Meeting Summary

The Roles of the Board in the Era of ESG and Stakeholder Capitalism

ESG Center Working Group Discussion Held Under the Chatham House Rule

Session 1 | Thursday, May 19, 2022 | Virtual Meeting

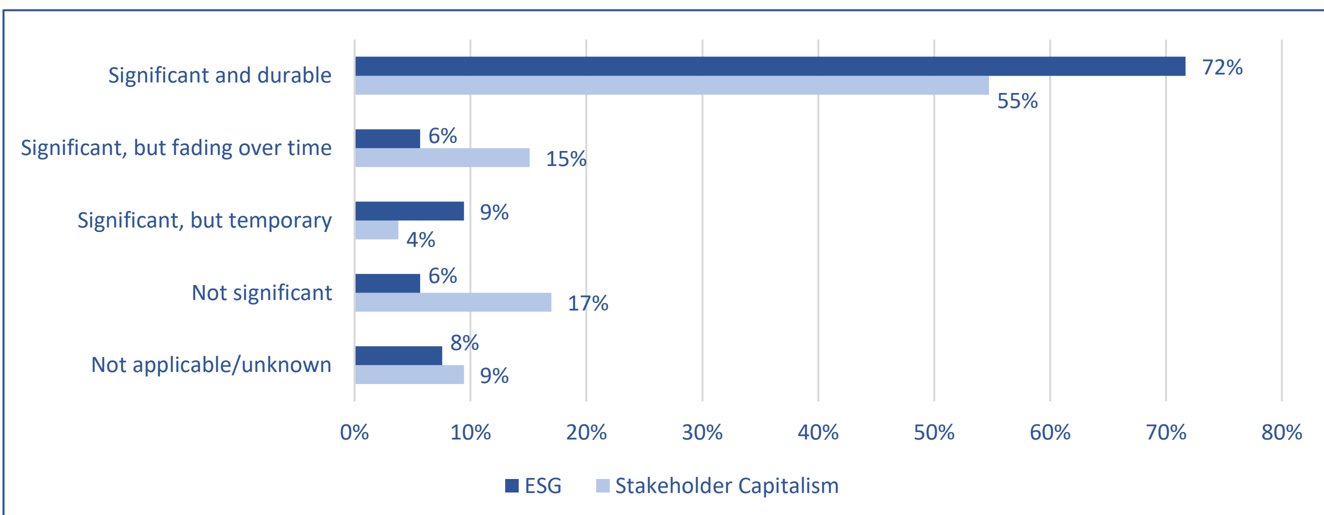
This Working Group, which consists of a series of four sessions held under the Chatham House Rule, discusses the evolving roles of the board of directors as companies navigate two fundamental and related shifts in capitalism: the broader focus on environmental, social, and governance (ESG) issues and the simultaneous shift to a multi-stakeholder form of capitalism.

The first session on May 19th focused on (i) the current environment and impact of these shifts on boards thus far; (ii) how to incorporate ESG and a multi-stakeholder perspective into the board's role in planning (strategic, business, operating, and capital budget); and (iii) how to incorporate ESG and stakeholder capitalism into the board's other key business decisions (e.g., M&A, organizational restructuring, product launches, internal controls, and reporting).

The Current Environment & Impact on Boards

1. **72% of respondents believe that ESG and 55% believe stakeholder capitalism will have a *significant and durable impact* on boards over the next five years,** with 15% believing that stakeholder capitalism is likely to *fade over time*.

Pre-Meeting Survey: How would you describe the impact of ESG issues / stakeholder capitalism on the board over the next five years?

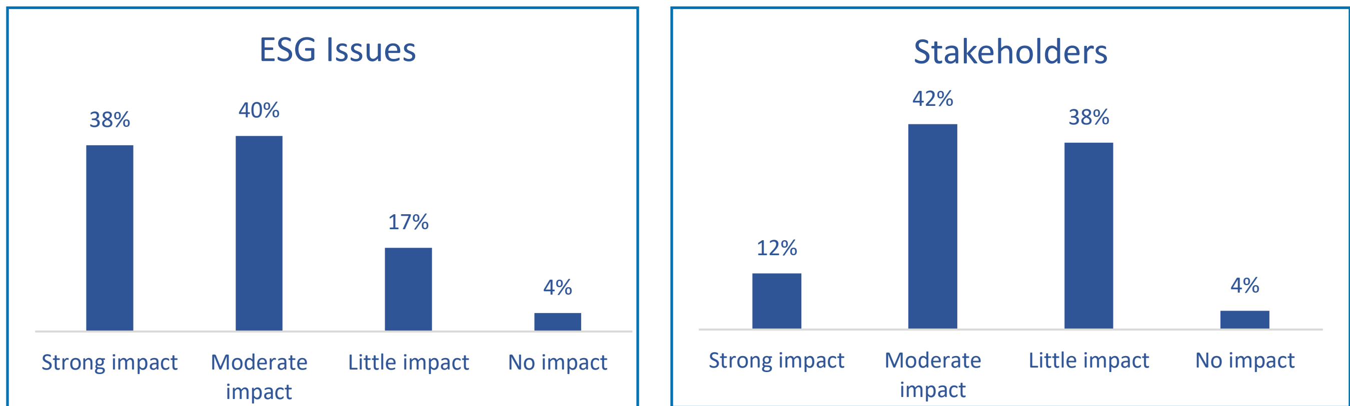


N=53.

2. **The "what" is having a bigger impact than the "whom."** 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: (i) boards might have already been considering multiple stakeholders

as part of their ordinary business, so the increased focus doesn't have that much more impact; (ii) the focus on stakeholder capitalism is somewhat newer than the focus on ESG, so it doesn't have a strong impact *yet*; and/or (iii) there's a stronger external pressure on companies to address environmental and social issues than to serve multiple stakeholders. Indeed, to a large extent, the focus on ESG is driven by institutional investors and now regulators.

Pre-Meeting Survey: To what extent has the increased focus on ESG issues / consideration of the interests of multiple stakeholders affected your board in the past two years?



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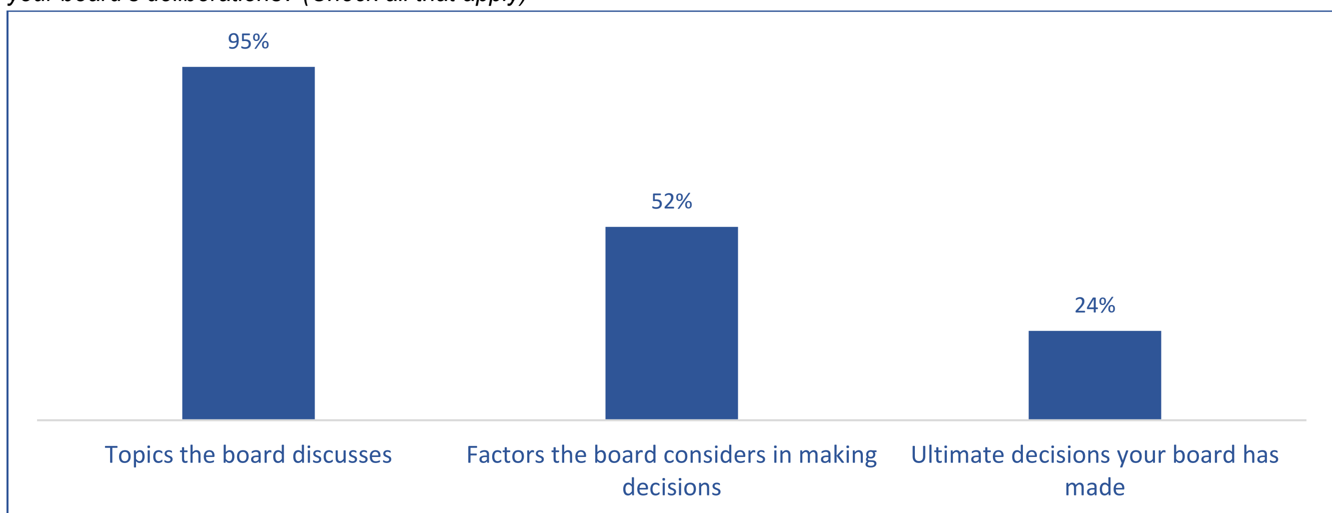
3. To date, **the focus on ESG and concern about the long-term welfare of stakeholders have affected the board in various degrees**.
    a. For virtually all boards (95%), it has affected *topics* discussed.
    b. For a majority of boards (52%), it has affected *factors* the board considers in decision-making.
    c. For a significant minority of boards (24%), it has affected the *actual decisions* they make. Based on the roundtable discussion, it has changed both the outcome and timing of the decisions, sometimes accelerating the board's action on environmental, economic, and social topics.

In-Meeting Poll Question: To date, how have the focus on ESG and concern about the long-term welfare of stakeholders affected your board's deliberations? (Check all that apply)



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Drivers of the Shifts Toward ESG and Stakeholder Capitalism

4. **Even though companies have focused on ESG issues and their stakeholders to some extent for many years, a confluence of various factors has accelerated and intensified their focus.**

   d. Internal pressure. Younger generations, especially Millennials and Gen Z, care more about environmental and social issues than their older counterparts. But as they feel that the government isn't doing enough to address these problems, they look to their companies for leadership. Whereas in the past companies could refrain from taking stands, they are now expected by employees to take public positions on a plethora of issues and act on climate change. (For more on this topic, see Choosing Wisely: How Companies Can Make Decisions and a Difference on Social Issues)

   e. External pressure. Mainstream investors have embraced the shifts toward a focus on ESG and a multistakeholder model. This is, among other things, coming through in their support for E&S proposals. Additionally, customers are more vocal, and social media is pushing on ESG issues. (For more on these topics, see 2022 Proxy Season Preview and Shareholder Voting Trends and Sustainability Features That Sway US Consumers Are Changing)

   f. Ongoing COVID-19 pandemic. Talent management has become the focus of attention as the pandemic forced companies to shift from an in person to a virtual workplace, thereby removing the "barriers to exit." Indeed, many employees aren't bound to a physical location anymore and can leave their firm virtually overnight if they disagree with the actions (or lack thereof) of their company. Moreover, companies that *really* cared about the health, safety, and overall well-being of their employees during the height of the pandemic didn't suffer as much from the 'Great Resignation.'

   g. Increasing regulations. The current US Administration has accelerated the focus on E&S issues, including through SEC proposed disclosure rules on cybersecurity and climate change (with proposed rules on human capital management (HCM) still expected). The regulatory regimes in Europe are more advanced and comprehensive.

   h. Other factors, including (i) the 2019 BRT statement on the purpose of a corporation, which declared that companies should serve not only their shareholders, but also deliver value to their customers, invest in employees, deal fairly with suppliers, and support the communities in which they operate; (ii) the Delaware Chancery Court's decisions in the *Marchand* and *Boeing* cases, which focused on the board's *Caremark* duty to ensure that the firm has a system of controls in place to manage mission-critical risks relating to major social harms (unsafe food and airplanes); (iii) stock exchanges pushing companies on certain ESG issues (e.g., Nasdaq's Board Diversity Listing Standards); and (iv) wildfires and other weather events that have put climate change front and center on companies' agendas.

5. **Another factor affecting boards are the commitments that companies have made,** in areas such as net-zero emissions, HCM, and supply chain. Sometimes these pledges are made without much consultation of the board and, subsequently, boards find themselves on the hook for commitments they didn't buy into. Companies will want to ensure their board doesn't become disenfranchised by the firm's commitments.

6. **The consideration of broader ESG factors and the welfare of multiple stakeholders can drive innovation and talent management**, as companies look for new ways to produce and deliver sustainable goods and services. This, in turn, has an impact on resources and talent management, as companies are looking to allocate more resources to create these products – and they need the right talent to be able to do so.

Dealing with Skeptics

7. **It's pivotal to fully engage – rather than ignore – skeptics on the board, by listening to their concerns and focusing on the *business case* for taking into consideration ESG issues and multiple stakeholders**. First, it's important to keep in mind that companies have flexibility to decide where they want to position the company on ESG issues and the stockholder-to-stakeholder spectrum. Driving ahead without a solid consensus is dangerous. Second, directors often 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 an experience in a social issue dividing a board. It's vital to listen and understand those experiences and to address them. In addition, some board members 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. Moreover, climate-related disasters adversely impact companies' operations, products, and services. By offering a strong financial – rather than moral or political – case, companies can demonstrate that the focus on ESG and multiple stakeholders isn't driven by altruism or ideology, but by the bottom line. These direct effects are in addition to the impact that failing to address ESG and stakeholder welfare can have on society and the environment, which can add to broader systemic risks that can threaten our economic and political systems.

8. **Equally important is to demonstrate that decisions can be improved significantly by incorporating relevant environmental and social issues into 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.

9. **And although regulations aren't driving the shifts toward ESG and stakeholder capitalism, more is to come – and companies will have to comply with and respond to those regulations**, including any SEC rules on cybersecurity, climate, and HCM, as well as those coming from Europe. That's another reason why this isn't a passing fad.

Legal Limits on the Ability of the Board to Focus on ESG and the Long-Term Welfare of Stakeholders

10. **Apart from "special cases" such as selling a company or dealing with insolvency, boards have a lot of latitude for taking into consideration 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 fundamentally 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.

11. **In fact, a far greater risk for boards is to treat short-term value as the north star and fail to take into consideration ESG issues – especially when those are "mission critical."** Under *Caremark*, 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* it was food safety; in the case of *Boeing* it was airplane safety). In fulfilling its *Caremark* duties, a board therefore ought to be mindful of ESG risks. Moreover, the Delaware Chancery Court's decision to deny a motion to dismiss in the *Boeing* case demonstrates that boards can't merely rely on management and face increasing liability for a lack of any formal mechanism or written record of oversight regarding mission critical risks. (Read more on the link between *Caremark* and ESG here.)

12. **With the board having legal permission to take broader ESG factors and multiple stakeholders into consideration, so does – and should – management.** This might not change the ultimate decision, but it can accelerate (the discussion around) decisions as well as the execution associated with the decision, as the criteria and lens through which decisions are evaluated are different.

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

13. **The board's increased focus on ESG factors and stakeholder perspectives/impact does not fundamentally change the line between the board and management or the role the board plays with respect to certain topics.** The board still has broad decision-making, oversight, advisory, and engagement roles. It does mean, however, that the board now is addressing more topics than before (e.g., the workforce, climate, and cyber). As a result, boards look to management for more information in these areas, including reports that track progress on issues. And some boards are adding new performance metrics to executive compensation.

14. **Although boards may want to add functional experience on the board in critical ESG areas, they should not sacrifice business strategy or international experience to achieve specialized expertise**. A recent report by The Conference Board found a decline in the reported percentage of board members with business strategy and international experience. This is worrisome, as board members without broad strategic experience can hinder effective board discussions and will likely be less useful partners for management. Moreover, board members that bring an international perspective can help spot issues and opportunities others may miss, especially as the world has become more interconnected in terms of customers and supply chains. Finally, as boards are adding functional expertise, they are more likely to cross the line between them and management.

15. **Especially with respect to social issues, the board's role is to make sure that 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 individual issues. (Also see Choosing Wisely: How Companies Can Make Decisions and a Difference on Social Issues.)

16. **There are some risks related to the board broadening its aperture to focus on a broader array of ESG issues and multiple stakeholders**, including if:

    a. The board works on these issues independent of or separate from management, as this may create a rift between the board and management.

    b. The board focuses on these issues in a haphazard, unstructured manner, which will impede the ability to provide thoughtful oversight.

    c. Not enough attention is placed on the management-level governance around these issues. For example, if the board focuses on diversity at the board level but not at the management level.

d. ESG issues are either isolated to an individual board member or individual committee, and the board as a whole lacks fluency in ESG or doesn't have a broad understanding of the relevance of ESG issues for the company.

Incorporating ESG and Stakeholder Capitalism in Key Board Decisions

17. **Generally, companies believe their boards have incorporated ESG better into their decisions than they have the interests of multiple stakeholders**, particularly when it comes to strategic and business planning, and external and internal communications. Conversely, with respect to decisions on product/service offerings and internal controls, boards are considering stakeholder perspectives/impact more so than ESG issues.

18. **There are only few places where boards are factoring ESG issues *and* multiple stakeholders into their key decisions *very well*.**

    a. Regulatory Disclosure. This makes sense, as these are areas where companies are required to address ESG.

    b. Corporate Culture. This is somewhat surprising since at the same time boards aren't believed to consider ESG issues and stakeholders in decisions on *organizational structure & staffing* and *compensation & benefits* – which are closely related to corporate culture. Moreover, a recent poll found that companies believe they are generally only at the *early to middle stages* of embedding sustainability into corporate culture. This implies that boards have a fair amount of distance to go before they really incorporate ESG issues and stakeholder perspectives into the full suite of decisions that affect corporate culture.

How Well Boards Consider ESG Issues *and* Stakeholders in Key Decisions

Very well	Moderately well	Not well
• Regulatory Disclosure	• Strategic Plan	• M&A
• Corporate Culture	• Business Plan and Operating Budget	• Organizational Structure and Staffing
	• Product and Services	• Compensation and Benefits
	• Internal Controls	• Capital Budget
	• External Communication	
	• Internal Communications	

Source: The Roles of the Board in the Era of ESG and Stakeholder Capitalism Working Group.

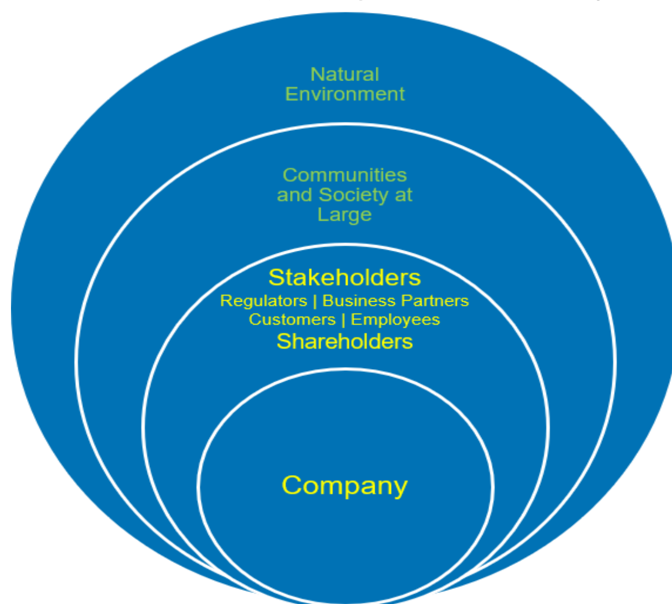
19. **The board has two powerful levers to drive ESG and stakeholder capitalism at their company: time allocation and executive compensation**. Indeed, whatever is on the board agenda will be on the company's agenda, because how – and on which issues – the board spends its time automatically trickles down to how the CEO, management, and employees spend their time. Additionally, what executives are

paid for will naturally drive their focus. Therefore, boards will want to consider how ESG issues and stakeholder perspectives are built into their agenda and executive compensation.

20. **It's incredibly helpful to develop a framework that incorporates a multi-stakeholder focus and a consideration of the firm's key ESG issues for making key business decisions**. Such a framework can provide guidance on whether and how to act in a *consistent* and *comprehensive* manner, both for the board and management. There's no one-size-fits-all model, but some ways of thinking about this include:

    a. Using a "repeatable assessment" framework for each significant board decision that focuses on the following areas: (i) potential **financial return** of the activity; (ii) opportunity for **sustainable/quality growth**; (iii) potential to have **positive impact on the environment and society**; and (iv) ability to uphold the firm's reputation as a **trusted partner**.

    b. 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 Conference Board.

21. **Such a framework can also be used for – and simplify – executive compensation decisions.** Indeed, rather than adding a bunch of ESG measure to executive compensation, it may be better to assess performance against the abovementioned dimensions (e.g., Did you deliver financial return? Did you deliver sustainable growth? Is the company – within your ambit – having a positive impact on society? Did you uphold the company's reputation as a trusted partner?). This way of addressing ESG and stakeholder welfare is more straightforward than adding an array of ESG metrics.

22. **M&A is good place to start in incorporating ESG and stakeholder perspectives into board decisions as well.** Companies generally don't think their boards incorporate ESG issues and stakeholders into M&A transactions very well. However, considering the impact of a transaction on critical ESG issues (e.g., environmental footprint or human rights within the supply chain) and stakeholders (e.g., customers, employees, business partners, communities) is fairly straightforward. Doing so provides a more complete picture of risk, may decrease deal fever, and can help prepare for regulatory review.

e. **It may require expanding the circle of those involved – and upskilling the core M&A team.** M&A is often tightly held. Companies should consider how to bring in sustainability, communications, and other executives earlier on, as well as providing more training on ESG issues to the core M&A legal and finance team as they often don't take these issues or stakeholder perspectives into consideration.

23. **M&A also provides a playbook for measuring impact more broadly.** Just like it's best practice for companies to conduct a post-mortem analysis to measure an M&A transaction's impact on a variety of dimensions, companies can assess the impact of their decisions on ESG issues and stakeholders after each strategic and business planning cycle, rather than merely measuring the financial results.

24. **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 anti-competitive. 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 therefore is helpful look how deals can have a positive impact.

The Board's Expanding Role in Disclosure

25. **The board's role in communications and disclosure is expanding as a result of the increased focus on ESG / stakeholder capitalism and, consequently, the growing demand for companies to report on the impact of their ESG efforts**. But whereas the board ought to review *all* SEC disclosures, it doesn't have to review all CSR/ESG reports. However, it needs to make sure management has processes in place to ensure both quality and reliability of data, and consistency in all forms of communications. Boards may also want to consider widening the scope of disclosure controls from merely financial statements to communications in general.

26. **The board should be comfortable with the scope of disclosures**, including any significant commitments the company is making that go beyond what's required in regulatory filings, because these may have an impact on the company's strategy and bottom line.

The Impact of ESG and Stakeholder Capitalism on the C-Suite

27. **With the increased focus on ESG and stakeholder capitalism, boards may soon be looking for executives with a somewhat different skillset.** Whereas C-suite executives traditionally are selected and assessed on *hard* skills and functional expertise, there now is a much greater focus on *soft* skills, such as people and communications skills. Indeed, there is an absolute necessity for C-suite executives to be leaders and motivators, empathetic, agile, inspiring, and authentic. They also need to place a premium on diversity. (For more on this topic, see Toward Stakeholder Capitalism.)

28. **Gaining experience in human resources roles before heading to the C-suite may make sense**, as these roles naturally focus on soft skills more so than hard skills. As such, this is a good place to build a balanced skillset.

29. **The increased focus on ESG issues and stakeholder capitalism may very well lead to a change in the composition of the C-suite.** For example, with the need to measure the firm's impact on ESG issues and stakeholders may come the need to have a Chief Impact/Reputation Officer.