May 1, 2020

ESG and Incentive Compensation Programs

The recent release by the proxy advisor Glass-Lewis of an informal survey and report on the use of environmental and social goals in the incentive plans of S&P 500 companies in selected industries represents the latest reminder of the increasing significance of environmental, social and governance ("ESG") goals in public company incentive compensation plan design. Consistent with other surveys and our experience, the Glass-Lewis report, titled *E&S Metrics in Executive Compensation*, observes that recent years have witnessed companies "increasingly adopting nonfinancial metrics, particularly those relevant to environmental and social factors," as part of a broader "trend … reflective of a rising focus on sustainability among diverse stakeholder groups, including prominent shareholders."[1]

The report, however, also notes that the use of these metrics is often of relatively modest weight, and in many cases subsumed within qualitative or individual performance components of the programs. Indeed, the principal challenge in implementing ESG incentive goals is devising objective criteria for measurement that will stand the test of time and shareholder receptivity, especially in the event that achievement of ESG metrics results in payouts when stockholders may not be reaping similar rewards under traditional financial measures. In our view, these challenges are not insurmountable, and the Glass-Lewis report offers a balanced investor group perspective on them. While acknowledging some wariness that environmental and social goals will prove too qualitative and discretionary, Glass-Lewis recognizes the importance of setting and achieving such goals as integral to the long-term value creation of a company, so long as the company can demonstrate and articulate in its proxy statement an appropriate rationale connecting the environmental and social goals to that long-term vision. Ultimately, ESG-related incentive goals may not fall squarely within current Institutional Shareholder Services and other proxy advisor frameworks for evaluating incentive compensation programs, but resisting the urge to run with the herd may be a necessary part of a larger movement to refocus what it means to be a successful company.

To that end, it is prudent for companies to give conscious thought at both the board and management level to the relationship between ESG goals and incentive compensation. The discussion must begin with an assessment of which ESG issues are most relevant to the individual company and an evaluation of whether all constituents will likely be in general agreement as to appropriate metrics and goals. Coordination between compensation teams and other internal groups focused on sustainability, corporate mission, and long-term strategy and drivers of profitability, is essential. Glass-Lewis's thoughtful engagement provides an opportunity, as does the COVID-19 pandemic generally, to pause and reflect; in this instance, as to how ESG goals that are considered proactively and deliberately can motivate sustainability as well as profitability, helping to build long-term value for all stakeholders.

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[1] As discussed extensively in our memorandum of April 13, 2020, the COVID-19 pandemic has further highlighted ESG issues, especially in the areas of human capital preservation, business model and supply chain resilience, consumer welfare, and social impact.