January 27, 2023

Update on ESG, Stakeholder Governance, and Corporate Purpose

As we previously described (most recently here and here), environmental, social, and governance (ESG) topics have become prominent (and polarized) political issues in recent months. In the two months since our last update, significant developments in the attack on ESG have occurred in a few areas, as illustrated in the examples set out below. In providing this update, we underscore that the public and political scrutiny of ESG must not dissuade directors and officers from confronting and addressing ESG risks — to the contrary, fiduciary duties and *Caremark* obligations require it, and the long-term value of the corporation depends on it.

Asset Managers, ESG Funds, and Proxy Advisory Firms. The major asset managers remained in the spotlight, with BlackRock in particular subject to continued criticism due to CEO Larry Fink's outspoken support for ESG. For example, Florida announced that it would begin divesting $2 billion worth of assets currently managed by BlackRock. Louisiana, Missouri, South Carolina, Arkansas, Utah, and West Virginia made similar announcements over the course of 2022. ESG funds have also been affected, suffering significant outflows in 2022 with more money flowing out of than into such funds for the first time in over a decade. Finally, the proxy advisory firms have become targets of the anti-ESG coalition, joining asset managers as a punching bag for opponents of so-called "woke" capitalist policies. In January 2023, 21 Republican attorneys general authored a letter to Institutional Shareholder Services and Glass Lewis, the two major proxy advisory firms in the United States, challenging whether their net-zero emissions policies are based on the financial interests of investment beneficiaries rather than on other social goals, and asserting that their boardroom diversity policies may violate contractual and fiduciary duties as well as state anti-discrimination laws.

Policy and Regulatory. Other developments occurred in the policy realm. Texas held a hearing to probe the ESG investment policies of BlackRock and other major asset managers — but notably excused scrutiny of Vanguard following its withdrawal from the Net Zero Asset Managers initiative. In Florida, Governor Ron DeSantis and the Trustees of the State Board of Administration (SBA) approved measures to separate Florida's investments from ESG, and Governor DeSantis also proposed legislation that would permanently prohibit SBA fund managers from considering ESG factors when investing the state's money. Other states are in various stages of similarly considering, introducing, and implementing anti-ESG regulations, including through state law, investment resolutions, and/or opinions of the attorney general or state treasurer. Additionally, updated European ESG regulatory guidance has resulted in widespread downgrades in the designations of ESG portfolio funds of many of Europe's top asset managers. Early January 2023 estimates indicate that at least $140 billion in portfolio funds were downgraded, reflecting concern about the unclear rules and potential legal exposure resulting from improper classification. Moreover, the European Banking Authority's quarterly risk assessment, published in January 2023, specifically highlighted challenges that banks face in relation to climate data availability and modeling techniques — noting that failure to meet stated climate disclosure commitments could translate into greater legal and reputational risks, in particular with respect to greenwashing.

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Shareholder Activism. Anti-ESG shareholder activism is on the rise and will be an important trend to watch as the 2023 proxy season gets underway. It is likely that the number of anti-ESG proposals will increase relative to the number of such measures put to a vote in 2022 and that anti-ESG proponents will become more vocal and numerous, in part strengthened by the growing political backlash against ESG. Consider the growth of anti-ESG activists, epitomized by Strive Asset Management, a fund that was launched in May 2022 to take on the major U.S. asset managers and "restore the voices of everyday citizens." Strive has already approached at least four large U.S. companies (ExxonMobil, Disney, Chevron, and Home Depot) to demand that they undo certain ESG-related initiatives, and Strive recently launched its "ESG Transparency Campaign" encouraging everyday investors to question their financial advisors about whether they are invested in funds that voted in favor of racial equity audits, emissions reduction plans, or executive compensation tied to environmental and social goals.

These developments — attacking what various interests choose to impute to the "ESG" label — should not obscure the reality of the substantive risks and strategies underneath that label that must be factored into corporate decisionmaking. ESG, properly understood, simply refers to some of the risks and strategies that a company must carefully balance in seeking to achieve long-term, sustainable value. Regardless of one's political preferences, the inescapable reality is that ESG risks have long been considered by boards and management — along with all other material risks and issues (as we recently discussed here) — and must continue to be so considered in order to ensure the company's value over the long term. The complex stakeholder issues that companies face today are integral to corporate sustainability and responsible risk management, and if corporate fiduciaries were to ignore these topics it would ultimately wreak harm on long-term corporate value and, in turn, shareholder value. Addressing ESG and sustainability-related risks in the context of considering the interests of all relevant stakeholders is consistent with directors' fiduciary duty of care, as well as with the board's legal obligation under *Caremark* (which we recently addressed here) to implement and monitor systems to identify material risks and to address risks once identified.

In sum, it remains incumbent upon each board of directors to look beyond short-term shareholder profits, to seek long-term value creation by taking into account the interests of all stakeholders. Whether they are labeled as ESG or something else, each of the components of ESG represents risk factors and strategies that must be managed, along with all other material considerations, by companies in order to arrive at the outcome that best promotes sustainability over the long term. Recent anti-ESG rhetoric does not undermine stakeholder governance as the proper model of corporate purpose, nor does it undermine the right and duty of directors and management teams to consider stakeholder and ESG risks and strategies.

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