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Expert Analysis

# Employment Law Considerations For ESG in Upcoming Proxy Season

Another year of a pandemic coupled with the public's focus on social justice issues and climate change have made "ESG" a hot topic for this upcoming proxy season. The term "ESG" refers to the environmental, social, and governance factors used by many investors to evaluate companies. Employment laws play a meaningful role in the "S" and "G" factors of ESG, including, but not limited to, a company's diversity efforts, workplace conditions, and anonymous reporting measures to address leadership issues. Many companies have already implemented ESG efforts and many more are considering the issues, including whether to make ESG-related disclosures. Companies

By **David E. Schwartz**

And **Emily D. Safko**

should be cautious not to overstate efforts, as doing so may risk Rule 10b-5 violations or other legal liabilities.

## Employment Aspects of ESG

ESG values matter to investors now more than ever. ESG issues are important for companies to consider as investors prioritize these factors and are increasingly focused on sustainable investing. Indeed, more brokerage firms and mutual funds now offer exchange traded funds and other products that implement ESG criteria. Further, investors believe that a company's ESG efforts have a practical purpose beyond ethical concerns. Not only is ESG used to evaluate a company's ethical behavior, but some investors also believe that a company's ESG strategy can help predict a company's future financial performance.

The intersection between employment law and ESG is found primarily in the social and governance factors. The social factor in ESG encompasses a company's treatment of its employees. Do the company's working conditions show high regard for employee health and safety? Does the company encourage and embrace diversity? The governance factor in ESG relates to how a company is controlled, including company policies, executive compensation, compliance, and more. Do the workplace policies and company's code of conduct reflect up to date ESG values? How are alleged violations of policies reported and dealt with?

In particular, a company's diversity, equity, and inclusion (DEI)

DAVID E. SCHWARTZ *is a partner at the firm of Skadden, Arps, Slate, Meagher & Flom.* EMILY D. SAFKO *is an associate at the firm.* ZEINAB BAKILLAH, *an associate at the firm, assisted in the preparation of this article.*

efforts are a major component of the social pillar of ESG. Many companies have prioritized diversity issues in light of the 2020 Black Lives Matter movement, focusing on historically underrepresented groups of employees, such as women and racial minorities. DEI efforts include increased representation of employees in the workforce, specifically in leadership and executive roles, higher retention rates and equity compensation among different groups.

It can be difficult for companies to measure and report on diversity and to communicate diversity initiatives externally. Some companies disclose minimum and maximum pay, report pay gaps or provide other quantitative data. Other efforts are more qualitative in nature, such as disclosing policies used to hire, promote and retain diverse candidates or offering workplace affinity groups.

Another employment aspect of the "S" in ESG includes worker safety, health and well-being issues. The COVID-19 pandemic has played a new role in evaluating workplace conditions, such as social distancing measures put in place and protective equipment provided to employees. Companies have begun to offer hybrid and remote work options in an effort to protect workers facing health and safety concerns. The National Council on Occupational Safety and Health publishes a "Dirty Dozen" list of the most dangerous employers in the United States each year. The pandemic has undoubtedly placed an increased importance on the health and safety requirements implemented within the workplace.

The "G" in ESG focuses on the accountability and oversight structures put in place to assess a company's leadership. This factor includes internal controls such as anonymous hotlines to submit complaints and ensuring a good process for the handling of reports. In fact, the Sarbanes-Oxley Act of 2002 requires that public companies maintain internal policies and procedures governing receiving employee complaints and protections provided to whistleblowers who report company misconduct. Further, the Dodd-Frank Act, signed into law on July 21, 2010, provides job protections and financial incentives to whistleblowers. The SEC's Office of the Whistleblower administers awards to whistleblowers who provide the SEC with information leading to successful enforcement actions. Although the Dodd-Frank and Sarbanes-Oxley Acts are not new, whistleblower complaints remain a growing component of the governance aspects related to a company's ESG efforts.

Many companies have already implemented ESG efforts and many more are considering the issues, including whether to make ESG-related disclosures. Companies should be cautious not to overstate efforts, as doing so may risk Rule 10b-5 violations or other legal liabilities.

## Proxy Season ESG Disclosures

Proxy season, which occurs in mid-April to mid-June, is soon approaching. In the past few years, shareholders have requested more reporting on ESG ahead of annual meetings. Many public companies are answering requests and increasingly reporting on their ESG efforts. This response is seen through both published ESG reports and the ESG disclosures in SEC filings.

A record number of 39 environmental and social (E&S) related shareholder proposals won majority support in 2021, almost double the number in 2020 and more than triple the number in 2019. Notably, DEI efforts are of particular focus, including information related to company goals and efforts to increase, recruit and promote protected classes of people. 13 of the 39 proposals were related to board diversity, workforce diversity and other human capital-related matters. Companies are increasingly incorporating ESG risk disclosure, including the racial and ethnic diversity makeup of boards, into their financial filings.

The ESG branch of the proxy advisor Institutional Shareholder Services (ISS) has urged companies to disclose the ethnicities of directors and senior executives. ISS uses the disclosed information to rate a company's ESG program. Most U.S. public companies are also required to file EEO-1 reports to the Equal Employment Opportunity Commission, which includes demographic workforce data by race, ethnicity, sex and job categories. In recent years, shareholder proposals to publicly disclose EEO-1 reports have garnered strong support. In 2021, 10 shareholder proposals that requested companies disclose their EEO-1 report went to a vote.

Many are expecting the SEC to mandate ESG-related disclosures in the near future. In 2020, the SEC requested public comment on 15 detailed questions related to ESG disclosures to which it received over 550 responses. In late 2021, the chairman of the SEC asked staff to begin thinking about a "human capital" disclosure requirement for public companies. Accordingly, ESG is likely to remain a critical topic as the 2022 proxy season approaches.

## Don't Overstate ESG Efforts

There are risks associated with growing ESG disclosures. For example, materially misleading or false ESG-related disclosures may result in liability under Rule 10b-5 of §10(b) of the Securities Exchange Act of 1934, the principal anti-fraud provision. Rule 10b-5 imposes liability for material misrepresentations, misstatements, omissions or other acts that deceive another person conducting securities transactions. As a result, SEC enforcement actions, shareholder litigation and class actions are of concern.

Employers should pressure test any ESG disclosures for accuracy and ensure that statements made in ESG reports and disclosures are supported by actual practice and factual data.

In 2021, the SEC also created an ESG Task Force in its Division of Enforcement to oversee a division-wide effort to develop initiatives to proactively identify ESG-related misconduct. The task force is made up of 22 attorneys and specialists who analyze disclosure issues related to ESG. Specifically, the task force pursues whistleblower complaints on ESG-related issues. The SEC set up an online portal to submit whistleblower tips and complaints, including those related to ESG disclosures. No enforcement actions have yet been filed, but this reporting mechanism demonstrates a new regulatory involvement in ESG matters and reporting.

ESG remains a complex subject matter that continues to evolve over time, and ESG matters remain an important concern for investors and shareholders. Employers should consider the extent to which the employment law aspects of ESG (DEI, workplace safety, whistleblower reports, and more) will play a role in the upcoming proxy season. Employers should pressure test any ESG disclosures for accuracy and ensure that statements made in ESG reports and disclosures are supported by actual practice and factual data. In other words, disclose, but do not overstate.

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