key environmental and social risks such as the impact of climate change on the company’s business and stakeholders. We discuss ESG factors more below, but any assessment of key risks facing a company should incorporate material environmental and social factors that affect the company’s business, given the potential impact on capital availability, talent and business opportunities.

Integrate ESG Considerations Into Board Processes and Strategy

The ESG landscape has evolved significantly over the past year. It is safe to say that the Board of Directors of every public company, regardless of that company’s business or size, is expected to be engaged actively in ESG management, from sustainability to diversity and inclusion. Continued momentum towards more engaged ESG management, even in the face of a global pandemic, has made clear it is not a passing trend. BlackRock’s CEO announced in his 2020 annual letter to CEOs that sustainability would be the $7 trillion AUM asset manager’s new standard for investing, and his 2021 letter to CEOs expanded on that theme, stressing the importance of continued efforts on sustainability and diversity, equity and inclusion. The Big Three of BlackRock, State Street and Vanguard also announced positions on Board diversity, including the intention to oppose certain directors should diversity concerns not be addressed adequately. Proxy advisor firms have also ramped up pressure. In order to assist shareholders in

engaging on diversity and inclusion issues, ISS announced that it will identify in its 2021 research companies lacking diversity at the Board level, and begin recommending against certain directors in the 2022 season if the Board fails to address diversity shortcomings. Regulatory focus has intensified as well. In September 2020, California enacted a law that requires California-headquartered public companies to have at least one director on their board of directors who is from an underrepresented community by the end of 2021. In December 2020, Nasdaq filed a proposed rule change with the SEC, which was subsequently amended in February 2021 and is still under consideration, that would require most Nasdaq-listed companies to publicly disclose diversity statistics regarding their board of directors and to have, or explain why they do not have, a minimum number of diverse directors. While the prior administration began to push back on private sector ESG initiatives, the new Democratic White House and Congress can be expected to pull hard the other way, as early actions presage.

Capital inflows to ESG-focused investment products accelerated in 2020, and the shareholder landscape now includes investment managers dedicated to ESG-focused shareholder activism. Socially-responsible activist investment firm Engine No. 1 announced its launch and first campaign in December 2020, targeting Board change at ExxonMobil, with public backing from pension fund CalSTERs. Each of Inclusive Capital Partners (launched 2020) and Impactive Capital (launched 2018) has ESG front and center in their investment approach. And mainline activists also are running ESG-themed campaigns. In November 2020, TCI Fund Management submitted climate change shareholder proposals to each of Canadian Pacific Railway and Canadian National Railway for consideration at those companies' 2021 annual meetings. Shareholder support for environmental and social proposals has continued to rise, hitting all-time highs in 2020. Activist alignment with institutional investors and others focused on ESG considerations creates the potential for significant shareholder alignment around engagement with perceived ESG laggards. And green finance and ethical debt are part of a new field of borrowing available to companies, providing opportunities to finance specific "green" projects or to incentivize certain targeted behavior on the part of the borrower. These green bonds and loans grew 37% in 2020, to $744 billion in total, and represent a significant and expanding alternative source of capital for companies prepared to exploit it.

Addressing these critical subjects is not just about reacting to and complying with shareholder, regulatory or other stakeholder requirements or standards, however important those may be. Stakeholder focus and increased asset flows towards ESG investment products are part of a broader recognition among the investment and business communities that putting ESG concerns on the critical path can materially improve a company's performance and value. Research has drawn positive correlations between companies that do good and companies that do well financially—and by extension, do well for shareholders. An analysis of more than 2,200 studies on ESG and corporate financial performance found that 90% show either a positive relationship to corporate financial performance or at least no-negative relationship, with the large majority reporting positive findings. On top of this, focusing on ESG factors can have a material business and reputational impact on a company, including access to capital, talent and business opportunities.

A key task for the Board is to work with management and other stakeholders to establish systems to formally *measure, and monitor*, critical ESG factors. Climate risk, diversity and inclusion, income inequality, and others are capable of being analyzed, tracked and addressed by companies. Institutional investors and other stakeholders are increasingly demanding that Boards

be transparent with respect to both how they oversee and measure these factors, and how the corporation has performed. For sustainability reporting, it is true that no unified standard exists, but given recent developments there will undoubtedly be significant progress towards universal standards in the coming year. The World Economic Forum, together with the Big Four accounting firms, announced their collaboration in early 2020 and recently released a white paper on a unified reporting framework. In December 2020, the SEC's ESG subcommittee recommended that the SEC adopt standards requiring the disclosure of material ESG risks in a manner that is "consistent with the presentation of other financial disclosures" and that facilitates "uniform comparison of material ESG risks across industries and specific comparison within industries." In September 2020, the International Financial Reporting Standards Foundation announced it would develop a new sustainability standards board, the International Sustainability Standards Board, which received support from BlackRock, among others. And in September 2020, key groups working on reporting standards, including the Sustainable Accounting Standard Board, Global Reporting Initiative, Climate Disclosure Standard Board, and International Integrated Reporting Council, announced a statement of intent to work together to develop a comprehensive reporting framework. Mandatory climate-related and sustainability-related financial disclosure frameworks are already in effect in the European Union (as of January 1, 2021) and United Kingdom (as of March 2021), and action can be expected from US regulators in the coming months, given the Biden-Harris Administration's plan to "require[e] public companies to disclose climate risks and the greenhouse gas emissions in their operations and supply chains." Indeed, in the past few weeks, the US Securities and Exchange Commission has issued a series of press releases and statements regarding climate-related disclosure and ESG initiatives, signaling substantive action in the coming months and years.

While this area is still developing, that is not a reason for inaction. Major institutional investors are already holding Boards responsible for publishing relevant ESG data and managing ESG factors. The world's three largest asset management firms, BlackRock, State Street and Vanguard, have each put forth disclosure frameworks and ramped up their engagement efforts with companies in which they are invested, including by voting against incumbent Board and management proposals. For example, in July 2020, BlackRock announced that it had identified 244 of its portfolio companies who had made insufficient progress in integrating climate risk into their business models or disclosures, had voted against the management of 53, and had the remaining companies on its watch list. In 2020, State Street's CEO announced plans to take action against the Boards of companies that underperformed in ESG management, which he recently reaffirmed, citing the resilience and outperformance of companies with strong ESG characteristics during the pandemic. ESG concerns at a company can create natural areas of cooperation among disparate shareholders, including activist investors. Boards should be informed about the company's ESG measures and performance. This includes potential vulnerabilities of individual Board members and management who could be singled out for criticism. Any such exposures create openings for campaigns for change at the Board and management levels that could draw broad-based shareholder support.

Investors and other stakeholders are demanding action on ESG management, and directors are under pressure to respond now. Understanding how your company measures up, what it is doing to monitor and address any shortcomings or weaknesses, and how it is communicating that information to stakeholders is critical regardless of your company's business model, industry or market capitalization. And companies perceived as laggards on ESG issues, or engaged in non-substantive "greenwashing" exercises, can expect difficult conversations with investors, employees and others in the coming days, months and years.

Conduct a Ground-Up Reassessment of Corporate Strategy

COVID-19 understandably drew the focus of many corporations to crisis management and the near-term risks and opportunities created by pandemic-related dislocations. Elements of corporate strategy were a natural part of this discussion, and have continued to be discussed as companies adjusted to the new environment. In light of the fundamental shifts in companies and our economy and society over the past year, directors should consider engaging with management to go beyond a regular annual strategic review and conduct a ground-up reassessment of the company's corporate strategy. Depending on the company, the pre-COVID strategy may need only fine tuning or possibly a wholesale rewrite. What is important is to revisit all aspects of corporate strategy and test old assumptions, taking into account the lessons from the company's COVID Scorecard and update of its risk oversight systems. Any new, or increased, risks in the company's business model could be addressed through portfolio realignment or partnership/acquisition strategies, for example. A review of corporate strategy should include a fresh look at near and long-term strategic goals, identify accountability milestones for those goals and anticipated barriers to achieving them, and ensure the alignment of capital allocation priorities in the plan with those goals and milestones.

This corporate strategy update should not just focus on the new risks and opportunities identified in the pandemic. What is expected of Boards and management teams today is embracing a broader notion of corporate strategy beyond business and operational considerations or near-term value maximization strategies. While the debate between shareholder and stakeholder primacy is far from settled, the notion that a corporation has a purpose beyond just shareholder value maximization has drawn broad acceptance from the corporate world. The Business Roundtable's "Statement on the Purpose of a Corporation", released in August 2019, espouses a stakeholder-centric approach, and has received the endorsement of the CEOs of over 180 major corporations. Moreover, purpose can also protect and create value for the company, ultimately benefiting the shareholders. Per BlackRock Investment Stewardship, "[w]e believe that a strong sense of purpose builds business confidence, aligns employees with management's strategy, creates loyal customers, and informs other stakeholders." And on the flip side, a corporate strategy that runs counter to the company's culture and mission can create friction with employees, customers and other constituencies.

In addition, as part of the purpose-driven strategy, stakeholders are increasingly demanding that the company's strategic plan address ESG considerations, such as climate change and diversity. In his 2021 letter to CEOs, BlackRock Chairman and CEO Larry Fink requested that companies disclose a plan for how their business model will be compatible with a net-zero economy and describe how this plan is incorporated into the company's long-term strategy and reviewed by the company's Board of Directors.

The impact of these requests is significant. Integration of purpose and ESG considerations into corporate strategy is more than a public relations exercise. Purpose-driven strategy requires setting concrete goals—and capital allocation priorities–based on goals such as sustainability, diversity and inclusion, and creates accountability on the Board and management for hitting those targets. It also requires that directors are fluent in the company's purpose and how the company's strategic plan meshes with, and reinforces its mission and values. Stakeholders of all stripes—employees, investors, customers, community—now increasingly expect the Board and management of a company to ensure that the company's strategic plan reflects and reinforces

the company's purpose. It is incumbent on the Board to ensure that the company's purpose is spelled out and integrated into the corporate strategy.

Prepare for a New Environment of Engaged Shareholders

It's safe to say that the so-called "COVID truce" from activist and other engaged investors is over. While 2020 witnessed a decline in activist activity of approximate 10% globally on an annual basis, the last quarter of the year saw a swell of new activity, with total new campaigns exceeding the fourth quarter of 2019. Fifty-seven new campaigns launched globally in the fourth quarter (including 30 in the US, a 200% increase from the prior quarter), lifting the 2020 total back in line with recent averages. Opportunities for activist stake building have been enhanced with continued market volatility and enhanced options liquidity, offering the potential for accelerated stake building and more attractive valuations. Moreover, the universe of engaged shareholders has continued to grow. First time activists made up almost a third of all activist campaigns worldwide in 2020, continuing recent trends. Investors outside of "mainline" activist investment managers have increasingly used activist shareholder tactics, and exercised their shareholder franchise to register their approval, or disapproval, of corporate action. Private equity funds, traditional investment firms and passive institutional investors like KKR, Neuberger Berman and T. Rowe Price have publicly employed hard activist tactics, including proxy fights and no vote campaigns, to achieve their goals in recent situations. While in the past support among many of these groups for core activist campaigns was largely tacit, these groups are increasingly willing to speak up and join the fray publicly.

In this environment, it is imperative that the Board dusts off, and updates, the company's response plan to an engaged shareholder campaign. This is more than just defensive readiness. The response plan should integrate key takeaways from the company's COVID Scorecard, updated risk oversight and corporate strategy review and ESG management. And directors should ensure broad-based support among fellow Board members and management for the plan. An informed and uniform position on each of these subjects is critical to an effective response to activist campaigns. And to preempt attacks and understand shareholder perspectives, directors and management should engage with the company's shareholder base now to articulate the company's positions and hear shareholder input and concerns. Anticipating, and addressing, perceived areas of weakness reduces the opportunities for, and potential success of, activist campaigns, and fortifies the Board's relationship with the shareholder base.

Lastly, conducing a response dry run with management and advisors will provide the opportunity for building rapport among the Board, management and their advisors. This can help facilitate effective responses to activist pressure by ensuring a level of trust among the parties and familiarity with key issues affecting the company. Having this relationship before being subject to a fast-moving, and potentially contentious, campaign can help ensure a productive working environment and engaged, unified team from day one.

Strengthen the Board and the Corporation

A key determinant of Board effectiveness is an engaged and strong directorship that is capable of examining its composition and function critically and addressing any weaknesses. Key takeaways from the points discussed above that can strengthen the Board and the company include the following:

- Ensure the Board has experience in key functional areas for the company, such as finance, supply chain, technology, governance and strategy, and identify areas that could be bolstered or filled.
- Address Board diversity and inclusion head on. Nominating and Governance Committees should look at their processes and consider how they take diversity into account. If the Board falls short of diversity standards, it should be prepared to explain why and the steps it's taking to remedy that.
- Assess whether the Board has adequate resources to address all the responsibilities that the Board is expected to handle in today's environment. This includes both internal skills and bandwidth (including determining whether additional directors are needed) and external advice and guidance.
- Examine Board structure for fit with the company's business and strategy. Does the Board have the optimal committee structure to monitor the key areas of risk to the company? For example, if the company is highly technology dependent or handles sensitive client information, should the technology oversight function be vested in an existing committee (e.g., Audit) or the full Board, or should a technology-focused committee take lead on oversight, and how regularly should that oversight review be conducted?
- Ensure that the Board has a strong independent lead director or non-executive chairperson, someone who works well with management but can be a strong independent voice. With the responsibilities and expectations placed on boards of directors in today's environment that are separate from and in addition to those on management, having an effective lead is critical to ensure the Board is able to perform its role. This person will be essential to set agendas, and to communicate the Board's perspective and positions in meetings with shareholders and other key stakeholders.
- Ensure that adequate time is allotted at meetings to address critical issues confronting the company, including management focus. Make sure each critical workstream is on the agenda, with adequate time for discussion, at Board meetings, including future meetings with updates.

Deficiencies in any of these areas can both weaken Board effectiveness and create openings for engaged shareholders to pursue Board change. Establishing strong governance at the company helps to ensure that the company deals effectively with developing and implementing corporate strategy, overseeing key risks, addressing environmental and social factors relevant to the company's business, and communicating its mission and culture, and translating the same into corporate action. Directors should ensure that the Board, working with management, can take point on these items and develop the message and strategy. Tone at the top is important.

The complete publication, including footnotes, is available here.