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Making Sense of the Current ESG Landscape

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Editor's note: Peter Atkins, Marc Gerber and Richard Grossman are partners at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden memorandum by Mr. Atkins, Mr. Gerber, and Mr. Grossman. Related research from the Program on Corporate Governance includes Socially Responsible Firms by Alan Ferrell, Hao Liang, and Luc Renneboog (discussed on the Forum here) and Social Responsibility Resolutions by Scott Hirst (discussed on the Forum here).

The question whether a public for-profit company can "do good" and make money at the same time has never been more relevant. Public companies are being bombarded with messages, requests and demands around "ESG"—environmental, social and governance—matters. These come from shareholders, asset managers, special interest groups, activist investors, private equity funds, ESG rating firms, trade groups, politicians, regulators, academics and others. They take a variety of forms, including shareholder proposals, surveys and questionnaires, letter writing campaigns, proxy voting policies, investor stewardship reports, speeches, white papers, academic studies, and legislation. Topics covered (putting aside the "G"—the governance issues with which boards are likely to be familiar) are numerous and varied, including sustainability, climate change, water management, human capital management, gender pay equity, board and workforce diversity, supply chain management, political and lobbying expenditures, the opioid crisis, and gun control. Boards of directors and management of public companies need to understand the increasing importance of this ESG landscape in which the company and investors are operating, including the growing prominence of ESG investing, the company's environmental and social (E&S) profile and vulnerabilities, and the path forward for the company as it deals with particular E&S issues.

This post briefly summarizes some of the key trends of the rapidly evolving E&S landscape of which directors and company management should be aware. In addition, it highlights a corporate law framework that has particular relevance for directors of companies incorporated in states such as Delaware that follow a shareholder primacy model—that shareholder welfare is the sole goal of directors, and that other interests may be taken into account only to further that goal.

ESG Investment. Recent reports place the level of ESG-focused investment at approximately $20 trillion of assets under management. New ESG funds and ETFs are being launched on a regular basis and with increasing frequency, and studies show that millennials have a greater interest in socially responsible investing. Within this umbrella, ESG investing can take various forms, for example making investments in companies viewed as positively addressing environmental or social issues, choosing to exclude companies in certain industry sectors viewed as problematic from an ESG perspective, or integrating ESG data into an assessment of risk-adjusted returns in order to make investment decisions.

The demand for ESG investment approaches has spurred a number of traditional investors, activist funds and private equity funds to enter this space. For example, in January 2018, ValueAct Capital launched its Spring Fund to invest in companies addressing environmental and societal problems and capture the excess returns it believes will be generated thereby. Another activist investor, Jana Partners, is reported to have hired staff for a new socially responsible fund to be named Jana Impact Capital. Also, recent reports indicate that private equity firm TPG is raising $3 billion for its second social impact fund, after previously raising a $2 billion fund focused on investments with positive social and environmental impacts.

ESG Ratings. An inevitable corollary of the increase in ESG-focused investment is the demand by those investors for ESG data and the corresponding and exponential growth in the number of entrants into the business of collecting, aggregating, synthesizing and ranking that data. The challenge is that each ESG ratings provider has its own methodology, and a company may receive widely divergent ratings from different organizations. Moreover, the ESG rating agencies may use different combinations of data sources other than company disclosures, including press reports, litigation filings, internet postings and other third-party sources, even though the company may not agree with the veracity or accuracy of those data sources.

It is possible that, over time, some ratings methodologies may prevail over others and the field will narrow to two or three dominant raters, as is the case in the governance space with ISS and Glass Lewis. And ISS and Glass Lewis are attempting to protect their turf by also including E&S ratings in their reports. In February 2018, ISS announced the launch of its E&S QualityScore, which seeks to analyze company disclosure across more than 380 factors organized into four environmental pillars and four social pillars. ISS includes those scores in its annual meeting voting recommendations report, and in May 2018 expanded its E&S coverage to 4,700 companies. Recently, Glass Lewis announced that guidance on material ESG topics from the Sustainability Accounting Standards Board would be integrated into its proxy research reports and vote management application.

ESG Activism. On January 6, 2018, activist Jana Partners and the California State Teachers' Retirement System (CalSTRS) published an open letter to Apple Inc. The letter expressed their view that Apple needed to offer parents more tools to protect children and to ensure that young customers use Apple products in an appropriate manner. Citing various studies regarding potential negative consequences of children's use of smart phones, the letter linked the issue to Apple's long-term value and called on Apple to take various steps to address the issue. Days later, Apple announced that it would introduce new features and tools to assist parents in combating children's overuse of smart phones. It remains to be seen whether other traditional activist investors, seeking to attract ESG-focused capital, launch similar ESG-themed campaigns.

ESG activism can also take the form of industry-wide or issue-specific campaigns. For example, a coalition of 30 treasurers, asset managers, and faith-based, public and labor funds formed Investors for Opioid Accountability and filed shareholder proposals on board oversight of business risks related to opioids at 10 companies involved in the manufacturing or distribution of opioids. Recently, another group of investors launched a resource to evaluate and act on water risks in investment portfolios, including tips on engaging with companies and on water-related shareholder proposals.

ESG Shareholder Proposals. According to ISS data, for 2017 and year-to-date 2018, proposals relating to E&S now make up a majority of all shareholder proposals submitted to US companies, at 53.4 percent and 54.4 percent, respectively. ISS reports that the median vote results year-to-date are at a record high of 23.4 percent, but it is noteworthy that median results for some topics are significantly higher—41.4 percent for sustainability reporting and 36.4 percent for workforce diversity. In a turning point, in 2017, climate change proposals relating to two degree Celsius scenarios received majority support for the first time, at three different companies. Other 2017 majority-supported E&S proposals related to sustainability reporting and board diversity. This year appears to have set a new record, with 10 E&S proposals receiving majority support year-to-date: two on climate change, two on sustainability reporting, three on other environmental topics, one on governance measures related to managing the opioid crisis risk and two calling on gun manufacturers to produce reports on gun safety measures.

Perhaps in recognition of these increasing levels of support, 2018 has been noteworthy for the increased withdrawal rate, with almost half of all E&S proposals submitted being withdrawn. Based on various reports and anecdotal evidence, it is likely that a large portion of the withdrawals were the result of company engagement with proponents and reaching satisfactory agreement for the company to take some action or make some additional disclosure.

Company Actions. In the financial activist space, the advice that has crystallized over the past few years is to look at your company the way an activist and/or a long-term shareholder would; anticipate and analyze the potential criticisms and be ready to respond; engage with institutional investors to learn their views and establish the board's and management's credibility with them; and communicate the company's business strategy, and the board's role in overseeing the development and execution of that strategy, clearly and coherently, to build support before an activist shows up.

It turns out that there are many parallels in the ESG space and, as described above, the lines between financial activists and ESG activists may continue to blur. As a result, a company's ESG vulnerability and profile may need to be given appropriate attention alongside traditional valuation and operational metrics.

Shareholder Primacy as a Guidepost. ESG should not be perceived as divorced from traditional economic metrics. At least for companies incorporated in states such as Delaware, that are subject to a fiduciary model of shareholder primacy—where the ultimate priority is the preservation and enhancement of shareholder welfare—boards should consider whether there is a nexus (and, if so, how strong) between specific ESG issues and the pursuit of shareholder welfare. The starting point involves consideration of ESG in light of the company's business strategy, which is the driver of shareholder value, the dominant component of shareholder welfare. Questions may include: Will addressing ESG topics allow the company to satisfy growing consumer trends and increase sales? Will addressing other ESG factors position the company to have a better workforce and decrease worker attrition and the related costs?

Even in those cases where a particular ESG matter does not fit directly within a company's business strategy, a company may need to consider whether inaction or a failure to be responsive to an issue presents risks to a company. These might include negative perceptions by consumers, regulators, employees or the public that could lead to a boycott of the company's products, regulatory intervention, active employee protest or morale decline, negative publicity, or other forms of harm to the company's ability to compete and produce shareholder value.

The rise in ESG investing presents new risks and perhaps opportunities. ESG investors' dissatisfaction with a company's ESG policies (or lack thereof) or responsiveness may have significant adverse effects. In particular, this could include loss of interest in the company as an investment or, perhaps, initiation of a public campaign, submission of shareholder proposals, or an election contest or a "vote no" campaign focused on changing the company's ESG position. On the positive side, understanding and anticipating ESG issues that may be promoted by investors might attract positive interest in the company and support from such investors.

These and many other potential questions are strategic decisions—like any other business strategy decisions—and as such are subject to board oversight. And once the board and management determine how, if at all, ESG factors align with that business strategy or are otherwise appropriate topics for action to preserve or enhance shareholder welfare, the board needs to determine the level of corporate investment appropriate in light of the expected returns (or losses avoided), how to measure success and how to incentivize management accordingly. Shareholder engagement then presents a forum to understand the concerns of investors and how they view the company, as well as to explain ESG in the context of that business strategy and the board's oversight role. It then becomes critical for the company to communicate, whether in annual reports, proxy statements, sustainability or corporate social responsibility reports, or other public statements, its approach to ESG matters as part of its overall business strategy.

Over the years there has been a debate, which continues loudly today, about whether directors can or should consider the interests of non-shareholder constituencies. The Chief Justice of the Delaware Supreme Court, Leo E. Strine, Jr., has made clear where Delaware law stands on the subject:

> "[A] clear-eyed look at the law of corporations in Delaware reveals that, within the limits of their discretion, directors must make stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare."[1]

ESG issues can be presented as having, and often do have, an "other, non-shareholder constituency" character. However, the context today is quite different than during the 1980s, which witnessed the rise of corporate constituency statutes that have been adopted by more than 30 states. That difference is manifested by the concentration of U.S. public company ownership in a relatively few institutional asset managers, the active and growing support from those entities (and from other equity owners) for environmental and social responsibility by public for-profit companies, and the heightened level of consciousness in the media, academia and general population regarding the demand for ESG responsibility by public for-profit companies.

To borrow a phrase from then-Justice Andrew Moore of the Delaware Supreme Court, in his 1985 *Revlon* decision, directors would appear to have wide latitude—and responsibility—for dealing with ESG issues to the extent they represent matters "rationally related [to] benefits

[1] Leo E. Strine, Jr., "The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law," 50 *Wake Forest Law Review* 761,771 (2015).

accruing to the stockholders." That said, it is incumbent on directors to do their homework and apply appropriate processes to establish informed decision-making regarding that key determination—which also will enable them to defend challenges to spending shareholder money on "causes" that not all shareholders may support and to demonstrate to the "new" shareholder constituency, ESG investors, the attention paid to the subject at the board level.

Beyond that, of course, are a myriad of other important and potentially difficult decisions that may be required. These may include: Whether, when, to whom and how to engage in outreach regarding ESG issues. Choosing among ESG matters. Deciding how, how much and when to spend company resources to support selected ESG matters. How and when to communicate choices made and actions taken.

In the end, although more consequential than ever, these are board decisions just like others, requiring the exercise of business judgment in the best interests of the company and its shareholders.