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CORPORATE GOVERNANCE

Analysis

Integrating ESG Into Corporate Culture: Not Elsewhere, but Everywhere

In this edition of their Corporate Governance column, David A. Katz and Laura A. McIntosh write that in order to be a meaningful factor in effectuating corporate purpose, ESG—or, more accurately, EESG (including Employees as well as Environmental, Social, and Governance)—must be integrated throughout corporate affairs, not just in the boardroom.

By David A. Katz and Laura A. McIntosh | March 24, 2021 at 12:45 PM



David A. Katz and Laura McIntosh. Courtesy photos

A prominent securities regulator recently [observed](#) that "ESG no longer needs to be explained." ESG is firmly ensconced in the mainstream of corporate America, a frequent topic in boardrooms, C-suites, investor meetings, and regulators' remarks. Perhaps less obvious is that ESG has yet to be mainstreamed, as it were, in internal corporate governance and operations at the individual company level. In order to be a meaningful factor in effectuating corporate purpose, ESG—or, more accurately, [EESG](#) (including Employees as well as Environmental, Social, and Governance)—must be integrated throughout corporate affairs, not just in the boardroom.

The internal mainstreaming of EESG is the next step in its remarkable journey from activist wishlists to board and regulatory agendas. The good news is that this should not be difficult for most organizations to accomplish, so long as corporate leaders recognize that engaging with EESG considerations is not something that happens "elsewhere," but "everywhere." When EESG is integral to the culture and values of a company, it will naturally be incorporated in the work that is done throughout governance and operations,

including strategic planning, risk management, compensation, communications, and disclosure. This approach to EESG is beneficial in a number of important ways: It is conducive to long-term value creation and responsive to investor interests; it improves efficiency and transparency while demonstrating commitment to EESG goals; and it can help forestall legal liability and reputational harm.

Investors See Value in EESG

Investors today consider EESG issues fundamental to performance and value, and regulators have taken notice. Climate change, one of the more visible topics on the global stage, is at the forefront of how investors and regulators are expecting EESG issues to be handled. Last year, Mark Carney, then-Governor of the Bank of England, [articulated](#) his goal for mainstream private finance: to "ensure that every financial decision takes climate change into account." The U.K. and Europe are moving toward full integration of climate change metrics into business decisions, and the United States is likely to follow. Acting SEC Chair Allison Herren Lee stated in a recent [speech](#): "There is really no historical precedent for the magnitude of the shift in investor focus that we've witnessed over the last decade toward the analysis and use of climate and other ESG risks and impacts in investment decision-making."

Certain other EESG concerns—particularly the interests of employees—moved to the forefront during the COVID-19 pandemic, due to the necessary shift in focus from ordinary course operations to acute concerns such as liquidity, employee health, customer safety, supply-chain continuity, and the company's contributions to the well-being of the community. Even in the midst of this unprecedented disruption, it was clear from the outset that investors expected EESG issues to be front-and-center both in the management of the pandemic and in the eventual recovery. Cyrus Taraporevala, CEO of State Street, [wrote](#) to companies in March 2020—while acknowledging that companies had pivoted to crisis management mode—"we continue to believe that material ESG issues must be part of the bigger picture and clearly articulated as part of your company's overall business strategy." Mr. Taraporevala urged companies to "articulate how COVID-19 might impact or influence your company's approach to material ESG issues as part of your long-term business strategy."

The past 12 months have markedly increased public sensitivity to the role of corporations in society, especially to employee welfare concerns such as fair wages, health and safety, and diversity and inclusion. Before COVID-19, institutional investors were paying attention to what companies were doing on behalf of their workers; the pandemic accelerated and intensified this interest, and companies are taking action in response. Treating workers fairly is understood today as a positive factor in creating long-term value and enhancing the company's reputation. Eventually, compensation at all levels is likely to be affected by EESG considerations: Once standardized metrics-based disclosures are widely implemented, executive compensation will almost certainly be linked to long-term metrics,

including certain EESG metrics. This should incentivize CEOs to continue the growing trend toward thinking about corporate impact more broadly, which has led to companies' increasingly seeking cooperation from suppliers and other third parties as they work toward fulfilling their own EESG goals.

Activist investor Jeff Ubben's latest venture exemplifies a new mindset that recognizes EESG considerations as pervasive and value-generating, both within companies and across industries. In his 2020 announcement of a new fund to realize value through companies' progress toward EESG goals, he [wrote](#): "The intention of integrating ESG factors has been, from the beginning, to identify material risks and opportunities alongside fundamental analysis as any investor worth one's salt should want to do." In other words, he views EESG factors as essential elements of risk assessment and strategic analysis at the company level. At the industry level, Mr. Ubben said he intends to seek EESG-related opportunities in what would have been considered unlikely sectors not long ago. Recognizing that these investments will have to be "more proactive" and will entail "longer-term payouts," Mr. Ubben announced that his new fund will invest in "the very companies sustainable funds tend to avoid—including oil and gas, utilities, [etc.]." In this new form, EESG-focused investing will not take place "over there" in specified sectors, but everywhere, even—and in practice, Mr. Ubben purchased, through his fund, \$10 million of Exxon Mobil stock earlier this month, just days after he was named to the Exxon board, and he is expected to increase his investment significantly. The appointment of Mr. Ubben and another executive to the Exxon board [reportedly](#) came "amid a push by prominent shareholders for it to focus more on clean energy and improve its financial performance," and the stock price responded positively to the company's announcement of the new directors.

Integrating EESG Is Efficient and Demonstrates Commitment

As companies move thoughtfully toward meaningful integration of EESG, a useful starting point may be ensuring that the same personnel that currently perform fundamental business analysis do so from the EESG perspective as well. For example, strategic planning and risk management teams should incorporate EESG considerations directly into their work. This approach avoids duplication of efforts and facilitates seamless absorption of EESG factors into existing workstreams. It also avoids treating EESG as a "check the box" exercise or an inconsequential appendage to core business concerns. A pitfall to avoid is assigning internal ownership of EESG to a person or team that does not have a broad and clear pathway to engage with top decision-makers. EESG should not be seen as primarily a public relations or communications issue. It would be a mistake—both substantively, and, ironically, optically—for the investor relations department to have principal ownership of EESG. Within a company, EESG should not be viewed as something that is handled somewhere else; rather, it should be understood across departments as being addressed "right here." EESG should not be separated from legal and compliance, for example, or research and development, or human resource management, but integrated into each function. This may be easier than it sounds, as corporate personnel already undertake all

of these activities and can integrate EESG factors into the work that is ongoing. This approach makes sense for companies of all sizes, though it may happen more organically at smaller companies with leaner management and operating teams.

If EESG is substantively part of strategy and risk management, then meaningful communications and disclosure will follow. To borrow a [phrase](#) from former SEC Chair Jay Clayton and investor Mark Wiseman, the goal of disclosure, EESG or otherwise, is to provide "decision-useful information." Writing about the 2021 framework set out by BlackRock CEO Larry Fink regarding climate change disclosure—i.e., that a company should disclose its plan for carbon neutrality by 2050—Messrs. Clayton and Wiseman observed that it "responds to the key question: Does the company have a credible strategy for adjusting to and performing in the expected future commercial and regulatory environment?" As implied by Mr. Fink's framework, companies can use disclosure metrics as decision-making tools. The objective with regard to EESG, as with other elements of corporate strategy, is to pick achievable goals and communicate clearly and transparently about their relevance and achievability. The goals should be precise rather than phrased in general terms. Corporate communications should articulate why certain topics and metrics were chosen, and why management believes those topics and metrics are important for the company and its stakeholders. The company should also explain what the measurement tools are, and how progress and success will be evaluated.

EESG-related communications and disclosures must be subject to the same rigor as their non-EESG counterparts. EESG disclosure made in response to regulatory requirements should be drafted by the disclosure team, not by an EESG "specialist" who is generally uninvolved with the disclosure process. Given political interest in EESG and recent indications from the [SEC](#) that a "comprehensive ESG disclosure framework" is on the horizon, companies should be prepared for expanded regulatory scrutiny. They should also be aware that institutional investors and other stakeholders are paying more attention than ever to EESG and other sustainability-related disclosures.

In order for companies to be successful in integrating EESG throughout corporate affairs, employees and other stakeholders need to understand and believe in the company's commitment to EESG goals. To achieve stakeholder buy-in, corporate commitment must be authentic. It has to be earnestly, consistently communicated by leaders with strong credibility. Notably, the World Economic Forum's 2020 draft [discussion paper](#) on ESG metrics included a measurement of "the percentage of each stakeholder group that is aware of the company's stated purpose and believe they are authentically realizing it." Though this proposed disclosure metric dropped out of the [final version](#), its initial inclusion is indicative of a sea-change in how investors, regulators, and corporate leaders view the saturation of EESG throughout the corporate hierarchy and beyond.

Board Oversight Can Forestall Liability and Reputational Harm

Boards should also take an integrated approach as they fulfill their fiduciary responsibilities regarding EESG-related strategic planning and risk management. A healthy, functioning board understands how corporate priorities, including EESG priorities, align with strategy and planning, and also appreciates that risk oversight must include risks from failing to address EESG concerns adequately. EESG considerations therefore need to be incorporated into the broad range of work that is already performed by the board. EESG oversight responsibilities should be either allocated sensibly across board committees, or addressed at the whole-board level, not limited to the purview of one committee (such as the audit committee or a newly created "sustainability" committee). Rather, the same committee that handles, for example, significant employee issues for purposes of risk management and compliance should also handle the related EESG issues in an integrated way. The precise allocation of EESG oversight tasks will depend on the specific issues faced by the company and its industry, the composition of the board, and the expertise available on each committee. Boards may wish to review committee charters to better determine how to best allocate key EESG-related responsibilities across committees.

A useful touchstone for boards is the landmark Delaware case of [Caremark](#), which in the years since its issuance in 1996 has become shorthand for the duty of oversight. Former Delaware jurist Leo E. Strine Jr. recently [wrote](#) that "EESG is best understood as an extension of the board's duty to implement and monitor a compliance program under Caremark. If a company decides to do more than the legal minimum, it will simultaneously satisfy legitimate demands for strong EESG programs and promote compliance with the law.... By integrating compliance and EESG, corporations can meet growing societal demands in an effective and efficient manner that capitalizes on existing structures." As companies and boards rise to the challenge of meeting the expanding expectations of major investors relating to EESG, they should recognize that the duty of oversight (itself derived from the primary duty of conducting business in a lawful manner) realistically includes oversight of environmentally responsible actions, honest dealings with customers, safe working conditions and fair employment practices for employees, and work towards diversity and inclusion.

Companies already have faced Caremark suits involving their failure to attend to key compliance/EESG risks, and the most important outcome is not necessarily the legal result; when a company defends a Caremark litigation, it has already experienced negative publicity, regulatory scrutiny (and often fines), and management turnover. An approach that effectively integrates compliance, risk management, and EESG efforts will help companies identify key areas of concern earlier and address them internally, preempting a scenario in which company stakeholders and the company's reputation suffer material harm. Particularly in these unsettled times, the adoption of best practices in oversight—that is, the full integration of EESG considerations into decision-useful information and the

decision-making processes themselves—can go a long way toward avoiding legal jeopardy and establishing reputational credibility.

In the aftermath of the pandemic, politicians, regulators, and activists will surely demand that corporations renew and deepen their commitment to community well-being in a variety of EESG-related ways. There is a growing expectation not only that corporations work to eliminate their own active harms to society—such as pollution, waste, or unfair employment practices—but also that they take proactive steps where possible to ameliorate larger societal ills and injustices in their community. Increased attention to the needs of workers and the societal responsibility of businesses is likely to persist beyond the COVID-19 crisis, and a deeper reckoning may come with the recovery. EESG everywhere is profoundly relevant as companies look ahead to the post-pandemic future.

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