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Q&A: Akin Gump's Kerry Berchem and Charles Smith on the intersection of corporate governance and ESG

By Kerry Berchem, Esq., Akin Gump Strauss Hauer & Feld LLP, Charles Edward Smith, Esq.

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Publicly traded companies and their boards of directors face continuous and building pressures to adopt and implement corporate governance structures that are designed to deliver long-term value to shareholders, while simultaneously being mindful of ever-evolving, voluntary undertakings to a more broadly defined set of corporate "stakeholders."

This is particularly true as these stakeholders — shareholders, directors and officers, regulators, employees, suppliers and the broader communities in which companies operate — are widely embracing environmental, social and governance principles across all aspects of their operations, the broader economy and financial markets.

Generally speaking, companies with weak governance structures tend to underperform financially and face significant costs relative to regulatory scrutiny and litigation.

Thomson Reuters asked Akin Gump's Kerry Berchem and consultant Chad Smith to share their view of the "state of play" at the intersection of corporate governance and ESG.

Thompson Reuters: Who is driving the increased focus on ESG? Shareholders, regulators, management?

Kerry Berchem and Chad Smith: Everyone.

Shareholders, regulators, employees, customers, communities, and the media are primary drivers. Management, in some cases, can often feel like a passenger on the journey — particularly given the absence of a defined roadmap with clear regulations and disclosure requirements — but they, too, have become drivers as a result of the increased and increasing focus on ESG, particularly by investors.

According to Morningstar, by the end of September 2021, "global sustainable fund assets doubled in the past six months to reach $3.9 trillion" and investments in "ESG assets" are on a "pathway to exceed $53 trillion globally by 2025."

Investors and other stakeholders are articulating the import of ESG factors when making financial and investment decisions as they focus on creating sustainable, inclusive and ethically responsible businesses as a basis for, and component of, long-term value creation. Relatedly, financial and other investment products and transactions increasingly are tied to ESG metrics and returns are being measured against ESG. As a result, investors are increasingly demanding access to ESG-related data that is reliable and consistent.

Likewise, regulators are focused on ensuring that products and services — financial or otherwise — claiming to be sustainable or consistent with ESG principles are, in fact, produced and sold in ways that correspond to such principles.

As a result, corporate boards of directors and management are focusing on creating and implementing business strategies and governance structures that include ESG principles designed to support and enhance long-term value creation.

TR: Historically environmental concerns seemed to drive ESG. Are the other factors (S and G) gaining in importance? If so, what are the impetus for those changes?

KB and CS: Environmental concerns have been a clear driver of ESG. In particular, we have seen focused efforts intended to mitigate the potentially existential risks represented by climate change. This focused prioritization has translated into regulatory and corporate efforts intended to consider and weigh environmental related risks and impacts more closely, which can not only challenge the near-term bottom line, but also pose risks to the longer-term viability of companies and the communities in which they serve. Further, the attention to environmental related issues has prompted regulators and politicians to focus on rulemaking initiatives (e.g., updating and/or adopting climate-related disclosure obligations for public companies) that are intended to foster greater transparency into how corporations (including supply chain vendors) address climate and other ESG-related risks in the corporate oversight and risk assessment programs. These efforts are also proceeding on a parallel path with the ongoing development of financial products and funds that are characterized as "green" or "sustainable."

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Of course, good corporate governance has long been an important factor for boards in the pursuit of long-term value creation. Generally speaking, companies with weak governance structures tend to underperform financially and face significant costs relative to regulatory scrutiny and litigation. Relatedly, directors of public companies with poor governance structures are more likely to find themselves the target of activist shareholders. Indeed, activist shareholders have been joined in these battles by large asset managers who are demanding that boards of directors take governance and other ESG principles seriously or face "no" or "withhold" votes during proxy season. Proxy advisors are paying closer attention to these issues, too. For instance, in February 2021, ISS launched its Environmental & Social QualityScore, which grades the quality of corporate disclosures on these issues. The evolving role of proxy advisors in terms of monitoring how boards of directors respond to these considerations makes fulsome disclosures on these matters even more important, particularly in light of the fact that ISS often controls more than 20% of shareholder voting results.

Boards should ensure that compliance and reporting processes and procedures exist (or are developed) in order to monitor implementation of the company's ESG strategy.

As for the "S" in ESG, board diversity has been a prominent issue for investors (including activist investors) for the past decade or so. Over the past decade we have seen some pretty profound steps among many companies to diversify their boards. Notably, the importance of board diversification has been underscored by initiatives such as the recent SEC-approved Nasdaq Diversity Rule and the adoption by a handful of states and foreign jurisdictions of diversity requirements for boards of directors. Likewise, substantially all of the index funds have expressed the expectation to see more women elected to boards of directors and some have stated that they will vote against nominee directors if a board is not committed to diversity. A key point our clients make is that when they talk about diversity, they do not embrace simplistic or symbolic gestures, but are really looking for diversity of experience — people who have different backgrounds and perspectives, in addition to demographic diversity.

TR: What business risks do companies face in taking a stance and/or not taking a stance on ESG issues?

KB and CS: Obviously, not all companies are created equally, nor are their priorities the same. Facts and circumstances relative to corporate entities vary depending on size, whether a company is public or private, industry sector and any number of other factors. Some companies operating in a manner consistent with ESG principles can trace their commitment to these principles back to the days of "corporate social responsibility" and beyond. Other companies find themselves playing catch-up on these principles due to many factors. This is particularly true for companies that have operated in the energy industry, for instance, where legacy operations are believed to have contributed to the very issues proponents of ESG are seeking to address (e.g., climate change).

We come at the question of taking a stance or not taking a stance as being somewhat beside the point: Most, if not all, companies are likely to confront ESG considerations irrespective of whether or not they intend to do so. For some companies, failing to take a stance on ESG could lead to significant business losses, reputational deterioration and reduced access to liquidity and the capital markets.

Further, we are aware of any number of companies that are requiring companies within their supply chains to adhere to ESG principles and to provide ESG-related data with respect to their practices. Other companies may find themselves unable to satisfy evolving disclosure requirements and contractual provisions driven by ESG principles.

The other side of this coin, of course, is that some customers and suppliers may have tangible reasons that they cannot or may not be able to take a stance on ESG or operate in a manner consistent with ESG. For instance, a company could operate in a geographic area that does not have access to demographically diverse human capital or it has limited resources to undertake a costly ESG compliance program. That said, if these companies are following "best practices" from a corporate governance perspective, we believe these obstacles can be ameliorated by these boards of directors developing records with respect to their efforts and being able to demonstrate that they nevertheless take these issues seriously, despite applicable limitations.

TR: What is the board of directors' role in a company's ESG strategy?

As your readers know, boards of directors bear ultimate responsibility for overseeing a company's business and affairs and making fundamental decisions about a company's strategic direction. Directors are charged with overseeing a company's risk management practices (including internal controls and compliance with laws), monitoring financial reporting and public disclosures, and, to the extent applicable, engaging e with shareholders.

As a company develops and implements an overall ESG strategy, directors must necessarily adjust a company's historical, narrowly drawn focus on its own shareholders and expand its perspective to take into consideration the interests of a more broadly defined set of stakeholders who have financial and other forms of investment in the company. These stakeholders include shareholders, a company's human capital, suppliers, customers, regulators and the broader communities in which these companies operate.

TR: How should a board engage on ESG issues?

KB and CS: Practically speaking, as a board develops an ESG strategy, it should undertake the following:

- Work closely with management to evaluate ESG priorities and how such priorities fit within the company's overall business operations and strategic direction;

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- Evaluate how ESG considerations potentially impact the company's overall risk profile and develop policies and procedures to address how ESG is to be taken into account as the company executes on its business strategies;
- Develop oversight and compliance frameworks relative to the ESG strategy and undertake regular implementation and gap analyses of the company's ESG efforts;
- As part of the board's oversight function, ensure that the company either has a committee dedicated to ESG matters or that one or more committees are charged with regularly assessing the company's ESG efforts and reporting such assessments to the full board of directors;
- Develop policies, processes and procedures to capture ESG-related metrics for financial reporting and shareholder relations;
- Periodically review relevant corporate governance policies, procedures and processes to ensure alignment with any ESG principles adopted by the company (e.g., boardroom and human capital diversity, etc.); and
- Memorialize the foregoing in the form of written corporate minutes, policies and procedures.

TR: How can companies/boards best balance ESG efforts with their business strategy and fiduciary duties to shareholders?

Answer: Directors have an obligation to carry out their work by exercising the fiduciary duties of care and loyalty. At a high level, these duties require directors to act in good faith, on an informed basis and in the best interests of the corporation and its shareholders.

In the context of the evolving impact ESG is having on boardrooms, the legal constructs and director duties have not changed. But the fulfillment of the duty of care included what an "ordinarily prudent person would do" and, in light of the current governance environment, stakeholders are requiring attention to an integration of ESG principles into a company's broader strategic and operational affairs. Accordingly, we believe directors will benefit from focusing on how to engage with stakeholders (other than shareholders) and not whether to engage with such stakeholders.

TR: How should a board integrate ESG principles?

KB and CS: Boards should evaluate the company's proposed strategy and assess how it fits into the company's broader strategic vision. Boards should ensure that compliance and reporting processes and procedures exist (or are developed) in order to monitor implementation of the company's ESG strategy.

Further, boards, or a designated committee of the board, should receive regular reports with respect to the strategy and whether the company is satisfying its ESG undertakings or obligations. These reports should include, among other things, ESG data and metrics to enable the board to evaluate the efficacy of the strategy and to ensure that the company can timely satisfy its financial reporting and disclosure obligations.

Relatedly, directors should periodically determine whether any conflicts-of-interest may arise in the context of managing ESG efforts (e.g., in the context of awarding contracts to vendors in the supply chain or financing arrangements).

Obviously, the foregoing is not an exhaustive list of examples of the steps directors should take in connection with integrating ESG into the boardroom and evaluating ESG efforts once it has done so; rather, we are attempting to show that, as is the case when making other significant decisions, the fiduciary duties of care and loyalty necessitate how ESG considerations must still be evaluated on an informed, considered basis.

TR: What are the best measures of success on ESG initiatives?

KB and CS: At a high-level, a company that has developed ESG initiatives should be able to point to several objective and supportable metrics that demonstrate the success of such initiatives: reduced carbon emissions; more diverse boardrooms and human capital; improved long-terms returns on ESG-tied investments; improved sales figures relative to "green" or sustainable product offerings; reductions in supply chain risks; and increasing positive shareholder votes. More subjectively, ESG success should result in reputational enhancement and a company being known for establishing and having a positive cultural dynamic.

Increasingly, success also will be able to be measured as market actors begin integrating ESG factors into corporate finance and M&A transactions. For instance, demand for "green" bonds and other financial instruments is growing tremendously and in the private financing space, instruments are tying the cost of borrowing to certain ESG-related criteria (e.g., satisfying — or not — carbon reduction targets). ISDA recently published a white paper covering the expanded use of "key performance indicators" (or KPIs) in swaps and other derivatives trading activities. As the financial markets turn to these types of criteria to price or otherwise play a role in transactions, we expect that companies will be able to demonstrate how successfully they have deployed their ESG strategies.

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About the authors

Kerry Berchem (L) is the co-leader of **Akin Gump Strauss Hauer & Feld LLP**'s environmental, social and governance group and its corporate governance and shareholder activism group, and a member of the firm's management committee. Based in the firm's New York office, Berchem is a recognized corporate transactional partner with more than three decades of experience in public and private mergers and acquisitions and capital markets transactions. She can be reached at kberchem@akingump.com. **Charles Edward Smith** (R) is a Seattle-based consultant with Akin Gump's corporate group and assists the firm and its clients with advice and content regarding ESG matters. Smith has more than 25 years of legal and business experience advising and working with public and private companies, particularly in corporate governance, M&A, corporate finance and securities law matters. Most recently, he played a leading role in connection with the Washington Mutual Chapter 11 proceedings. He can be reached at cesmith@akingump.com.

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