Harvard Law School Forum on Corporate Governance

ESG Momentum Remains Strong but May Face Headwinds in 2023

Posted by Marc S. Gerber, Greg Norman, Kathryn Gamble, Skadden, Arps, Slate, Meagher & Flom LLP, on Monday, January 16, 2023

Editor's note: Marc S. Gerber and Greg Norman are Partners and Kathryn Gamble is an Associate at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden memorandum by Mr. Gerber, Mr. Norman, Ms. Gamble, Anita B. Bandy, Raquel Fox, and Simon Toms. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and For Whom Corporate Leaders Bargain (discussed on the Forum here) both by Lucian A. Bebchuk and Roberto Tallarita; Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock (discussed on the Forum here) by Leo E. Strine, Jr.; and Stakeholder Capitalism in the Time of COVID (discussed on the Forum here) by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita.

Key Points

- ESG is expected to remain a priority in 2023, with investors, employees and other stakeholders continuing to press for climate change and diversity policies and disclosures.
- Companies in the U.S., U.K. and EU will face new government ESG mandates and proposals in the new year.
- Businesses should closely monitor developments in legal challenges to companies' diversity, equity and inclusion programs. U.S. Supreme Court rulings on affirmative action cases also have the potential to impact corporate diversity efforts.

As companies grapple with the business challenges that rising interest rates and an uncertain economic outlook present, there are the inevitable questions about whether companies should worry less about environmental, social and governance (ESG) matters. While stakeholders and regulators in the U.S., Europe and elsewhere seemed to be moving in the same direction regarding ESG concerns in 2021 and 2022, it is possible that 2023 will see divergences. This is particularly the case in the U.S., where ESG has become highly politicized and is likely to remain so for at least the next two years, given a divided Congress.

Nevertheless, companies will still have plenty to grapple with in 2023: the plethora of regulations and other initiatives already in place or in the works, and investors, employees, customers, communities and other stakeholders continuing to push companies along in their "ESG journey."

Legal Guardrails

For U.S. companies generally, and particularly those incorporated in Delaware, the north star continues to be shareholder welfare. As companies and boards of directors consider the wide array of topics that fall under the ESG umbrella, they should assess how those topics ultimately accrue to the benefit of shareholders.

This shareholder benefit may be long-term, even if imposing near-term costs. It can take the form of an increased ability to attract and retain a skilled workforce, or managing and mitigating a company's exposure to climate transition risks or the risks of a toxic workplace culture.

Disclosure Controls and Procedures

More U.S. proposals on the way. The U.S. Securities and Exchange Commission (SEC) has a number of ESG-related proposals pending, with more expected in 2023. These include extensive proposals covering climate-related disclosure and cybersecurity matters, as well as measures relating to human capital management and board diversity disclosures. Companies need to assess their methods of collecting and analyzing the relevant information should these rule proposals become effective.

Voluntary disclosures. Regardless of the SEC proposals, investors and proxy advisory firms continue to call on companies to voluntarily disclose information relating to ESG topics, either within or outside of their SEC filings. These voluntary disclosures can subject companies to potential liability, and companies are encouraged to approach them with the same rigor they apply to their SEC-mandated disclosures.

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New reporting rules in the EU. Meanwhile, public and other large companies with a presence in the European Union will need to consider the new Corporate Sustainability Reporting Directive (CSRD), effective January 1, 2024, with the first reports due in 2025. Any large EU company, and any non-EU company with net turnover in the EU in excess of €150 million, will be within scope of the rules. Companies will need to review in 2023 whether they have appropriate systems in place to gather the data required for these new reports.

Continued climate-related disclosures in the U.K. In the U.K., the plans to develop U.K.-specific sustainability disclosure rules may have been paused due to shifting legislative agendas arising from changes in government, but companies listed on the London Stock Exchange have had to include climate-related disclosures on a "comply or explain" basis in their reporting since January 1, 2022 (or January 1, 2021, in the case of premium-listed companies).

Shareholder Proposals

The 2022 proxy season in the U.S., U.K. and Europe brought a significant increase in the number of shareholder proposals related to environmental and social topics submitted for shareholder votes, and a marked decline in average support for those proposals compared to 2021.

In the U.S., the averages conceal a pattern: The 2022 proposals that were highly prescriptive fared poorly, while proposals regarding topics such as racial equity audits, efforts to combat workplace harassment and discrimination, disclosure of greenhouse gas emissions reduction targets and reducing the use of plastics did well.

Board and Workforce Diversity Matters

Investors and proxy advisory firms continue to focus on board composition generally and director diversity in particular. Investors also have focused on companies' efforts to enhance the diversity of their workforce and to consider the impacts of their business practices and policies on diverse communities. Investor attention to these topics shows no sign of abating.

Gender balance efforts in the EU. In October 2022, the Council of the European Union finalized legislation intended to improve the gender balance on boards of public companies. Under these rules, companies listed in the EU will be required to meet certain quantitative objectives and report on gender representation in their annual reports.

Diversity target progress disclosures in the U.K. Companies listed on the London Stock Exchange have had to disclose progress toward diversity targets on a comply-or-explain basis for financial years starting April 1, 2022.

Challenges to diversity programs in the U.S. There are potential countervailing forces, however. In 2023, the U.S. Supreme Court is expected to rule on challenges to the use of race as a factor in college admissions. A ruling against affirmative action could have implications for corporate diversity initiatives. In addition, private groups in the U.S. have started to bring challenges to diversity, equity and inclusion programs at companies, alleging that those result in illegal racial discrimination. Companies will need to monitor these developments over the coming months.

In Sum

ESG will continue to be an important business landscape feature in 2023, whether mandated by governments or initiated by companies to create long-term shareholder value, mitigate risk or respond to campaigns by investors, customers, employees and other stakeholders. Companies and their boards need to prepare to navigate the sometimes conflicting legal, regulatory and political challenges that ESG is likely to present in the new year.