The Economic Club of New York

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Impact of COVID-19 on Board Governance and Litigation

Webinar

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Introduction
Chairman Marie-Josée Kravis

Good afternoon and welcome. I'm Marie-Josée Kravis, the Chair of The Economic Club of New York and a Senior Fellow at The Hudson Institute. And I want to welcome all our members to The Economic Club of New York which is one of the nation's leading nonpartisan forums for discussions of economic, social and political issues. And I'd also like to welcome our guests, the members of The Economic Clubs of Chicago and Washington who were invited to join us today, and I thank you for being with us.

As we continue to learn as much as we can about the economic, social, political impacts of the coronavirus, we really feel it's our responsibility to bring to you the day's most relevant information, to separate fact from noise, and to try to help you gain a better understanding of the health crisis and all of its implications.

And we have the pleasure today to help us with that, to have as our guest, Martin Lipton who is the founding partner for Wachtell, Lipton, Rosen & Katz and a Centennial Member and former board member of The Economic Club of New York. So, Marty, thank you for joining us.

Martin Lipton: I'm delighted to be with you, Marie-Josée.

Chairman Marie-Josée Kravis: So, just for our members, Marty specializes in advising major corporations on mergers and acquisitions and matters affecting corporate policy and strategy. He is really the ___ for major corporations, not only in the U.S. but all over the world. He's a trustee of New York University, a trustee of the New York University School of Law, a trustee of the NYU Langone Medical Center, an emeritus member of the Council of the American Law Institute, a member of the Board of Advisers of the Institute of Judicial Administration, and an Honorary Chair of the American College of Governance Council. Marty is a member of the Executive Committee of The Partnership for New York City and he served as co-chair of the partnership from 2004 to 2006.

He has a Bachelor of Science in Economics from the Wharton School of the University of Pennsylvania and an LL.B. from the New York University School of Law. He is an adjunct professor of law at New York University School of Law, a member of the American Academy of Arts and Sciences and a Chevalier de la Legion d'Honneur. Marty is an Emeritus Chairman of Prep for Prep, having served as chairman from 1990 to 2002.

So, Marty, after reciting that, I know that your time is precious. So I again thank you for being here. The format today is going to be a conversation which I'm fortunate to moderate. We will end promptly at 3:45. And I should point out that the conversation is on the record and we do have media on the line. And members have sent in questions which I will try to integrate in our conversation.

Conversation with Martin Lipton

CHAIRMAN MARIE-JOSÉE KRAVIS: So just starting off, today the headline in the *Wall Street Journal* as we approach the end of earnings season emphasized how little clarity, Marty, there is as to where companies are headed. In fact, the headline was, "Investors Struggle for Insight." And I'm wondering if you might tell us what you're telling your clients about guidance, about disclosures. This traditional play book is no longer very useful, or maybe it is. You can contradict.

MARTIN LIPTON: The play book is useful but it's not what I would call comprehensive today. Lots of changes in order to accommodate the uncertainties created by the pandemic. For companies obviously the single most pressing problem is coping with all of the dislocations that are caused by the pandemic and one of them obviously is liquidity. It's probably the single most significant area for companies today. And, interestingly enough, companies were relatively well prepared to fortify their liquidity through lines at banks that were available to them and they quickly drew down their lines and improved their liquidity. But a pandemic that results in a lockdown causes problems well beyond immediate liquidity. And I would say, for the last three weeks, four weeks, the basic function in most companies has been to bolster their liquidity and survive.

One example that is dramatic is Boeing borrowing $25 billion in order to have the liquidity to survive what looks like two to three years of downdraft in the airline business. The same thing is true with respect to the major airlines and so on. And, of course, the federal government has provided assistance so that those companies can continue. And one thing that isn't immediately apparent but has become very serious is the interplay between different industries and a very good example is the interplay between the retail industry and the real estate industry.

As retailers are not doing business and are unable to pay their rent, that, of course, deprives the real estate people of income and they're unable to meet their mortgages and that, of course, then has an impact on the consolidated loan obligations that are backed by mortgages and so on. So, a problem in one industry can quickly spread throughout a number of industries and into the banks from a financial standpoint. So this pandemic has not only been a medical pandemic, it's also been a financial pandemic.

CHAIRMAN MARIE-JOSÉE KRAVIS: Yes, it's very interesting because we talk a lot about supply chains and there's been a lot of discussion about repatriating, you know, supply chains and suppliers. But when we talk about it, we tend to think about it in terms of manufacturing and so parts of the manufacturing process that you want to be more resilient and want to bring back. But what you're pointing out is something that's quite different. It's really a supply chain or spillover effect in the service industry or in other industries that you can't just repatriate – they're here – but the problems are immense. And you seem to have been spending a lot of time on the financing requirements of these companies.

MARTIN LIPTON: Yes, that's, it's interesting that what happens in a law firm is when there's this kind of macro event, suddenly a lot of the things that you're usually doing on a day-to-day basis, the kinds of matters you handle suddenly are replaced by the urgent problems of clients who are heavily affected by the pandemic. That's been true for the last, oh, I guess, eight weeks now. And it's what generally requires 24/7 attention to try and get something done before it's no longer feasible for it to get done and companies are then in an irretrievable position.

CHAIRMAN MARIE-JOSÉE KRAVIS: But talk about some of the disclosure aspects relating to this. I was interested last week hearing the SEC encourage companies to be more forthcoming with disclosures or guidance yet we're in the middle of a storm and it's hard to see where we're going.

MARTIN LIPTON: It is indeed. And the SEC did encourage making disclosure and it's feasible for companies to do it. Obviously, it's almost impossible to predict earnings or predict the extent of losses and so on. But a company can talk about the factors that most affect its business and how it's trying to deal with those factors and give a reasonable estimate as to what the company sees as the length of the impact and the ultimate result of it. Almost every law firm has issued bulletins to its clients setting out the parameters for making this type of disclosure which is not usually done and advising as to the things that the companies should say to qualify the disclosures and protect the company against litigation.

The companies are always hesitant to issue information that would affect the value of their securities for fear that if it turns out to be incorrect, they will be the subject of lawsuits. And there is a doctrine, the Safe Harbor Doctrine, that if a company makes disclosure and in connection with that disclosure explains what could make the disclosure not accurate, then it's protected against both an investigation by the SEC and against private litigation if it turns out that the estimates or description of what the future looks like turn out to be incorrect.

CHAIRMAN MARIE-JOSÉE KRAVIS: You mentioned litigation and that is also one of the, I think the nightmares facing, or feared by corporations is that either they will be sued for practices that they had before the pandemic exploded. And, you know, many will argue these were practices that they had for decades which didn't cause any illness but now they did. And they're also worried about litigation if they do reopen and some of their employees are ill and it seems to be a subject that's creating a lot of division in Congress also. How do you advise your corporations in terms of your clients, in terms of dealing with that issue?

MARTIN LIPTON: Well, it depends. As you mentioned, there is a proposal in Congress to provide that as companies reopen that they are protected against litigation by their employees who get ill after returning to work. Obviously the first factor is how the employer structures the working environment. If an employer structures the working environment in order to minimize the exposure to becoming infected and has provided appropriate protective equipment and advice as to what to do and so on, the employer presumably has properly protected itself against litigation.

But in the real world, litigation by infected employees generally results in some damage and this then goes into the insurance factor with respect to it. Are employers presently insured by their former insurance policies against (1) damages for employees or customers who claim that they got sick on the premises or doing business with the company and whether the insurance policy covers a pandemic? Some policies do and some policies don't. And not infrequently there's considerable litigation as to whether the policy covers it.

And then beyond that, beyond the policy covering physical personal damage, the question is does the policy cover loss of business – business interruption insurance – and whether a particular policy form – interestingly enough, these policies differ in form and not infrequently, there are four or five different forms of policy that are available. Some forms have protection against pandemics and some forms actually exclude it, specifically excluding it, and some policies are silent on it. So you have three different types of litigation that can follow just from the question of the impact on an employer and its customers – employees and customers. And those issues are being dealt with right now. Some of them are being settled. Some of them are being arbitrated. And some of them will end up in litigation because the courts are substantially closed at the moment other than for the virtual – doing what we're doing right now – appearing digitally. That litigation will be with us for quite some time after the current situation is pretty much over with.

CHAIRMAN MARIE-JOSÉE KRAVIS: But, you know, virus safety measures can be very broad. You know the definition can vary tremendously. And I'm thinking, for example, of comorbidities. We know that people with comorbidities have had a higher fatality rate, or higher rate of infection, higher fatality rate. Older people also have had higher rates of infection and higher fatality rates. Do you think companies can make a distinction in terms of the employees that they bring back in terms of how they protect certain more than others or in a different way?

MARTIN LIPTON: Well, I don't think they can protect people differently. I think that would probably expose them to...

CHAIRMAN MARIE-JOSÉE KRAVIS: Discrimination.

MARTIN LIPTON: Yes, yes. But it's clear that people who have problems, people who are over the age of 60 or 65 are more susceptible to serious impact by it. All you can do is the best you can do. It's not possible to sort people out but you can do the best that...the best that's available. And presumably, you will have fulfilled your obligation but that doesn't really satisfy the liability issue and there will be, unless there's legislation that deals with it, the liability issues will continue.

This is another example of the socialization of liability for the normal conduct of business. The one that people are most familiar with is Workmen's Compensation. Rather than have a dispute as to whether the factory or the workplace was properly equipped for safety, any injury that's occurred during the course of employment has a specific assignment of a value and instead of having litigation as to damages and who was responsible and so on, you go in and you make the, the employee goes in and makes the claim and the claim is paid and the employer is protected against further litigation for liability unless they've done something really bad which would override the protection of the statute.

CHAIRMAN MARIE-JOSÉE KRAVIS: Marty, we could go on and on about Covid but I'd like to hear you and hear your views on other aspects of corporate governance. And one of them has to do with ESG, which is very much with us and is very much – I hate to say a trend – I would say more a fundamental factor now of doing business. It's not something trendy. I think it's something that's very much with us and that is bound to stay with us. And the Europeans, I guess, next month are coming out with a more formal approach to legislation. I wonder if you might comment on that and also comment on where you think we stand on ESG.

MARTIN LIPTON: Well, I think you have to combine ESG with stakeholder governance. Naturally, ESG is an aspect of stakeholder governance. And the fundamental question is whether a business corporation's primary purpose is to maximize return for the shareholders or whether the purpose of a business corporation is to seek to create long-term growth in value while making an appropriate allocation among all of the stakeholders who are critical for the operation of the business – the employees, the customers, the suppliers, and the communities in which it operates. And the communities has a much broader scope in talking about stakeholder governance. It includes society and the economy in addition to the actual communities in which the company operates.

This is something that has been debated for a long time. And without going back into history, in recent days and particularly following the 2008 financial crisis, there's been more and more emphasis placed on stakeholders and the concomitant inequality that results from employees not being treated as well as they might otherwise be.

And so that we came into a period where two things had a major impact. One is climate. And this goes back a ways but climate as a concern has been at the forefront of governance really for the last ten years. And the other aspect is inequality and whether corporations have been basically run for the benefit of the shareholders and the financial world to the detriment of the typical employee of the corporation.

The Business Roundtable in August of last year abandoned a position that they originally took in 1997 which basically was that the primary purpose of the corporation was to maximize return for shareholders.

CHAIRMAN MARIE-JOSÉE KRAVIS: ...Milton Friedman.

MARTIN LIPTON: This is basically abandoning Milton Friedman's views that date back, some people date it to 1970 when he had an Op-Ed piece in *The New York Times* magazine basically sponsoring and proposing shareholder primacy. And I'd say that the debate went on year after year from 1970 and it's still going on today. Interestingly enough, this morning a paper appeared from Glenn Hubbard who was very important in The Economic Club of New York, a former Dean of the Columbia Business School and one of...

CHAIRMAN MARIE-JOSÉE KRAVIS: And he was one of our guests about ten days ago.

MARTIN LIPTON: ...who together with a professor from Colorado has written a paper saying that stakeholder governance is a mistake. The appropriate purpose of a corporation is to maximize return for shareholders. Well, in a way the academic debate doesn't really determine the actual day-to-day operations as a corporation. No corporation can function effectively if it doesn't take into account all of its stakeholders.

CHAIRMAN MARIE-JOSÉE KRAVIS: But wouldn't you say that the practice of business has, you know, surpassed the academic debate that in fact the academic debate is not that central to the practice of business that employees and consumers and customers have forced corporations' hands?

MARTIN LIPTON: That's exactly correct. What has happened over the years is that while the academic debate was taking place, corporations had been paying much more attention to all of the aspects of stakeholders and to all of the aspects of ESG. In large measure from a business standpoint, it was good business to...(Inaudible -Audio Issue) it was critical, particularly for companies that deal with the public and depend on their reputation for being able to do business.

Maybe it's best described as a company has a fundamental objective of creating long-term value. And in creating long-term value, a company wants to exist, wants to be sustainable and we want companies to be sustainable. And in creating long-term value, you can't allocate all of the revenues to shareholders. You can't create long-term value without research and development, without investment in capital equipment, without training and retraining of employees – employees that are enthusiastic in their jobs and working for the benefit of the corporation.

So what has happened is that in large measure businesses had adopted stakeholder governance during the past 15 years or so and what the Business Roundtable did in August of last year was essentially recognize that and abandon the shareholder primacy approach and adopted a stakeholder approach in which the Roundtable said the purpose of a corporation is to meet the needs of all of the stakeholders – shareholders included, but all of the stakeholders – as over the last five of six years, I guess six years, it was the first CEO letter issued by Larry Fink of BlackRock saying that in reviewing investments and making decisions on corporate issues, BlackRock would look at stakeholder issues.

That was quickly followed by Vanguard and State Street. So the basic index funds, which today in the aggregate, on average, account for 15% to 20% of the shares of most of the major companies, have been supporters of stakeholder governance, supporters of the ESG factors, particularly with respect to environment, climate and so on.

CHAIRMAN MARIE-JOSÉE KRAVIS: But that's been very tricky. I mean it's been very tricky, if you look, for example, at Larry Fink or BlackRock how they've been attacked by the environmentalists because some of their funds hold energy stocks – or hydrocarbon stocks, I should say. And so it is a tricky balance, though, isn't it, to manage through this transition?

MARTIN LIPTON: Well, like any situation, interests to a lot of different people and interests that have very strong feelings, you can never satisfy the people who are focused solely on climate or the people who are focused solely on equality and so on. And this is the crux of this whole issue is how do you resolve the competing interests of stakeholders? There are two ways in which you can resolve it. You can have a board of directors, using its business judgment, deciding with an objective of growing the long-term value of the company how to allocate among the different stakeholder claimants on the profits of the business.

The other way is you have government set the standards. That's basically state corporatism of one type or another. And we, two years ago, Senator Warren proposed a statute which would essentially subject all major companies, those with annual revenue of more than a billion dollars to being registered with a federal agency and have a board of directors with 40% of the directors elected by employees and mandated to follow stakeholder principles of governance.

And, as you mentioned, even longer in Europe, the EU has been focused on this. In the UK, the Financial Reporting Council has again revised both the company governance principles to focus on stakeholder governance and concurrently to revise the stewardship principles that are applicable to the institutional investors and large asset managers in the UK to disclose their position with respect to, call it stakeholder governance, so that the companies basically know what their shareholders think and the shareholders know what the companies think. And companies and their shareholders should engage in periodic discussion so that the companies understand what the shareholders are looking to and the shareholders understand just where the company is going and can decide whether they want to continue holding shares in the company or not.

CHAIRMAN MARIE-JOSÉE KRAVIS: And in doing so, what's your advice in terms of balancing short-term obligations and long-term goals? Because the two sometimes, I mean the market is so punishing when companies don't meet their quarterly earnings but on the other hand you have these long-term goals and the creation of value that boards of directors and the governance of corporations have to take into account. So what's your view on how corporations balance these competing obligations?

MARTIN LIPTON: Well, I pass the buck to the board of directors of the company and point out to them that they have to evaluate each of these factors – and some of them are long-term, some of them are short-term, some of them suddenly become short-term who were previously long-term. And no two companies are exactly alike. What I've been an advocate for is that companies and their shareholders engage periodically so each knows what the other is doing and you don't have these surprises and disappointments. If the shareholders know that the company is embarking on a research development project or on a major capital investment that will penalize short-term earnings for a year or two years and they have agreed with the company that this is an interesting project and should be done, then there'll be no short-term pressure from those investors. So basically there is no simple solution. There's no one approach that satisfies everybody.

But what has happened over a period of time is that activists have seen an opportunity to become intermediaries between investors, asset managers, and companies. If the total shareholder return combination of dividends and market price fall below a peer average and so on, activists feel that they can come in, agitate for changes in the business or agitate for the company to spin off a division or merge, sell itself and so on, which has put a great deal of short-term pressure on companies.

CHAIRMAN MARIE-JOSÉE KRAVIS: Activists have been rather quiet in this Covid environment.

MARTIN LIPTON: No, they have not.

CHAIRMAN MARIE-JOSÉE KRAVIS: Or maybe Covid is still in the headlines.

MARTIN LIPTON: Activists have been, I won't say they've been doing all that they were doing but activists continue to be effective and they continue to be lobbying to avoid regulation. The SEC proposed a regulation on proxy advisers, ISS and Glass Lewis, that would require them to give companies, in effect, notice of what they were going to say before they say it and let the companies comment on what the proxy advisers were planning on putting out. And the activists, a group of activists lobbied strongly and the SEC dropped that amendment. No, activists are still out there. They've changed the type of their business a bit. But it's a rare day that goes by when there isn't a new activist story.

So they are not gone and they exist solely on the basis that they can get support from the major asset managers. Basically, the activists buy between 1% and 5% of the stock of a company. That doesn't give them a controlling interest or a powerful voice in the company. What does give them a powerful voice is that the large shareholders will – if they back them – then they have control and can change the board of directors.

CHAIRMAN MARIE-JOSÉE KRAVIS: Marty, I'm sorry that I have to interrupt you because we could have had a whole discussion just on that very trend, but unfortunately…

MARTIN LIPTON: We were just getting started.

CHAIRMAN MARIE-JOSÉE KRAVIS: Exactly. Time flies when you're having a good time. So I just, I want to thank you and I'd also be remiss if I didn't today, before closing, thank all of our front-line workers who are making our lives so much safer and better during this difficult time. So, to the healthcare workers, the grocery workers, the truckers, delivery people, all of the front-line workers, thank you so much for making our lives easier. I want to thank our members for being with us and encourage you to stay connected through our website as we will announce more of these conversations. And we'll have to have you back, Marty. Thank you.

MARTIN LIPTON: Thank you, Marie-Josée. And I'd like to join in your thank you to the people who have done so much for us over these past weeks.

CHAIRMAN MARIE-JOSÉE KRAVIS: Thank you.