April 13, 2020

Key ESG Considerations In the Crisis

The social and economic turmoil unleashed by the global spread of COVID-19 and the collapse in the price of crude oil has brought to the fore a number of critical incident and systemic risk management concerns, including traditional ESG concerns such as human capital issues, business model and supply chain resilience, and consumer welfare and social impact. As governments across the globe implement assistance packages for affected companies and industries and their employees, attention has also turned to certain governance matters, notably, executive compensation, dividend payouts and stock buybacks. At the same time, while crisis management remains the first priority, influential institutional investors have signaled their continued focus on environmental matters and ESG disclosures.

As management and boards of directors focus on addressing the immediate-term challenges of the crisis, ESG factors will be critical elements of both short-term strategic decisions and longer-term strategic planning. Many companies will face questions from their investors, employees, consumers, local communities and other stakeholders over their handling of COVID-19 as well as their preparedness for similar future shocks. We discuss below ESG issues that are likely to be of particular concern to key stakeholders:

Board Oversight of Risk Management. In times of crisis, boards of directors play a critical oversight role (as discussed here and here). In seeking to minimize and mitigate the impact of COVID-19 on their businesses, employees, customers and other stakeholders, boards should understand the risks facing the company and the concerns of key stakeholders. Directors should maintain regular contact with management to receive timely updates on the well-being of employees, customers and the communities in which the company operates. Directors will also need to assess the short-, medium- and long-term viability of the business and identify appropriate strategic changes to preserve business continuity, including working with management to preserve access to credit, optimizing capital allocation, overseeing public messaging to and engagement with stakeholders, ensuring compliance with new rules and regulations, and protecting the company from opportunistic investors, including activist investors. Boards may also need to review and update management compensation plans, as appropriate, and as the immediate crisis dissipates for any particular company, reassess strategic plans and opportunities. Lessons learned from the current crisis should be applied to future risk assessments, business strategies and crisis management planning.

Critical Incident and Systemic Risk Management. The current crisis will test the efficacy and responsiveness of many companies' existing critical incident and systemic risk management policies and procedures. The rapid and crippling spread of COVID-19 has shown that effective risk management needs to be dynamic, forward-looking, comprehensive and nimble: it is possible that unexpected challenges will continue to

arise in the coming weeks and companies should remain vigilant. Events in recent weeks have shown that entire industries are vulnerable to low-likelihood, high-impact exogenous shocks and that shortfalls in operating cash flow, cuts to credit ratings and curtailed access to capital can quickly endanger business continuity.

Critical incident risk management extends to the health and wellbeing of employees and the preservation of customer and supplier relationships and business reputation. As companies and their employees transition online, businesses become vulnerable to cybersecurity threats from hackers seeking access to sensitive company and consumer data from unprotected home computers of employees. Companies should be aware of potentially sensitive data that is being collected and stored on their systems and work to ensure that employees, third-party service providers and customers remain on heightened alert for potential security threats.

Human Capital Issues. Employee health and safety, and issues of workforce preservation and culture generally, have come to the fore as the spread of COVID-19 prompts shareholder scrutiny over how companies are taking measures to protect their employees. Effective communication channels and safety protocols can help minimize the spread of COVID-19 among the workforce and, in some instances, suppliers and customers. Other measures companies may consider taking include providing protective gear to employees who are vulnerable to COVID-19 exposure, providing adequate sick pay for employees who fall ill, implementing flexible work arrangements that can adapt to external challenges such as school closures, re-evaluating leave and benefits policies to ensure employees and their families have sufficient resources to stave off and recover from infection, hazard pay and other financial assistance, and providing employees technological resources to work effectively from home. Failure to mitigate the spread of COVID-19 among employees could lead to direct adverse impacts on business operations, employee morale and productivity as well as longer-term reputational impacts.

As employees self-isolate and work from home, the strength of a company's culture and purpose will become critical to maintaining morale and productivity. The current crisis provides an opportunity for management to foster collective unity among employees and management. Where appropriate, soliciting employee input and keeping employees engaged and informed of challenges facing the company may help management make better informed decisions and inspire employee confidence, particularly if tough choices are being made. Companies expecting to undertake large-scale layoffs or salary reductions as a result of the current crisis should take steps to provide employees with adequate advance notice and ensure compliance with law, including the WARN Act and COBRA, and should consider, where possible, steps to reduce the financial burdens on former employees, including extending healthcare coverage. Looking ahead, companies should think about whether their retained workforces have sufficient talent and skills to meet business demands as the economy

recovers. Actions taken today will be judged in hindsight by employees, customers, suppliers, communities and shareholders – particularly shareholders that increasingly consider ESG issues as part of their investment and engagement process.

Business Model Resilience. Alongside risk management considerations, companies may also need to consider the resilience of their business model under different scenarios. Even before the outbreak of the recent crisis, investors, including BlackRock, State Street and other key stakeholders, were already calling on companies to disclose their strategic plans for a future low carbon economy. As a number of major companies move to suspend earnings guidance, as the retail, hospitality and travel industries continue to suffer amid collapsing revenues and new travel restrictions, as the energy industry faces an uncertain future, and as teleworking service providers and medical suppliers struggle to cope with increased demand, investors, employees and consumers will be scrutinizing how companies are able to adapt their business for future contingencies. Companies may need to assess how evolving environmental and social realities may place their business models at risk and find strategies to provide reassurance and confidence to nervous investors, employees, consumers and other stakeholders.

Supply Chain Resilience. Even well-diversified companies have not been spared the supply chain challenges created by COVID-19. Today's globalized, online economy is acutely vulnerable to supply chain threats, with the current shortage in medical supplies underscoring the risks of concentrating key supply infrastructure among a relatively small number of geographically concentrated manufacturers. Supply chain concerns have not been limited to medical supplies: in February, a number of major companies in various industries began issuing profit warnings in response to concerns about the impact of COVID-19 on their supply chains. Supply chain risks also exist closer to home where the current pandemic has created additional strains for the already stretched trucking industry, leading to ongoing challenges for last mile deliveries to stores that have been emptied by recent waves of panic buying. The challenges of the past few weeks provide companies an opportunity to closely re-examine their supply chains, identify potential risks and weaknesses, and work to reconfigure their supply chains to quickly anticipate future disruptions to global supply dynamics.

Executive Compensation. As companies revise profit forecasts for 2020 and grapple with tumbling stock prices, executive compensation has become a key area of scrutiny for investors and regulators, and several companies have announced temporary pay reductions for executives and directors. While there is no one-size-fits-all prescription for companies, boards and management should carefully consider updates to executive compensation plans, including incentive plans, to align with the new economic reality. The Coronavirus Aid, Relief and Economic Security Act (the "CARES Act") also sets executive compensation limits for certain business recipients. Companies should understand and consider the impact of those limits in determining whether to participate in the CARES Act assistance programs.

Dividend Payouts and Stock Buybacks. A number of companies have moved to suspend dividend payments and stock repurchases in order to preserve liquidity. The CARES Act also imposes limitations on dividend payouts and stock buybacks for business recipients of federal funds. Going forward, boards and management should carefully assess how to optimize capital allocation amid ongoing economic uncertainty. For many companies, suspending dividend payouts and stock buybacks may be the right path forward; however, boards and management should resolve to act in the best interests of the company and respond directly to the unique circumstances of the business.

Consumer Welfare and Impact on Communities. Companies, particularly those operating in essential industries, will also need to take heed of consumer concerns and recognize their outsized impact on the wellbeing of the communities in which they operate. Industries operating at the frontline of the pandemic, such as grocery chains, banks, elder care facilities, hospitals, transportation providers and mail and shipping providers will be expected to play an outsized role in helping mitigate the spread of COVID-19. A challenge for such companies is finding ways to ensure continuity of service without overstretching its own workforce and resources. Other companies have found ways to contribute financial, intellectual property and human resources to relief efforts. Current conditions present both a challenge and an opportunity for companies to demonstrate their ability to innovate and adapt to consumer demands and to provide critical infrastructure and resources in times of need. The scale, scope and impact of a company's contributions to its local communities and the broader markets in which it operates amid this crisis may be used as a marker for assessing its performance on "social" metrics in the months and years to come.

Shareholder Engagement. Many investors are keen to understand how companies are responding to COVID-19: Vanguard issued a statement noting that "[c]ompanies that communicate clearly and regularly in times of crisis can provide much-needed reassurance to their investors and other stakeholders." The current crisis has refocused the attention of certain investors. State Street's CEO, Cyrus Taraporevala, stated in a letter to boards of directors that its engagement conversations will shift "to more immediate ESG issues such as employee health, serving and protecting customers and ensuring the overall safety of supply chains." State Street also called on companies to communicate to their investors the short- and medium-term impacts of COVID-19 and explain how they may affect the company's "approach to material ESG issues as part of [its] long-term business strategy." Similar sentiments are reflected in the recent public statement issued by the UN's Principles for Responsible Investing (PRI). Other key investors, notably BlackRock, have indicated that they will continue to pursue their existing priorities at this year's annual meetings and companies should remain prepared to engage on longer-term issues such as climate change resilience.

ESG Disclosures Remain Critical. Most public companies will have extensive disclosure about the impact of COVID-19 on their business, including in many cases

quantification of the costs of actions taken in response. This type of disclosure, including the inevitable comparisons that will follow, may well prompt an even greater push among investors and other stakeholders for universally comparable and metrics-based ESG disclosures. Major institutional investors, including State Street and Vanguard, have indicated that while management and boards should be given flexibility to respond to the immediate needs of their companies, longer-term considerations such as addressing climate change risk, remain important. The unprecedented crisis has also exposed a number of operational weaknesses across a number of companies and industries, and investor scrutiny toward risk management, board oversight and capital allocation practices may evolve into questions on long-term business sustainability and resilience, all of which may lead to pushes for additional ESG disclosures. The crisis has also shown that companies do not operate in a vacuum and that external environmental and social issues can have a material and lasting impact on the bottom line. Boards and management teams will be well-advised to set aside time to discuss how the current crisis may inform future ESG policies and disclosures.

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