SQUIRE PATTON BOGGS

The ABC's of ESG

(and some musing about its implications for and beyond proxy season)

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ESG: What and How Significant Is It?

With "proxy season" kicking into high gear, issuers are already beginning to think about how to address concepts that are both complex and amoeba-like: environmental, social, and governance ("ESG") matters.[1] According to some leaders in the field:[2]

"1. The 'E' captures energy efficiencies, carbon foot printing, greenhouse gas emissions, deforestation, biodiversity, climate change and pollution, waste management and water use.

2. The 'S' covers labor standards, wages and benefits, workplace and board diversity, racial justice, pay equity, human rights, talent management, community relations, privacy and data protection, health and safety, supply-chain management and other human capital and social justice issues.

3. The 'G' covers the governing of the 'E' and the 'S' categories—corporate board composition and structure, strategic sustainability oversight and compliance, executive compensation, political contributions and lobbying, and bribery and corruption."

As explained below, dealing with these topics—especially as disclosure guidance becomes more demanding—is only in the early stages. One of the theses of this paper is that what some view as relatively modest new disclosure requirements are not really very modest at all and that, moreover, as issuers interact with these disclosure issues they may be drawn into much more fundamental questions about who they are, and want or need to be. It may well be in the interest of issuers, their stockholders and other stakeholders – and boards – to become proactive and fully engage on these matters rather than being taken for a ride in a boat with a torn sail in stormy waters.

Indeed, the more one thinks about it, the more one concludes that this may be a "don't miss" opportunity for important dialogue and coordination among a multitude of interest groups rather than being distracted by wondering how one can possibly get everything into 15 pages of risk factors.

Setting aside the current political difficulties, which cause some elements of our government to look more like a professional wrestling match than a functioning democracy, the development of ESG could provide a unique opportunity for the affected sectors to be part of the process—forging a more effective partnership to achieve both socially conscious outcomes and rational rules of the road rather than waiting to find out what is happening to them. It departs from the traditional private sector emphasis on financial performance and embraces the notion that companies should also serve social purposes. Yet, despite its rising prominence, the legal and regulatory landscape relating to ESG is underdeveloped, leaving companies with scant macro and micro guidance on how to operationalize ESG disclosure and launch rational initiatives.

Questions involving ESG run the gamut. Companies wonder: "What is ESG in the context of our company? I don't get it." "What is its significance?" "Is ESG simply a trend that will be replaced by another hot topic and fall by the wayside, or is it here to stay?" "What impact does ESG have on the company's board of directors?" "What are the associated risks?" "How can we be responsive in a changing environment without painting ourselves into a corner—or being an outlier?" "What are the short-term and long-term consequences associated with ESG?" "Given all that is going on, shouldn't we be hoarding cash?" [3] These types of issues complicate a company's business and day-to-day existence as it struggles to strike a balance between sometimes competing financial and ESG interests. The absence of clear relevant standards makes it a frustrating topic.[4]

In July 2021 the then new SEC Chair Gensler referred to the SEC's earlier checklist and suggested that the scope of ESG disclosure could be broad indeed, including a range as broad as climate change, board diversity, human capital management, and cybersecurity risk governance. Even the more narrow topic of emissions has meaningful scope: (1) greenhouse gas emissions from the issuer's own operations; (2) emissions from its use of electricity and similar resources; and (3) emissions generated by third parties in the issuer's supply chain.

1 The concept of ESG is also addressed in related literature by other terms such as corporate social responsibility (CSR) and corporate social governance (CSG). The author uses "ESG" throughout this paper.

2 Mark S. Bergman et al., *Introduction to ESG*, Harv. L. School Forum on Corp. Governance (Aug. 1, 2020), https://corpgov.law.harvard.edu/2020/08/01/introduction-to-esg/.

3 *See* Bergman, et al., *supra* note 3. "Employees responsible for preparing and updating ESG disclosures should be sensitized to the risk associated with public disclosures and to the importance of ensuring the ESG statements are consistent with the company's description of its business, its MD&A and its risk factors in annual and quarterly reports, even if those latter disclosures have no apparent ESG themes."

4 We should all remember that many worried about the introduction of the "pay ratio" disclosure a few years ago; it turned out not to be such a big deal, yet.

This paper is not intended to serve as a GPS device leading in a particular direction. Frankly, it's not that easy. There will no doubt be some awkwardness and internal resistance to some elements of this subject. But like it or not, we are all taking the ride until at least the first stop; it would be a tragedy not to take advantage of—rather than being left at the mercy of-- an unusual coincidence of events. We hope to provide background that may be of assistance to companies as they navigate the immediate compliance complexities of ESG as well as its long-term implications.

ESG: Who Is Focused and Serious?

ESG matters are broad and complicated, difficult to isolate, and more amenable to teams rather than individual leadership. Thus, at the outset it is necessary to understand who cares about this. Who are the SMEs? Who has their eye on this? Perhaps as many as eight groups. First, issuers that characterize themselves as "green" or "carbon neutral" or not contributing significantly to climate change. Second, issuers that are definitely part of the climate change dilemma. Third, individual investors who want to limit their portfolios to companies that are environmentally friendly. Fourth, passive investment funds that sell themselves as being portfolios of green stocks. Fifth, activist holders that either have, or feel the need to have, a climate change agenda. Sixth, rating agencies, proxy advisory firms and others of that ilk. Seventh, the accountants and others who will have to explicitly or implicitly sign off on some of the numbers. Eighth, the regulators and others who focus on securities and funds.

The sensitivity of the progressive constituencies will either give the movement a reputation for being credible, sensible and to be taken seriously when they interact with other serious players (e.g., the Business Roundtable, Martin Lipton, major universities, national and international government agencies, and the like), or make it difficult to recover from a credibility deficit. Their focus will likely require issuers to give some serious thought to new disclosures and more. All of this is complicated by the fact that, although the interests of these various constituencies are not generally consistent, they may nonetheless find it necessary to collaborate from time to time.

Now is the time.

The Impact of ESG: Moving from Purpose to Mission, Materiality and Metrics

Materiality and metrics are key factors underlying how companies should be addressing ESG. Companies should of course ask how material ESG is to them, their customers, suppliers, employees and investors. This is not even close to one size fits all. Fundamentally, who cares in a material way? [5] The approach taken by professional services businesses, for example, will likely be very different from most energy businesses. Many companies will conclude that ESG is not material. They should be mentally prepared to joust with their accountants and the SEC on that conclusion and intellectually prepared to produce all manner of things like schedules of assets and operations that are not emission sources or impaired by the passage of time and the refresh of technology.

In his 2021 letter to CEOs, Larry Fink of BlackRock observed that "the pandemic has presented such an existential crisis—such a stark reminder of our fragility—that it has driven us to confront the global threat of climate change more forcefully and to consider how, like the pandemic, it will alter our lives."[6]

We respectfully caution that issuers should be careful about getting out over their public skis when that is not necessary, as doing so can come back around to bite. The question should not be who produces the nicest graphics or the most daring commitments, but who does the best job of conveying seriousness of purpose and complicated substantive information that help convince serious people that material elements of ESG are getting the proper attention. Put another way, let's focus more on truth and consequences and less on the politics. In Mr. Fink's words:

> "We believe that when a company is not effectively addressing a material issue, its directors should be held accountable. Last year [2020—the number was higher in 2021] BlackRock voted against or withheld votes from 4,800 directors at 2,700 different companies. Where we feel companies and boards are not producing effective sustainability disclosures or implementing frameworks for managing these issues, we will hold board members accountable. Given the groundwork we have already laid engaging on disclosure, and the growing investment risks surrounding sustainability, 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."[7]

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5 There is no doubt about there being *a high level of interest in ESG, but for there to be a disclosure violation the defect needs to be "material." See TSC Indus., Inc. v. Northway, Inc.* 426 U.S. 438, 449-50 (1976). Decided in the context of a proxy fight under Rule 14a-9, the U.S. Supreme Court explained that "The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote…. It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available . . . The issue of materiality may be characterized as a mixed question of law and fact . . . The determination requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact."

6 Larry Fink, *2021 Letter to CEOs*, BlackRock, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter (last accessed Dec, 15, 2021).

7 Larry Fink, *2021 Letter to CEOs: A Fundamental Reshaping of Finance*, Blackrock, https://www.blackrock.com/us/individual/larry-fink-ceo-letter (last accessed Dec. 19, 2021).

Once again, required disclosure presages and eventually evolves into a combination of reporting with action, as explained by Mr. Fink:

"But, as we have seen again and again, the actions that damage society will catch up with a company and destroy shareholder value. By contrast, a strong sense of purpose and a commitment to stakeholders helps a company connect more deeply to its customers and adjust to the changing demands of society. Ultimately, purpose is the engine of long-term profitability."[8]

Having a proactive chat with principal investors about their perception of a company's ESG reporting regime and communications and operating philosophy may make sense. BlackRock is, to be sure, a powerful force, but has not been appointed as the spokesperson for all capital sources.

It is becoming both fashionable and urgent to be attentive to ESG issues, but corporations should not be taking on issues that are in fact either irrelevant or immaterial just because some of their competitors are being aggressive about their ESG plans. Each company has decide what is right for that business. Once the board decides what the overall approach and scope should be, how and in what areas and according to what priorities should the efforts be implemented? This is complicated stuff. Is what management and the board are thinking about consistent with what the board and the company have said and the board's other duties, including the duty to maximize shareholder value? Or put more broadly, is there a material purpose here? The Business Roundtable and others think so.

Notwithstanding the impressive genesis of the Business Roundtable statement, not everyone saluted its introduction. Reaction was swift. On the day after the publication of the statement, the Council of Institutional Investors ("CII") issued a release complaining that the Roundtable's statement "suggests corporate obligations to a variety of stakeholders, placing shareholders last, and referencing shareholders simply as providers of capital rather than as owners."[9] According to the CII, the Business Roundtable statement "undercuts notions of managerial accountability to shareholders."[10] The CII acknowledged that "While it is important for Boards and management to have and articulate long-term strategy where they have strong conviction, a fundamental strength of the U.S. economy has been and continues to be the efficient allocation of equity capital."[11]

Although we cannot be sure, it is possible that, Milton Friedman, a leading conservative free-trader who focused on monetary policy and was the informal leader of the so-called "Chicago School" of economics, a Nobel awardee, and adviser to Presidents Nixon and Reagan, rolled over in his 2006 grave when the Business Roundtable statement reached him.

When asked about Friedman and his followers and their reaction to the Business Roundtable statement, leading NY Times financial reporter, Andrew Ross Sorkin, a participant in the New York Times "*Daily Business Update*," on August 20, 2019, recalled Friedman's focus on profits, noting that in the view of many, rule number one is not to miss your profits numbers. Another article in the same edition of the Times, "*Shareholder Value Is No Longer Everything, Top C.E.O.s Say*," reminded readers that the subject of executive compensation was not covered by the Roundtable Statement.[12]

The division of opinions on these topics invite at least an elementary understanding of the metrics of ESG materially.

FASB and the SEC

As an initial matter, it helps to understand the roles of various organizations in setting financial accounting standards as applied to ESG endeavors. The SEC has broad authority over financial accounting principles and financial reporting for public companies. It recognizes the Financial Accounting Standards Board ("FASB") as the designated independent financial accounting standard setter for public companies. FASB standards are also recognized as the authoritative source of generally accepted accounting principles ("GAAP") for private companies and not-for-profit entities by many organizations such as state Boards of Accountancy and the American Institute of Certified Public Accountants. Although the FASB does not (yet) establish standards for ESG reporting, the application of many current accounting standards requires a company to consider changes in its business and operating environment when those changes have a material impact.

In March 2021, the FASB issued a Staff Education Letter focusing on the "intersection of environmental, social and governance matters with financial accounting standards," commenting that:

"[ESG] reporting is an area of growing focus for a wide range of interested parties including investors, credit rating agencies, lenders, preparers, regulators, and policy makers. ESG reporting includes a broad spectrum of qualitative and quantitative information. Interested parties seek to underset the effects of relevant ESG matters on an entity's business strategy, cash flows, financial position and financial performance. In other cases, parties seek that information from a public policy perspective or to influence corporate behavior."[13]

A complicating factor is that the same item can be, but need not be, important for policy purposes and immaterial for financial accounting purposes. ESG can touch many lines in the financial statements, and such matters are important to accounting firms, large and small, and their clients.

8 *Id.*

9 *Council of Institutional Investors Responds to Business Roundtable Statement on Corporate Purpose*, Council of Institutional Investors (Aug. 19, 2019), https://www.cii.org/aug19_brt_response.

10 *Id.*

11 *Id.*

12 *See* David Gelles and David Yaffe-Bellany, *Shareholder Value Is No Longer Everything, Top CEOs Say*, NY Times (Aug. 19, 2021), https://www.nytimes.com/2019/08/19/business/business-roundtable-ceos-corporations.html.

13 *Intersection of Environmental, Social, and Governance Matters with Financial Accounting Standards*, FASB (Mar. 19, 2021), https://fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1176176379917.

For example, Deloitte has published materials relating to how ESG impacts accounting and financial reporting.[14] Questions can relate to ESG accounting or disclosure requirements arising under existing rules and whether or not more SEC policy standards and comment letters on ESG will be forthcoming. They will.

The SEC will be a major player here, but it has not yet adopted many specific regulations concerning ESG disclosures and related items. There is no doubt that more are coming, and issuers may want to take into account what is on the horizon, perhaps as early as January, when thinking about this year's Form 10-K and Proxy Statement. Some reorganization and fresh writing will likely be required. Issuers will need to deal with shifting tides.

By way of illustrating the SEC's limited association with these issues to date, the SEC and U.S. Department of Labor have been engaged in an interesting battle (well, that's one word for it) over the significance of ESG. In September 2020, toward the end of the Trump Administration, the DoL adopted a rule governing investment decisions of plan participants to the effect that, despite contrary evidence, ESG factors are not material to ERISA plan investment and financial performance. On April 9, 2021 the SEC's Division of Examination issued a *Review of ESG Investing*, reporting "observations of deficiencies and internal control weaknesses from examinations of investment advisers and funds regarding ESG investing."[15] Based on a possible settlement that would eliminate many of the restrictions resulting from this exercise, it might be expected to go away for the most part with the change of Administrations. For example, in late February 2021, the SEC's Office of Investor Education and Advocacy made available to the public a balanced view of ESG investing.[16] This is a good example of how these kinds of matters can become politicized, heated, and then sensibly disappear.

On May 4, 2021, the SEC announced the creation of a 22-member ESG Task Force in the Division of Enforcement.[17] The positioning of this Task Force in the Enforcement Division emphasizes that the Commission is focused on enforcing existing obligations as well as not yet proposed new requirements. It is too early to expect specific returns from this effort, but there are pending matters and an Order resulting from the VW "diesel gate" investigation, with other cases pending.

In May 2021, the Chief Accountant of the Division of Corporation Finance cautioned that the Staff was actively thinking about climate-related risks and obligations, and obsolescence.[18] The same thoughts were reiterated by then new Chair of the SEC, Gary Gensler, on June 24 in London, when he confirmed that he had asked the Staff to put together recommendations for mandatory company disclosures on climate risk, to include considerations around governance, strategy and risk management related to climate risk.[19] Chairman Gensler uttered the word "metrics"—not for the last time—in this speech.[20]

In September 2021, the SEC Division of Corporation Finance published an "illustrative" comment letter providing "sample comments" regarding climate-related disclosure—or the lack thereof—primarily in the MD&A and Risk Factors.[21] As discussed below, a meaningful issue is where ESG disclosures should be placed go in a company's filings, and how ESG and related findings should be coordinated with other metrics. In light of its importance to those working on draft filings, a copy of the SEC's letter is attached to this overview. (See Appendix 1). It is an attention grabber.

Thus, there are already a variety of ongoing assessments related to ESG. Many of these will be difficult to convert to a common understanding of financial risk from the standpoint of the issuer, a fund, or an investor in either; however, efforts are ongoing, including attempts to gain familiarity and understanding of the effects of ESG on financial statements and efforts to mitigate related challenges. Targeted for publication in January 2022, the SEC's proposed ESG rules may be controversial as well as thought-provoking.

Worldwide Economic Forum

The subject of metrics is without a doubt very important unfinished business currently being addressed by leading industry groups and experts. In December 2019, the Executive Chairman of the World Economic Forum, Klaus Schwab, emphasized that new metrics, including a new measure of "shared and sustained value creation," will need to include ESG goals in addition to standard financial metrics in order to uphold the principles of stakeholder capitalism."[22] Fortunately, an initiative to develop a new standard along these lines is already underway, with support from the "Big Four" accounting firms.

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14 *See Do ESG Matters Affect Accounting and Financial Reporting Today?*, Deloitte (May 26, 2021), https://dart.deloitte.com/USDART/home/publications/deloitte/heads-up/2021/esg-affect-financial-reporting.

15 *Risk Alert: The Division of Examinations' Review of ESG Investing*, SEC Div. of Examinations 2 (Apr. 9, 2021), https://www.sec.gov/files/esg-risk-alert.pdf.

16 *See Environmental, Social and Governance (ESG) Funds – Investor Bulletin*, SEC Off. Of Investor Education & Advocacy (Feb. 26, 2021), https://www.sec.gov/oiea/investor-alerts-and-bulletins/environmental-social-and-governance-esg-funds-investor-bulletin.

17 *See* SEC Press Release, *SEC Announces Enforcement Task Force Focused on Climate and ESG Issues*, SEC (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42.

18 *See* Jian Choi & David M. Lynn, *SEC Comments on Climate Change*, Harvard L. School Forum on Corp. Governance (Oct. 17, 2021), https://corpgov.law.harvard.edu/2021/10/17/sec-comments-on-climate-change-disclosure/.

19 *See id.*

20 *Id.*

21 *Sample Letter to Companies Regarding Climate Change Disclosures*, SEC Div. Corp. Fin. (Sept. 2021), https://www.sec.gov/corpfin/sample-letter-climate-change-disclosures.

22 *See* Klaus Schwab, *Davos Manifesto 2020: The Universal Purpose of a Company in the Fourth Industrial Revolution*, World Econ. Forum (Dec. 2, 2019), https://www.weforum.org/agenda/2019/12/davos-manifesto-2020-the-universal-purpose-of-a-company-in-the-fourth-industrial-revolution/.

In July 2020, the World Economic Forum followed up on the subject of metrics by publishing *A New Paradigm for Business of Data*.[23] That monograph focuses on the explosion of data resulting from a digital revolution created by COVID-19.

Another metric that may draw special attention is executive compensation. (Woe unto Compensation Committees.) Mr. Schwab commented that "since the 1970s, executive pay has skyrocketed, mostly to 'align' management decision-making with shareholder interests. In the new stakeholder paradigm, salaries should instead align with the new measure of long-term shared value creation."[24] This is probably not yet obvious from a review of the Compensation Discussion and Analysis in most proxy statements. But it should become clear in relatively early days, as compensation tends to focus the mind on an understanding of what senior management wants to achieve and how. Compensation is perhaps the clearest way to measure alignment.

"Finally," Mr. Schwab concluded, "large companies should understand that they themselves are major stakeholders in our common future. Clearly, all companies should still seek to harness their core competencies and maintain an entrepreneurial mindset. But they should also work with other stakeholders to improve the state of the world in which they are operating. In fact, this latter proviso should be their ultimate purpose."25

TCFD

The Task Force for Climate-related Financial Disclosures ("TCFD") was created in 2015 by the Financial Stability Board ("FSB") to develop consistent climate-related financial risk disclosures for use by companies, banks, and investors in providing information to stakeholders.[26] Increasing the amount of reliable information relating to financial institutions' exposure to climate-related risks and opportunities will strengthen the stability of the financial system, contribute to greater understanding of climate risks and facilitate financing the transition to a more stable and sustainable economy.[27] The TCFD framework provides both general and sector-specific guidance, but only on climate-related topics, such as climate change. It has been well-accepted in the EU.

In his 2021 letter, Mr. Fink commented:

"TCFD reports are the global standard to helping investors understand the most material climate-related risks that companies face, and how companies are managing them. Given how central the energy transition will be to every company's growth projects, we are asking companies to disclose a plan for how their business model will be compatible with a net zero economy—that is, one where global warming is limited to well below 2° C consistent with the global aspiration of net zero greenhouse gas emissions by 2050. We are asking [companies] to disclose how this plan is incorporated into [the company's] long-term strategy and review by [their] board of directors."[28]

The following table and its first column (the "What" column) are based on TASC materials; the others provide examples of the broad array of players that need to brought aboard to achieve stated goals.

The "Who" column is submitted for target practice. Who in the company has dealt with things like this in the past? We all understand that there is not an oversupply of leadership in most organizations; in the words of Jim Collins, get the right people on the bus for this effort. Where does the buck stop? Does the company have a lead in this area? Is there a Chair letter or plan that provides guidance? Is the Company likely to be willing to dare to take a step in the direction of Stakeholder Capitalism?

23 *See A New Paradigm for Business of Data*, World Econ. Forum (July 2020), https://www3.weforum.org/docs/WEF_New_Paradigm_for_Business_of_Data_Report_2020.pdf.

24 Klaus Schwab, *What Kind of Capitalism Do We Want?*, TIME (Dec. 2, 2019), https://time.com/5742066/klaus-schwab-stakeholder-capitalism-davos/.

25 *Id.*

26 *See About the Task Force on Climate-related Financial Disclosures*, Fin. Stability Board, https://www.fsb-tcfd.org/about/ (last accessed Dec. 9, 2021).

27 *Id.*

28 Larry Fink, *2021 Letter to CEOs*, BlackRock, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter (last accessed Dec, 15, 2021).

The What, Who and Where of ESG Issues and Disclosures

(Based on TCFD Matrix)

What (Topics)	**Who** (Internal: Management/ Board/ Committee) and External	**Where** (10-K Business or Litigation, MD&A, Etc.) (Board Committee/ and Management/ Regulators)	**Comments**
Environmental			
Climate Change	Legal and Business SMEs; Board	Business or 10-K, Litigation	Investors and Funds
Ecological impacts, such as pollution, deforestation, and loss of biodiversity	Same as for Climate Change	Business; 10-K	
Energy Management, such as energy-efficient buildings and production processes	Relevant Managers and SMEs	10-K	?
Greenhouse gas emissions	Relevant Managers and SMEs	10-K	
Litigation Risk, for example related to environmental contamination	Legal	Legal	
Policies and regulations	Legal; SMEs; Board	10-K?	
Raw material sourcing	Purchasing	10-K	
Renewable energy	Purchasing	10-K	
Sustainable products and packaging	?	N/A	
Water and waste management	?	N/A	
Social			
Community Relations	CEO; IR	10-K	
Diversity, Equity and Inclusion	Board; HR & Board Comm. Diversity officer	10-K; Proxy Statement	
Employee Health & Safety	HR	10-K	
Human capital development	HR, Bd. Comm. Diversity Officers	10-K	
Labor management	HR	10-K	
Privacy and data security	SMEs, Sales and Legal	General Counsel and SME	
Product quality and safety	?	Risk Factors	
Supply chain standards	Purchasing	10-K Businesses; Risk Factors	
Governance			
Anti-bribery and anti-corruption	Legal	Legal; HR/Legal Training Function	10-K
Business Ethics	Legal, CEO and Board Committees	Legal, Audit Committee, Management; Ethics Committee;	Proxy Statement
Corporate Resiliency	Board and CEO	10-K Businesses	Proxy Statement or 10-K?
Diversity of Leadership	HC Committee; Board	DOL; Provide 5500 on some basis?; HR Comm.; HR	Proxy Statement
Executive Compensation	Compensation Committee	Proxy Statement	Proxy Statement
Lobbying and political contributions	Management	?	Proxy Statement
Ownership structure	NA	NA	NA
Tax transparency	CFO and Tax Director	Notes to Financials; MD&A	

There are many others involved in developing sensible metrics for ESG. AS noted above, In July 2020 the World Economic Forum followed up on the subject of metrics by publishing *A New Paradigm for Business of Data*.[29] Investors, lenders, and other capital providers have become increasingly aware of the impact ESG issues have on a company's financial performance and prospects. This will become a standard element of diligence related to financings and acquisitions.

To nurture stronger communications with shareholders, companies are turning to initiatives such as the Global Reporting Initiative (GRI), Principles for Responsible Investment (PRI), and Sustainability Accounting Standards Board (SASB) to define relevant sustainability issues and understand their impact on a company's financial performance and prospects.

SASB Mission and Standards, and Collaborators

SASB was designed to assist corporations in developing and disclosing financially significant sustainability information to investors. To do this, SASB identified a complete set of ESG metrics that are most important to financial performance across 77 industries. Six of those industries are shown in Appendix 6, a partial illustration of the SASB Materiality Map. Like a well-written MD&A, SASB's Materiality Map is intended to identify the financially material issues that are reasonably likely to impact the financial condition or operating performance of a company. In tandem with the TCFD, the SASB provides a broad range of data, but in the case of SASB only on climate-related topics such as the risks of climate change.

The general SASB categories are grouped under five primary topics: Environment, Social Capital, Human Capital, Business Model & Innovation, and Leadership & Governance. From there, sector-level and industry-level mapping identifies how likely an issue is to be material for companies.[30]

The SASB Standards are designed to:

- Surface and pinpoint financially-material sustainability information that is likely to affect the financial performance of a typical company within a specific industry;[31]
- Produce information that is decision-useful for investors;
- Be cost-effective for companies to use; and
- Provide an evidence-based and market-informed process (which is modeled after the process used to develop financial accounting standards).[32]

The SASB standards are maintained under the oversight of the Value Reporting Foundation, a global nonprofit organization created to help businesses and investors develop a shared understanding of enterprise value and how it is created, preserved or eroded.

Also of interest is the work of the Sustainability Accounting Standards Board ("SASB"), a non-profit organization that merged with the International Integrated Reporting Council ("IIRC") in late 2021 with the aim of offering investors and companies a comprehensive corporate reporting framework to drive global sustainability performance. SASB standards provide guidance on the disclosure of "financially material sustainability information" by companies to their investors.[33] The goal is to create a credible international organization that maintains an integrated reporting framework, advocates integrated thinking, and sets sustainability disclosure standards for enterprise value creation.

In September 2020, five leading framework and standard-setting organizations – CDP, CSDB, GRI, IIRC and SASB – announced a shared vision for a comprehensive corporate reporting system that includes both financial accounting and sustainability disclosure, connected via integrated reporting. The joint statement outlines how existing sustainability standards and frameworks can complement generally accepted financial accounting principles (Financial GAAP). In December 2020, the "group of five" published a prototype climate-related financial disclosure standard that illustrates how the concepts from the group's joint paper can be applied to climate disclosure and consolidates content and metrics into one practical guide.

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29 *See A New Paradigm for Business of Data*, World Econ. Forum (July 2020), https://www3.weforum.org/docs/WEF_New_Paradigm_for_Business_of_Data_Report_2020.pdf.

30 *See* Appendix 6.

31 *See generally*, Doug Sundheim & Kate Starr, *Making Stakeholder Capitalization a Reality*, Harv. Bus. Rev. (Jan. 22, 2020), https://hbr.org/2020/01/making-stakeholder-capitalism-a-reality. This is one of the goals of Blackrock.

32 *See The Strategic Value of ESG Materiality Assessments*, Goby, https://www.gobyinc.com/esg-solutions/strategic-value-of-esg-materiality-assessments/ (last accessed Dec. 21, 2021).

33 *See SASB Standards: About Us*, SASB Value Reporting Foundation, https://www.sasb.org/about/ (last accessed Dec. 9, 2021).

Proxy Advisory Firms: ISS and Glass-Lewis

The recent Institutional Shareholder Services ("ISS') announcement of proposed policy changes, endorsed by the TCFD, is important enough to be set out in full:

"Climate change and climate-related risks are now among the most critical topics for many investors. Proposed ISS Benchmark policy changes for 2022 include the assessment of and focus on the world's highest greenhouse gas ('GHG') emitting companies, and adding policy provisions for so-called "say on climate" votes. A new climate-related board accountability policy is proposed in several major markets, based on expectations from many investors that high emitting companies should assess, mitigate, and report on their climate change risks and targets.

For ISS' Benchmark policies for those markets, changes are proposed that will provide for recommendations to vote against the re-election of relevant directors (or other appropriate voting items) at high emitting companies if appropriate climate-related disclosures, such as those according to the recommendations of the Task Force on Climate-Related Financial Disclosures ('TCFD'), have not been made, or the company has not set quantitative GHG reduction targets. In all markets, additional information will be provided in ISS' Benchmark reports on high emitting companies' climate-related disclosures and GHG reduction targets.

With the growing numbers of management proposals seeking shareholder approval of climate transition plans, and of shareholder proposals requesting climate reporting and, often, regular shareholder votes on companies' climate transition plans and progress, ISS is also proposing new policies codifying its analytical frameworks for these items for 2022. For company climate transition plans presented for shareholder approval, the completeness and rigor of the plans will be assessed case-by-case, including considering the quality of disclosures, the rigor of targets, whether targets are science-based, the existence of external verification, and a range of other information.

For shareholder proposals requesting 'say on climate' votes or other climate-related actions, under the new proposed policy ISS will analyze each on a case-by-case basis, taking into account the details of the request and the company's current climate-related disclosures and performance."[34]

Translation: No rest for the wicked or producers of greenhouse gas.

In addition, on October 29, 2021 ISS launched "Net Zero Solutions," described as a data-driven suite of solutions utilizing automated portfolio reporting that will track the alignment of portfolios against the Paris Agreement's goal of limiting global temperature change.[35]

The Glass-Lewis approach to climate change uses a three-tiered system based on the TCFD analysis to measure whether the issuer is adequately managing climate risk.[36] The policy is also "aligned" with TCFD in terms of measuring issues with climate-related risk against management of greenhouse gas.[37] And like ISS, Glass-Lewis is offering services in this area, with a "dedicated Custom Policy team" providing the "solution."[38]

For brief comments on other ISS and Glass-Lewis proxy voting recommendations, see Appendix 4.

Role of Directors in Management of Corporations: Legal Standards

The board of directors is legally responsible for managing the corporation. For example, Section 141(a) of the Delaware General Corporation Law ("DGCL") states that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors. . . ." In most public companies and most states, the board's role is one of oversight, not day-to-day management; however, the Board remains ultimately responsible.

The board makes decisions on behalf of the corporation by: (1) appointing officers who run the day-to-day operations of the corporation, propose strategies and objectives, and implement corporate plans; (2) supervising corporate officers; (3) making major decisions for the corporation (e.g., selling the corporation or entering into a significant joint venture); and (4) creating board committees which themselves may wield significant power.

As Mr. Lipton and others have commented, we should understand that large companies themselves are major stakeholders in our common future. Clearly, all companies need to continue to focus on commercial success. But they should also work with other stakeholders to improve the state of the world in which they are operating. In fact, this latter goal might be one of their ultimate purposes.

So do boards have the balance right? Or is stakeholder capitalism stepping out of bounds? We submit that energized, moderate (but with a sense of urgency) and smart leaders are the answer.

Core Fiduciary Duties of the Board of Directors

In the abstract, the law in this area is relatively simple. Every director owes fiduciary duties to the corporation and its stockholders. Absent qualifications under state law indemnity and director (but not so much officer) liability protection statutes, directors can be subject to personal liability for breaches of these duties. The core fiduciary duties the board of directors must pay the most attention to are the duty of care (i.e. acting on a good faith informed basis) and the duty of loyalty (i.e. acting in the best interests of the corporation). Other duties such as the duty of good faith, duty of disclosure, and duty of oversight stem from the core fiduciary duties.

34 *ISS Launches Open Comment Period for 2022 Proposed Benchmark Voting Changes*, ISS (Nov. 4, 2021), https://insights.issgovernance.com/posts/iss-launches-open-comment-period-for-2022-proposed-benchmark-voting-policy-changes/.

35 *See ISS ESG Launches Net Zero Solutions*, ISS (Oct. 29, 2021), https://insights.issgovernance.com/posts/iss-esg-launches-net-zero-solutions/.

36 *See Climate Policy*, Glass Lewis, https://www.glasslewis.com/climate-policy/ (last accessed Dec. 9, 2021).

37 *Id.*

38 *Id.*

To Whom Are Fiduciary Duties Owed?

Fiduciary duties are owed by corporate directors and officers. Directors and officers owe their fiduciary duties to the corporation and its stockholders. The corporation itself does not owe fiduciary duties to the stockholders. If the board commits a breach of fiduciary duty, the complaint is with the Board, not the corporation.

Duty of Loyalty

The duty of loyalty requires directors to: (1) act in good faith for the benefit of the corporation and its stockholders, not for their own personal interest, and (2) refrain from conduct that would injure the corporation and its stockholders, or deprive them of profit or advantage. Directors may not advance their own interests (or those of their affiliates) over the corporation's interests. Some decisions suggest that bad faith is an element of breach of this duty.

Duty of Care

The duty of care requires that directors be informed of all material information reasonably available to them when making decisions for the corporation. A director must act with the care that a person in a like position would reasonably believe appropriate under similar circumstances. Directors can rely on information and opinions from consultants and management, if those persons are reasonably believed to be competent.

Director Liability and the Business Judgment Rule

In making business decisions, directors are protected in most states by the business judgment rule. The rule creates a rebuttable presumption that disinterested and independent directors act in accordance with the duties of care and loyalty, i.e.:

- On an informed basis (i.e., with due care).
- In good faith.
- In the honest belief that the action was taken in the best interest of the corporation.

Director Liability: Protective Provisions in State Law

The DGCL authorizes inclusion of a provision in the certificate of incorporation to protect directors from liability to the corporation or its stockholders for monetary damages for certain breaches of their duties as directors.[39] A number of other states have similar protective provisions. Some are even stronger.[40]

Evolution of the Duty of Oversight and Role of ESG

In a world that is becoming more complex by the day, and with businesses creating mountains of data by the week, the duty of care will increasingly force boards to have an understanding of issues such as what those mountains could or should tell directors. It is at once a resource, a risk factor and a job for really good artificial intelligence. Do companies have a sense of what is out there in the data? Is that not an element of disclosure and financial controls? Should companies have a risk and disclosure review committee?

As part of the duties of care and loyalty, directors owe a duty of oversight such that, among other things, (1) they must "assure [that] a reasonable information and reporting system exists" [41] and (2) after directors have awareness of issues and risks, they must not only make the necessary disclosures, but also take appropriate responsive action. This is especially true of certain businesses. Delaware courts have noted the relationship between the nature of the company's business and the implications of the *Caremark* case: "[W]hen a company operates in an environment where externally imposed regulations govern its 'mission critical' operations, the board's oversight function must be more rigorously exercised."[42]

The recent 100-page slip opinion of Vice Chancellor Zurn in *Boeing* may become a leading *Caremark* precedent. Since the case was settled for $237.5 million in November 2021, there will be no Delaware Supreme Court ruling.

Boeing arose out of the crashes of two 737 MAX airplanes manufactured by Boeing. It was a traditional derivative action brought by and on behalf of stockholders against Boeing board members and officers to recover damages suffered by Boeing in relation to the 737 MAX plane crashes in October 2018 and March 2019. Because the decision was on a motion to dismiss, the facts, as pleaded by the plaintiffs, were essentially taken as true. The question was whether the Boeing stockholders had alleged facts such that "a majority of the Company's directors face a substantial likelihood of liability for Boeing's losses . . .based on the directors' complete failure to establish a reporting system for airplane safety, or on their turning a blind eye to a red flag representing airplane safety problems."[43] The Court ruled for the plaintiffs.

The opinion detailed a multitude of problems that plagued Boeing in the period from 2013 (Dreamliner issues) through 2019. The Audit Committee was charged with responsibility for risk oversight, but it seems that neither the Audit Committee nor the Board as a whole focused – or were focused by management –on safety. For example, "The Board was unaware of whistleblower complaints regarding airplane safety, compliance, workforce exhaustion, and production schedule pressure at the 737 MAX facility."[44]

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39 *See* DGCL Section 102(b)(7).

40 *See e.g.,* VA Code Section 13.1-692; MD Corporations and Associations Code Section 2-405.2.

41 *In re Caremark Int'l Inc. Deriv. Litig.,* 698 A.2d 959, 971 (Del. Ch. 1996).

42 *In re Clovis Oncology, Inc. Deriv. Litig.,* 2019 Del. Ch. LEXIS 1293, at 28 (Del. Ch. 2019); *see also Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019) (case involving a listeria outbreak at Blue Bell Creameries).

43 *In re Boeing Co. Deriv. Litig.,* No. 2019-0907-MTZ, 2021 Del. Ch. LEXIS 197, at 3 (Ch. Sept. 7, 2021).

44 *Id.* at 30.

Board minutes focused more on restoring profitability, efficiency and supply chain issues than safety.[45] The CEO was replaced in January 2020.[46] The 737 MAX fleet was grounded for 20 months, until November 2020, and in January 2021 Boeing consented to a costly criminal information charging the Company with fraud.[47]

Vice Chancellor Zurn moved on from the facts to a review of *Caremark* and its progeny, explaining that courts have recognized the difficulty of alleging facts that would satisfy the elements of a cause of action under *Caremark*:

"Delaware courts routinely reject the conclusory allegation that because illegal behavior occurred, internal controls must have been deficient, and the board must have known so. Rather, the plaintiff must plead with particularity 'a sufficient connection between the corporate trauma and the board.' 'To be sure, even in this context *Caremark* does not demand omniscience. But it does mandate that 'to satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then monitor it.''"[48]

On the other hand, the court also emphasized that *Caremark* does not create a "freestanding fiduciary duty that could independently give rise to liability."[49] What is required is for directors to have acted in bad faith, or with scienter. As the *Boeing* court cautioned, '[O]nly a sustained or systematic failure of the board to exercise oversight—such as an utter failure to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.'"[50]

Emerging Roles of the Duty of Oversight and Stakeholder Capitalism

It is perhaps not surprising that the duty of oversight is being weaponized at the same time as Stakeholder Capitalism is evolving. They arise from different legal foundations, but over time could play very complementary roles.

The increasing significance of ESG is apparent from the level of attention it is garnering from a variety of sources. It came at least as a mild surprise to many when, in August 2019, the Business Roundtable published a new *Statement on the Purpose of a Corporation*,[51] endorsed by 181 CEOs.

The Statement reminds readers that since 1978 the Business Roundtable has issued, from time to time, revised versions of the *Principles of Corporate Governance*, which have consistently endorsed principles of shareholder primacy — "that corporations exist principally to serve shareholders."[52] The new Statement, described as a "modern standard for corporate responsibility," goes much further and commits participating companies to deliver value to customers, invest in employees, deal fairly and ethically with suppliers, and support the communities in which they work (including by protecting the environment and embracing sustainable practices), and, yes, generating long-term value for shareholders.[53]

The 2019 Business Roundtable developments followed in tracks created in significant part by Martin Lipton of Wachtell, Lipton, Rosen & Katz, the Davos World Economic Forum and others. In August 2016, Mr. Lipton presented to the International Business Council of the World Economic Forum, *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*.[54] The *Roadmap* outlines priorities for the corporation, the CEO, the Board and investors. It functions as a manual of sorts for directors and executives and emphasizes the alignment of long-term thinking with sustainability.

In December 2019, the World Economic Forum published the 2020 *Davos Manifesto*,[55] which was consistent with the Business Roundtable's August 2019 Statement and the other writings referred to herein. The *Davos Manifesto*:

- "Explains that [t]he purpose of a company is to engage all its stakeholders in shared and sustained value creation. In creating such value, a company serves not only its shareholders, but all its stakeholders—employees, customers, suppliers, local communities and society at large. The best way to understand and harmonize the divergent interests of all stakeholders is through a shared commitment to policies and decisions that strengthen the long-term prosperity of a company.
- Echoes, in comments coincident with those of others, that [a] company provides its shareholders with a return on investment that takes into account the incurred entrepreneurial risks and the need for continuous innovation and sustained investments. It responsibly manages near-term, medium-term, and long-term value creation in pursuit of sustainable shareholder returns that do not sacrifice the future for the present.

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45 See id. at 38.

46 *See id.* at 57.

47 *See id.*

48 *Id.* at 66-67.

49 *Id.* at 67.

50 *Id.* at 69.

51 *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans*, Bus. Roundtable (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

52 *See id.*

53 *See id.*

54 *See* Martin Lipton, *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*, Harvard L. School on Corp. Governance and Fin. Reg., (Jan. 11, 2017), https://corpgov.law.harvard.edu/2017/01/11/corporate-governance-the-new-paradigm/.

55 *See* Klaus Schwab, *Davos Manifesto 2020: The Universal Purpose of a Company in the Fourth Industrial Revolution*, World Econ. Forum (Dec. 2, 2019), https://www.weforum.org/agenda/2019/12/davos-manifesto-2020-the-universal-purpose-of-a-company-in-the-fourth-industrial-revolution/.

- Asserts that [a] company is more than an economic unit generating wealth. It fulfills human and societal aspirations as part of the broader social system. Performance must be measured not only on the return to shareholders, but also on how it achieves its environmental, social and good governance objectives. Executive remuneration should reflect stakeholder responsibility.

In September 2020, *Enacting Purpose Within the Modern Corporation—A Framework for Boards of Directors*[56] ("EPI"), was published by a multi-institution partnership among the University of Oxford; the University of California, Berkeley; BrightHouse (a BCG company); the British Academy; Federated Hermes EOS; and Wachtell, Lipton, Rosen & Katz. EPI was intended to guide boards of directors, senior management, and investors on the articulation, implementation, and reporting to global investment management firms and others of their purpose.

Once one accepts the proposition that we may be drifting toward, or indeed, targeting, a new stakeholder paradigm, the question becomes whether that is the right direction. Where do we go from here?

Relationship Between Stakeholder Capitalism and State Law

There are not many (if any) cases dealing with shareholder capitalism as such, and boardroom lawyers faced with doubtful directors will need something to say about whether the relevant state corporation law supports stockholder capitalism without tested state law and charter documents. Is it obvious that the company can safely subscribe to stakeholder capitalism? In another context, would the board be safe in concluding that the company should remain independent, or in the alternative borrow a ton of money at historically low rates in order to achieve strategic growth and performance, or buy back a lot of stock, or put itself on the auction block: in each case moving forward based on stakeholder capitalism? Should other priorities prevail or at least be part of the analysis?[57]

The doubtful have expressed concern not only as to what might be referred to as "corporate power" and "due authorization," but also director liability:

"To counter claims of breach of fiduciary duty, directors can now show that they engaged in a deliberative process and considered, and weighed, facts they deemed relevant in arriving at a decision they determined to be in the best interests of shareholders. If, however, directors decide to base a decision on the interests of suppliers, with negative consequences to employees or other constituencies, what will determine whether that judgment was reasonable or constituted a breach of fiduciary duty? It is an issue which the plaintiffs' bar will be eager to explore."[58]

The importance of the availability of well thought-out choice of law and state case law was demonstrated in *CTS Corp. v. Dynamics Corporation of America*, 481 U.S. 69, 89-90 (1987), where Justice Powell observed:

"We think the Court of Appeals failed to appreciate the significance for Commerce Clause analysis of the fact that state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law. As Chief Justice Marshall explained:

> A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. *Trustees of Dartmouth College v. Woodward*,

. . . .

Every State in this country has enacted laws regulating corporate governance. By prohibiting certain transactions, and regulating others, such laws necessarily affect certain aspects of interstate commerce. This necessarily is true with respect to corporations with shareholders in States other than the State of incorporation….The markets that facilitate this national and international participation in ownership of corporations are essential for providing capital not only for new enterprises but also for established companies that need to expand their businesses. This beneficial free market system depends at its core upon the fact that a corporation — except in the rarest situations – is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation."

In *CTS* the Court surprised a number of disbelievers by upholding the Indiana Control Share Acquisition Statute[59] against a Commerce Clause challenge.

56 *See* Rupert Younger et al., *Enacting Purpose within the Modern Corporation*, Harv. L. School. Forum on Corp. Governance (Sept. 2, 2020), https://corpgov.law.harvard.edu/2020/09/02/enacting-purpose-within-the-modern-corporation/.

57 There are actual and virtual libraries full of scholarly content on the financial impact of state takeover laws: "The financial cases for and against state-level takeover regulation is beyond the scope of this piece. There has not been much activity in the state takeover litigation arena in recent years, at least in substantial part because of the success of the poison pill. But most poison pills result in short term effects rather than the promotion of long-term thinking. There have been loads of financial analyses on the effects of state takeover regulation." *See e.g.,* Emiliano M. Caftan & Marcel Kahan, *Law and Finance of Antitakeover Statutes*, New York University of Law, NYU Center for Law, Economics and Organization Working Paper No. 4-39 (2014).

58 Morton Pierce, *Analysis of the Business Roundtable Statement*, Harv. L. School Forum on Corp. Governance (Sept. 26, 2019), https://corpgov.law.harvard.edu/2019/09/26/analysis-of-the-business-roundtable-statement/; *see also* Patrick D. Daugherty et al., *The Purpose of a Corporation*, Foley & Lardner Legal New: Business Law (Nov. 2019), https://www.foley.com/en/insights/publications/2019/11/the-purpose-of-a-corporation.

59 Bias alert: The author was a member of the committee that drafted the first of that generation of state takeover laws.

Support From State Anti-Takeover Laws

In *CTS* we knew what the Indiana statute said. In other cases that infrastructure may not exist. There the approach might be to engage in self-help by amending the corporation's state law articles, declaration of trust, or bylaws or equivalent in an even-handed way. This works in theory, but runs into logistics challenges as to issues such as restrictions on transfer. Most who have done this successfully have done it very carefully; such transactions require at least due care and some imagination.[60] In terms of state law comforters, thus far we have mentioned several generations of state takeover laws, the *CTS* decision, the movement toward stakeholder capitalism, the success of poison pills (rights plans), and well-reasoned case law. Most of these elements eventually delegate the core issues to the board and to the shareholders. Companies that are organized in states with less helpful case law or more ambiguous corporate statutes may want to be more proactive and amend their corporation's corporate laws to enhance the means of achieving stockholder capitalism. There are complications, but several generations of so-called, "anti-takeover" laws, including some put in place in the late 1980s and 1990s, could be useful as reminders of the power of state law and what the states have said and done about the interests of non-shareholder constituents.

Today there are a number of state laws[61] that support the proposition that the board can consider a number of factors before taking action, either generally or specifically in connection with consideration of a takeover. These factors typically include things like:

(1) The interests of employees, suppliers, creditors, and customers;

(2) The economy of the state and nation;

(3) Community and societal considerations; and

(4) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests or any beneficial purpose set forth in the corporation's articles, may be best served by the continued independence of the corporation."

These factors are broad and support both anti-takeover and other matters.

The New York law, BSC Section 717(a) and (b) of the New York Business Corporation Law, is similar to the Ohio statute. It provides that in an action (including without limitation involving a change of control) a director may consider: "both the long-term and the short-term interests of the corporation and its shareholders"; the effects the actions may have in the short-term or in the long-term on the prospects for growth; and current employees, retired employees, customers, and creditors. All of these fall within the penumbra of stockholder capitalism. More than half of the states have such a statute, sometimes referred to as constituency statutes.[62]

The parties in some of the cases carried out on the hostile takeover battlefields claimed that so-called "takeover defenses" should be treated as dead on arrival since the sole purpose of the corporation is to maximize shareholder wealth. Then along came the 1986 *Revlon* case. In *Revlon*, the Delaware Supreme Court stated that a board may consider corporate constituencies beyond the shareholders when addressing a takeover threat so long as there is still "some rationally related benefit accruing to the stockholders" in doing so.[63]

That maximization of short-term value is not the road that must always be taken was reaffirmed in *Paramount Communications Inc. v. Time Inc.*, Del. Supr., 571 A.2d 1140, 1150 (1989), where the Delaware Supreme Court commented on the duty of a board of directors to develop a corporate strategy, and on the broad discretion of the board in choosing among strategies that emphasize either short- or long-term results:

[W]e think it unwise to place undue emphasis upon long-term versus short-term corporate strategy. Two key predicates underpin our analysis. First, Delaware law imposes on a board of directors the duty to manage the business and affairs of the corporation. 8 Del. C. § 141(a). This broad mandate includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. Thus, the question of "long-term" versus "short-term" values is largely irrelevant because directors, generally, are obliged to charter a course for a corporation which is in its best interest without regard to a fixed investment horizon. Second, absent a limited set of circumstances as defined under any Revlon [v. MacAndrews & Forbes Holdings, Inc., Del. Supr., 506 A.2d 173 (1986)], a board of directors, while always required to act in an informed manner, is not under any per se duty to maximize shareholder value in the short term, even in the context of a takeover.[64] [Emphasis supplied.]

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60 As to utilization of charter documents, *see* Neil Whoriskey, *Outlaws of the Roundtable? Adopting a Long-Term Value Bylaw*, Harv. L. School Forum on Corp. Governance (Oct. 24, 2019), https://corpgov.law.harvard.edu/2019/10/24/outlaws-of-the-roundtable-adopting-a-long-term-value-bylaw/.

61 *See e.g.,* Ohio Revised Code Section 1710.59(D), California CA CORP Section 309, Florida FL ST Section 607.0830(6), Illinois 805 ILCS 5/8.85, Ill. Comp. Stat. Ann. Ch. 805, § 5/8.85 (West 1995). 3. Conn. Gen. Stat. § 33-313(E) (1991); Fla. Stat. Ann. § 607.0830(3) (West 1989); Ga. Code Ann. § 14-2-202(B)(5) (1989); Haw. Rev. Stat. § 415-35(B) (Supp. 1995); Idaho Code §§ 30-1602, 30-1702 (Supp. 1995); Ill. Comp. Stat. Ann. Ch. 805, § 5/8.85 (1992); Ind. Code §§ 23-1-35-1(D), (F), (G) (Supp. 1995); Iowa Code § 491.101b (1991); Ky. Rev. Stat. Ann. § 271b.12-210(4) (Baldwin 1991); La. Rev. Stat. Ann. § 12:92(G)(2) (West Supp. 1995); Me. Rev. Stat. Ann. Tit. 13-A, § 716 (West Supp. 1990); Mass. Gen. L. Ch. 156 B, § 65 (Supp. 1995); Minn. Stat. § 302a.251(5) (1990); Miss. Code Ann. § 79-4-8.30(D) (Supp. 1990); Mo. Rev. Stat. § 351.347.1(4) (Supp. 1990); Neb. Rev. Stat. § 21-2035(1)(C) (1990); N.J. Stat. Ann. §§ 14a:6-1(2)- 14a:14(4) (West Supp. 1995); N.M. Stat. Ann. § 53-11-35(D) (Mich. 1993); N.Y. Bus. Corp. Law § 717(B) (Mckinney Supp. 1991); Ohio Rev. Code Ann. § 1701.59(E) (Anderson Supp. 1990); Or. Rev. Stat. § 60.357(5) (1994); 15 Pa. Cons. Stat. §§ 1711-1712, 1715-1717, 1721 (1990); R.I. Gen.

62 *See e.g.,* Ill. Comp. Stat. Ann. Ch. 805, § 5/8.85 (West 1995). 3. Conn. Gen. Stat. § 33-313(E) (1991); Fla. Stat. Ann. § 607.0830(3) (West 1989); Ga. Code Ann. § 14-2-202(B)(5) (1989); Haw. Rev. Stat. § 415-35(B) (Supp. 1995); Idaho Code §§ 30-1602, 30-1702 (Supp. 1995); Ill. Comp. Stat. Ann. Ch. 805, § 5/8.85 (1992); Ind. Code §§ 23-1-35-1(D), (F), (G) (Supp. 1995); Iowa Code § 491.101b (1991); Ky. Rev. Stat. Ann. § 271b.12-210(4) (Baldwin 1991); Mass. Gen. L. Ch. 156 B, § 65 (Supp. 1995); Minn. Stat. § 302a.251(5) (1990); N.J. Stat. Ann. §§ 14a:6-1(2)- 14a:14(4) (West Supp. 1995); N.M. Stat. Ann. § 53-11-35(D) (Michie 1993); N.Y. Bus. Corp. Law § 717(B) (Mckinney Supp. 1991); Ohio Rev. Code Ann. § 1701.59(E) (Anderson Supp. 1990); Or. Rev. Stat. § 60.357(5) (1994); 15 Pa. Cons. Stat. §§ 1711-1712, 1715-1717, 1721 (1990).

63 *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.,* 506 A.2d 173, 176 (Del. 1986).

64 *Paramount Commc'ns Inc. v. Time, Inc.,* 571 A.2d 1140, 1150 (Del. 1989).

Thus, there is sophisticated case law that paves the way for corporations to choose a stakeholder strategy even without the ultimate supportive state statutory vaccines that many states have.

In distilling guidance from statutory and case law, it becomes clear that, at least when without the cover of a good statute, it is imperative to create the best possible record of the board's considerations so a reviewing court is able to determine that such considerations were undertaken at least in part for the benefit of the corporation and its stakeholders.

This approach depends not only on the law, but on the facts and circumstances, such as whether the board (or better yet the shareholders) incorporate into the organic documents a preference for stakeholder capitalism over the lack of such a purpose. Assuming that the organic documents are clear and amended with the cover of clear disclosure that is regularly reflected in public documents so interested parties are aware of the Company's bias in these things, it should be possible to build a record that supports rational decisions based in whole or in part on stockholder capitalism and long-term values supported by the common law, statutes where they exist, and charter and bylaw provisions if drafted, adopted and utilized property.[65]

Possible Scope and Opportunistic Consequences of ESG

We are not audacious enough to think we could effectively describe a complete list of ESG topics that are or will remain the focus of management, boards, institutional or activist holders, and regulators, but in the short run certainly they include climate change and other environmental concerns, the interests of employees generally and being proactive in addressing the effects of systematic racial bias and promoting inclusion and fairness. This is not to say that a vote for ESG is a vote for banning a particular substance or focusing on something else from this week's stack of "breaking news," or that a company needs to score the highest on whatever metrics we pick. The trick here is thoughtful definition of a company's ESG process, and then becoming comfortable with the accuracy of the disclosure and that description's likely implications for the future direction of the business. Boards and management will need to think "around the next corner" and be careful about what they say and do on the ESG front in order to maintain both currency and flexibility over time.

And as outlined elsewhere, with leadership from the likes of the Business Roundtable, the Davos World Economic Forum, Blackrock, and Martin Lipton, the "stakeholder capitalism" model has much to recommend it as a guideline and tool. Indeed, younger generations—such as those wondering if going back to work in the traditional sense makes sense as the pandemic (hopefully) winds down or up or both—may have already decided that a different model would work better for them. And they are an important element of our human capital.

Is the business world facing a set of circumstances that are uniquely different and challenging and at the same time full of opportunity for makers of change, perhaps including those in the private sector? In part due to the associated misery, this combination of need for change, openness to change, risk, opportunity and respected leadership will not often coincide[66] A new global risk factor might be that we could fail to meaningfully address the obligations and opportunities of ESG in a manner that our grandchildren – of all colors, genders and backgrounds – would approve of. Send them a universal proxy card and see what they think.

65 *See* Steve Klemash et al., *Stakeholder Capitalism for Long-Term Value Creation*, Harv. L. School Forum on Corp. Governance (June 13, 2019), https://corpgov.law.harvard.edu/2019/06/13/stakeholder-capitalism-for-long-term-value-creation/. This supports the commentary from the Harvard Law School Forum on Long-Term Value creation, which discusses market-driven analysis of the impact of stakeholder capitalism. *See* Whoriskey, *supra* note 53 (discussing among other things the effects of short-termism and the possible use of charter documents to adopt an enforceable long-term value orientation).

66 *See* Appendix 9.

Appendix 1

Sec Sample Comment Letter

Sample Letter to Companies Regarding Climate Change Disclosures[i]

The Commission has stated that a number of its disclosure rules may require disclosure related to climate change. [2] For example and depending on the particular facts and circumstances, information related to climate change-related risks and opportunities may be required in disclosures related to a company's description of business, legal proceedings, risk factors, and management's discussion and analysis of financial condition and results of operations. Disclosure matters discussed in the 2010 Climate Change Guidance include the following:

- the impact of pending or existing climate-change related legislation, regulations, and international accords;
- the indirect consequences of regulation or business trends; and
- the physical impacts of climate change.

Companies also must disclose, in addition to the information expressly required by Commission regulation, "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."[3]

The Division of Corporation Finance selectively reviews filings made under the Securities Act and the Exchange Act to monitor and enhance compliance with applicable disclosure requirements. The following illustrative letter contains sample comments that the Division may issue to companies regarding their climate-related disclosure or the absence of such disclosure. The sample comments do not constitute an exhaustive list of the issues that companies should consider. Any comments issued would be appropriately tailored to the specific company and industry, and would take into consideration the disclosure that a company has provided in Commission filings.

September 2021

Name

ABC Corporation

Address

Dear Issuer:

We have reviewed your filing and have the following comments regarding compliance with the topics addressed in the Commission's 2010 Guidance Regarding Disclosure Related to Climate Change, Release No. 33-9106 (Feb. 2, 2010). In some of our comments, we may ask you to provide us with information so we may better understand your disclosure. Please respond to these comments by providing the requested information and/or revising or updating your disclosure as applicable. If you do not believe our comments apply to your facts and circumstances, please tell us why in your response.

General

1. We note that you provided more expansive disclosure in your corporate social responsibility report (CSR report) than you provided in your SEC filings. Please advise us what consideration you gave to providing the same type of climate-related disclosure in your SEC filings as you provided in your CSR report.

Risk Factors

2. Disclose the material effects of transition risks related to climate change that may affect your business, financial condition, and results of operations, such as policy and regulatory changes that could impose operational and compliance burdens, market trends that may alter business opportunities, credit risks, or technological changes.
3. Disclose any material litigation risks related to climate change and explain the potential impact to the company.

Management's Discussion and Analysis of Financial Condition and Results of Operations

4. There have been significant developments in federal and state legislation and regulation and international accords regarding climate change that you have not discussed in your filing. Please revise your disclosure to identify material pending or existing climate change-related legislation, regulations, and international accords and describe any material effect on your business, financial condition, and results of operations.
5. Revise your disclosure to identify any material past and/or future capital expenditures for climate-related projects. If material, please quantify these expenditures.
6. To the extent material, discuss the indirect consequences of climate-related regulation or business trends, such as the following:
   - decreased demand for goods or services that produce significant greenhouse gas emissions or are related to carbon-based energy sources;
   - increased demand for goods that result in lower emissions than competing products;
   - increased competition to develop innovative new products that result in lower emissions;
   - increased demand for generation and transmission of energy from alternative energy sources; and
   - any anticipated reputational risks resulting from operations or products that produce material greenhouse gas emissions.
7. If material, discuss the physical effects of climate change on your operations and results. This disclosure may include the following:
   - severity of weather, such as floods, hurricanes, sea levels, arability of farmland, extreme fires, and water availability and quality;
   - quantification of material weather-related damages to your property or operations;

- potential for indirect weather-related impacts that have affected or may affect your major customers or suppliers;
- decreased agricultural production capacity in areas affected by drought or other weather-related changes; and
- any weather-related impacts on the cost or availability of insurance.

8. Quantify any material increased compliance costs related to climate change.
9. If material, provide disclosure about your purchase or sale of carbon credits or offsets and any material effects on your business, financial condition, and results of operations.

We remind you that the company and its management are responsible for the accuracy and adequacy of their disclosures, notwithstanding any review, comments, action or absence of action by the staff.

Sincerely,

Division of Corporation Finance

[1] The statements in this guidance represent the views of the staff of the Division of Corporation Finance. This guidance is not a rule, regulation, or statement of the Securities and Exchange Commission ("Commission"). The Commission has neither approved nor disapproved its content. This guidance, like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

[2] Commission Guidance Regarding Disclosure Related to Climate Change, Release No. 33-9106 (Feb. 2, 2010) [75 FR 6290] (Feb. 8, 2010) ("2010 Climate Change Guidance").

[3] Rule 408 under the Securities Act of 1933 ("Securities Act") and Rule 12b-20 under the Securities Exchange Act of 1934 ("Exchange Act").

Appendix 2

Things Tto Think and Act On?

Get the non-financial and financial members of the annual meeting/annual report team (the "Team") together at an early date.

Do we have the right board committees and the right directors and staff on the right Teams? Do we understand what our "purpose" is, and then what our "mission" is—closely related topics

Are we making and testing decisions based on purpose vs mission?

Do we have a risk committee or an audit or other committee with the room and skills to serve as a risk committee?

How are our ESG terms organized?

Does the Compensation/Human Relations Committee have the right (broad enough) remit?

Do we know who our key players are? Are they stable-successions in place?

Should there be an internal ESG Committee along the lines of the Disclosure Committee?

Have we reviewed our COVID response in an organized way to incorporate lessons learned? What will be we doing differently?

Do we need to have more "crisis simulations"? Is the emergency operations plan up to date?

Do we have our arms around cybersecurity issues?

Do we owe external updates to shareholders/stakeholders about any of this?

Stockholder programs likely?

Have we thought enough about MD&A and risk factors to be comfortable that we are dealing with the right things in the right place?

For example, did relatively stable 2021 results come from cost cuts that are "one-timers" and not replicable?

What will our CRMs be?

Are we over-using Non-GAAP data?

As we deal more with ESG metrics and KPI's do they make sense, and will they be measurable year over year so as to support comparative analysis? Who are the key players here? Are we on top of this?

Does the Board have an understanding of the environment we are operating in and the challenges facing us?

Is there any stomach for taking on the "Stakeholder Capitalism" model?

If so, how to get there in a year?

Identify the most significant ESG issues and what (1) should be the highest priority and (2) the most difficult (not always the same)

Are we violating the "perfect is the enemy of good" rule?

Appendix 3

Concerns/Risk Factors

Three issues that keep you up at night

- New risk and other factors
- COVID-19 and variants
- Supply chain

Cyber issues? Are we aggressive enough?

Impact of inflation—in general terms, how long are we locked into particular rates, including on cost-plus structures; employee issues?

Dysfunctional US politics

Racial and gender /inclusiveness

Should we use the "Rooney Rule"?

More churn/turnover? Are we addressing aggressively enough?

Impact of Biden programs

International challenges: autocracies, Russia, Russia/Ukraine, Afghanistan withdrawal, China, UK economy, Africa, Latin America

Get everything in—but in less than 16 pages

Appendix 4

Iss/Glass-Lewis Issues

Possible Shareholder Proposals	ISS	Glass-Lewis
Say on Climate Proposals (Climate Change, Audits, Reports)	As to proxy voting recommendations, both ISS and Glass-Lewis are expected to support a company on climate-related proposals when it is in compliance with the relevant international standards, but reasonable shareholder proposals for "say on climate" punitive measures may become favored	Same as ISS
Significant GHG Emitters; Tiered Approach	Align with TCFD (Scopes 1, 2 and 3)	Same as ISS; aligned with TCFD
Board Oversight on E and S Issues	Same as Glass-Lewis	Requires explicit disclosure on overseeing environmental and social issues; likely to support pressure for improvements
Unequal Voting Stock	Negative	Negative
Equity Plan Burn Rates	In 2023 will move to a Value Adjusted Burn Rates	
Racial Equality Updates	Case by Case; Essentially the same as Glass-Lewis	Case by Case; starting in 2022 will support negative notes on Nominating Chair if Boards of 6 or more do not have 2 gender diverse members; 1 is min. for Boards of less than 6; moving to 30 % test.
Nasdaq Rule as to 1 Female approved by SEC in August	Supports	Supports
Waiver of Retirement or Tenure Policies	Disfavors	
Board Gender Diversity	Follows Nasdaq mandate for a "comply or explain" approach and aim for 2 gender diverse Board members by 2123 [Vote against nominating committee Chair]	Essentially the same as ISS; likely will become a % test
Unequal Voting Rights	Will withhold some votes for some directors based on unequal voting rights on a case by case basis	Essentially the same as ISS; two year grace periods are over
Board Compensation		Minimum say on pay vote threshold that triggers a response to go from 70 to 80%
Reacting to COVID-19 Impact on Performance-Based Compensation	Will likely be support for getting rid of looser standards and waivers at this stage of COVID	See ISS

Appendix 5

Things to Discuss With The Board

- Need to think fresh and dig in for a long process
- Be prepared to discuss whether we need the 'Davos Manifesto" for a better kind of capitalism?
- How far would we be willing to go?
- Given our experience with COVID and other matters, what are the lessons learned? Do we have the right risk command and control structure?
- Stakeholder capitalism is gaining momentum in an unusual set of circumstances
- It offers an opportunity to tackle today's environmental and social challenges
- How far does the Company and Board want to go here? Are we aligned?
- Do the Board committees work?
  - Need more?
- Should we move toward operational vs Par_______ guidance?
- Should we move _____ or pay to a modern trust?
- Is there enough free time with Board and middle management?

Appendix 6

SASB Materiality Map

Below is an example of how six (6 of 77) industries have different sustainability risks and opportunities.

		6 of SASB's 77 industries					
Dimension	**General Issue Category**	**Health Care Delivery**	**Non-Alcoholic Beverages**	**Electric Utilities & Power Generators**	**Advertising & Marketing**	**Auto Parts**	**Metals & Mining**
Environment	GHG Emissions						
	Air Quality						
	Energy Management						
	Water & Wastewater Management						
	Waste & Hazardous Materials Management						
	Ecological Impacts						
Social Capital	Human Rights & Community Relations						
	Customer Privacy						
	Data Security						
	Access & Affordability						
	Product Quality & Safety						
	Customer Welfare						
	Selling Practices & Product Labeling						
Human Capital	Labor Practices						
	Employee Health & Safety						
	Employee Engagement, Diversity & Inclusion						

		6 of SASB's 77 industries					
Dimension	**General Issue Category**	**Health Care Delivery**	**Non-Alcoholic Beverages**	**Electric Utilities & Power Generators**	**Advertising & Marketing**	**Auto Parts**	**Metals & Mining**
Business Model & Innovation	Product Design & Lifecycle Management						
	Business Model Resilience						
	Supply Chain Management						
	Materials Sourcing & Efficiency						
	Physical Impacts of Climate Change						
Leadership & Governance	Business Ethics						
	Competitive Behavior						
	Management of the Legal & Regulatory Environment						
	Critical Incident Risk Management						
	Systemic Risk Management						

Appendix 7

ESG Steps[67]

This hypothetical company has little ESG knowledge or policies, but has recently received the demand for ESG from investors. Steps this company would take during their materiality assessment would include:

- Assess existing policies, strategies, & initiatives
- Identify & engage key stakeholders
- Implement ESG training, workshops & other engagement events
- Understand current & needed growth for ESG issues & topics
- Identify opportunities
- Define metrics
- Select systems for performance tracking
- Aggregate goals across stakeholder groups
- Launch

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67 Based on Ford, "*The Strategic Value of ESG Materiality Assessments*" Unlocking the strategic value of ESG materiality assessments | *Goby gobyinc.com*)

APPENDIX 8

Other Sec Rule Updates

About the only thing that has not changed is our renewed determination to take a hard look at the Form 10-K and Proxy Statement. And quite a bit of it is required under SEC rule. [Revise re 2019]

Form 10-K

In August 2019, as part of the SEC's Disclosure Effectiveness Initiative, the Commission proposed revisions of Items 101, 103 and 105 of Regulation S-K. An initial batch of amendments were adopted in August 2020. We need to fully implement this year.

- Business Description Overview, Item 101(a). Gives the Company more flexibility in fashioning the description of the business by adopting a "principles based" approach to disclosure of information material to an understanding of the development of the business rather than responding to specific requirements. The five-year timeframe was eliminated. In addition, the filing may incorporate by reference prior descriptions and focus on material developments rather than including the full discussion. How management wants to respond to this additional flexibility is probably an internal discussion item.
- Business Description Specifics, Item 101(c). A principles-based approach is also adopted with respect to the "laundry list" of items historically covered by Item 101(c). The revised list is non-exclusive and thus allows both more and less. There are two important changes to be observed:
  - Registrants are now required to include a description of the company's human capital resources to the extent material to an understanding of the business. This requirement coincided with the plans of many companies to enhance ESG disclosures in the Proxy Statement or Form 10-K, partially in response to institutional investors and pressure from the proxy advisory firms. This is another area where the Form 10-K/Proxy Statement team will want to intersect with management in terms of developing a comfortable and consistent approach. Our sense is that many companies will be beefing up disclosure in this area, particularly given the impact of COVID-19 on the workforce.
  - The other specific item change is an expansion of the regulatory disclosure requirement to cover all material government regulations rather than just environmental laws, as has been required for many years. Focus on this expanded item might include an internal assessment of how the company stacks up against the evolving *Caremark* line of cases dealing with the Board's duty to provide compliance oversight. ESG is clearly within scope here.
- Litigation, Item 103
- Risk Factors, Item 105

Management's Discussion and Analysis; Financial Information [Items 301-303)

Critical Audit Matters; Will ESG be on the List?

SEC Coronavirus Disclosure Guidance

Appendix 9

Recipe for Stakeholder Capitalism

The opinions expressed in this update are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

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