THE CONFERENCE BOARD

The Roles of the Board in the Era of ESG and Stakeholder Capitalism: Supplement 1

Incorporating ESG and Stakeholder Interests into Board Business Decisions

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Today's corporate boards are charting unprecedented waters. A recent survey by The Conference Board found that 68 percent of companies believe ESG issues and 53 percent believe stakeholder capitalism will have a *significant* and *durable* impact on boards over the next five years.[1] Likewise, 90 percent of C-suite executives believe that a shift to stakeholder capitalism is underway, with 80 percent saying it is happening at their company.[2] At the same time, however, companies are facing growing anti-ESG sentiment from the investment community, leaders at the state level, and others who are either skeptical about whether ESG can actually drive companies' financial performance or who are fiercely against companies' playing a more prominent role in addressing environmental and social issues.[3]

Drivers of the Shifts Toward ESG and Stakeholder Capitalism

While companies have focused on ESG issues and their stakeholders to some extent for many years, a confluence of factors has deepened their focus recently.

- **Pressure from capital markets.** There is a significant rise of ESG investing in *equity markets*. Indeed, ESG funds are expected to soar from $8 trillion in 2021 to $30 trillion by 2030.[4] Mainstream institutional investors, who increasingly think *like* and *about* stakeholders, believe that environmental and social factors can have a material impact on companies' long-term financial performance and expect their portfolio companies to address these issues.[5] Additionally, in *debt markets,* the focus on ESG is affecting the terms on which companies' access capital—not least because credit rating agencies are stepping up their efforts to assess material ESG considerations.[6] And sustainability-linked bonds grew from $30 million dollars in issuances in 2013 to $1.6 trillion dollars in 2021.[7]
- **Pressure from labor markets.** Younger generations, especially millennials and Gen Z, generally care more about environmental and social issues than do their older counterparts. And they look to their companies' leaders to take stands on an array of issues.[8]
- **Pressure from markets for goods and services**. After price and other core brand features, fair labor practices and support for human rights are the leading drivers of consumer purchases (among sustainability characteristics),[9] and 81 percent of consumers across the world believe it's very or extremely important for companies to improve the environment.[10] Furthermore, business partners are increasingly considering sustainability when selecting new suppliers and renewing contracts.[11] They are asking others to be part of their ESG journey and expect companies to address issues such as human rights and climate change, which is leading to a cascading effect of ESG through the value chain.[12]

- **Increasing regulation**. The current US administration has accelerated the focus on environmental and social issues, including through SEC proposed disclosure rules on cybersecurity[13] and climate change,[14] with proposed rules on human capital management still expected. EU regulations, which are even more comprehensive, will also have implications for US-based companies.[15] In addition, US and international stock exchanges are addressing certain ESG issues (e.g., Nasdaq's Board Diversity Rule).
- **Other factors**, including:
    - **COVID-19 pandemic**, as a result of which employee health & safety and talent management have each become a focus of attention;
    - **War in Ukraine**, leading to supply chain disruptions and putting a spotlight on human rights violations;
    - **Delaware Chancery Court's decisions**, for example in the *Marchand* and *Boeing* cases, which focused on the board's *Caremark* duty to ensure the firm has a system of controls in place to manage mission-critical risks relating to major social harms (such as unsafe food and airplanes); and
    - **Wildfires, tornadoes, and other extreme weather events** that have put climate change risk front and center on companies' agendas.

Especially given the broad market forces at play, both public and private companies are focused on integrating ESG and the welfare of multiple stakeholders into their business strategies more deeply than before.[16] This, in turn, has important implications for boards.

Impact of the Shifts Toward ESG and Stakeholder Capitalism on Boards

According to the working group participants,[17] the focus on ESG and concern about the long-term welfare of stakeholders have affected boards in various degrees.

- For virtually all boards (95 percent), it has affected *topics* discussed.
- For a majority of boards (52 percent), it has affected *factors* the board considers in decision-making.
- For a minority of boards (24 percent), it has affected the *actual decisions* they make—changing both the outcome and timing of the decisions, and sometimes accelerating the board's action on environmental, economic, and social topics.

Generally, the increased focus on ESG issues seems to have a stronger impact on boards than the increased consideration of multiple stakeholders. This could be due to a number of factors, including 1) boards might have already been considering multiple stakeholders as part of their ordinary business, so there may not be as much of a noticeable change; 2) there's stronger pressure on companies (e.g., by investors) to address ESG issues than to serve multiple stakeholders; and 3) the focus on stockholder welfare is so engrained as a company's North Star, and reinforced by powerful incentives (stock price, shareholder voting, and the threat of stockholder activism or shareholder derivative litigation) that companies are hesitant to explicitly or consciously shift their focus to the welfare of other stakeholders.

How management can help boards build ESG and stakeholder perspectives into their processes

The shifts toward ESG and stakeholder capitalism don't mean the board needs to reinvent the wheel: the board still has multiple decision-making, oversight, advisory, and engagement roles. But these changes do require boards to take a fresh look at their roles and responsibilities and to address more topics than before, which is why boards should consider how they can build ESG and stakeholder perspectives into existing processes.

Management can facilitate this by taking the following actions:

- **Map current board roles and responsibilities**. First, management should map the board's and board committees' existing responsibilities with respect to core business matters (strategic planning, business plan, operating budgets, capital budgets, M&A), and other areas such as compliance, disclosure, compensation, and disclosure.
- **Inventory the board's current approach to ESG issues and stakeholder views**. Next, management should identify how the board and committees are already addressing ESG issues and stakeholder views in these areas. Companies may be pleasantly surprised by how much they are already doing.
- **Consider how to further integrate ESG and stakeholder views into existing areas of responsibility and processes**. Having determined the ESG issues that are relevant to the company's business (see *The Role of the CEO in Driving ESG*), management should propose how to further integrate relevant ESG issues and the welfare of stakeholders into the board's responsibilities and processes. This goes beyond revising the board's corporate governance policy and committee charters and involves considering key processes (budgeting, etc.) as well. It is then up to the board, generally upon the recommendation of the nominating/governance committee, or perhaps a task force of directors representing each of the major committees, to approve this approach. As part of this endeavor, management and boards should consider what type of role the board should play in each area. For many new issues, it may be inclined to take an oversight role, but there might be areas where it will need to make decisions, advise management, or engage with stakeholders.

Management and boards should approach this project with flexibility in mind. The board's responsibilities and processes may evolve as the company moves along its "ESG journey" and faces increased regulatory and market pressures. Thus, unlike the past when committee charters tended to be relatively "fixed," both board governance documents and processes may evolve.[18]

Legal Grounds for the Board to Focus on ESG and the Long-Term Welfare of Stakeholders

Apart from "special cases" such as selling a company or dealing with insolvency, boards have significant latitude for considering a broader array of ESG issues as well as the welfare of stakeholders—as long as there are legitimate corporate interests at play (meaning that

any actions have to be aligned with long-term corporate interests, rather than, for example, "saving the environment just to save the environment"). Courts will defer to a board exercising its business judgment about what lies within the range of legitimate corporate interests and how to create long-term value for the corporation.

In fact, a far greater risk for boards is to treat short-term value as their only goal and fail to consider ESG issues—especially when those are "mission critical." Under the *Caremark* line of cases, directors may face exposure if the board "utterly failed" to implement a system for risk identification or if it intentionally "ignored" a red flag. Delaware law gives boards great discretion to design an information and monitoring system that is appropriate to the company's business, operations, and risks. But some of a firm's mission-critical risks may also be ESG risks. This is especially true for broader social issues (for example, in the case of *Marchand v. Barnhill*, it was food safety; in the case of *Boeing,* it was airplane safety). In fulfilling its *Caremark* duties, therefore, the board has to be mindful of ESG risks. The Delaware Chancery Court's decision to deny a motion to dismiss in the *Boeing* case demonstrates that boards can't wholly rely on *management* but need to ensure that the board itself has mechanisms and written records of oversight regarding mission-critical risks.

Dealing with Skeptics on the Board

While many companies seem to have accepted and embraced (at least to some extent) the shifts toward ESG issues and stakeholder capitalism, individual directors may view the importance of ESG and stakeholder views very differently. It's pivotal for management to fully engage—rather than ignore—skeptics on the board for several reasons:

- **Driving ahead on ESG and stakeholder capitalism without a solid consensus can lead to dysfunction on the board.** Companies have flexibility to decide where they want to position themselves on ESG issues (e.g., complying with the law, reducing costs, managing reputation, or becoming an industry leader) and on the stockholder capitalism–to–stakeholder capitalism spectrum. The board itself is responsible for deciding its roles in these areas. Ignoring divergent opinions on how far the company and board want to go in each area can lead to simmering tensions, which in turn hinder board effectiveness.
- **Individual board members may have valid reasons for being skeptical.** Directors may bring specific experiences that have soured them on ESG or a stakeholder focus: it could be an interaction with an institutional investor, a failed approach at another company, or a bad experience with a social or political issue dividing a board. It's vital to listen and understand those experiences—and to properly address them. One way to align director perspectives is by ensuring that ESG is integrated into the company's business strategy and engaging (and educating) the board on the company's most important ESG risks and opportunities. Different views can also be addressed and resolved through reaching consensus on a company purpose statement. If the board finds common ground on the company's purpose, it can have a cascading effect in maintaining a touchstone of consensus for future discussions.

- **By offering a strong financial—rather than moral or political—business case, companies can demonstrate that the focus on ESG and multiple stakeholders isn't driven by altruism or ideology, but by the bottom line.** Some directors may think that ESG and stakeholder capitalism are just another passing fad, or something that will be put on the back burner when an activist focused on purely economic return shows up. However, sustainability drives both talent acquisition and retention as well as consumer purchases. And procurement executives increasingly consider sustainability performance when selecting new suppliers and renewing contracts.[19] Moreover, climate-related disasters adversely affect companies' operations, products, and services.
- **Decisions can be improved significantly by incorporating relevant environmental and social issues into board discussions and the decision-making process.** ESG data provide a lot of relevant information that can help boards and management make better decisions. For example, when thinking about supply chain resilience, health and safety risk within the supply chain can have direct financial implications.

How the Increased Focus on ESG and Stakeholders Affects the Line Between the Board and Management

Companies' increased focus on ESG factors and stakeholder perspectives/impact does not fundamentally change the line between the board and management. Indeed, the board's role is to make sure management has the right policies, processes, and criteria in place to deal with these issues, rather than debating whether, when, and how to respond to these issues or engaging on isolated topics. However, boards will look to management for more information in these new areas, including reports that track progress on issues. And boards, especially at larger companies, are increasingly adding ESG performance goals to executive compensation.[20]

Nonetheless, there are some risks related to the board broadening its aperture to focus on a wider array of ESG issues and multiple stakeholders. Boards can sidestep these risks by:

- **Collaborating with management.** The board working on these issues independently of or separately from management may create a rift.
- **Proceeding in a structured fashion.** The board focusing on these issues in a haphazard, unstructured manner will impede the ability to provide thoughtful oversight.
- **Focusing attention on management-level governance around these issues**. For example, if the board focuses on diversity at the board level but not at the management level, its efforts may be viewed as inauthentic.
- **Making ESG fluency a priority for the entire board.** ESG issues should not be isolated to an individual board member or individual committee; instead, the board as a whole should have a broad understanding of the relevance of ESG issues for the company.

Incorporating ESG and Stakeholder Interests in Key Board Decisions

Companies generally believe their boards have incorporated ESG issues better into their decisions than they have the interests of multiple stakeholders. There are, however, a couple of places where boards are factoring ESG issues *and* multiple stakeholders into their key decisions very well: strategic planning, product and service offerings, corporate culture, internal controls, and regulatory disclosure.

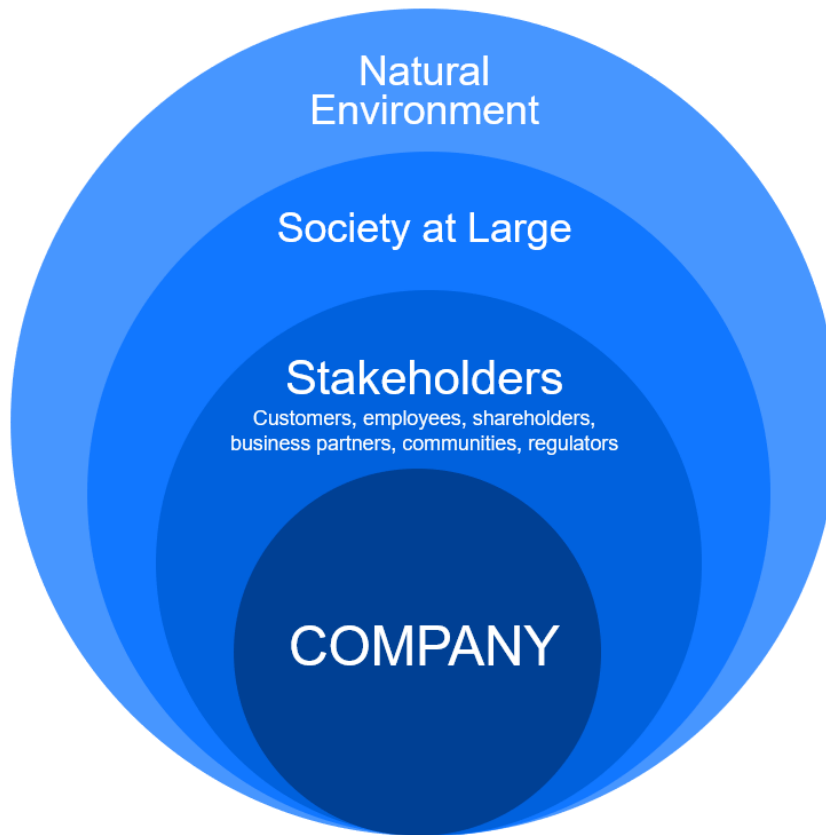
Source: *The Roles of the Board in the Era of ESG and Stakeholder Capitalism*, The Conference Board, February 2023

The board has a powerful lever to integrate ESG and stakeholder views into the company's business: *time allocation*. Whatever is on the board agenda will be on the company's agenda, because how—and on which issues—the board spends its time automatically trickles down to how the CEO, management, and employees spend their time. Because of time constraints, boards will want to consider how ESG issues and stakeholder perspectives are built into their agenda and executive compensation.

It can be helpful to develop a framework that incorporates a multistakeholder focus and a consideration of the firm's key ESG issues for making key business decisions. Such a framework can provide guidance for both the board and management on whether and how to act in a consistent and comprehensive manner.

There's no single correct model, but some ways of thinking about this include:

- **Using a "repeatable assessment" framework for each significant board decision that focuses on the:** 1) potential financial return of the activity; 2) opportunity for sustainable/quality growth; 3) potential to have a positive impact on the environment and society; and 4) ability to uphold the firm's reputation as a trusted partner.
- **Focusing on the company's purpose and looking at all key decisions (including those regarding business strategy, budgeting, etc.) through the following lenses**: Is the decision good for the company? Is it good for the company's stakeholders? Is it good for the communities in which the company operates and society at large? And finally, is it good for the natural environment?



Source: *The Roles of the Board in the Era of ESG and Stakeholder Capitalism*, The Conference Board, February 2023

M&A, a Good Place to Start

M&A can serve as a natural starting point for incorporating ESG and stakeholder perspectives into board decisions. Companies generally don't think their boards incorporate ESG issues and stakeholders into M&A transactions very well. However, taking into account the impact of a transaction on critical ESG topics (e.g., environmental footprint or human rights within the supply chain) and stakeholders (e.g., customers, employees, business partners, communities) is relatively easy and can 1) provide a more comprehensive picture of risk, 2) reduce deal fever, and 3) help the company prepare for regulatory assessments.[21]

However, this may require expanding the circle of those involved and upskilling the core M&A team. Indeed, the M&A process is often tightly held, so companies should consider how to engage sustainability, communications, human capital, and other executives' perspectives. They should also provide more training on ESG issues to the core M&A legal and finance teams, which often don't take these issues or stakeholder perspectives into consideration.

Moreover, factoring ESG and stakeholder impact into M&A decisions will help prepare companies for multiple waves of antitrust reform across the globe. Traditionally, antitrust law has used the consumer welfare standard to determine whether mergers or business

practices were anticompetitive. Now, policymakers in the US and around the world are looking at reforms that would shift away from the consumer welfare standard to use antitrust law to serve broader social and environmental goals. It is therefore helpful to consider how deals can have a positive impact.

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[1] The Roles of the Board in the Era of ESG and Stakeholder Capitalism Working Group Pre-Meeting Survey; over 80 general counsel and corporate secretaries participated in the survey.

[2] Charles Mitchell at al., *Toward Stakeholder Capitalism*, The Conference Board, December 2021. Some 212 C-suite executives participated in the survey.

[3] *ESG Funds: Is Green the Color of Money?* The Conference Board CEO Perspectives podcast, August 2022.

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[17] Forty-two respondents.

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[21] Spierings, *The Role of the CEO in Driving ESG*.