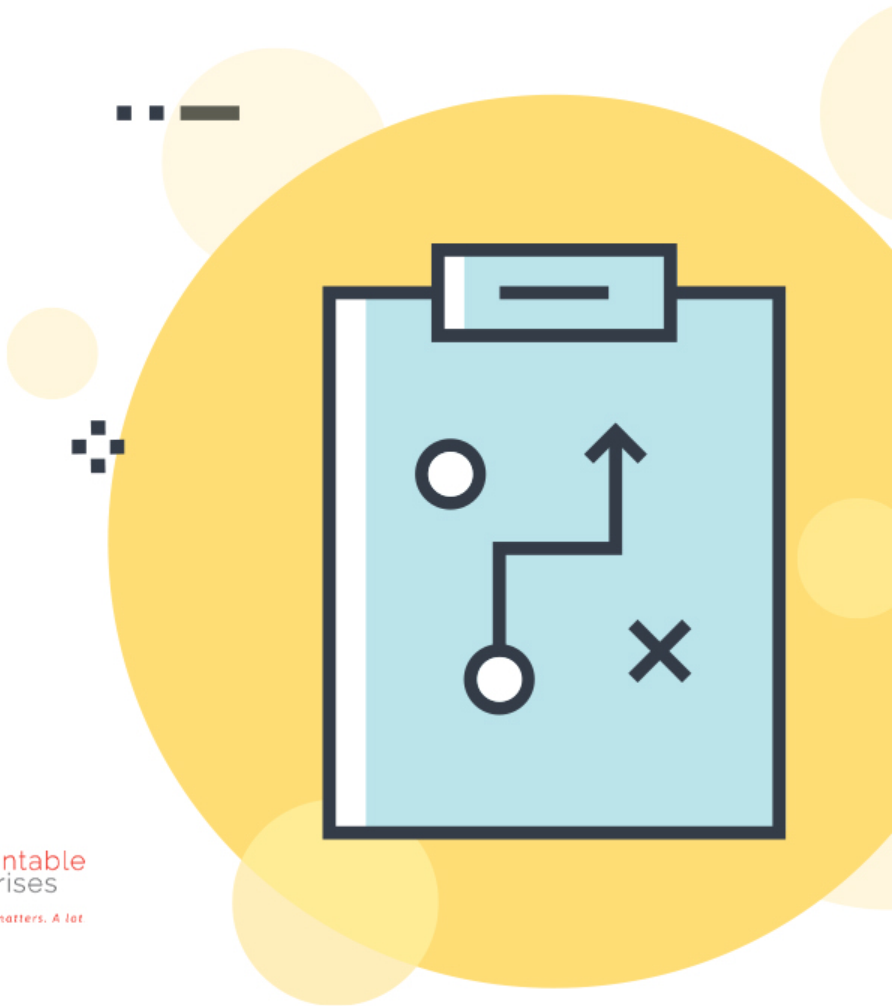
Roadmap for Overcoming Unbalanced Short-Termism

July 29, 2020



Reinhart Boerner Van Deuren s.c. Attorneys at Law

Susman Godfrey LLP

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Welcome and Introductions

Keith L. Johnson

Shareholder, Reinhart Boerner Van Deuren

The Honorable Leo E. Strine, Jr.

Delaware's Former Chief Justice

Ken McNeil

Partner at Susman Godfrey L.L.P.

Tiffany R. Reeves

Shareholder, Reinhart Boerner Van Deuren

Alison Taylor

Executive Director of Ethical Systems

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Three key webinar topics today focus on practical ways to improve long-term investor and corporate performance

1. How corporate decision-makers can weave ESG and *Caremark* principles into their business models to stop corporate short-termism
2. How long-term investors can influence corporate decision makers to employ long-term strategic planning
3. How to use effective advocacy skills to persuade corporate decision makers to change their way of thinking on short-termism

Topic One:

How corporate decision-makers can weave ESG and *Caremark* principles into their business models to stop corporate short-termism

Leo Strine – questions by Ken McNeil

Former Delaware Chief Justice Leo Strine, Jr. has been a founding father and architect of **two separate streams** of thinking that are **now converging**

(1)

Pressing long-term investors to influence corporate board members to do long-term risk-assessment and decision-making

(2)

Helping Delaware courts expand the *Caremark* line of cases to a more proactive monitoring of such risks

Under his speaking and writing hat, Justice Strine has been the founder for the movement to encourage investor fiduciaries to press corporations to do more long-term strategic investment

Former Delaware Supreme Court Chief Justice Leo E. Strine, Jr.

"[T]o **foster sustainable economic growth**, stockholders themselves must act like genuine investors, who are interested in the **creation and preservation of long-term wealth**, not short-term movements in stock price."

Under his judicial hat, Justice Strine has strengthened corporate board obligations to proactively monitor company regulatory compliance and exposure to material ESG factors

"If *Caremark* means anything, it is that a corporate board must make a good faith effort to exercise its duty of care. A failure to make that effort constitutes a breach of the duty of loyalty. Where, as here, a plaintiff has followed our admonishment to seek out relevant books and records and then uses those books and records to plead facts supporting **a fair inference that no reasonable compliance system and protocols were established as to the obviously most central consumer safety and legal compliance issue facing the company**, that the board's lack of efforts resulted in it not receiving official notices of food safety deficiencies for several years, and that, as a failure to take remedial action, the company [Blue Bell Ice Cream] exposed consumers to listeria-infected ice cream, resulting in the death and injury of company customers, the plaintiff has met his onerous pleading burden and is entitled to discovery to prove out his claim."

Marchand v. Barnhill, 212 A.3d 805 (Del. 2019)

Strine's efforts are paying off: In 2019, over 200 CEOs in the Business Roundtable have now committed to a long-term planning perspective

The New York Times

Shareholder Value Is No Longer Everything, Top C.E.O.s Say

Chief executives from the Business Roundtable, including the leaders of Apple and JPMorgan Chase, argued that companies must also invest in employees and deliver value to customers.

"Just as we are committed to doing our part as corporate CEOs, we call on others to do their part as well. **In particular, we urge leading investors to support companies that build long-term value** by investing in their employees and communities."

– Press Release by the Business Roundtable, August 2019

In the webinar today, we are talking with former Delaware Chief Justice Strine about ways to transform the aspirational goals of ESG into reality in corporate decision making – consistent with *Caremark* and its monitoring requirements

CAREMARK AND ESG: PERFECT TOGETHER:

A PRACTICAL APPROACH TO IMPLEMENTING AN INTEGRATED, EFFICIENT AND EFFECTIVE CAREMARK AND EESG STRATEGY

By

The Honorable Leo E. Strine, Jr.[1]
Kirby M. Smith, Esq.[2]
Reilly S. Steel, Esq.[3]

Keynote Lecture

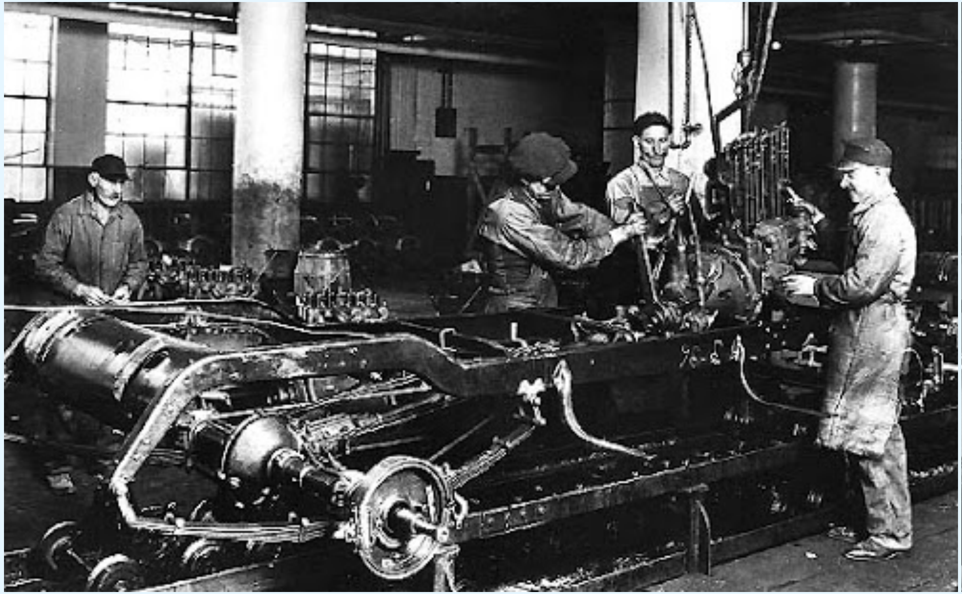
Virtual Board Leadership Forum
Ira M. Millstein Center for Global Markets and Corporate Ownership
and
Deloitte.
Columbia Law School
May 12, 2020

Topic Two:

How long-term investors can influence corporate decision makers to employ long-term strategic planning

Panel Discussion with Ken McNeil

The requirement under *Caremark* – that directors **monitor** their corporation's conduct – is so crucial because corporations **"think" through their accounting systems**



Automobile industry post-World War I
Rise of short-term account systems designed by Alfred P.Sloan of General Motors

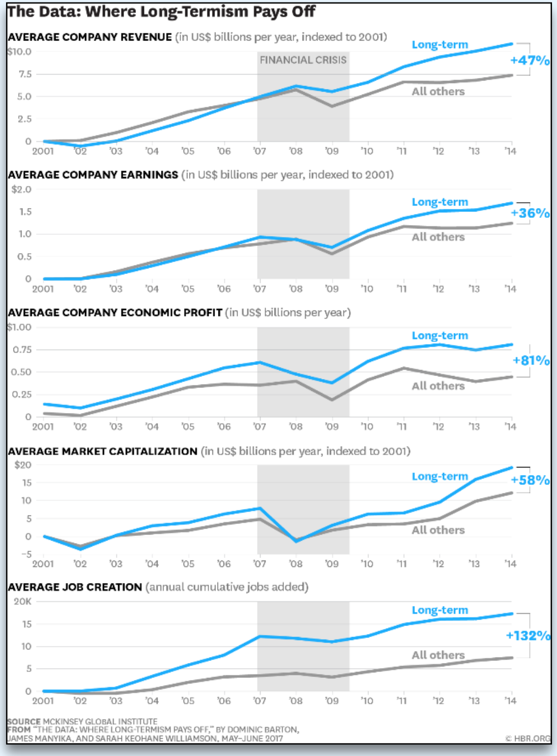
Automobile industry after Japanese invasion in late 1970s-early 1980s
Introduction of longer-term accounting measures of customer satisfaction

Unfortunately, most of the S&P 1500 corporations' decision making is biased towards the short-term – with no accounting systems monitoring risks over the long-term

No Strategic Plan	No Method of Measuring Long-Term Capital Efficiency	No Method of Measuring the "Future Value" of the Company	No Long-Term Incentive Plans
85% of listed companies longest **strategic planning horizon is less than 5 years** (McKinsey/CPPIB Survey)	**75%** of S&P 1500 companies have **no long-term measures of capital efficiency** (Equilar)	**85%** of investee companies have **no disclosed Future Value metrics** for issues like innovation (IRRC Study)	**85%** of listed companies in the S&P 1500 have Long Term Incentive Plan performance periods of **less than 3 years** (IRRC Study)

Evidence now shows the extreme systemic nature of this short-term bias in decision making – in over 80% of U.S. corporations

Corporate directors have a duty to maximize long-term profits for the investor – and companies with long-term planning make more profits



- Long-term US companies, as defined by five financial metrics, have generated superior growth over time (capex/depreciation, accruals/revenue, margin growth, EPS vs. earnings growth, and narrowly missing EPS targets)
- During the financial crisis, long-term companies were punished by the market but by staying the course staged a stronger rebound in its aftermath
- Had short-term companies been able to achieve similar results, the **US would have created an additional five million jobs and added $1 trillion in asset wealth**

The “nuts and bolts” question is how to change these short-term accounting systems to include long-term strategic planning and monitoring

The path toward long-term thinking completely parallels the duty of monitoring imposed on corporate directors by the *Caremark* line of cases

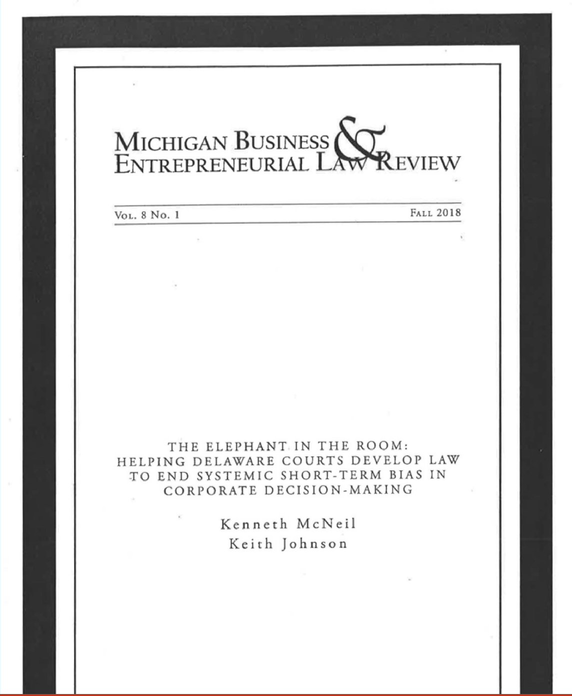
Graham v. Allis-Chalmers (1963)	***In re Caremark (1996)***	***In Re Abbott Laboratories (2003)***	***Marchand v. Barnhill (2019)***
1960s	**1990s**	**2000s**	**2010s**
Liability for **failing to heed "red flags"** of probable wrong-doing – even though not expected to ferret out wrong-doing - Delaware Supreme Court	Liability for lack of good faith for the "**utter failure" to institute a systematic law compliance program** - Delaware Supreme Court	Liability for "a **conscious disregard of known risks**, which conduct, if proven, **cannot have been undertaken in good faith** - Delaware Supreme Court	Liability for failure to "make a **good faith effort to exercise its duty of care**. A failure to make that effort constitutes a **breach of the duty of loyalty**." - Delaware Supreme Court

Failure to heed red flags → **Failure to institute legal compliance** → **Conscious disregard of known risks** → **Failure to make good faith effort of duty of care**

Many of the goals embodied in ESG are long-term goals and will only be implemented through long-term strategic risk assessment in corporate accounting/monitoring systems

That is the "elephant in the room" that must be addressed

What needs to be changed are the **“rules of the game”** for corporate decision making – and ***Caremark*’s focus on the duty to monitor** should provide more leverage for corporations to adopt long-term strategic planning



MICHIGAN BUSINESS & ENTREPRENEURIAL LAW REVIEW

VOL. 8 NO. 1 FALL 2018

THE ELEPHANT IN THE ROOM:
HELPING DELAWARE COURTS DEVELOP LAW
TO END SYSTEMIC SHORT-TERM BIAS IN
CORPORATE DECISION-MAKING

Kenneth McNeil
Keith Johnson

This analysis is set forth in more detail in
“*The Elephant in the Room” law review article*

Indeed, the failure of corporate directors to monitor long-term risks is as disastrous as using a three-mile radar on a super-tanker

PEARL HARBOR
VISITORS ★ BUREAU

"**Short-termism in corporate decision-making is as problematic for long-term investors as relying on a three-mile radar on a supertanker. It is totally inadequate for handling the long-term risks and opportunities faced by the modern corporation**. Yet recent empirical research shows that up to 85% of the S&P 1500 have no long-term planning. This is costing pension funds and other long-term investors dearly."

"The Elephant in the Room: Helping Delaware Courts Develop Law to End Systemic Short-Term Bias in Corporate Decision-Making" Kenneth McNeil and Keith Johnson, *Michigan Business & Entrepreneurial Law Review*, Fall 2018

One need only look at recent headlines to understand the lessons we are learning from corporate short-termism

September 15, 2019

The New York Times

Purdue Pharma, Maker of OxyContin, Files for Bankruptcy

The filing is a centerpiece of an agreement to settle thousands of cases against the company for its role in the opioids crises. But it is expected to be vigorously contested by many states.

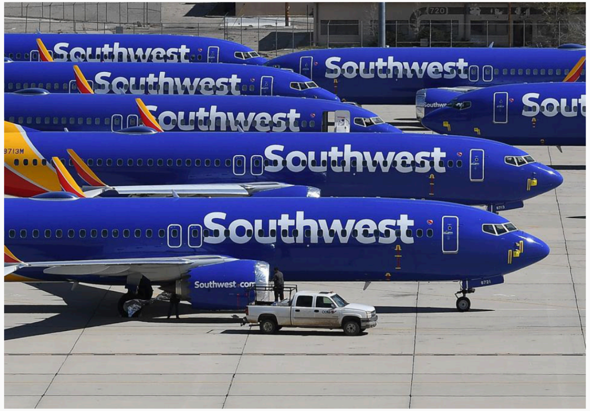
Purdue Pharma's headquarters in Stamford, Conn., on Thursday.
Frank Franklin Ii/Associated Press

By Jan Hoffman and Mary Williams Walsh

January 5, 2020

In 2020, Have Boeing's Problems Just Begun?

Michael Goldstein Contributor
Travel



Southwest Airlines Boeing 737 MAX aircraft are parked on the tarmac after being grounded, at the ... [+] AFP VIA GETTY IMAGES

February 8, 2020

Facebook's troubles continue to grow: What you need to know

The social network is under fire for how it collects user data.

BY QUEENIE WONG, RICHARD NIEVA | FEBRUARY 8, 2019 2:58 PM PST

Facebook CEO Mark Zuckerberg
Christophe Morin/Getty Images

Facebook can't seem to get through a week quietly.

This week, Germany's antitrust regulator ordered the world's largest social network to stop combining data from the Facebook accounts of its German users with information it collects about them from other sites unless they give their OK. The Federal Cartel Office's order covers not only Facebook's site, but Instagram,

Investors have a spectrum of choices for engaging with corporations using in a “carrot and stick” approach – including using Delaware courts to enforce and expand *Caremark’*s monitoring requirements

Engaging with corporations to encourage long-termism strategic thinking

Litigating to confirm that corporate directors have fiduciary duty to engage in long-term planning

Investor Letters

Collaborative Engagement

Shareholder Resolutions

Books and Records Actions

Suing for Breach of Fiduciary Duty

It is more than a spectrum – it is a menu of options that can be used to force the Business Roundtable CEOs to make good on their promises

- **Publicize** the issue through investor policies and collaborative communications demanding long-term strategic planning by directors
- **Engage** corporations around long-term strategic planning and transparency
- **Vote proxies** to promote improved reporting, addition of directors with long-term planning expertise and aligned incentive compensation
- File **shareholder resolutions** requesting reports on board oversight and implementation of long-term strategic planning
  - The SEC approved a shareholder resolution requesting improved reporting on long-term strategic planning at Motorola in 2002
- **Use books and records inspections and enforcement actions** to test reliability of planning and accuracy of disclosures
- **Develop a litigation strategy** to establish clear corporate law strategic planning duties drawn from the "Elephant in the Room"
  - Turn board legal counsel, insurers and advisors into advocates

Never was there a more perfect time for long-term investors to shift corporate thinking toward the long term

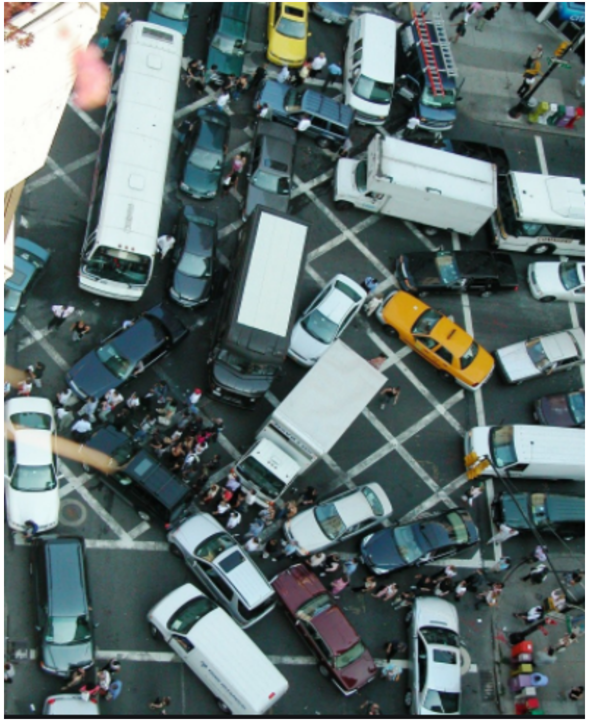
1. Long-term investors have huge leverage – money the corporations desperately need in this new COVID era.
2. COVID is upending traditional business models – making it easier to shake up old ways of short-term thinking.
3. *Caremark* provides legal leverage for long-term investors to change the "rules of the game" in the corporate boardroom away from short-termism.

Topic Three:

How to use effective advocacy skills to persuade corporate decision makers to change their way of thinking on short-termism

Panel Discussion with Alison Taylor

We know short-termism is a problem, but rational arguments aren't enough



Investors know that long-term thinking is key, but are seeking to drive this via a focus on corporate performance on overlapping, inconsistent and confusing ESG ratings.

Company leaders know that long-term thinking is key, but default to quick fixes and status quo approaches. They understand **what** needs to change, but not **how** to do it.

Ethical Systems

The Rider and the Elephant

The Rider

The conscious, rational, thinking brain

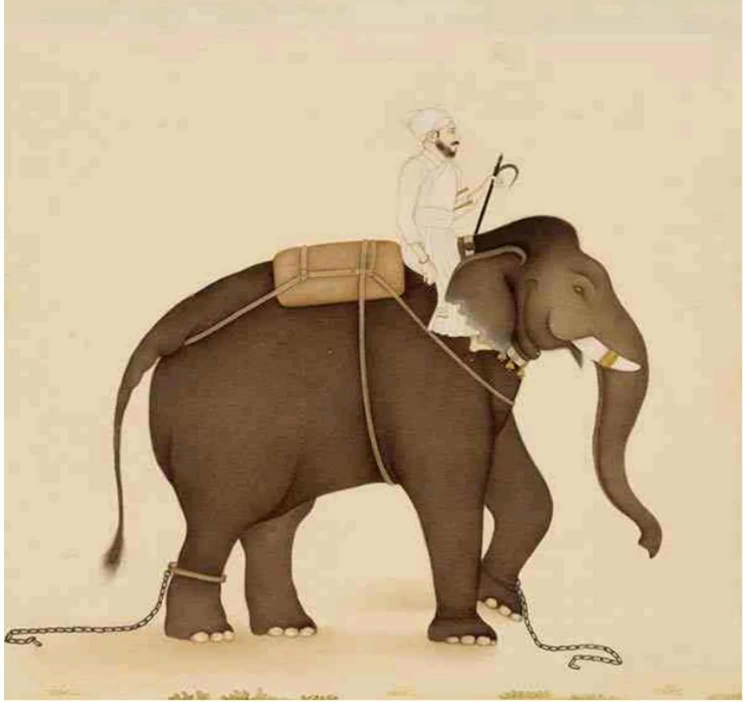
Slow, effortful, analytical

Clarity is key

Makes decisions based on self awareness and control

Easily exhausted

Often defaults to listening to the (more powerful) elephant



The Elephant

The emotional, experiencing brain

Fast, automatic, intuitive

Stories are key

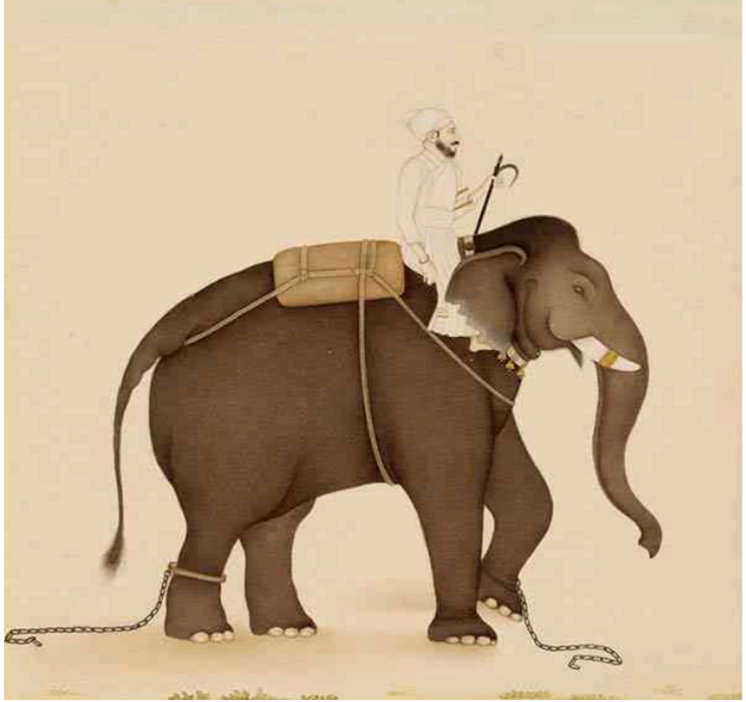
Lacks self-awareness and control

“What you see is all there is”

Energetic, and powerful

Ethical Systems

How to drive change



Direct the rider:

Give clear direction, reduce mental paralysis

Motivate the elephant:

Understand and leverage intuition and bias for positive change

Shape the path:

Reduce obstacles, tweak the environment, make the journey go downhill

The social matrix

Two lessons:

1) Social reality is a social construction

2) The situation is more powerful than we realize

3) Change the environment, change the path,
direct the elephant where you want him.

Ethical Systems

Understanding and working with cognitive bias

Bias	Manifestation
Messengers	We are influenced by who communicates to us. If we trust the messenger, we give more weight to the message.
Incentives	Our responses to incentives are shaped by predictable shortcuts. Losses loom larger than gains, driving loss aversion and risk aversion.
Norms	We are strongly influenced by what others do. We conform to the majority opinion even when we know it is wrong, as the famous Asch experiment shows.
Defaults	We “go with the flow” of pre-set options.
Priming	Our acts are often influenced by subconscious cues.
Affect	Our emotional associations can powerfully shape our actions.
Commitment	We seek to be consistent with our public promises. Moreover, we are willing to punish unfair behaviors even when it is costly to do so; and we feel compelled to reciprocate a good turn.
Ego	We act in ways that will make us feel better about ourselves. We are subject to self-serving attributions, especially around over-performance.

Human Behavior and ESG Investor Engagement

Key Drivers of Investor Influence

Power

- Ownership levels
- Potential to use shareholder rights
- Ability to divest or reduce holdings

Legitimacy

- Strong business case
- Deep knowledge of the company
- Credible as long-term owners
- Reputation
- Investor interpersonal skills
- Constructive interaction

Urgency

- Major ESG risks/negative events
- Investor persistence
- Impending regulatory change
- Reputational threats and activism
- Media coverage supporting investor angle

Ethical Systems

Engagement Approaches and Success Factors

Direct dialogue is less confrontational than other approaches, but is the best enabler of constructive discussion, and facilitates mutual sharing of insights. Productive discussions can shape corporate culture, and greatly improve mutual understanding of culture, performance and strategy, leading to better long-term outcomes. Meeting face to face is best, if possible!

Approach	Success Factors
Direct Dialogue	Business case, clear set of actions, time and preparation, powerful company decision-makers, cultural alignment, investor collaboration, solutions-oriented tone, repeated engagement.
Shareholder Proposals	Strong business case, focus on visible players to influence wider market, clear reputational risk facing the company in question, input from wider investor community, specific requests to companies, and performance tracking, solution-oriented tone.
Proxy Voting	Institutional investor alignment, focus on visible players, educational campaigns to initiate collective action, voter expertise and familiarity.
Public Policy Engagement	Investor collaboration and collective voice, allocation of resources, participation in shaping of policy solutions.
Divestment	Awareness, momentum and deployment of public statements, moral and financial arguments reinforce each other, attracts public and policy attention.

Ethical Systems

How can investors increase impact through their choice of messenger and message?

Picking the Messenger

Collaboration works: Research shows that **coordinated engagements** with lead and supporting investors are more likely to succeed, as they indicate shifting norms.

Cultural alignment is key: Success is more likely when the lead investor is **domestic**, supporting investors are international, and the investor coalition is influential. If the lead investor is linguistically, socially and culturally aligned with the target company, success rates are elevated.

Build credibility: Seniority and experience matter, a lot. A former public company Board member will be more effective than a 20-something MBA.

Self-knowledge matters: Reporting changes at pension funds have driven short-term thinking and many pension funds equate long-term thinking with indexed funds, meaning that pension funds "are perpetual investors making short term investments in companies, forever." Investors must manage their own incentives before influencing others.

Focus on the powerful: Include key decision-makers in dialogue if possible, not only Investor Relations.

Clarifying the Message

Focus: Long-term strategic foresight provides a business and moral imperative, and may be the most useful way to frame even issue-specific efforts.

Use the E and S to drive the G: After successful engagements on E and S issues, poorly governed firms improve their governance. Use E and S issues of concern as leverage to drive more fundamental changes to governance, leadership and culture.

Target incentives: Any efforts must consider and reflect incentives for change. Governance and climate efforts move markets. Resource allocation must consider how investment in intangibles takes time to pay off.

Align with efforts to shift norms: Align with the Business Roundtable, long-term investment efforts and international governance bodies to build momentum behind shifting norms and help companies reconsider their default positions.

Rinse and repeat: Active ownership can reduce internal **managerial myopia** and shift internal norms. **Repeated engagement** and familiarity can gradually shift norms and decision-making defaults.

Ethical Systems

How can investors increase their legitimacy with companies before and during direct dialogue?

Before the Dialogue

Establish the facts: Do deep research into the issue, and understand lack of disclosure may not mean lack of action

Deepen knowledge: If the issue is very technical or specific, work with NGOs or other experts to understand what is possible

Clarify the objective: A clear, focused, long-term business case will help

Focus: Prioritize a small number of key messages, such as long-term strategic thinking. Notify intentions in advance to allow the company to prepare.

Select messengers: Go beyond Investor Relations to reach key decision makers.

During the Dialogue

Present clear actions: Come with clear expectations and a business case for long-term thinking

Collaborate: Collaboration with other investors will shift norms faster

Select messengers: Ensure key company decision-makers are present

Offer solutions: Develop a specific, solution-oriented path

Prime your audience: Frame your requests as drivers of strategic foresight

Consider culture: Consider cultural and geographic influences in your conversation

Ethical Systems

Draft Long-Term Planning Resolution Example

RESOLVED that [the company's] board provide a more comprehensive report to shareholders within the next year (at a reasonable cost and without disclosure of proprietary information) on the company's long-term strategic business plans and the board's related oversight processes. Shareholders invite the board to consider more comprehensive reporting on long-term strategic planning and risk assessment, including analysis of [material company long-term risks and opportunities, time horizons, implementation plans, metrics, incentives, scenarios . . .] We believe this would help attract long-term shareholders, increase investor support for company strategy and improve company performance over the long term.

Draft Corporate Long-Term Bylaw Example

The primary objective of the board is to build sustainable long-term stockholder value. In support of this objective, the board shall be responsible for monitoring company long-term strategic planning and risk management processes. The board shall ensure that the importance of employees, customers, suppliers, communities and the natural, economic and social systems which support the sustainable creation of long-term stockholder value are considered in the development and implementation of company business plan, governance and reporting practices.