ESG And The Board: Avoiding Risky Business

By David Woodcock

Environmental, social and governance issues have taken over so much of corporate and boardroom discourse that we overlook just how fraught and subjective the ESG topic is. Who are your actual "stakeholders," and how does the board weigh their interests? What happens when ESG concerns conflict? How does ESG differ from overall corporate risk management?

Public company directors find themselves caught in the middle of an increasingly political debate over the importance and relevance of environmental, social, and governance (ESG) issues. Proponents of ESG have for many years faced little opposition in the drive for more disclosure, commitment, and action on ESG. However, in the past year there has been political and legal pushback across a number of fronts, and we are seeing a number of big investors step back from their previously strong ESG rhetoric.

Almost overnight, we have gone from concerns about "greenwashing" (saying you are doing more than you are on ESG) to questions about "greenhushing" (not saying how much you are actually doing on ESG).

For many reasons, including the staggering amount of investment dollars pursuing ESG and increasing ESG disclosure obligations mandated by regulators, the subject is unlikely to disappear from the corporate agenda anytime soon. Against this backdrop, how can boards navigate this political minefield, while satisfying their fiduciary duties to shareholders and ensuring that their companies effectively address key ESG risks?

One answer lies in assessing and managing ESG risks along with other corporate risks through a dispassionate and holistic enterprise risk management (ERM) framework. The structure ERM provides can make it easier to consider the needs of ESG-focused stakeholders, while understanding that boards cannot please all stakeholders all the time. This is more than a compliance or disclosure issue.

The board's role is to help create long-term corporate value for the shareholders, and that means boards should ensure their limited time and attention are focused on those corporate risks that most impact corporate value. Although the solution may sound simple, all this can be easily overlooked in the politically polarized environment.

Despite all of the attention on ESG, the concept itself remains surprisingly elusive. Even ESG-focused rulemaking by the Department of Labor refused to define the term.

☐ ***The rise of ESG.*** Developed almost 20 years ago to allow the measurement of certain "environmental, social, and governance" metrics, the ESG movement promised that a focus on ESG would help businesses and investors do well by doing good. ESG's influence is now ubiquitous, having grown into a formidable complex of ESG rules, ESG officers, ESG raters, ESG activism, and ESG-focused investment funds. Some predict these funds will have over $53 trillion in so-called ESG assets by 2025.

Although the idea of sustainability and corporate social responsibility have been around for many decades, corporations have been under more pressure than ever over the past few years to say and do more on ESG. As a result, sustainability and ESG reports highlighting corporate disclosures and commitments have grown considerably in length over the past few years. According to one study, these have grown from an average length of 102 pages in 2019 to 165 pages in 2022. Almost every large company produces one.

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Companies are also doing more on ESG issues. Commitments have proliferated on greenhouse gas emissions, diversity and inclusion, supply chain diligence, and many other issues. Investor and activist coalitions are now moving to the next stage of their engagement by seeking accountability and actions on those commitments.

It is difficult to conceive of some issue that could not be labeled an ESG risk. Is the board supposed to have expertise on *all* ESG issues?

□ ***The problems with ESG.*** Despite all of the attention on ESG, the concept itself remains surprisingly elusive. ESG raters do not agree on one set of "ESG" factors. Many large ESG-focused funds look eerily similar to their non-ESG counterparts. And just last year the SEC published rules that target potential investor confusion when companies use "ESG" in their fund names.

Even recent ESG-focused rulemaking by the Department of Labor actually refused to define the term. Likewise, a report by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) noted that there is no "universal or agreed-upon definition of ESG-related risks" but settled on defining it as "the issues that are prominent on investors' and other stakeholders' agendas."

A more recent COSO report defined ESG by reference to sustainability, but then defined sustainability as "meeting the needs of the present without compromising the ability of future generations to meet their own needs"—a vague definition at best.

This definitional uncertainty leads ESG to being wildly overinclusive. Today, it now includes almost every conceivable risk a business might encounter: governance, bribery and corruption, accounting, business ethics, community relations, data privacy and security, emissions, environmental and social impact of products and services, human rights, and human capital. There is also compliance with labor and employment laws, land use and biodiversity, supply chain, occupational health and safety, resilience, resource use, renewable energy, labor management, and product safety. One report even discussed how the sale of weapons to Ukraine could constitute an ESG issue.

Taken together, it is difficult to conceive of something that could not be labeled an ESG risk. Yet, the components of these lists are also almost completely unrelated to each other. For example, it is not clear what investment in biodiversity has to do with labor relations, or whether the company has a shared CEO and chairman. What has cybersecurity got to do with greenhouse gas emissions or tax transparency? Is a company a good ESG performer if it has active diversity program but a weak environmental record? What about a renewable energy company with a poor human rights record because of sourcing in its supply chain?

Even if you could find a tenuous connection between the issues, how is the board or anyone else supposed to weigh them? Is the board supposed to have expertise on all ESG issues? If so, how can it oversee all these different risks when it has such limited time and resources and also must oversee the actual business being conducted? Ultimately, speaking in overly broad terms about "ESG risks" is not very helpful.

□ ***ESG could distract from more fundamental business risks.*** A problem stemming from ESG's over-inclusivity is that it may distract the board from those risks that drive corporate value. Given the wide-ranging definitions, it cannot be that every ESG issue constitutes a material risk to every company. Boards must determine which ESG risks are material to their particular business.

Perhaps this makes ESG itself just another form of risk management. If that is true, however, then it is too narrow and limiting because it gives much more relative weight to environmental and social issues than to traditional risks faced by businesses. Even the governance issues are largely framed around how companies are managing environmental and social issues, while underemphasizing (or even ignoring) the more mundane risks of running a business. From a corporate value standpoint, it is far from clear what evidence exists for such an overemphasis on environmental and social issues.

The hot-button environmental and social issues may be important to some stakeholders, but for nearly all companies, risks like product quality, customer satisfaction, operational execution, supply chain management, regulatory compliance, and safety are always amongst the most important.

For instance, efficiently and safely producing a company's products is inherently tied to its success. The down-time, distractions, and legal liability associated with a company's work force being injured as a result of failure to oversee safety risks will clearly affect the company's bottom line.

Labeling these core or central corporate risks as ESG risks adds little to the company's efforts to manage them because companies were managing them long before we had ESG. The goal should be for ESG to add to the corporation's understanding of its key risks, because that is how it can contribute to corporate value.

There is a nearly limitless variation on the views and goals that "stakeholders" may have on almost any topic.

□ ***The "stakeholder" model is unhelpful.*** Much of the push for ESG comes from those who argue for a stakeholder model of corporate governance. Here, the board "is entitled to consider the interests of all corporate constituencies and make decisions that benefit constituencies other than shareholders even when doing so does not produce net benefits for shareholders in the long term." Some go further, arguing that corporate governance needs to be remade to give stakeholders legal status at least equal to shareholders. As with the over-inclusive definitions of ESG, the stakeholder concept is so broad that it raises more questions than it answers.

For instance, who are the stakeholders whose interests the board should consider? Stakeholders include shareholders, employees, customers, suppliers, regulators, and communities within which the company operates. It may also include single-interest advocates who are frustrated by the lack of regulatory consensus or governmental action on the environmental or social issues they care about—without regard to the impact these issues may have on the financial success of any particular corporation.

It is fair to say that none of these stakeholder groups share the same opinions, either across groups or even within groups. There is a nearly limitless variation on the views and goals that "stakeholders" may have on almost any topic.

Ultimately, stakeholder theory is not helpful to deciding which of these interests to prioritize or favor in any particular decision. This suggests that the board should instead focus on its traditional legal role of maximizing the value of the corporation for the benefit of its shareholders.

Trying to address challenging societal problems through corporate governance risks taking the board's eyes off creating long-term corporate value for shareholders.

□ ***ESG has become polarizing.*** Another problem with ESG is that the term itself has become polarizing. Perhaps it was inevitable because ESG finds its beginning in the United Nation's Global Impact initiative. This champions laudable but substantive political goals around human rights, the environment, labor, and anti-corruption. These goals are not necessarily tied to the success of a particular corporation.

Although ESG is ostensibly about doing well by doing good (tying corporate value to corporate action on environmental and social issues), those who care deeply about the social or environmental goals embodied in ESG may not be satisfied by companies focusing only on risks that impact corporate value. Many of the most-discussed ESG issues center not on corporation-specific risks, but instead on the externalities that corporations impose on society irrespective of the laws that apply to a corporation's business.

The threat to companies is that if they do not respond to these stakeholders' demands on things like climate change or social policy, they could lose their license to operate.

However, using corporate governance to effect political change is unlikely to lead to the desired social

and policy outcomes. It is not clear why corporate boards have any better sense of how to address complex social policy questions than the public at large. The issues are very complicated, and the solutions involve trade-offs that society has to make through political processes with input from all affected constituencies. Trying to address challenging societal problems through corporate governance risks taking the board's eyes off what it is legally charged with doing—creating long-term corporate value for shareholders.

What, then, are boards to do?

☐ ***Manage potential ESG risks through an ERM framework.*** Boards should approach ESG risks by treating them like other risks. Evaluate them through a dispassionate and holistic enterprise risk management (ERM) framework that connects directly to the corporation's mission and strategy. COSO has defined ERM as "[t]he culture, capabilities, and practices, integrated with strategy-setting and its performance, that organizations rely on to manage risk in creating, preserving, and realizing value."

Managing risks is just part of running a business, and includes both negative effects (downside risks) as well as positive effects (opportunities and upside). Although integrating ESG into an ERM framework is not a new idea, it is becoming more critical as ESG matures from simple disclosures, to aspirational commitments, to concrete actions that can have serious implications for corporate strategy and planning for years to come.

The current ESG paradigm simply does not provide an effective or objective way for boards to address the very real concerns that some ESG risks might present. ERM can fill that gap. It provides a rational process to identify risks and make good faith decisions about the level of oversight and monitoring to apply to all corporate risks.

With a comprehensive and prioritized view of the most significant risks, ERM can prevent boards, who are under serious pressure to say and do more on ESG, from making statements and taking actions that have not been tested or fail to fully consider the implications to long-term corporate value. ERM can provide process and structure to a risk management effort that, in the case of ESG, can often feel like a marketing exercise.

One practical challenge to creating unified risk management is that the ESG or sustainability groups often operate separately from the groups that oversee the ERM process, and report to different parts of the organization. Aside from possible misalignment or conflict, siloed ERM and ESG processes can create the risk of inconsistencies between the company's ERM framework, public ESG reporting, risk disclosures in SEC filings, and board agendas, materials, and deliberations. Grounding all corporate risks (including potential ESG risks) in a well-designed ERM process can help avoid siloed behavior and the potential for inconsistencies.

While not all ESG risks are mission critical, the board's process for determining which are critical should be the same for all corporate risks.

☐ ***Document the board's process and deliberation on key risks.*** A central theme discussed here is how the board can faithfully exercise its fiduciary duties. In the past several years, there has been a trend in Delaware courts of allowing so-called *Caremark* claims against directors to advance beyond the "motion to dismiss" stage.

These claims allege failures of the board to oversee a central compliance or "mission critical" risk to the corporation in the face of some corporate trauma. This violates the directors' duty of loyalty, and puts them at risk of personal liability. How does a board address ESG issues in light of its *Caremark* duties?

First, not all ESG risks are mission critical, but the process for determining which are should be the same for all corporate risks. Second, labeling core risks like safety, compliance, operational management, labor management, and supply chain resilience as "ESG risks" does nothing to better manage those risks. ESG may add value, but not by stretching its meaning to include every corporate risk. If everything is an ESG risk, then nothing is.

In thinking about risk management overall, the

board should ensure that its valuable but limited time is spent overseeing "mission critical" risks—those most important to corporate value (as determined by a rigorous ERM process). Less of its time should be spent on the latest politically charged issues that do not drive corporate value for its shareholders. Finally, the hard work it has done to oversee the corporation's risks must be well documented in the board agendas, materials, and minutes.

Process and deliberation, and the documentation of both, are crucial to showing that the board acted reasonably, especially in the event the corporation faces some unforeseen corporate trauma in the future.

☐ ***Engagement requires consideration of (but not always adherence to) stakeholders' views.*** Virtually all shareholders want to know that the board is overseeing the company's risks in a thoughtful way to maximize the value of their investment in the company. For some stakeholders however, especially single-issue advocates, what they really seek is corporate action on their issue, not necessarily tied to the financial success of the corporation.

There is no easy solution to engaging with these stakeholders. Engagement cannot solve the puzzle of how to please them all or resolve how boards should prioritize and oversee their conflicting demands while maximizing corporate value. However, focusing on corporate value drivers and rigorous risk management can free the board to exercise its judgment to pay less attention to certain hot-button ESG risks. While important to some vocal proponents, these are unrelated to driving value for the corporation's shareholders.

Managing public relations and engagement with those single-issue stakeholders requires special care, especially when they seek highly prescriptive change or reporting that is not tied to material risks or long-term value.

To that end, the Business Roundtable's 2019 statement on "the purpose of the corporation" may be a helpful guide. Although it has been described as a "seismic shift" to a stakeholder model, what it actually said may not be quite so radical. Well-run corporations have always sought to invest in employees to ensure a strong labor pool, deal fairly and ethically with suppliers, support the communities in which they operate, and deliver value to customers by exceeding their expectations. These are the things that allow the corporation to generate long-term value for shareholders. They existed long before we had ESG. Ultimately, the BRT statement signals to stakeholders, to whom boards do not owe fiduciary duties, that they nevertheless are important to the company's effort to create and maintain value for its shareholders.

The process and effort to ensure reasonable stakeholders that their interests have been considered, even if they are not followed, may be the best that boards can do in a highly politicized environment where stakeholders have conflicting and competing demands.

ESG issues are not going away. Neither are the problems caused by the increasing polarization around the concept. Still, companies and directors cannot be all things to all stakeholders. The best way for boards to address ESG issues that are important to the company is to ensure that all key risks are incorporated into a robust and well-functioning ERM process. Doing so will help boards satisfy their fiduciary duties by appropriately directing valuable board time and attention to risks that matter most for corporate value, while avoiding the potentially distracting and costly political debates. ■

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