ESG 101: Landscape & Considerations

March 2022

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Executive Summary

This white paper is a compilation of a four-part series published in August and September 2020 in the midst of the COVID-19 pandemic, updated to account for the shifts that have taken place since the initial publication. While no longer new, the dialogue of ESG (environmental, social and governance) as a financial value proposition and necessary component of a sustainable and resilient business was pushed to the forefront during the pandemic and the increased engagement on racial and social inequality in 2020.

This series provides the reader with the landscape of ESG and the following roadmap:

- In Part I, we provide a brief history of the evolution of ESG and its relation to other investor and business approaches, that emphasize purpose and impact of a business' activities while addressing some common misunderstandings.
- In Part II, we summarize the disclosure ecosystem that pushes and pulls business to share its strategy and progress on ESG issues, along with a framework to consider in shaping disclosures, as a reflection of strategy and progress.
- In Part III, with the potential for liability for potentially inconsistent, inaccurate, and misleading statements, we provide lessons for disclosure.
- In Part IV, we focus on the role of the Board, senior management, and executive compensation in shaping an ESG strategy.

We hope you enjoy this series.

ESG–The Building Blocks of a Sustainable and Resilient Business

By Ameena Y. Majid with Contributing Author, Catherine Musulin, Sr. Manager, Sustainable Development & B Corp, Danone North America

Before the global COVID-19 pandemic, the debate around ESG (environmental, social and governance) factors as drivers for long-term shareholder value was underway in earnest. Those discussions have continued with even more vigor since. The debate is anchored in demonstrating how seemingly non-financial drivers are financially material to a company. As businesses emerge from the pandemic with some long lasting changes, the debate continues, but with a greater focus on the “S” and refining the business case for how ESG factors are financially important to a company’s long-term sustainability.

Larry Fink’s 2019 Annual Letter to CEOs elevated purpose with profit – demanding businesses lead in a more holistic way. The Business Roundtable followed with its August 2019 modernized Statement on the Purpose of a Corporation, signaling a shift from a shareholder, profit-only purpose to a multi-stakeholder focus that considers a company’s impact on its entire value chain of customers, employees, supplier relationships, communities, and shareholders.

Shortly after 2020 began, the pandemic disrupted global supply chains, exacerbating risks of labor trafficking and modern slavery, and put human capital management front and center. Taken together, these events have reverberated globally and have uprooted long ignored systemic social issues. Social uprisings on racial and social inequality have also evoked an across-the-board corporate response at an unparalleled breadth and level with specific calls to action to dismantle systemic racism and rebuild systems that create actual diversity, equity, and inclusion.

Both the pandemic and the racial inequality crises reveal that one company’s resiliency depends upon another company’s resiliency. In this context, the ESG discussion is much more about long-term sustainability and action instead of solely ‘feel good’, performative corporate social responsibility.

While ESG has been primarily a profit and arguably purpose-aligned investment approach, it can also serve as a framework for businesses to build resiliency. However, the sustainability ecosystem is complex, confusing, and fragmented, with no common metric or disclosure system for comparison by disparate stakeholders. As such, company ESG disclosures are often met with skepticism as to the authenticity of the information (also known as greenwashing).

This four-part legal series:

- Unpacks some common misunderstandings about ESG and differentiates it from other investor and business approaches;
- Provides a roadmap to navigating the variety of ESG disclosure guidance and rating and ranking systems;

- Addresses the current landscape of legal risks; and
- Discusses governance structure and oversight, and how executive compensation is and can be used as a way to incentivize ESG strategies.

ESG Categories: In broad terms, ESG factors are premised on elements of good corporate citizenship and, for many factors, financial relevance. They generally cover the following:

Environmental	Social	Governance
• What are the natural resources a company uses in business operations (e.g., energy, water, land use, chemicals, and plastics) • How does a company's use of natural resources impact the environment or climate • How does climate impact the company's business strategy	• How are employees (aka human capital) treated, taking into account, among other things, well-being, fair and equitable pay, health and safety, talent management, inclusion, equity, and diversity • Supply chain management • Human rights and labor standards, including the prevention of forced labor, both within a business's own operations and those in the supply chain, and generally keyed to international standards or laws • Community impacts • Data Privacy & Cybersecurity	• Board structure and independence • Board diversity • Business ethics • Executive compensation • Anti-Corruption • Accounting practices

Companies currently address some of these factors through processes and policies, such as anti-discrimination/harassment policies, codes of conduct, and supplier codes of conduct, which emphasize a compliance perspective. However, responsibility for implementation and execution of the factors can be siloed and not well integrated across the organization and into the supply chain.

Integrating ESG factors is a call for companies to treat the factors as relational, keyed to international principles, and holistically embedded into the operations. The challenge, among many others, is that ESG is multi-disciplinary and must be driven by the Board and senior management given the disparate aspects of ESG and the need to assess the materiality of the various factors to the industry and business.

The "E" often dominates the conversation, particularly in the US. The global COVID-19 pandemic can somewhat be credited with increasing the focus on the "S" as well. Nevertheless, many other events and crises have fallen under the "S" umbrella, creating tremendous reputational risks for companies. These include the "Me Too" movement, the heightened focus on human rights at the international level, and modern slavery legislation. See link here.

Sustainable or Socially Responsible Investing Morphs into ESG

ESG is simple in concept, but complex and nuanced in implementation and execution. It's development has led to confusion about whether ESG, in its current state, is pecuniary or not. Shaped by the investor and international communities, investors use ESG factors to align investments and values and to evaluate a company's long-term sustainability. This is expected to return higher financial performance. Boards and senior management can use ESG factors as a roadmap to a more long-term sustainable and resilient business. The latter is the investor community's expectation.

The term ESG was coined in a 2005 report published by the United Nations (UN) Global Compact called "Who Cares Wins" following a 2004 study intended to provide recommendations on integrating ESG factors. A look at how ESG principles of today have evolved from social responsibility investing is helpful to dispel some myths around what is ESG.

ESG investing has its origins with religious groups, including Methodists, Quakers, and Muslims, that sought to make investments aligned with their religious beliefs. The groups typically used an exclusionary or negative screening approach to eliminate investments in certain products like alcohol, tobacco, and weapons. For Muslims, this approach allows for compliance with Sharia or Islamic law.

As time passed, ESG moved from religious or socially driven investments to a means toward good corporate citizenship and sustainability for the long-term.

1970s

- Social activism against the Vietnam War and use of chemical weapons led to an exclusionary investment approach to avoid investing in companies that contributed to the Vietnam War.
- Two United Methodist ministers launched the Pax World mutual fund, considered to be the first sustainable mutual fund and still traded today.

1980s

- Shareholder concern for businesses' environmental practices gave rise to the Coalition of Environmentally Responsible Economies (Ceres), made up of businesses, investors, and public-interest groups to develop sustainable business practices and move toward a low-carbon economy.

1990s

- Some 26 sustainable funds with approximately $1.9 billion of assets under management.

2000s

- In 2000, the Global Reporting Initiative (GRI) released its first framework for standards of sustainability reporting.

- The UN Global Compact was created as a global initiative to use business as a force for good, led by then UN Secretary General Kofi Annan.
- The UN Global Compact's 10 principles reflect a multi-stakeholder view of business, integrating international principles related to human rights, labor, the environment, and anti-corruption into business strategies. Currently, more than 10,000 companies have committed to adhere to these principles.

As the ecosystem for ESG disclosure, ratings, and rankings becomes more crowded and complex, there is a push toward a common and core set of metrics (discussed in the next Part). In this push, industry groups are returning to these international principles as the foundation for ESG considerations and implementation.

While the ESG ecosystem has evolved, other investor and business approaches have as well, causing some confusion around defining and understanding ESG. It is worth noting that terms like sustainability, ESG, impact, and purpose are not necessarily mutually exclusive in this space. Ultimately, each company needs to define impact and purpose for itself.

ESG vs. Impact Investing

Beginning in the 2000s, the notion of impact investing was also introduced and somewhat attributed to the launch of the Global Impact Investing Network (GIIN). There is no one definition of impact investing. However defined, impact investing focuses on using investments in mission-driven companies seeking to influence a positive outcome on society and/or to address and remediate a societal issue (e.g., business models that address elimination of poverty, recidivism reduction, and economic and women empowerment). In contrast, consideration and integration of ESG factors is viewed, primarily by the investor community, through a lens of both good corporate citizenship and contribution to long-term financial performance. Distinctions aside, the approaches can be combined to achieve sustainability and resiliency while also creating impact if a business wants to achieve both, as discussed in this insightful article co-authored by the CEO of Impact Engine, a leading investment venture fund.

ESG vs. Certified B Corporations

Currently, there are more than 4,370 certified B Corporations ("B Corps") that aim to balance purpose and profit. B Lab, a third-party entity, certifies companies as B Corps using an impact assessment that holistically considers five dimensions of the business: governance, employee workforce, customers, environment, and community.

At a macro level, B Corps and companies integrating ESG factors into their business strategy do intersect. Because of the mission-based ethos and nature of B Corps, B Corp certification is much more about identity and purpose. The dimensions evaluated by B Lab are very relational and are not profit or financial metric driven. Rather, being a certified B Corp is about a way of building trust across the value chain and doing well by doing good, which is reflected in the structure, standards, and policies of a certified B Corp. These companies are often characterized as purpose-driven companies.

B Corps have largely been the domain of private companies. As a condition to the certification, the company must reincorporate as a benefit corporation if the state law where the company is domiciled allows for this type of legal entity. While 37 states offer a benefit corporation as a legal entity, Delaware is the most notable as it allows for incorporation as a Public Benefit Corporation. Any company that incorporates as a benefit corporation under the relevant state law can identify purposes, such as environmental and social, other than maximizing shareholder profits. This allows some legal protection for boards of directors.

Because of the need for, and cost associated with, a shareholder vote to reincorporate an entity, among other reasons, this can be a practical barrier to B Corp certification for public companies. Notwithstanding, B Corps are slowly making their way into the public company space - with Danone North America leading as the world's largest B Corp. At this juncture, the few other public B Corps were certified before becoming public.

Incorporating ESG factors and being a B Corp are not exclusive. A company can do both. In this regard, the impact assessment tools and guidance available through B Lab are a useful resource for companies seeking to heed the Business Roundtable's 2019 call to action, to align progress of its business practices to the UN Sustainable Development Goals, and as a reference point for potential changes to environmental and social policies.

ESG vs. the US Department of Labor

As of Q3 2021, US retirement assets totaled $37.4 trillion. Fiduciaries appointed with investment oversight have a duty to manage the assets prudently and for the exclusive benefit of participants and beneficiaries using the fiduciary duty principles of the Employee Retirement Income Security Act of 1974 ("ERISA"). Over the years, the US Department of Labor (DOL) has expressed its views on the degrees to which fiduciaries, as investors, can consider ESG factors when making investment decisions. The DOL's views have shifted with different Presidential administrations, leaving many fiduciaries uncertain on how they can consider ESG factors and topics with respect to retirement investments without running afoul of ERISA's fiduciary duties.

Historically, the DOL has largely discouraged ESG-driven investments in retirement plans despite the investment and international communities moving toward them. While the DOL's latest guidance is significant in its own right and outside the scope of this series, it is worth noting that the DOL's current position and guidance is becoming aligned with the broader marketplace. Please see our alert discussing the latest guidance. The DOL's focus, however, is on retirement plan investors and not on a company's evaluation and incorporation of ESG from the perspective of creating long-term multi-stakeholder value and a resilient business.

Stakeholder Capitalism – Everyone Has a Say or View

The shift to stakeholder capitalism - a term now top of mind for business -- is premised on the theory that maximizing shareholder value as a company's sole focus has largely failed. It is encapsulated within The Davos Manifesto issued in 2020. While the stakeholder capitalism theory is appealing and gaining traction in the current climate, moving into practice is another challenge altogether. Development and implementation of ESG factors is the main path for traditional, for-profit companies (i.e., non-B Corp and non-impact focused companies) to shift toward stakeholder capitalism.

The ESG ecosystem continues to grow and mature. The tides are moving toward companies using a more holistic approach to assess and communicate their environmental and social risks and opportunities across the value chain. This trend is reflected in voluntary disclosure frameworks. As a result, it is especially important for senior management and boards of directors to identify gaps in awareness, implementation, and execution through effective governance structure and oversight.

Up Next

In Part II, “Getting into the ESG Disclosure, Rating and Ranking Game,” we provide a roadmap to making sense of the ESG ecosystem and the challenges.

Getting into the ESG Disclosure, Rating, and Ranking Game

By Ameena Y. Majid with Contributing Author, Catherine Musulin, Sr. Manager, Sustainable Development & B Corp, Danone North America

In Part I, we discussed the evolution of the ESG (environmental, social and governance) landscape and how it is imbedded in or distinguished from various investor and business approaches such as impact investing and B Corp Certification. At the beginning of 2020, investors directed $35.3 trillion in ESG investments in the US, Europe, Japan, Canada, Australia, and New Zealand, according to the Global Sustainable Investment Alliance. Representing a 15 percent increase over 2018, this reflects the continued growing importance of ESG considerations for investors. In parallel, the ecosystem for evaluating, rating, and ranking company ESG efforts has also expanded, illustrating a push for companies to become more transparent through public disclosure of ESG impact areas and reflecting the shift to stakeholder capitalism.

The public sector is also creating pressure as disclosure of various aspects of ESG are either mandated or encouraged in many jurisdictions. These include, for example, the UK with respect to mandatory gender pay gap reporting, France pursuant to Grenelle II, and modern slavery disclosures for certain companies under California, UK, and Australia laws (to name a few). However, there is currently no common government regulated standard for comprehensive disclosure or measurement that allows for comparable, useful, and verifiable information.

In the US, under the prior administration, the SEC was reluctant to shape the ESG disclosure conversation. Despite this, on May 14, 2020, the SEC's Investor Advisory Committee, heeding the investor calls toward more ESG disclosure, recommended the SEC take a leading role in establishing a framework for ESG disclosure to investors. And, following a July 2020 US Government Accounting Office report evaluating the ESG disclosure arena, Senator Mark Warner called on the SEC to create a task force to establish an ESG disclosure framework for reporting companies. The SEC's focus on ESG quickly changed under the current administration with the appointment of Gary Gensler at the helm of the SEC. Please see our alert discussing how the SEC has approached ESG from all sides.

Because disclosure still is largely voluntary in the US, the sustainability ecosystem is made up of (1) organizations that provide different sets of disclosure frameworks and standards for ESG self-reporting, and (2) organizations that rate and rank company ESG efforts by aggregating publicly available data, sometimes confirming findings with organizations and sometimes not.

Disclosure to Evaluate Risk

As discussed in our first Part in this series, the current business climate highlights that reputational and operational risks are on par and are interrelated to financial risk. In the Fourth Industrial Revolution, more than 80 percent of a company's value is made up of intangible assets, including intellectual property, market share, brand awareness, good will, and perceptions of a company's effect on society and the environment, according to Ocean Tomo. This is the reverse of almost 40 years ago when tangible assets comprised more than 80 percent of a company's value.

This fact bolsters investors' views that ESG considerations are necessary to evaluate all elements of risk in their investment decision. It also frames the basis for the increased pressure by customers and consumers to be transparent and accountable on ESG elements, like climate and labor rights. For consumer businesses, in particular, reputational risks are now strongly grounded in how a company manages its role as a corporate citizen.

Regardless of the particular stakeholder's perspective, ESG has become a matter of risk management, and disclosure is the means for stakeholders to evaluate all types of risk. Internal business conversations that weigh disclosure are not always straightforward as there is a tension between making the financial business case for disclosure and the calls for transparency, accountability, and shared value creation. This has also contributed to a fragmented ecosystem that caters to disclosure for different purposes and different audiences.

Disclosure Frameworks and Standards

According to the Governance & Accountability Institute, in 2020, 92 percent of the S&P 500 companies issued a sustainability report covering various environmental and social metrics. Companies take a variety of approaches for shaping their ESG disclosure from broad frameworks that drive global commonality in reporting to specialized disclosures that target specific stakeholders.

Broad Frameworks

The main players in the ESG disclosure realm have created frameworks that are accepted and endorsed by the major financial institutions, most notably BlackRock.

- GRI (Global Reporting Initiative) – Through many iterations of metric recommendations, GRI evolved from environmental reporting in 1997 into an independent standards board that sets global standards for sustainability reporting to the broadest group of stakeholders. Partnering with many other international organizations, such as the UN Global Compact, they provide a marketable way to facilitate disclosure of a company's economic, environmental, and social impacts and implementation toward sustainable development.

  Materiality is generally defined with reference to the significance of a company's impact on (and for) internal and external stakeholders. GRI defines impact as the effect an organization has on the economy, the environment, and/or society, which in turn can indicate its contribution (positive or negative) to sustainable development. In this regard, the UN Sustainable Development Goals serve as an important guide toward identifying a company's sustainable development.

- Sustainability Accounting Standards Board (SASB)* – Created in 2011 and modeled after the International and Financial Accounting Standards Boards, SASB is a non-profit, independent organization that sets standards for disclosure among the sustainability dimensions of the environment, social capital, human capital, business model, innovation, leadership, and governance. Because SASB caters to the investor audience, it establishes industry and sector standards for companies to identify the ESG issues that are reasonably likely to impact the financial performance.

- Integrated Reporting Framework (IRF)* – The International Integrated Reporting Council (IIRC) urges companies to issue reports that combine the traditional, annual financial information with ESG data. Similar to SASB, global investors, lenders, and insurers are the primary audience for these reports.

*In June 2021, SASB and IIRC announced their merger to form the Value Reporting Foundation (VRF).

In the spirit of advancing stakeholder capitalism and harmonizing the disclosure ecosystem, earlier this year, the World Economic Forum's International Business Council, a critical player in the global ESG discussion, proposed a common set of ESG metrics for disclosure in annual reporting.

Specialized Disclosure

- Task-Force on Climate-Related Disclosures (TCFD) – As its name suggests, the TCFD is focused on the environment. While TCFD is voluntary, the Principles for Responsible Investing, beginning in 2020, is requiring its signatories to report on the TCFDs.

- Human Rights – In 2011, the United Nations published its "Guiding Principles on Business and Human Rights," setting its expectation of both governments and businesses to protect and respect human rights. Following this, a number of jurisdictions have adopted laws requiring certain companies subject to the law to disclose, in general, where modern slavery is occurring in their operations and supply chains, and their efforts to remediate and prevent modern slavery. California, the UK, Australia, and New South Wales are among those mandating this disclosure. Many foreign and US multinationals are subject to these laws and are, or will be, publishing their Modern Slavery Statements, accordingly.

  Notably, human rights is not just forced labor. Human rights is a broad arena capturing diversity and inclusion, gender equality, land use, income inequality, and a host of other rights keyed to the International Bill of Rights. For more information on this topic, please see our blog series on the landscape for addressing modern slavery by business and framing a human rights due diligence strategy that allows for the policies and checks and balances needed for appropriate disclosure.

In April 2020, the EU announced an intent to legislate mandatory human rights due diligence, signaling a shift from voluntary disclosure to a "know and show" approach for human rights. A draft directive is anticipated sometime in 2022.

Disclosure Misconceptions

If a company undertakes ESG disclosure, it is also critical to understand the various misconceptions.

- *Misconception #1: Frameworks Are An Either/Or* – GRI and SASB are distinct, but complementary frameworks. Because SASB is focused on financial materiality and the investor audience while GRI is focused on broader risk management (financial, operational, and reputational) and all stakeholders, many companies that disclose using SASB cross-reference to the GRI standards. In fact, SASB and GRI have a work plan that allows disclosures to use both standards. Similarly, they can be used to shape a disclosure per the TCFD standards.

- *Misconception #2: Disclosures Are Only for Public Companies* – Given the support by the institutional investor community, like BlackRock, State Street, and others, it may appear that disclosure is just for public companies. However, given the movement toward stakeholder capitalism, the disclosure standards are intended for all companies. And, even if a company chooses not to disclose, the frameworks are useful tools to understanding and shaping the material sustainability priorities of a company.

- *Misconception #3: Disclosure is only for Certain Industries* – Environmental issues (green-house gas and carbon emissions, water use, land use) have often dominated the ESG conversation in the US, giving the perception that disclosure may only be for certain industries. Addressing ESG generally is industry-agnostic. But, the specific issues to address and disclose can be sector specific, which is something that SASB recognizes by developing industry and sector-specific standards.

- *Misconception #4: Disclosure in a Regulatory Filing* – Unless a jurisdiction mandates a disclosure in a regulatory filing, the disclosures do not need to be made in a regulatory filing for the investor audience. In fact, companies disclose in a variety of ways – through an annual sustainability report, integrated reports, and even through varying social media if the company chooses to create a level of transparency that is tangible to the end consumer.

Rankers and Raters

The sustainability ecosystem also includes a plethora of organizations that are ranking and rating companies on their ESG performance and risk. Sustainalytics, now wholly owned by Morningstar, and MSCI are the two main rating agencies. A host of others include, but are not limited to: Bloomberg, Dow Jones Sustainability Index, Institutional Shareholder Services (ISS), Thomson Reuters, and others. In general, these companies collect data on companies via questionnaires, surveys, and publicly available information to rank and rate companies.

In addition, organizations within the ecosystem partner with other organizations to benchmark companies on specific issues. For example, Know the Chain, a partnership between Sustainalytics, Humanity United, the Business & Human Rights Resource Centre, and Verité, benchmarks companies on their human rights efforts, primarily forced labor. It recently published its 2020/2021 rankings for the Information and Communications Technology (ICT) sector, Apparel and Footwear sector, and Food and Beverage sector, all of which are high-risk industries for various human rights violations. These reports serve as examples of how players in the space collaborate to aggregate data and use it to influence behavioral changes.

The raters and rankers can be criticized for moving ESG to a check-the-box endeavor and/or compliance type exercise instead of a mechanism to drive genuine engagement, education, and overall shared value through collaboration and continuous improvement. ESG disclosures are already met by some with a suspicion of greenwashing. And, if the ratings and rankings are dependent, in large part, on public disclosures, a loop of mistrust can be created.

Approaching Disclosure

The ESG reporting space is incredibly fast-moving as the definition becomes more inclusive, raising a challenge for companies to sift and organize the macro frameworks and adapt to the tension of varying disclosure guides that may not reflect what is material for the company or its sector. Companies also experience fatigue and a resource drain as they respond to questionnaires that may have the effect of companies focusing on non-material factors to their business.

If companies choose to disclose, disclosure should be approached carefully and cautiously. When deciding where and when to disclose, consider the following:

- *Why does a company want to disclose?* Stakeholders are increasingly becoming more sophisticated and vocal. As such, disclosure for disclosure sake or as a check-the-box exercise should not drive disclosure. Over the last decade, investors have become privy to organizations "paying to play" for a score and not authentically integrating the "E" and the "S" into their overarching "G." The why is needed to shape the narrative.

- *What does a company need to disclose and to whom?* Because the frameworks discussed above are (for now) only intended to be guides, a company first needs to assess what is material for their business and shape the narrative in a way that is most authentic, transparent, and tangible to its specific stakeholders.

- *What are you willing to disclose?* When sustainability reports are used solely for marketing purposes, there is a temptation to disclose only the strengths and conveniently or strategically leave out the opportunities for continuous improvement. As such, while there may be a hesitancy not to disclose less positive elements, it can minimize litigation risk and build trust with customers and consumers if a company also highlights the areas for improvement.

Up next

With all the eyes on ESG, particularly the social factors, disclosure is almost never without litigation risk. In Part III, we highlight the current theories being advanced in the space, lessons learned, and best practices for disclosures.

ESG Disclosures: Lessons Learned and Best Practices

By Ameena Y. Majid, Sarah Fedner, and William Prickett

In Part II, we described the sustainability reporting ecosystem, including the approaches to voluntary disclosure given the current lack of regulatory mandates on disclosure. As a result, companies are navigating their way toward a more transparent and accountable way to engage with their stakeholders using a variety of ESG (environmental, social and governance) disclosures. However, the uptick in disclosures has caused companies to face new theories of liability and litigation.

In this Part, we discuss the creative avenues in which stakeholders have pursued claims against entities related to their disclosures. The cases filed so far provide some insights and guideposts for companies to consider when preparing their disclosures and mitigating litigation risks. But, as the business case for financial impact of ESG considerations continues to be refined, stakeholders push for a “know and show” approach, and third-party verification becomes more sophisticated, it is likely the legal claims will only increase.

Theories of Liability

In the current climate of increased social accountability and reputational risk, companies are starting to face litigation resulting from ESG disclosures. These cases are being brought not only by shareholders, but also by non-government organizations (NGOs) and consumers. The cases cross multiple industries, including technology, consumer goods, mining, metals, and automotive. In addition, they have covered a range of ESG issues that include ethics, corruption, use of forced or child labor in supply chains, ethical sourcing, safety, the environment, and board diversity.

Thus far, litigation resulting from ESG disclosures generally arises in two contexts: (1) securities fraud claims under federal law, or (2) consumer protection or consumer fraud claims under federal or state laws.

In both contexts, plaintiffs usually allege that the company provided false or misleading information or omitted material information in their ESG statements (whether in formal government filings or less formal disclosure formats), including sustainability reports, corporate social responsibility reports, or codes of conduct. Plaintiffs allege that they relied on these statements in making investment or purchasing decisions. Stakeholders commonly bring these claims after serious accidents or disasters reveal purported misstatements or omissions in ESG disclosures. Cases that survive the motion to dismiss phase are generally settled, sometimes for very large amounts.

In the securities fraud context, claims are most commonly asserted under Section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”) and SEC Rule 10b-5, which require companies, directors, and officers to make accurate and not misleading statements to investors. Shareholders have also brought claims against corporations under Sections 11 and 12(a)(2) of the Securities Act of 1933 (the “Securities Act”), which provide strict liability for material misstatements and omissions made in connection with securities offerings. Directors and officers can also face “control person” liability under Section 20(a) of the Exchange Act for primary violations of federal securities law. In these lawsuits, courts generally have found aspirational language or forward looking statements regarding ESG non-actionable (particularly where adequate and specific cautionary language is included). In contrast, cases are more likely to be allowed to proceed where factual statements, the accuracy of which could be proven, are at issue.

Consumer fraud or protection claims are generally brought under state law including, for example, California's Consumers Legal Remedies Act, Unfair Competition Law, or False Advertising Law. Cases brought under consumer protection or fraud theories have been slightly less successful on motions to dismiss than securities fraud claims. In these cases, some courts have found that companies do not have a duty to disclose ESG information beyond known product safety and defect issues. Courts have also found that consumers do not have standing to bring such a cause of action where they did not rely upon any such ESG information in making their purchasing decision.

Lessons for ESG Disclosures

Drawing on the cases to date, the following can be helpful guides in preparing ESG disclosures.

- **Start with Purpose and Take Stock:** ESG disclosures are an output that reflect the strategy and progress relevant for the organization. It is important to first identify and organize current ESG practices and challenge them for consistency and reflection of the organization’s purpose. Fundamental questions to ask are: Why does the organization exist? Who does it serve and how? Is the strategy and implementation for any given ESG disclosure topic consistent with the organization’s purpose, values, and mission?

- **Consider Context and Timing:** ESG disclosures do not exist in a vacuum. The context and timing of a disclosure impacts how it may be interpreted by stakeholders and whether it is considered misleading. For example, statements issued in response to accidents or government investigations may be more likely to be considered “material.” In addition, when ESG disclosures are included in product packaging or government filings, plaintiffs may be able to prove reliance and materiality more easily.

- **Use Aspirational Language:** Word choice is critical in reducing litigation risks associated with ESG statements. As discussed above, courts have generally found an absence of liability where aspirational language or statements about future goals are used, including qualifying language such as “aim,” ”belief,” “expect,” “goal,” and “ask.” In contrast, courts are more likely to allow claims to proceed where the disclosures include concrete, statements of fact, which could be proven or disproven. Aspirational language aligns well with companies that look to the UN Sustainable Development Goals to shape their ESG strategy.

  Related to this, cautionary language can help demonstrate that they are aspirational in nature and, therefore, non-actionable. This is especially true when making statements related to the impact of climate change, given the unpredictability of future events. Disclosures should include disclaiming language indicating that they should not be mistaken for “guarantees,” “promises,” “predictions,” or “forecasts.” They should also indicate that they are based on various assumptions, which may not ultimately pan out as anticipated. Additionally, in situations where investors sign offering memoranda prior to making investments, the inclusion of language indicating that investors only relied upon information contained in the memoranda can minimize liability for any ESG statements made outside of such memoranda.

- **Review for Accuracy:** Claims are most likely to survive the motion to dismiss stage, where plaintiffs sufficiently allege that a factual statement in a disclosure is false or misleading. Inevitably, ESG disclosures will likely contain some statements of existing fact. This is especially true when it comes to industries that have a high risk of having human rights abuses that are monitored by third parties, like Human Rights Watch and others. These statements should be thoroughly reviewed and verified by internal parties with sufficient knowledge to confirm their accuracy.

- **Ensure Consistency:** Given the wide variety of disclosures and rankings systems, companies are more commonly engaging in different types of ESG disclosures, using different platforms, including social media. Inconsistent statements can be used as evidence to demonstrate that a disclosure is false or misleading. Thus, companies must ensure that their various disclosures are consistent with one another. For example, a company should confirm that ESG statements made on its website do not conflict with any ESG statements in more formal regulatory filings. Liability could also be reduced by including qualifying language in formal regulatory filings that any less formal electronic ESG disclosures are not deemed to be part of or incorporated into any governmental filing.

- **Disclose Areas for Improvement:** If ESG statements set forth areas of success, it is helpful to provide a complete picture and disclose areas of potential weakness. Whether or not a company is disclosure-oriented, this can be an unsettling approach and not desirable given a general preference to only show what ESG facets look good. Examples include areas of gender pay, diversity, and forced labor. However, stakeholders often meet statements that are too positive with skepticism. For example, one company recently faced securities litigation after making statements about its commitment to diversity. These statements were allegedly false or misleading, because they omitted information regarding recent investigations into diversity issues at the company. Additionally, third parties have knowledge of high risk areas for forced labor in the supply chains and are looking for companies to recognize the existence of it and play a role in addressing it in line with the expectations of the UN Guiding Principles on Business and Human Rights.

As a result, painting a picture that ESG practices are great or close to perfect could potentially expose entities to litigation. ESG disclosures noting areas of success have been found non-actionable where areas of improvement were also included.

Best Practices to Prepare ESG Disclosures

- **Create a Cross-Functional Team:** Many organizations are often siloed, which increases risks related to the accuracy and completeness of disclosures. Creating an ESG team of individuals across functional areas is essential to minimizing risk. This team should be delegated responsibilities related to drafting, reviewing, and aligning any ESG statements.

- **Deploy Trainings:** Any employees involved in the drafting or reviewing process should receive regular trainings on associated legal risks. New disclosure parameters and best practices will evolve quickly. Corporate counsel should ensure awareness of the developments and ensure that these trainings remain contemporary and relevant.

- **Create a Reasonable Board Oversight Process:** In order to minimize liability, a Board oversight and reporting process should be implemented and regularly reviewed for improvements. Board oversight is essential in preventing and responding to risks created by ESG statements, especially since the Board and senior management face potential liability.

- **Don't overlook D&O Insurance Coverage:** In a world with increased focus on corporate social accountability, as well as a general increase in securities lawsuits, companies and their directors and officers may face litigation despite taking all steps to minimize risk and ensure disclosure compliancy. As an additional layer of protection, D&O insurance policies should be reviewed carefully to ensure they cover ESG related claims.

Up Next

As we discussed, Board oversight and procedures are critical in minimizing risks related to ESG disclosures and needed for the "G" in ESG. In Part IV, we highlight best practices with respect to corporate governance and the role of executive compensation to incentivize ESG strategies.

Building an ESG Strategy: The Role of the Board and Executive Compensation

By Ameena Y. Majid, William Prickett, and Candace Quinn

As discussed in Part III of this series, legal risks will likely increase as ESG (environmental, social and governance) disclosures become more robust and stakeholders (and the plaintiffs' bar) continue to become more sophisticated in evaluating and challenging the disclosures. At present, understanding and integrating ESG (or more broadly, sustainability) into business is a means to manage and mitigate reputational and operational risks. However, when ESG is viewed only through a risk management and/or compliance prism, a company will likely fall short of being well-positioned to adequately and fully balance all stakeholder interests. This will also likely leave gaps in disclosures and increase a company's susceptibility to greenwashing and legal claims.

Boards and senior management can position the company to be proactive in shaping the ESG narrative versus reactive to the marketplace. More fulsome ESG disclosures may soon become mandatory. Before that time, boards of directors and senior management must evaluate (or re-evaluate), reimagine, and create the necessary internal processes, protocols, and structures for alignment of ESG with the business's purpose and values for long-term sustainability and resiliency. Governance is the link that guides and challenges a company's ESG focus, creates accountability, fosters transparency, eliminates the siloes, and creates incentives for achievement.

Many boards and senior management have had discussions about ESG in some form. Boards will need to be more involved in understanding and challenging the ESG strategy with senior management to provide effective oversight and manage risk.

In this final Part, we discuss ways the Board can cultivate a dynamic with senior management that provides oversight and shape to an ESG strategy and the role of executive compensation in incentivizing its achievement.

Building Blocks for an ESG Strategy

Approaching ESG in a coordinated and holistic way involves assessing and identifying the ESG factors that are aspirational, are financially and non-financially important to the business presently and in the future, and are realistically executable in a cohesive manner. At a macro level, the following resources serve as guides in this endeavor. As a reminder, these frameworks apply to any public and private company, regardless of size or industry.

- UN Sustainable Development Goals (SDGs): The UN SDG's 17 goals can provide a foundation to identify areas that a company can impact under the ESG umbrella and to assess, identify, and establish a company's aspirational and interim goals. The SDGs can be further organized into broad categories of climate, society, and economy as shown here. Relatedly, B Lab's SDG Action Manager is useful to set goals and track progress towards achievement.

- SASB's Materiality Map: As discussed in Part II, SASB's standards and materiality map, organized by industry and sector, can focus on the ESG issues most likely to impact the financial performance of a company. TCFD's disclosure standards can provide an additional resource on climate related issues.

- B Lab's Impact Assessment: Whether or not B Corp certification is relevant or appropriate for a company, B Lab's Impact Assessment is highly informative to assess and reshape the integration of non-ESG factors critical to a company's culture and values. The questions and elements related to workers, communities, and business partners provide a clear pathway to evolve multi-stakeholder focused practices.

- UN Guiding Principles on Business and Human Rights: The UNGPs provide a helpful and increasingly expected framework for the commitment to human rights, including a supply chain that identifies, remediates, and prevents forced labor and the associated due diligence framework.

Creating a cross-functional team of internal expertise, led by key members of senior management and counsel, is the most effective way to take stock of current practices, policies, and internal processes that likely already fit within ESG categories to identify a base line. Counsel, in-house and outside, can assist in guiding the process, and both identifying and bridging gaps in awareness, practice and policy. Next, the CEO and the appropriate internal team leaders can identify the strategy and ways to coordinate and implement the ESG factors relevant for the business. An effective ESG strategy requires both a top-down and bottom-up approach, with regular check-ins for alignment with purpose.

Board Engagement with Senior Management's ESG Strategy

Board oversight and engagement with senior management is fundamental to creating internal and external trust, and holistically managing an ever evolving new paradigm of business. Initially, as part of the Board's assessment, it should evaluate whether the members have the necessary experience and expertise to address ESG matters. Then, to effectively fulfill its oversight role of management's ESG strategy, the Board should imbed sustainable governing practices and protocols into the corporate structure or charter to position themselves to best understand, support, and challenge management's approach to ESG.

- **Board's Role and Responsibility:** Given the breadth of ESG issues, successful oversight and implementation generally requires the full Board's involvement. However, like the many facets of ESG, selected topics may be better suited for specific committees, including the human resources, audit, and compensation committees. To the extent separate issues are delegated among committees, there should be reporting into the full board for discussion and approval.

- **Understanding the ESG Strategy:** The ESG strategy should reflect management's understanding of the risks, opportunities, and impacts for the business and it's short- and long-term goals, both aspirational and tactical. The inventory referenced above should include such an assessment across the ESG topics and shared with the Board. The Board should challenge management on its processes for evaluating and developing the strategy (both short- and long-term), how it is integrating ESG into decision-making and operations, the weaknesses and areas for improvement, and whether the strategy and approach is consistent with the purpose and ethos of the enterprise. This assessment should also be consistent with existing company policies and/or identify the ways in which existing policies need to be refreshed and unified with the ESG strategy.

- **Multi-Stakeholder Concerns and Priorities:** The Board should develop a comfort level that senior management has a full and adequate understanding of its various stakeholders' concerns and priorities. For management, this means engaging with and reconciling the concerns and priorities of its employees, major investors, customers, consumers, business partners, and suppliers. Engagement can take many forms - surveys, conversations, and roundtables depending on the stakeholder. The priorities assessed, in part from these engagements, are most typically reflected in a materiality matrix set forth in an annual ESG or sustainability report. For the Board, it means understanding how management is engaging with these stakeholders and pertinent takeaways.

  In this regard, a cross-functional ESG team is imperative to coordinate and harmonize internal functions such as: investor relations, procurement and sourcing for supply chain issues (labor issues and diversity within both the raw materials and production supply chains), legal and compliance, marketing and corporate communications, and human resources, among others. Again, the organization's purpose and values should serve as the proverbial North Star.

- **Internal ESG Reporting:** With so much emphasis on external reporting and to which stakeholder audience, senior management, and the Board should have protocols in place for the CEO and senior management to also comprehensively report internally on execution and implementation. In this regard, leveraging and tailoring existing protocols is a useful starting point.

- **Infrastructure for External Reporting:** It should go without saying that as sustainability reporting becomes more robust and fulsome in the move to a "know and show" disclosure approach, senior management should have adequate internal processes in place to be able to substantiate the disclosures, regardless of the ESG factor being disclosed.

An ESG strategy and the integration of it, however, is a continuous process that is intended to evolve. And as ESG continues to evolve, executive compensation can play a critical role toward achieving the identified ESG goals.

The Role of Executive Compensation

The link between ESG and executive compensation is debated just as much as the link between ESG and long-term shareholder value. Executive compensation is complex in its own right. Currently, the ESG-executive compensation link is tenuous, which reflects the lack of clarity around ESG's role in a fragmented ecosystem.

According to PwC, 45 percent of FTSE 100 companies link executive pay to ESG criteria. Health and safety has been the dominant ESG metric with achievement assessed in annual incentive plans. Diversity and inclusion goals are increasingly becoming the new metric linked to ESG. These factors and other environmental or climate focused metrics (*e.g.,* reduction in green-house gas emissions) lend themselves to quantifiable measurement and are arguably verifiable. Incentivizing the other, less quantifiable factors have not gained as much traction.

At its simplest, compensation incentive structures – both annual, short-term, and long-term – are intended to motivate, retain, and incentivize employees to achieve the company's goals. Fundamentally, the performance metrics are reflective of the company's larger business goals and strategy. But they also shape a company's culture and focus, and are reflective of a company's purpose and values.

Executive compensation is very market and peer-group driven. Companies typically evaluate their self-selected peer groups to assess market practices, and the dominant short-term and long-term metrics within the group and application to their company. The heavy emphasis on peer group data can operate to hold companies back from linking less financially driven ESG factors to incentives unless the company is willing to stand out. In this regard, there are many challenges and benefits to linking ESG and executive compensation.

Challenges	Benefits
• Selecting ESG metrics that make sense to incentivize • Ascribing measurements to non-financially grounded metrics • Verifying achievement	• Increases accountability • Signals the company's values and purpose to the stakeholders, whether investors, employees, and communities • Reflects a move toward stakeholder capitalism • Creates a new dimension of transparency (particularly for public companies required to explain its compensation philosophies in the annual proxy) • Possible way to address the pay gap, diversity, environmental goals, and other ESG targets

Despite the challenges, according to the World Economic Forum, the idea of aligning ESG with executive compensation is gaining ground. A fundamental question is whether executing on an ESG factor is part of an executive's base roles and responsibilities. If not, is it something that warrants incentivizing? For example, cybersecurity is an area where a breach may happen rarely. When a breach occurs, it can create significant reputational damage. Should the lack of cybersecurity breaches be incentivized or is it just an expectation? If it should be incentivized, how does one ascribe a measurement and value to the lack of cybersecurity breaches? Alternatively, if it is not incentivized, should a breach trigger a clawback of pay?

In contrast, supply chain issues such as supplier diversity and labor rights have not traditionally been a base expectation. Yet, as modern slavery disclosures are becoming mandatory in several jurisdictions, the area has gained incredible attention over the past several years and is becoming top of mind, right behind pay equity and diversity and inclusion. Here, the question becomes whether the development, refinement, goals, and targets around a human rights policy and due diligence practice warrant incentivizing for some period of time until it is integrated and becomes a base expectation.

What is clear is that alignment of executive compensation with ESG integration should be critically evaluated as the financial relevance of ESG to a company's long-term value and will continue to evolve. Like the ESG movement itself, executive compensation as a tool to incentivize ESG integration is likely to become the expectation and a way to align profit and purpose.

Looking Ahead

ESG issues rapidly continue to be recognized as table stakes. As investors continue to have leverage and impact on these issues, voluntary reporting is expected to increase, become more sophisticated and robust, with reporting in line with SASB, TCFD, and GRI standards. Legal risk will likely increase for companies whose actions are not aligned with disclosure. At this time, the SEC is getting ready to release proposed guidance on climate disclosures, updated to address the investor focus on organization's impact on climate and climate's impact on an organization's resiliency. In addition, we are awaiting more prescriptive SEC guidance on human capital disclosures. Finally, we continue to watch the efforts to harmonize and develop a global standard on ESG issues, both as it relates to measurement and guidelines for disclosure.

While climate and human capital issues have been front and center and will continue for some time, operational and supply chain issues related to forced labor will come into greater focus, including mandatory due diligence requirements with the EU taking the lead.

COV1D-19, combined with social and racial awakenings, continue to push companies to a tipping point where they must address these issues in some way. As a result, it behooves companies to develop the necessary structures and assessments to effectively and efficiently be proactive in addressing ESG now. We hope you enjoyed this series.

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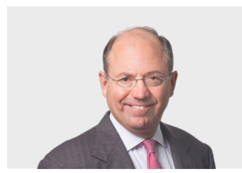

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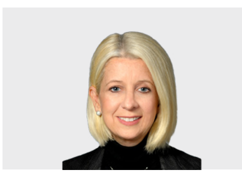
Human Capital Management



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