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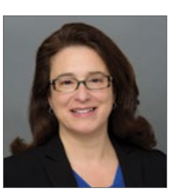
Addressing ESG Issues After the Events of 2020

The unprecedented confluence of the events of 2020, including the 2019 novel coronavirus (COVID-19) pandemic, the racial justice movement, extreme climate-related conditions, and the economic slowdown, have significantly impacted the ways in which companies are addressing environmental, social, and governance (ESG) issues. Practical Law asked *Helene R. Banks* of *Cahill Gordon & Reindel LLP* to explain how companies are incorporating ESG factors into their corporate strategies, policies, and operations in response to recent events, as well as provide guidance for companies seeking to enhance their ESG programs.



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How do the events of 2020 relate to companies' ESG initiatives?

The confluence of the events of 2020 has accelerated the ESG trends that had been occurring for years (for more information, search Expert Q&A on the Fundamentals of ESG on Practical Law) and has created new areas of focus. Each of the main drivers has impacted different aspects of the ESG discussion and, taken together, they have created an impetus for rapid change.

All constituencies have increased their focus on ESG, including:

- Employees.
- Consumers.

- Suppliers.
- Investors.
- Governments.
- Regulators.

For example, large institutional investors, such as State Street Global Advisors, Vanguard, and BlackRock, have issued statements emphasizing the importance of focusing on ESG matters in the wake of the COVID-19 pandemic (see, for example, State Street Global Advisors, COVID-19 and ESG: Four Dimensions (Apr. 2020), available at *ssga.com*; Vanguard, Vanguard Investment Stewardship: Update on the 2020 Proxy Season (Apr. 1, 2020), available at *americas.vanguard.com*; BlackRock, Sustainable Investing: Enduring Through COVID-19 and Beyond (Apr. 28, 2020), available at *blackrock.com*). This emphasis has transformed the question of whether ESG policies can be reconciled with the corporate goal of building shareholder value into the question of how companies can protect and enhance shareholder value by implementing a comprehensive plan to address ESG matters.

In the first half of 2020, investors poured over $20.9 billion into ESG-focused funds, an amount which was nearly as much as the total amount contributed in all of 2019 (a previous record year with four times more in contributions than any prior year) (see Morningstar, Inc., Sustainable Funds Continue to Rake in Assets During the Second Quarter (July 30, 2020), available at *morningstar.com*). The increase in investment follows recent research indicating that companies with a strong ESG rating outperform the market by a significant percentage in times of crisis.

For example, McKinsey & Company reports that "[a] strong ESG proposition correlates with higher equity returns … [and] a reduction in downside risk" (McKinsey & Co., Five Ways that ESG Creates Value (Nov. 14, 2019), available at *mckinsey.com*). Similarly, Institutional Shareholder Services Inc. (ISS) found that high ESG performance is generally positively related to valuation and profitability and negatively correlated with volatility (ISS, ESG Matters (2019), available at *issgovernance.com*). In this time of heightened social awareness, companies and their boards must take seriously the focus on ESG matters if they expect to increase the market value of their companies' stock.

During the early stages of the COVID-19 pandemic, many companies pivoted quickly to:

- Provide workers with extended health coverage options.
- Retool manufacturing to provide products needed by the community.
- Provide charitable support for both workers and communities.

In response to the racial justice movement companies have:

- Revisited diversity policies and practices.
- Provided opportunities for important and difficult conversations about systemic conditions and issues that may be contributing to discrimination and hostile environments.

These emergency measures all implicate ESG issues that boards and management need to examine to determine how they can be incorporated into a company's long-term strategy.

Have any specific ESG topics garnered more attention than others?

The COVID-19 pandemic and the racial justice movement have created an enhanced focus on the "S" in ESG. The social issues prong of ESG encompasses all aspects of how a company interacts with people and communities, including:

- Employees.
- Independent contractors.
- Suppliers.
- Cities and towns.
- Humanity at large.

As a result of the COVID-19 pandemic, companies have had to change how they interact with employees and communities, both as a practical matter due to regulations requiring shutdowns and new safety measures (for more information, search COVID-19: Employment Law and Development Tracker on Practical Law), as well as to assist and respond to pressures from various constituencies.

Many companies have made progress in the past few years on environmental sustainability measures and currently report on their waste and carbon footprint. Many companies have also adopted policies regarding corporate governance matters, such as board diversity and executive pay equity (for more information, search What's Market: Corporate Social Responsibility and Corporate Sustainability Disclosures on Practical Law). However, the social prong of ESG has been harder to tackle.

The events of 2020 have heightened the focus on social issues because employees, consumers, and communities want companies to adapt their policies to recognize the long-term impact of their actions, not just the short-term financial cost. The focus on human capital issues, including worker safety, health and wellness, and job and wage security, has resulted in some companies making quick adjustments to policies and left others defending against lawsuits, for example, for failure to provide ample protection for workers during the COVID-19 pandemic.

One important human capital issue that has taken center stage is remote work. COVID-19 pandemic-related shutdowns required companies to switch to remote work to stay in business. While reopenings are in progress, many employees continue to work remotely for various reasons, raising questions about the role of remote work. Companies should consider how they will adapt to facilitate remote work while maintaining productivity and company culture.

Companies should determine:

- Whether their employees want to work remotely and, if so, how often.
- Whether employees have the tools to be productive remotely.
- The cost of adapting the work being performed and the workplace where it is carried out.
- Whether a failure to adapt might be a competitive disadvantage in the long run.

Search Remote Employees: Best Practices and Remote Employees: Best Practices Checklist for more on the key legal considerations and best practices for employers with remote employees.

Additionally, public companies need to reconsider their disclosure regarding human capital. In August 2020, the Securities and Exchange Commission (SEC) adopted amendments to Item 101(c) of Regulation S-K that require public companies to disclose material human capital measures and objectives that are used in managing their businesses (see Modernization of Regulation S-K Items 101, 103, and 105, SEC Release No. 33-10825 (Aug. 26, 2020), available at *sec.gov*). The SEC explained that this includes matters related to employee:

- Recruitment.
- Retention.
- Development.

Search SEC Adopts Rule Amendments to Modernize Disclosures of Business, Legal Proceedings, and Risk Factors Under Regulation S-K for more on the amendments.

While the amendments aim to improve companies' disclosure, some critics, including two SEC commissioners who declined to approve the amendments, believe the new principles-based disclosure rules leave too much discretion in the hands of management while not requiring disclosure of key human capital metrics, such as the number of part-time and full-time employees, employee turnover rates, and diversity (see Commissioner Caroline Crenshaw, Statement on the "Modernization" of Regulation S-K Items 101, 103, and 105 (Aug. 26, 2020), available at *sec.gov*; Commissioner Allison Herren Lee, Regulation S-K and ESG Disclosures: An Unsustainable Silence (Aug. 26, 2020), available at *sec.gov*).

Boards and management will need to assess their human capital policies and practices in light of the new focus and rules, and adopt long-term approaches that are consistent with their mission and strategy. While the economic recovery is expected to take time for some companies, when planning for the long term, all companies should anticipate that employee retention will be a focal point. The companies that have made progress in addressing employee concerns are likely to have an edge in retaining and recruiting employees.

How have the events of 2020 impacted corporate governance matters?

The racial justice movement is shining a light on systemic practices and policies that may be obstructing progress toward racial equity. This has created a focus on corporate policies regarding the promotion and hiring of Black employees and increased the push for boardroom and management diversity not only based on gender, but also on race and sexual orientation.

Companies are being called out to answer for the confirmed lack of diversity in their boardrooms and management suites. For example, three of the largest technology companies, Oracle, Facebook, and Qualcomm, are being sued in California based on claims that the companies have failed to implement their own diversity policies, resulting in a lack of directors or executives of color (see Complaint, *Klein v. Ellison*, Case No. 20-cv-04439 (N.D. Cal. July 2, 2020); Complaint, *Ocegueda v. Zuckerberg*, Case No. 20-cv-04444 (N.D. Cal. July 2, 2020); Complaint, *Kiger v. Mollenkopf*, Case No. 20-cv-01355-LAB-MDD (S.D. Cal. July 17, 2020)).

The California legislature has also recently passed a law that expands the scope of its mandated focus on board gender diversity (see Cal. Corp. Code § 301.3) to a broader range of underrepresented groups, defined to include individuals who self-identify as "Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or … as gay, lesbian, bisexual, or transgender" (AB 979).

According to ISS data as of September 21, 2020, 1,260 of the Russell 3000 companies, 492 of the S&P 1500, and 71 of the S&P 500 lack minority ethnic or racial board representation. ISS's proposed voting guidelines for 2021 include a new policy for companies in the Russell 3000 or S&P 1500. The policy provides that ISS will generally recommend voting against or withhold for the nominating committee chair beginning in 2022 (or other directors on a case-by-case basis) if a company has no identified ethnic or racially diverse board members. (See ISS, Proposed ISS Benchmark Policy Changes for 2021 (Oct. 14, 2020), available at *issgovernance.com*.)

Search Board Diversity: Steering the Ship Under the Watchful Eyes of Shareholders, Lawmakers, and Regulators for more on improving board diversity.

Some companies are reexamining their diversity policies and have committed to engaging in difficult conversations on race to bring about sustainable long-term change. Other companies have announced significant measures intended to correct racial imbalances, including establishing:

- Funds to support Black-owned businesses (see Press Release, PayPal Announces $530 Million Commitment to Support Black Businesses, Strengthen Minority Communities, and Fight Economic Inequality (June 11, 2020), available at *newsroom.paypal-corp.com*; Press Release, Target Commits $10 Million and Ongoing Resources for Rebuilding Efforts and Advancing Social Justice (June 5, 2020), available at *corporate.target.com*).
- Specific targets for the hiring of Black employees and the increased use of Black-owned suppliers (see Letter to Employees, The Estée Lauder Companies Commits to Racial Equity (June 7, 2020), available at *elcompanies.com*; Facebook, Supporting Black and Diverse Communities (June 18, 2020), available at *about.fb.com*).

Companies will need to evaluate their diversity policies and practices and develop long-term strategies with measurable outcomes.

Additional issues brought to the fore by the events of 2020 relate to board governance. For example, according to a recent study reviewing the 2020 proxy season, shareholder support for independent board chair proposals increased, with two such proposals achieving a majority vote. The study credits the COVID-19 pandemic with likely having fueled this increase in shareholder support for independent chairs as a means to improve board oversight effectiveness. (See Georgeson, Viewing Independent Chair Proposal Support Through the Lens of COVID-19 (July 7, 2020), available at *georgeson.com*.)

Boards also need to evaluate their committee structures to be sure they have appropriately delegated oversight of issues such as diversity and health and wellness, and consider when committee-level issues should be raised to the full board. The events of 2020 have required management to pivot quickly. Good corporate governance suggests this is the time for boards to reconsider whether they are organized properly to support management in a crisis.

Specifically, boards should determine whether they:

- Have the necessary committees in place.
- Are able to easily conduct board meetings remotely.
- Are updated frequently enough by management.

Additionally, the events of 2020 have caused companies to evaluate their supply chains. This has been due in part to the practical implications of company shutdowns, as well as the pressure to reconsider business relationships with a view to worker health and safety and racial equity.

Companies should examine whether the actions of their suppliers are consistent with their corporate governance policies, and whether using those suppliers may have an impact on the company's reputation.

Search Corporate Social Responsibility and the Supply Chain for more on the steps companies can take to address corporate social responsibility in their supply chains.

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How can we expect environmental responsibility to unfold as companies reopen or ramp up their operations?

During the early days of the company shutdowns precipitated by the COVID-19 pandemic, there was much reporting on the positive environmental effects of slowing down businesses (for example, less pollution in the canals of Venice, Italy, clearer air in major US cities, and falling global carbon emissions). While the COVID-19 pandemic was wreaking havoc on health systems and the economy, it provided some environmental relief.

However, California, Oregon, and Washington are combatting the devastating impact of unprecedented wildfires. While causation is difficult to prove with any certainty, experts believe the length, number, and ferocity of the wildfires are being fueled, at least in part, by climate change (see The Washington Post, Western Wildfires: An "Unprecedented," Climate Change-Fueled Event, Experts Say (Sept. 11, 2020), available at *washingtonpost.com*; Reuters, Explainer: How This Year's Destructive U.S. West Wildfire Season Came To Be (Sept. 14, 2020), available at *reuters.com*).

These developments have served to further catalyze the movement to combat climate change and adopt environmentally sustainable practices. Many investors are using the events of 2020 to increase their focus on environmental sustainability.

What steps can companies and boards take to enhance their ESG programs?

There are no specific requirements imposed on companies regarding their ESG programs. This is both positive and negative. On the positive side, each company has a different ESG focus depending on its industry, size, products and, most importantly, the stage it is in on its ESG journey. A lack of specific requirements allows companies to develop bespoke programs. On the other hand, companies cannot be sure they are doing what is needed or desired by the various constituencies they are trying to satisfy. This makes the goal line a constant moving target.

However, companies seeking to enhance their ESG programs should consider evaluating their public disclosures. There are many ESG standard setting organizations, making it hard for companies to know what to disclose and even when and where. A consortium of five global standard setting organizations, including the Sustainability Accounting Standards Board (SASB), has proposed to work together to create a framework and standards for ESG reporting, and to link ESG disclosures with financial disclosures in one comprehensive report. Efforts to set ESG standards have been ongoing for many years by different organizations, but one set of standards remains a distant goal. The consortium hopes to accelerate that effort. (See Statement of Intent to Work Together Towards Comprehensive Corporate Reporting (Sept. 2020), available at *sasb.org*.)

Additionally, during the early stages of the COVID-19 pandemic, SEC Chairman Jay Clayton and the Director of the SEC's Division of Corporation Finance, William Hinman, issued a joint statement calling for companies to publish as much information as practicable about their financial situation and plans (see SEC, Public Statement, The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19 (Apr. 8, 2020), available at *sec.gov*).

As discussed above, recent changes to Regulation S-K adding human capital measures to the list of topics companies are required to address in their annual reports make it imperative that companies clearly articulate changing policies and practices affecting employees. The amendments to Regulation S-K also impact environmental disclosures, because they update the monetary thresholds for disclosure of environmental liabilities under Item 103 of Regulation S-K and emphasize disclosure of material environmental matters (see SEC, Modernization of Regulation S-K Items 101, 103, and 105, Release No. 33-10825 (Aug. 26, 2020), available at *sec.gov*).

In responding to the new disclosure requirements and the increased interest of investors in ESG matters, companies will need to continue to assess what outside standards they will follow and what is material, and tailor their disclosure accordingly.

The swift pivots that companies have had to make in 2020 have provided an impetus for change that might otherwise have taken much longer to effect. On the other hand, sustainable and effective changes warrant a thoughtful decision-making process that is focused on the long term. This pushes boards and management into what seems like an untenable balancing act. Boards can play a very important role in managing this tension. While management must tend to the day-to-day issues and put out fires as they arise, the board can provide the measured strategic guidance needed to ensure that the company stays on an effective long-term course.

Companies should evaluate their long-term ESG policies. For example, in the area of human capital management, the immediate reaction to the COVID-19 pandemic required employees to work remotely or be furloughed, and important measures were implemented by management almost overnight. The board is now in a position to consider how these short-term changes will affect long-term policies, including by determining whether:

- A remote workforce is able to effectively support the company.
- Remote work will be adopted as a permanent alternative for all or some of the company's employees.
- A remote work environment will affect other ESG concerns, such as diversity and environmental matters.

Further, while management may have publicly reaffirmed its commitment to diversity and inclusion as an immediate reaction to the racial justice movement, the board can take a measured look at those efforts, including by evaluating whether:

- Pay equity is being achieved.
- There is a sufficient pipeline of diverse candidates for senior positions.
- Diverse employees are given opportunities for advancement.

With the current heightened focus on ESG matters, some commentators have questioned whether companies have taken ESG considerations too far. However, it is important to look at this juncture in history not as an attack on the profit motive, but as an opportunity to preserve and enhance a company's value by focusing on the stakeholders needed to create that value. PL