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Directors, Take Note: ESG Can Drive Value in 2020

The message that environmental, social, and governance issues can drive stockholder value resonates ever more clearly today.

In 2017, Latham lawyers discussed how directors can use environmental, social, and governance (ESG) issues to enhance companies' value.[1] Since then, ESG has become a mainstream concern across companies, industries, and markets throughout the world. More than ever, companies' ability to manage ESG risks and take advantage of new market opportunities can help them drive value for their stakeholders. Indeed, the rise of "stakeholder capitalism" and the idea that companies might serve a broader purpose beyond short-term shareholder returns has intensified the focus on ESG, and in many ways has changed the playing field.

The Rise of Stakeholder Capitalism

In August 2019, the Business Roundtable issued its Statement on the Purpose of a Corporation, which embraced the concept of stakeholder capitalism. Under this paradigm, a corporation's purpose is to serve all of its key stakeholders by delivering value to *customers*, investing in *employees*, dealing fairly with *suppliers*, supporting its *communities*, and generating long-term value for *shareholders*.[2] While the statement was not universally well-received, it was subscribed to by 181 CEOs and reflects the recognition that companies increasingly are expected to take responsibility for their range of impacts on multiple stakeholders. Companies that embrace strong ESG principles by managing their human capital, ensuring ethical practices in their supply chains, addressing the environmental impacts of their operations, and dealing fairly with customers stand to gain competitive advantage.

A Company's Key Stakeholders Care

Key constituencies have intensified their focus on ESG, including:

- **Shareholders:** Now more than ever, shareholders are demanding information about how companies are managing their ESG risks and opportunities. Larry Fink, in his 2020 letter to CEOs, stated that companies must address their ESG risks or they will face divestment and boards will face votes of no confidence. The letter says, "We will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them."[3] Similarly, State Street's January 2020 letter to boards announced that it will take voting action against board members at companies that do not adequately identify their material ESG risks and build them into their long-term strategies.[4]

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- **Asset Managers and Mutual Funds:** The growth of sustainability-focused mutual funds and other investment vehicles has been steadily increasing. These funds frequently require their investments to meet ESG disclosure requirements and satisfy ESG performance criteria. Companies that fail to satisfy these criteria risk being excluded from investment vehicles.

- **Employees, Suppliers, and Other Business Partners:** ESG issues can be important to employees, suppliers, and other business partners. ESG factors can manifest in numerous ways, including in how companies treat their employees and their suppliers through a commitment to fair wages, anti-harassment, protection of human rights, and fair dealing. Stakeholders seek to hold companies accountable for their performance in these areas. Further, companies' commitment to ESG and transparency in describing their practices around climate change, employee diversity, human rights, and other ESG issues can enhance their attractiveness to employees.

- **Customers:** Customers' purchasing decisions may be influenced by the sustainability of the products or services offered. Increasingly, customers face investor pressure to ensure sustainability in their supply chains and flow those obligations down to suppliers. Customers also may select a supplier based on its reputation. Companies that demonstrate a commitment to sustainable business practices can drive top line growth through their ESG efforts.

- **Media and Reputation Management:** ESG has become an important reputational issue and companies perceived as contributing to climate change, pollution, or social harms are more likely to face boycotts, shareholder activism, employee walkouts, and other forms of backlash. Conversely, companies that convey an authentic message that reflects their commitment to ESG good practices can gain reputational advantages.

Building Business Resilience and Long-Term Value

Companies can build value through sustainable practices. The idea that companies can leverage their investment in ESG issues to create value has been captured in the concept of "shared value."

- A company's focus on sustainability can drive innovation and the development of new products and services that feed the market demand for sustainable alternatives.

- The investment in sustainable processes can reduce companies' operating costs; improve the resilience of their supply chains; and reduce their legal, operational, and reputational risk. For example, some companies that have adopted strong ESG practices have reduced their environmental footprint and at the same time addressed their exposure to resource depletion. Similarly, some companies that have invested in resilient supply chains have fostered strong social, economic, and environmental practices among the suppliers on which they depend. These suppliers, in turn, help to assure their long-term viability and success.

- Numerous studies link strong ESG performance with strong financial and stock market performance. Regardless of whether this link is causal or correlative, it indicates that companies that focus on ESG risks and opportunities frequently are well-managed and are able to drive long-term results. For this reason, investors increasingly are incorporating ESG performance in their investment screening processes to drive returns.

Good Governance — The Board's Oversight Role

ESG issues are difficult because they cover a range of issues and touch every company across the globe in *some* way, but not precisely the *same* way. Moreover, as SEC Chairman Clayton recently observed, "The landscape around these issues is, and I expect will continue to be, complex, uncertain, multi-national/jurisdictional and dynamic."[5] As such, they present challenges for companies and their boards.

A fundamental responsibility of the board of any public company is to oversee the company in a manner that ensures that board members are aware of material risks (and opportunities), and that the company implements systems and controls to properly manage those risks in accordance with the board's risk appetite. This framework applies equally to ESG risks.

Because ESG issues cover a wide swath, companies should first establish processes to identify their material ESG risks and opportunities. Various reporting standards address a broad range of ESG issues. Companies should not attempt to "boil the ocean" by devoting equal attention to all ESG issues but rather are better served to focus on those that are important to their businesses and their stakeholders. The process of identifying those material ESG issues typically requires the involvement of stakeholders across disciplines within the company, as well as key external stakeholders, with the assistance of outside advisors. Frameworks such as the Sustainability Accounting Standards Board (SASB) industry guides can be a beneficial point of reference to help identify the areas of material risk and incorporate appropriate ESG factors in company strategy.

Reporting — How a Company Tells Its Story Can Build Trust and Value

For companies reporting in the United States, the US Securities & Exchange Commission's (SEC's) reporting requirements with regard to ESG issues remain principles-based rather than prescriptive. This approach provides companies with substantial discretion to determine what ESG information to disclose. If material, disclosures typically would appear, as appropriate, in the business description, risk factors, management discussion and analysis (MD&A), and legal proceedings sections of the company's periodic reports or registration statements. While some companies provide integrated reports that include detailed descriptions of ESG factors in their financial reports, more commonly, companies issue a separate ESG or sustainability report in addition to the financial reports that are filed with the SEC.

Companies might consider the following factors when they craft their disclosures:

- Companies should take steps to ensure the consistency of disclosures in financial and sustainability reports.
- Even if information is included in the sustainability report, ESG information should be included in financial reports if material and called for by the regulations underpinning the disclosure documents.
- Information disclosed in sustainability reports is subject to the antifraud provisions of the securities laws even if not filed with the SEC. The information in companies' sustainability reports should be scrutinized and verified to ensure its accuracy and completeness as if it were filed with the SEC.
- Companies should explain the importance of the ESG factors in their disclosures to help the reader to understand why the information is meaningful to the company and how it fits within the company's strategy.

- Disclosures that are clear and transparent can build trust and demonstrate the company's thoughtful management of ESG risks and opportunities.

Key Takeaways

Directors are under increased pressure from myriad stakeholders to address ESG risks and opportunities. The approach to such issues varies from company to company. Taking an approach that proactively addresses ESG concerns can unlock value for companies and can demonstrate a sensitivity to the concerns of their shareholders, employees, customers, and other key stakeholders who are important to companies' long-term success. ESG is a dynamic area that Latham will continue to watch closely and help clients to navigate.

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Endnotes

1 Steven B. Stokdyk, Joel H. Trotter and Catherine Bellah Keller, "How Directors Can Use Sustainability to Drive Value," Latham & Watkins Boardroom Perspectives (March 22, 2017), available at https://www.lw.com/thoughtLeadership/directors-sustainability-drive-value-boardroom-perspectives.

2 Business Roundtable, "Statement on the Purpose of a Corporation" available at https://opportunity.businessroundtable.org/ourcommitment/.

3 Larry Fink, "A Fundamental Reshaping of Finance" BlackRock Letter to CEOs.

4 Cyrus Taraporevala, "CEO's Letter on our 2020 Proxy Voting Agenda," State Street Global Advisors (January 28, 2020).

5 SEC Chairman Jay Clayton, "Proposed Amendments to Modernize and Enhance Financial Disclosures; Other Ongoing Disclosure Modernization Initiatives; Impact of the Coronavirus; Environmental and Climate-Related Disclosure" (January 30, 2020).