ESG Background Reading Materials

FOR

Mergers and Acquisitions in India: is India the last oasis of hope in a global slowdown?

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Wachtell, Lipton, Rosen & Katz

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March 16, 2023

Larry Fink's Annual Letter to Investors

For more than ten years, Larry Fink, Chairman and CEO of BlackRock, the world's largest asset manager, has published separate annual letters — one to CEOs and another to BlackRock's shareholders. This year, Fink combined the two letters into one to underscore that in serving its clients, BlackRock has also created value for its shareholders — a demonstration of stakeholder capitalism at work.

As we recently explained, major asset managers such as BlackRock play a critical role in supporting companies as they seek to fulfill their fundamental purpose of pursuing long-term, sustainable value creation. Central to this mission is recognition that stakeholders (shareholders, employees, customers, suppliers, and communities) are critical to a company's long-term success, and that boards and management should consider their interests when exercising their business judgment. This is the conception of corporate purpose articulated in The New Paradigm (issued by the World Economic Forum's International Business Council in 2016), supported by the Business Roundtable beginning in 2019, and widely accepted by corporate leaders, investors, companies, and practitioners. Fink's letter highlights the importance of this ongoing relationship and partnership between companies and asset managers as well as between companies and their other stakeholders in the context of the stakeholder governance model of corporate purpose.

The latest letter also reiterates how evolving risks and opportunities — whether related to changes in globalization, supply chains, geopolitics, inflation, monetary and fiscal policy, climate, or human capital — continue to reshape the business environment, and that it remains paramount for asset managers including BlackRock to identify and manage investment risks that could impact client portfolios. Boards and management teams must also assess such risks, challenges, and opportunities where they could materially impact the future of a business. These company-specific assessments are critical not only to investors, as Fink's letter makes clear, but also to the board's fiduciary duty of care as well as its obligation under *Caremark* to implement and monitor systems to identify material risks and to address risks once identified.

The views expressed in Fink's letter are not "woke," and the pursuit of stakeholder capitalism and sustainable long-term value is not "woke" capitalism — it is sound and prudent capitalism. To quote Colin Mayer of Oxford University: "the purpose of business is to solve the problems of people and planet profitably, and not profit from causing problems." So too Adam Smith, the father of market capitalism, in *The Theory of Moral Sentiments*, the predecessor to *The Wealth of Nations*. Since 1979 when we wrote Takeover Bids in the Target's Boardroom, we have argued that the consideration of stakeholder interests is well within the bounds of law, a view shared by the Delaware Supreme Court in *Unocal*. Decision-making and action against the background of this formulation of corporate purpose will be fully protected by the business judgment rule, will appropriately manage material risks to the business, and will best position companies to pursue sustainable value and broad-based prosperity over the long term.

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March 13, 2023

On the Debate Regarding ESG, Stakeholder Governance, and Corporate Purpose

We previously described (most recently here, here, and here) the growing politicization of the consideration of environmental, social, and governance (ESG) factors in decision-making by asset managers, financial institutions and public companies, among others. In particular, a key target of political attention has been investment managers' and pension fund fiduciaries' consideration of ESG factors in their investment-related decisions. A prime example is a recent paper arguing that public pension trustees are prohibited by law from considering ESG factors in their investment decisions (or allocating capital to asset managers who engage in such practices) and, separately, that registered investment advisers may place client capital in investments promoting ESG objectives only after obtaining informed, express client consent. Notably, the paper defines ESG as a set of "loosely-defined but highly influential non-pecuniary criteria that purport to assess the extent to which companies are achieving certain social and political objectives with which many citizens disagree." This critique, which regards ESG as a matter of ideology rather than economics, has also found voice among conservative state treasurers and attorneys general and among certain presidential aspirants who are building anti-"woke" campaigns targeting ESG.

We write to make clear that this critique of the legality of ESG-related investment decisions is entirely separate from — and has no bearing on — the ability, and responsibility, of directors and officers of corporations to consider ESG issues to the extent such issues may materially impact the sustainable long-term value of the business. Companies and boards must address ESG factors and other risks (and opportunities) to fulfill the company's fundamental purpose of growing value over the long term, considering the stakeholders that are critical to the company's success (shareholders, employees, customers, suppliers, and communities) as determined in their business judgment and with regular engagement with shareholders. As we have stated, the complex stakeholder issues that companies face today are integral to corporate sustainability, responsible risk management and value creation; indeed, addressing these risks is consistent with directors' fiduciary duty of care and the board's legal obligation under *Caremark* to implement and monitor systems to identify material risks and to address risks once identified.

Although the legal debate on the propriety of ESG investing is distinct from directors' and managers' consideration of ESG risks in the context of corporate

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decision-making, it is important to recognize that major asset managers undeniably play an important role in supporting corporations in their pursuit of long-term, sustainable value creation. A key principle of The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth (issued by the World Economic Forum in 2016) is that institutional investors should engage actively and openly with corporations in the context of developed, long-term relationships, and make voting decisions on an informed basis in a manner consistent with the best interests of the asset manager's long-term beneficiaries. This ongoing, reciprocal dialogue — supported in numerous jurisdictions around the world, including by the UK Financial Reporting Council — is a critical component of the stakeholder governance model and ensures that the views of leading institutional investors and asset managers will be taken into account in company decision-making and risk management assessment.

Vigorous debate about the ability of pension plan fiduciaries and investment advisers to consider ESG factors likely will continue, as evidenced by the lawsuits seeking to reverse the Department of Labor's ESG rule. However, there should be no doubt about the responsibility of boards to consider and address ESG-related risks and opportunities when assessing and balancing all other issues that are material to the long-term value and sustainability of the company.

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January 30, 2023

Caremark: It's Not Just for Boards Anymore

The Delaware Court of Chancery last week held that corporate officers may be held liable for breach of "the duty of oversight." *In re McDonald's Corp. S'holder Derivative Litig.*, C.A. No. 2021-0324-JTL (Del. Ch. Jan. 25, 2023). Never before had oversight claims been applied to officers rather than directors.

At issue were allegations that McDonald's chief human resources officer was answerable in fiduciary breach for having failed to properly respond to evidence of sexual harassment at the company. The court had little trouble sustaining those claims in light of allegations that the officer himself had engaged multiple times in sexual harassment of employees. More generally, the court ruled that officers, like directors, owe *Caremark* duties—the duty to implement appropriate corporate controls, and the duty to react when "red flags" indicate those controls are not working.

The ruling, while not compelled by precedent or logically inevitable, is unsurprising given previous decisions indicating that the duties of officers largely mirror the duties of directors. And the decision importantly suggests principles to limit the scope of officer-oversight claims. The court made clear that a *Caremark* claim can be based only on knowing, bad-faith breaches of the duty of loyalty, so that negligent or even grossly negligent oversight failures will not state a claim. The court also emphasized that an officer's oversight obligations will typically extend only to matters within the officer's sphere of responsibility.

Notwithstanding these limiting principles, corporate defendants should brace for a wave of officer-oversight litigation, as the plaintiffs' bar explores the boundaries of the new doctrine. *Caremark* litigation has been on the rise for several years. Last week's decision should be expected to accelerate that trend.

But as we have recently emphasized, boards have powerful tools at hand to prepare for such litigation before it happens. Those same tools—including company-calibrated risk-management protocols, innovative board committee architecture reflecting the company's risk profile, and faithful record-keeping—will continue to be the best preventive medicine at the board level. Similar bespoke solutions can and should now be addressed at the level of the officer corps, to ensure compliance with best practices and reduce litigation risk. With effective preparation, *Caremark* exposure remains entirely manageable.

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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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January 26, 2023

ESG in 2023: Looking at the Year Ahead

While 2022 saw the rise of a vocal and politically charged anti-ESG movement, the coming year could prove to be a pivotal moment in the maturation of ESG discourse, disclosures and governance. The ongoing debate as to whether the integration of ESG-related considerations into investment decision-making and corporate strategy is merely "woke capitalism" will require companies and investors to confront the significant disinformation and disagreements surrounding what ESG means and the role it serves. Ultimately, the battles waged in boardrooms, legislatures and courts may bring much needed clarity to the role of ESG issues (and the role of management and boards) in creating and protecting shareholder value, particularly as companies continue to face myriad risks, including macroeconomic headwinds, geopolitical uncertainty, emerging nature and other resource-related threats, cybersecurity dangers, and competition for talent. Meanwhile, the alphabet soup of voluntary ESG disclosure frameworks looks set to further consolidate with the International Sustainability Standards Board (ISSB) expected to release global sustainability and climate reporting standards. Regulators are also moving ahead with mandatory disclosures: the U.S. Securities and Exchange Commission (SEC) is expected to release and/or finalize rules on climate, cybersecurity, human capital and board diversity, the European Sustainability Reporting Standards are expected to be finalized mid-year, and regulators in Australia, Canada, China, Hong Kong, India, Japan, and Singapore are also considering or mandating ESG-related disclosures. With inflows to ESG-oriented investment funds and products remaining robust throughout 2022 and outpacing investments that do not address ESG considerations, pressure and interest from investors, regulators and other stakeholders look set to continue in 2023 and be reflected in shareholder engagement, the coming proxy season, earnings and investor communications, and broader market discussions.

We set forth below some key trends and considerations for this year:

1. *The Anti-ESG Movement Will Force Companies and Investors to Crystalize What is ESG and Why it Matters*

In recent years, ESG has grown to accommodate a broad swath of interests ranging from climate activists to impact investors to institutional investors and active managers. ESG's nebulous boundaries, however, have made it a target of the anti-ESG movement which has questioned whether it is merely a manifestation of ideological interests. As we have noted previously, we view ESG to encapsulate the range of risks that all corporations must carefully balance, taking into account their specific circumstances, in seeking to achieve long-term, sustainable value. Oversight and management of material ESG-related considerations that may impact a company's performance and the creation and preservation of shareholder value lie squarely within the fiduciary duties of management and the board and are consistent with the board's obligations under *Caremark*. Materiality assessments conducted by companies in connection with voluntary reporting on ESG-related factors have already provided insight into issues likely to impact corporate performance as have risk factor disclosures in public filings. Forthcoming disclosures mandated by regulators will provide further clarity, including the quantification, of the scope and magnitude of such issues. Company reporting is being further supported by insurance data, which indicates that companies are finding it increasingly difficult and costly to obtain coverage for certain risks such as cybersecurity breaches, while 2022 saw

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record insured losses for severe weather incidents. As states such as Florida, Texas, Arizona, Indiana, North Dakota, Louisiana and others move to limit the consideration of ESG factors in investment decision-making, questions will inevitably be raised as to whether the pension plan fiduciaries of such states are fulfilling their fiduciary duties, particularly when companies have determined certain ESG factors to be financially material. The same questions may also arise in connection with lawsuits that seek to prohibit asset managers and pension plan fiduciaries from considering ESG factors in their investment decisions and efforts to reverse corporate policies designed to address identified ESG-related concerns, including in response to shareholder-supported proposals. It is perhaps notable that several of the tabled or enacted anti-ESG investment legislations do not prohibit the consideration of ESG factors outright or the ability of pension plans to provide ESG-oriented investments, but rather focus on eliminating the consideration of "non-pecuniary" factors. How companies and investors choose to respond to the public and legal challenges to the consideration of ESG factors by companies and investors may prove pivotal in crystalizing its value and purpose and addressing the criticisms of the anti-ESG movement. Ultimately, whether the concept of "ESG" matters or survives this debate may be secondary to the ability of companies and investors to continue addressing the range of risks and opportunities—many of which have been conveniently grouped under the "ESG umbrella"—that confront them in today's economy.

2. *The Long-Awaited Moment of Global Disclosures is Here, But…*

This year will likely see the culmination of multi-year efforts to consolidate voluntary global ESG reporting frameworks. The International Sustainability Standards Board (ISSB) is expected to complete the consolidation of existing voluntary frameworks including the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD) into new sustainability and climate-reporting standards to be released in the first half of this year. The new standards (both drafts were released in March 2022) will include Scope 3 emissions (subject to certain safe harbor protections) and climate-related scenario analysis disclosures. Nature-related disclosures and standards drawn from the Taskforce on Nature-related Financial Disclosures (TNFD), which will be finalized in September 2023, will also be reflected in ISSB's forthcoming standards. While the ISSB frameworks are not legally binding until formally adopted by a jurisdiction, it is expected that the UK will adopt the standards and Australia and China are among the countries considering adoption. A number of large asset managers, including BlackRock, State Street and Vanguard, have also voiced general support for ISSB's proposed frameworks.

In parallel with the consolidation of voluntary global reporting, the SEC is expected to finalize its rulemaking on climate and cybersecurity disclosures and adopt new rules on human capital metrics and board diversity. These rules come after the European Union last year adopted the Corporate Sustainability Reporting Directive (CSRD), which will, among other things, require public and private non-European companies with qualifying EU subsidiaries and which meet certain net revenue thresholds to comply with the EU Sustainability Reporting Standards, which are expected to be adopted mid-year. While the disclosure requirements for non-European companies will not be required until 2028, they are currently expected to be more expansive than that proposed by the SEC, covering, among other things, Scope 3 emissions, pollution, water, resource usage and biodiversity. Importantly, the disclosure standards will also apply "double materiality," meaning that companies will need to disclose material impacts to both investors and

stakeholders—in contrast to the investor-centric materiality standard used by the SEC. Looking ahead, multinational companies will need to carefully manage such policy divergences to avoid creating confusion and potential litigation risks over its sustainability disclosures.

3. *Greenwashing and Fraud Risks Will Refocus Attention on Governance*

Last year saw several enforcement actions on misstatements and omissions made by companies and asset managers on sustainability-related disclosures. The SEC has already indicated that it plans to continue stepping up enforcement actions on greenwashing and has proposed amendments to enhance and modernize the Investment Company Act "Names Rule," which would require funds whose names suggest a focus on a particular type of investment (e.g., sustainability) to adopt a policy to invest at least 80% of the value of their assets in those investments. Regulators in the European Union have also proposed new consumer protection legislation designed to target greenwashing, requiring companies to provide evidence backing up their green claims. Activists have also begun taking matters into their own hands through public social media campaigns.

As companies prepare for more rigorous and expansive disclosures, care will need to be taken to ensure that ESG reporting, particularly disclosed metrics, are subject to a similar degree of internal oversight and controls as are applicable to financial reporting. For U.S. issuers, the new SEC rules may require a reassessment of the allocation of oversight responsibilities for ESG reporting at the board level, including whether the board committee(s) tasked with oversight on reporting have sufficient bandwidth and current knowledge of best practices and regulatory and market expectations. In the M&A context, closer attention to due diligence and post-transaction integration processes can help mitigate the spread of ESG-related risks among companies, particularly the identification of internal controls and reporting weaknesses that could create heightened risks of reputational, legal and financial losses.

4. *Emerging Resource Risks—Biodiversity and Water—Are Coming to the Fore*

As we recently noted, new nature-related risks are quickly gaining focus among investors and regulators. In particular, focus has accelerated on resource loss, particularly biodiversity loss. Investor and regulator efforts to address biodiversity loss—estimated to lead to a $2.7 trillion loss to global GDP annually by 2030—have accelerated since the COP 15 summit last year and will be reflected in new disclosure standards being finalized by the Global Reporting Initiative (GRI), TNFD, ISSB, and the Science Based Targets Network. Notably, the recently launched Nature Action 100 initiative, comprising institutional investors working in partnership with Ceres and other advocacy groups, may herald the start of a new wave of shareholder engagement echoing the approaches taken by Climate Action 100+.

Water resource management is another issue that is emerging as a consequence of ongoing focus on climate risks. Ceres, in partnership with the Netherlands government, launched the Valuing Water Initiative in August 2022 with 64 institutional investor signatories representing $9.8 trillion in assets under management. The initiative has set forth key expectations for issuers, including commitments to avoid negative impacts on water availability and water quality across the value chain and board oversight and public policy engagement aligned with sustainable water resource management. In March, the UN will host the UN Water Conference, the second such conference in 50 years. Like COP 15, the conference agenda will

seek "commitments, pledges and actions, across all our sectors, industries and interests, uniting nations, stakeholders and professionals" with a focus on "accelerated implementation and improved impact" in meeting Sustainable Development Goal 6 (Clean Water and Sanitation).

5. *Effective Cybersecurity Risk Management Will Demand More Expertise and Controls*

Cybersecurity risks will likely continue to escalate in 2023 fueled by growing geopolitical instability, remote work, innovations in artificial intelligence (AI) and machine learning, shortages in technical expertise and increasing regulatory and investor expectations, all of which has prompted many to regard cybersecurity as an ESG risk, rather than just a technology challenge. IBM's recent report on the costs of cybercrime reported a 13% surge in data breach costs from 2020 to 2022 alone. U.S. companies are bearing the brunt of the losses, with companies suffering losses on average of $9.44 million per incident, more than double the global average. A report by the National Association of Insurance Commissioners (NAIC) released late last year also highlighted significant increases in insurance premiums (direct written premiums increased 75.3% year over year) as well as growing hurdles in underwriting policies with insurers becoming increasingly cautious when examining a company's risk profile, including risks presented by third parties with whom they work and contract as well as the robustness of internal security controls and cyber-risk procedures. Just this past week, the World Economic Forum published a new report highlighting trends in cybersecurity risks in which it noted that "cyber leaders still struggle to clearly articulate the risk that cyber issues pose to their organizations in a language that their business counterparts fully understand and can act upon." The SEC's proposed cybersecurity rules set to be finalized this year will further probe into the robustness of strategies and controls designed to mitigate and respond to cyber threats as well as the role and expertise of management and the board in overseeing and managing the organization's cybersecurity risks. To that end, organizations will need to continue to evolve and improve their efforts to equip their boards with the knowledge and tools to properly oversee risks, build a security-focused culture and recruit and retain skilled cyber professionals.

6. *Human Capital Management and the Competition for Talent Will Remain a Long-Term Challenge*

While the Great Resignation appears to be petering out, the talent war does not yet appear to be over. Recent reductions in force among the largest companies belie a labor market that continues to remain relatively tight. With the Covid-19 pandemic easing into the rearview mirror, a key legacy impact will be felt in the workplace where norms have shifted dramatically and could determine how talent is won or lost. The advent of remote work has created new opportunities to access and retain talent, while also creating challenges for training and integrating new employees. Companies will also need to prepare for a new generation of employees who are entering the workforce with heightened priorities regarding corporate purpose and employee wellness and mental health. The skills companies require today are also rapidly changing, and perhaps faster than the current workforce is able to adequately accommodate: ongoing innovations in AI and machine learning will render many roles obsolete while creating new roles that may require hiring or upskilling of employees. And companies will also need to address existing DEI commitments and targets, including how to address the impacts of reductions in force on workforce demographics and targets.

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The coming year presents new challenges and opportunities in the evolution of ESG. A global reporting regime looks to finally come into place, albeit with transatlantic divergences that will need to be carefully managed. Increased regulatory efforts at addressing greenwashing may again refocus attention on governance. Meanwhile, multiplying risks will continue to increase the responsibilities of boards and management. As in previous years, ESG continues to evolve rapidly, sometimes taking unexpected turns. Perhaps the biggest surprise of 2023 may be how the anti-ESG movement's efforts to unwind the consideration of ESG factors by companies and investors ultimately end up providing much needed clarity on the purpose and value of addressing the myriad of risks and opportunities that have fallen under the broad ESG canopy.

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January 23, 2023

Caremark Exposure—And What to Do About It

2022 set another record for lawsuits faulting boards of directors for failing to adequately oversee corporate operations, a third consecutive year of acceleration. Mounting evidence suggests the trend is here to stay. But here's some good news: there is much boards and managers can do to anticipate and thereby de-risk this exposure.

Corporate litigation when things go wrong is of course nothing new. When manufactured products prove to be harmful, or services prove defective, or customers are injured, the class action bar has always responded, demanding payment for alleged tort victims. And so after a 2015 listeria outbreak linked to Blue Bell Creameries' ice cream was linked to three deaths and infections in four states, substantial tort litigation ensued, successfully seeking compensation for the victims from Blue Bell.

In 2019, however, in a case arising from the same tragic facts, the Delaware Supreme Court approved a further avenue for broad-sweeping recovery: a derivative action brought by Blue Bell stockholders seeking damages from Blue Bell's directors for inadequately supervising the company's food safety program. Although the court invoked the traditional "duty to monitor" framework—often called the *Caremark* doctrine after the 1996 decision that conceived it—it reversed the trial court's order dismissing the claim and applied that framework in a way that appeared to liberalize it.

The plaintiffs' bar certainly saw it that way. *Caremark* claims spiked immediately and have continued to mount. As important, since the Blue Bell decision, the courts have sustained these claims far more frequently. *Caremark* claims previously survived a motion to dismiss only very rarely. Now one out of three survive motions to dismiss—acquiring enormous settlement value, without regard to the ultimate merits of the claim or the difficulty of showing any damages to stockholders. As a result, any announcement of adverse corporate news or regulatory exposure should now be expected to trigger not only tort claims from victims, but *Caremark* claims by stockholders.

But effective tools are available to boards to address this risk—both before and after bad news hits the headlines. One key is to ensure the company has an appropriate enterprise risk management and compliance program that is reviewed at the board level. Equally important is to ensure the company addresses "hot button" issues like consumer privacy, cybersecurity, and product, consumer, and employee safety. To manage firm-specific risks, the board should consider bespoke committee architecture and rapid response teams to address potential crises. Likewise essential is skillful engagement with early stockholder inquiries and swift consideration of procedural considerations before litigation commences.

Perhaps most critically: maintain a faithful written record of the board's risk-management efforts, crafted to be producible in litigation. That way, when the plaintiffs come calling, the directors will have a robust record demonstrating their attention to foreseeable risks and supplying a pathway to early dismissal of the claim.

William Savitt

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January 11, 2023

Antitrust and ESG

As boards continue to evaluate how environmental, social and governance ("ESG") considerations factor into corporate operations, some lawmakers and regulators have raised potential antitrust concerns about coordinated efforts. For example, several U.S. Senators sent letters to law firms admonishing them to advise clients of increased congressional scrutiny of "institutionalized antitrust violations being committed in the name of ESG." And, a group of state attorneys general inquired whether an investor-driven initiative on climate risks called Climate Action 100+ implicates antitrust laws. FTC Chair Lina Khan opined last month in The Wall Street Journal that ESG benefits are no defense for otherwise illegal mergers.

As we have previously explained (most recently here), a board's decision to take account of ESG factors is neither a corporate charitable activity nor anticompetitive. Quite the opposite. It reflects a business judgment that taking account of ESG matters, such as long-term sustainability, can create value and reduce risk for all company stakeholders. Some regulators in the United States have recognized that ESG considerations and antitrust principles are not in conflict. For example, a recent letter signed by seventeen state AGs argues that mutual support of climate policies by investment fund managers does not violate the Sherman Act. Antitrust regulators in the United Kingdom and the European Union, moreover, have offered specific guidance on applying antitrust laws to sustainability agreements and similar multi-firm conduct. As these regulators correctly recognize, in most circumstances, antitrust principles should not be a serious impediment to incorporating ESG into decision-making that is otherwise in the corporate interest.

Other than in rare circumstances, antitrust law is generally concerned with collaborative behavior between competing firms and negative effects on consumers. Companies seeking to take action to align themselves better with customer or market preferences, reduce their carbon footprint, choose suppliers who are themselves more sustainable (and thus reliable in the long term), be responsive to investor priorities, or otherwise take account of ESG factors, all in the interest of creating long-term value, generally have wide liberty in implementing such single-firm policies.

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Collaborative conduct motivated by ESG considerations should not, and need not, generally run afoul of core antitrust prohibitions, such as price fixing, bid rigging, boycotts, or market allocation schemes that give rise to "per se" illegality under the antitrust laws—meaning that courts would deem such behavior illegal without analyzing market effects. Non-core collaborative conduct is analyzed under the so-called "rule of reason," also called the "effects balancing test" in Europe, where the proposed conduct is analyzed for its purposes and effects and is not generally illegal unless the effects on competition outweigh its procompetitive benefits. While some collaboration in connection with ESG matters could, in theory, have incidental effects on competition, for the most part, initiatives such as sharing best practices, setting voluntary standards or nonexclusive certifications, and sharing information that is not competitively sensitive, are not likely to run afoul of antitrust laws when subjected to a reasonableness standard. This is particularly the case where there is no coercion (*e.g.*, enforcement of standards by members) or exclusion (where some firms may be excluded from an initiative or qualification), especially in the absence of market power.

Antitrust enforcers are correct that there is no antitrust exemption for activities related to ESG matters; however, this is far from tantamount to saying that any multi-firm matter wholly or partly informed by ESG goals are violations, and there does not appear to be any Biden Administration agenda specifically targeting these activities for enforcement. Companies should not be deterred from incorporating ESG considerations within the long-term value framework we have long counseled, and pursuing the resulting business agendas in sensible ways. In doing so, however, given the heightened politicization and scrutiny of ESG generally and currently aggressive antitrust regimes in the United States and abroad, companies should continue to account for relevant antitrust and other regulatory frameworks when considering ESG matters, especially for any contemplated multi-firm collaborations, and to seek appropriate advice.

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December 16, 2022

Nature as an Asset: The Coming Wave of "Natural Capital" and Biodiversity Shareholder Activism and Stewardship Pressure on Boards of Directors

As anticipated in our February 2021 memo, the terms "natural capital," "biodiversity," "nature loss," "ecosystem restoration" and the like have increasingly entered the investor and corporate lexicon. This has accelerated since the publication of The Economics of Biodiversity: The Dasgupta Review, the groundbreaking independent study commissioned by the U.K. Treasury which presented "Nature as an Asset" and was produced by Professor Sir Partha Dasgupta, Frank Ramsey Professor Emeritus of Economics at the University of Cambridge.

With natural capital depletion and biodiversity loss estimated to result in a decline in global GDP of $2.7 trillion annually by 2030, institutional investors are increasingly defining and grappling with these issues, forming organized coalitions, and deciding to press public companies for action, enhanced board oversight and new disclosures. These efforts have accelerated in recent weeks in the lead up to the COP15 summit and will be amplified by related reporting frameworks being finalized by the Global Reporting Initiative, the Taskforce on Nature-related Financial Disclosures, the International Sustainability Standards Board, and the Science Based Targets Network. How and whether to be "nature-positive" is also being explored by major corporations, investors and influential stakeholder groups.

For example, earlier this week, a coalition of institutional investors launched Nature Action 100, led by AXA Investment Managers, Columbia Threadneedle Investments, BNP Paribas Asset Management, Domini Impact Investments, Federated Hermes, and Christian Brothers Investment Services, among others, partnering with Ceres, the Institutional Investors Group on Climate Change and Finance for Biodiversity. This initiative will develop a target list of 100 focus companies, engage board members and executives at companies in sectors deemed important to reversing nature loss, and identify corporate actions to protect and restore nature. It parallels Climate Action 100+, an existing investor-led initiative that has driven significant investor engagement, activism and monitoring of corporate greenhouse gas emissions.

Nature Action 100's launch follows last week's Governance and Stewardship of Biodiversity Responsibilities Statement issued by the International Corporate Governance Network (ICGN), an investor-led corporate governance and stewardship coalition linked to $70 trillion in assets under management. The ICGN statement calls on investors and companies to:

- publicly commit to adopting science-based business targets (including credible interim targets) that contribute to stabilizing biodiversity loss by 2030 and to restoring ecosystems by 2050;

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- give "prime consideration" to ensuring that boards of directors have access to requisite expertise and are "held to account" for progress and impacts;
- begin the process of understanding biodiversity and natural capital dependencies and impacts, using the tools deployed by leading companies;
- ensure "robust" governance procedures and board competence for overseeing how management identifies, monitors, measures and manages biodiversity dependencies, impacts, risks and the opportunities that are aligned with a company's purpose and long-term strategy; and
- align CEO and senior executive pay and incentives with a company's purpose, strategy and workforce, while respecting global best practices.

An Accelerating Investor and Stakeholder Priority

The above initiatives come at the end of a year that saw the largest institutional investors express fresh concerns about natural capital stewardship and establish material nature-related risks and opportunities as a stewardship and engagement priority. In March, State Street Global Advisors (SSgA) identified land use, biodiversity, natural resources and the circular economy as focus areas and committed to providing portfolio companies guidance on these topics and conducting targeted engagements. Then in July, SSgA issued a letter to boards noting that "global deforestation—namely its direct linkage to biodiversity loss and climate change—presents financial risk to our portfolio companies" and called on boards and management to assess deforestation and land degradation risk in their value chains and loan portfolios and to enhance public disclosures. Similarly, BlackRock in February and April discussed how its role as a fiduciary to clients has sharpened its focus on natural capital as a stewardship priority and an investment theme. Where material issues are present, BlackRock will engage with portfolio companies on nature-related topics to understand board and management roles and monitor how business models, disclosures and practices are consistent with the sustainable use and management of natural resources such as air, water, land, minerals and forests, intersect with the broader health and wealth of the world's nature-related resources and habitats, implicate biodiversity volume and variety across animal, plant and microorganism species and affect ecosystem health. T. Rowe Price also incorporates material biodiversity and nature issues in its holistic investment assessments.

Reflecting the growing awareness and pressure on these issues, shareholders brought the highest number of Rule 14a-8 shareholder proposals relating to deforestation, recycling, pesticide use and pollution in recent years, with proposals relating to sustainable packaging and eliminating deforestation and primary forest degradation in consumer goods supply chains receiving record and even majority shareholder support in several instances. Companies that defeated such proposals did so on the basis of their strong practices and disclosures. In addition, some companies have begun engaging in

structured negotiations with proponents on these issues, and other companies have embraced commitments to the long-term health of the natural ecosystems that are essential to people, biodiversity and their businesses.

With investors expressing concern that natural capital depletion and biodiversity loss have accelerated due to coinciding factors, such as land and sea use change, climate change, overuse of natural resources, and pollution, other initiatives have been launched. In August, Ceres, in partnership with a coalition of 64 investors with $9.8 trillion under management, launched the Valuing Water Finance Initiative, which seeks to engage companies with large water footprints to value and act on water as a financial risk and take action to protect water systems. Specifically, Ceres released six water protection expectations for investors to use with portfolio companies, initially requesting that large companies commit that they will, by 2030: not negatively impact water availability in water-scarce areas or water quality; not contribute to the degradation of natural ecosystems critical to freshwater supplies; actively work to restore degraded habitats; contribute to achieving universal and equitable access to water, sanitation and hygiene (WASH) across their value chain; deploy their boards and senior management to oversee water management; and ensure that all of their public policy engagement and lobbying align with sustainable water resource management outcomes.

New Focal Points for Governance, Disclosure and Reporting

New biodiversity disclosure frameworks will launch next year and, if followed, will increase public scrutiny on how companies identify and manage biodiversity risks and their impact on value chains. These frameworks all reach how the board of directors provides oversight, including through committees, and engages with management on nature-related risks and opportunities where material to the company, as well as the role of management in assessing and addressing such risks.

For example, earlier this month, the Global Reporting Initiative (GRI), the most commonly used sustainability reporting framework globally, released its exposure draft on new biodiversity standards. The GRI draft seeks new or increased disclosures on supply chain and location-specific impacts on biodiversity, management responses, the direct drivers of biodiversity loss and the impact of company operations and supply chains on ecosystems and local communities.

Just last month, the Taskforce on Nature-related Financial Disclosures (TNFD), an initiative led by senior executives, financial institutions, corporates and market service providers, including AXA, BlackRock, Bank of America, BNP Paribas and Norges Bank, representing over $20 trillion in assets under management, released an updated draft of the TNFD reporting framework, which is to be finalized in 2023. The TNFD framework will likely recommend that companies disclose their governance (across management structures and board oversight), strategy and nature-related dependencies, impacts, risks, and opportunities, including by having—and disclosing—metrics and targets. While the

TNFD draft draws upon and adapts several of the recommendations of the Task Force on Climate-related Disclosures, it also includes additional disclosures for alignment between nature and climate policies and targets, and evidence of stakeholder engagement. TNFD's first pilot program reaches 23 publicly traded member companies representing $1.3 trillion in market value and covers three systems: energy, land use (including food, agriculture and forestry) and the built environment, which are the value chains said to account for about 90% of the pressure on biodiversity. And just this week, the International Sustainability Standards Board (ISSB) announced it will incorporate natural ecosystems into its formal definition of sustainability and address their relationship to financial value creation. With biodiversity being viewed as intertwined with climate change imperatives, ISSB also announced it would consider the TNFD's work on the intersection of climate and biodiversity disclosures in scoping ISSB's own research on complementing climate-related disclosure with nature-related disclosures.

In addition, the Science Based Targets Network (SBTN), an initiative whose partners include Ceres, the World Economic Forum and CDP, is finalizing nature-related corporate guidance and targets for an early 2023 release. SBTN will provide companies with guidance on assessing, identifying, measuring, disclosing and setting targets covering nature and biodiversity impacts material to their business. SBTN seeks to mirror the Science Based Targets initiative (SBTi), but for nature and ecosystem risks.

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Biodiversity loss and adverse impacts to nature are being viewed by investors as having wide-reaching impacts on the economy and the environment, directly and indirectly touching companies across sectors, with impacts most acutely felt by enterprises with significant reliance on nature-based resources in their primary businesses or with high dependence on natural capital in their operations and supply chains. In particular, companies with global supply chains, whose weaknesses were exposed during the Covid-19 pandemic and which are being rebuilt to adapt to the evolving geopolitical landscape, may come under further pressure to reduce ecological footprints and prepare for the potential loss of, or disruption to, traditional supply sources.

Looking ahead to 2023 and beyond, companies are well-advised to understand, assess, disclose, and actively manage their material nature-related risks and opportunities and decide on the appropriate role of the board of directors. Doing so will also help companies keep up with peers, engage more effectively with investors and stakeholders on relevant nature-related business topics and respond to evolving investor pressure and expectations, even as the legal, regulatory and public policy environment evolves.

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September 16, 2022

ESG, Stakeholder Governance, and the Duty of the Corporation

Recently, there has been much confusion and misinformation about (1) environmental, social, and governance (ESG) considerations, (2) the ways in which companies, boards, asset managers, investment funds, and other market participants can, do, and should factor such considerations into their decision-making processes, and (3) the need for companies to consider, balance, advance, and appropriately protect stakeholder interests in order to create value, generate sustainable returns, and guard against downside risks to value and corporate health. This cloud of confusion stems, in part, from nascent efforts to politicize ESG. Consider the Trump administration's proposed rulemaking in the Department of Labor that would have required fiduciaries of retirement plans making investment decisions to focus solely on "pecuniary" factors (and, in turn, would have burdened the ability of fiduciaries to appropriately take ESG factors into account in selecting investments and engaging in risk-return analyses). And consider the letter sent to BlackRock last month by 19 Republican attorneys general, accusing the asset manager of prioritizing its "climate agenda" over the interests of pensioners' investments. These developments unfortunately fail to appreciate that ESG, properly understood, is merely a collection of quite disparate risks that corporations face, from climate change to human capital to diversity to relations among the board, management, shareholders, and other stakeholders. We write to resituate the role of ESG and stakeholder governance within the well-established legal framework of corporate fiduciary duties.

Dating back to the 1932 law review exchange between Merrick Dodd and Adolf Berle, there has been a long-running debate over whether the purpose of the corporation is to maximize short-term profits for shareholders or, instead, to operate in the interest of all of its various stakeholders to promote the long-term value of the corporation. For several decades, the predominant view among corporate leaders, practitioners, academics, investors, and asset managers was that the role of the corporation was solely to maximize profits for shareholders. This theory, which came to be known as shareholder primacy, is epitomized by Milton Friedman's seminal 1970 essay, The Social Responsibility Of Business Is to Increase Its Profits, in which he argued that every corporation should seek solely to "increase its profits within the rules of the game." Friedman's shareholder-centric view of corporate purpose posited that a corporation that "takes seriously its responsibilities for providing employment, eliminating discrimination, avoiding pollution and whatever else may be the catchwords of the contemporary crop of reformers" would undermine "the basis of a free society."

We long have advocated for a broader view of corporate purpose than that espoused by Friedman — initially, as we wrote in 1979 in Takeover Bids in the Target's Boardroom, to empower boards to take into account the interests of all stakeholders, including the communities in which corporations operate, in repudiating takeover bids by opportunistic raiders; and later, to ensure that directors are encouraged to resist short-termist pressures and can exercise their business judgment to consider the variety of stakeholder interests essential to promoting sustainable success and growth in long-term corporate value. The 2008 financial crisis laid bare the dangers of the Friedman doctrine and marked the decline of shareholder primacy, exposing the reality that an exclusive focus on short-term maximization of shareholder value came at the expense of sustainable growth and innovation. Business leaders, policymakers, and investors have since increasingly

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advocated for a broader view of corporate purpose, one that promotes the long-term value of the corporation.

The growing acceptance of stakeholder corporate governance is captured by, among other developments, the World Economic Forum's publication of The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth; the Davos Manifesto 2020 (see our prior memo here); and the Business Roundtable's 2019 rejection of the shareholder-centric view to which it had held firm over the prior two decades (see our prior memo here). Stakeholder corporate governance's acceptance is also seen in the many actions and investments by corporations intended to benefit stakeholders, including investors and non-investor constituencies, and to reduce negative externalities.

The term "ESG" was popularized in the early 2000s following the publication of the UN Global Compact's report, Who Cares Wins. Today, the concept of ESG is multifaceted: companies and boards take into account ESG and stakeholder considerations when developing and delivering products and services, making business decisions, managing risk, developing long-term strategy, recruiting and retaining talent and investing in the workforce, implementing compliance programs, and crafting public disclosures. Many major asset managers, including BlackRock, State Street, and Vanguard as well as actively managed funds, consider ESG issues in formulating investment strategies, serving their clients, and exercising their fiduciary responsibilities. This encompasses investors being able to exercise their professional judgment in considering ESG-related information when evaluating the risk *and* return profile of portfolio holdings. Certain ESG investment funds may also invest exclusively in companies that satisfy predetermined ESG standards. And regulators and enforcement authorities develop principles to promote consistency and reliability across ESG disclosures, and scrutinize such disclosures in companies' public filings.

The phenomenon of ESG is prevalent not only in the United States but around the world, as companies, policymakers, global leaders, academics, and investors debate how best to promote sustainability over the long term. ESG, properly understood, is not a unitary principle or even a collection of a fixed set of particular principles. Rather, ESG encapsulates the range of risks that all corporations must carefully balance, taking into account their specific circumstances, in seeking to achieve long-term, sustainable value. It is thus no surprise that asset managers and asset owners, too, are expecting well-run companies to incorporate ESG matters into their business decisions appropriately. Although the ESG moniker is relatively recent, corporate boards and management have long considered ESG factors and risks in setting and executing strategy. As Jeffrey Sonnenfeld recently pointed out, doing so is associated with superior financial results, and consistent with long-accepted norms as to the place of business in society.

To be sure, not all market participants embrace ESG principles. Recently, an anti-ESG movement has emerged, one opposed to consideration of ESG factors in investment decision-making in favor of a Friedmanist exclusive focus on shareholder primacy. This false dichotomy between ESG and shareholder value mirrors the confusion sewn by critics of stakeholder governance who pit shareholders against other stakeholders through the misleading allure of an existential conflict that requires directors to choose between value for one versus the other. But as we have previously explained here and here, the law of corporate fiduciary duties nowhere demands

that choice — and opponents of stakeholder governance know it, as do critics of ESG. The purpose of a corporation is to conduct a lawful, ethical, profitable, and sustainable business in order to ensure the success and grow the value of the corporation over the long term. This requires consideration of all of the stakeholders critical to the success of the business (shareholders, employees, customers, suppliers, and communities), as determined by directors based on their business judgment and informed by regular engagement with shareholders. Such consideration includes ensuring that a company avoids ESG blindspots.

The first principle of corporate law is that a corporation must conduct lawful business by lawful means. To honor this axiom, the *Caremark* doctrine requires that companies have in place information and reporting systems reasonably designed to provide timely, accurate information to allow management and the board to reach informed judgments about the corporation's compliance with law and its business performance. The stakeholder governance model aligns closely with *Caremark* — for example, environmental risks have long been a core focus of compliance programs, and to the extent a company adequately addresses these risks through comprehensive compliance programs and operational adjustments, it will be well-positioned to meet the demands of the environmental component of ESG. As we recently wrote, it is important for companies to have high-quality risk management policies and processes, and for boards to oversee the monitoring and management of risk, to protect the long-term value of the company, and to fulfill *Caremark* duties. Risk management policies and oversight must reach ESG and sustainability-related risks that can damage and disrupt a company's strategies, business positioning, operations, and relations with stakeholders, including over the long term.

A holistic, stakeholder view of corporate purpose does not exalt ESG as the sole or weightiest consideration — to the contrary, it recognizes that the various elements of ESG are among numerous considerations that are essential to a company's sustainability and that must be carefully balanced by the board and management, in consultation with shareholders, to ensure the long-term health and prosperity of the business. One example, highlighted by BlackRock in its written response to the attorneys general, is the long-term risk to companies posed by climate change and the economic opportunities from the energy transition. By engaging with shareholders and thought leaders on these complex topics, management teams and boards can arm themselves with the knowledge necessary to understand the relevant risks and to develop strategies to support sustainable growth.

The unfortunate confusion that has entered the contemporary debate regarding ESG misunderstands the fundamental purpose of the corporation. We continue to believe it is essential that boards operate under a governance model that permits consideration of ESG principles and sustainable investment strategies, with the support of investors and asset managers, to promote long-term corporate value and to fortify the enterprise against relevant risks. There should be no doubt that the law in Delaware and in every other U.S. jurisdiction empowers boards to follow this course for responsible corporate stewardship and corporate success.

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April 4, 2022

The SEC's Proposed Climate-Related Disclosure Rules: Thoughts for Audit Committees

The SEC's proposed amendments to Regulations S-K and S-X to require new climate-related disclosures will, if adopted, require an expansion in the scope and responsibilities of audit committees. As described in our prior memo, the rules contemplate domestic and foreign issuers disclosing, in registration statements, annual reports and audited financial statements, information on board and management climate-related risk oversight and governance, material climate-related risks and opportunities over the short-, medium- and long-term, Scopes 1 and 2 greenhouse gas (GHG) emissions, impact of climate-related events on line items of audited financial statements, and climate-related targets, goals and transition plans (if any). Accelerated and large accelerated issuers will also be required to provide third-party attestation on their Scopes 1 and 2, and in certain cases Scope 3, emissions over time.

While the SEC's proposed rules are drawn from the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) and the Greenhouse Gas Protocol, elements of the proposed rules are more prescriptive and expansive in nature and will require expanded oversight by audit committees. In particular, the requirement for climate-related line items in audited financial statements will come within the scope of a registrant's internal control over financial reporting (ICFR). Climate-related disclosures within registration statements, including information filed in annual reports and incorporated by reference, will also be subject to liability provisions under the Securities Act of 1933 and will not be afforded protections under the forward-looking safe harbors pursuant to the Private Securities Litigation Reform Act. Additionally, all public climate-related disclosures are subject to the liability provisions of Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934. The fact that climate disclosures will need to be prepared within the 10-K filing window may also warrant additional forward-planning, including drawing upon and enhancing existing internal processes used for financial and ESG-related reporting.

Governance and Oversight

For companies that have not already engaged in climate-related reporting or otherwise allocated climate oversight and governance responsibilities within the board and management, the board will need to consider whether the entire board, the audit committee, a risk committee or a stand-alone committee should be tasked with oversight of climate-related risks and disclosures, and related internal controls and procedures. The proposed rules require disclosure of whether the board or a committee will oversee climate-related risks, the processes and frequency which the board or the responsible board committee discusses climate-related risks, and how the board or a committee considers climate-related risk as part of its business strategy and risk management financial oversight, among other governance disclosures. While oversight responsibilities can be allocated to a different board committee, or divided among committees, the audit committee's established financial reporting and compliance responsibilities and expertise will drive at least some portion of disclosure oversight to the audit committee. This is particularly true as it relates to climate-related line item disclosures in financial reporting and oversight of internal controls and processes used to compile climate-related data. Where some or all of the climate-related reporting responsibility will be allocated to a different committee, such

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as a risk committee, special attention should be placed on updating existing responsibilities to ensure that no gaps exist and that such other committee is also addressing the processes and procedures that will be required by the rules. Boards may also need to identify core skills and competencies needed to meet the heightened oversight expectations mandated by the proposed rules as well as the requirement to disclose whether "any member of a registrant's board of directors has expertise in climate-related risks" including "sufficient detail to fully describe the nature of the expertise." Coordination between the board and management may also need to be reviewed to ensure the board is receiving timely information on material climate-related issues affecting the company and that management, in turn, is implementing processes to monitor, identify and assess climate-related risks.

Disclosure Controls and Procedures

The proposed rules will also require companies to review their internal controls and procedures on climate-related disclosures. Under the proposed rules, companies will need to disclose: risks and opportunities (including the impact on corporate strategy, the business model and outlook), Scopes 1 and 2 emissions for all issuers, Scope 3 emissions (if material or if the issuer has set Scope 3 targets, with smaller reporting companies exempted), internal carbon pricing (if used), and transition plans and scenario analysis (to the extent used by the issuer). In addition, the proposed rules will also require a financial statement note concerning the impact of severe weather events, other natural conditions and transition activities on financial statement line items, and financial estimates and assumptions impacted by such climate-related events and transition activities. Importantly, the proposed rules contemplate climate-related line items disclosed in a registrant's financial statements to come within the scope of ICFR and the SEC continues to consider whether GHG emissions disclosures should be subject to a similar degree of heightened scrutiny. Accordingly, the board and its audit committee will need to engage in discussions with management and the company's independent auditors on what changes will need to be implemented to ensure ICFR effectiveness if the SEC's proposed rules are implemented.

Third-Party Assurance

Beginning in 2024 and 2025, respectively, accelerated and large accelerated filers will be required to have an independent third party verify the required Scope 1 and 2 emissions disclosures. Initially, this verification will require "limited assurance" (a form of negative assurance which does not include an assessment of the sufficiency of internal controls), later increasing to affirmative "reasonable assurance." The attestation service provider will need to meet minimum qualifications and independence requirements, and the accompanying attestation report will similarly need to meet minimum standards. As proposed, the rules do not require the assurance provider to be a traditional auditor. Audit committees should consider which firms are capable and best suited to engage in the assurance process, with an eye towards any processes such firms will require for both levels of assurance.

Scenario Analyses, Transition Plans and Internal Carbon Prices

The new rules will require companies to disclose scenario analysis and carbon pricing, if used, as well as any transition plans. The release defines scenario analysis as tools "used to consider how … climate-related risks may impact a registrant's operations, business strategy, and consolidated financial statements over time" or "to test the resilience of their strategies under

future climate scenarios, including scenarios that assume different temperature increases." If adopted as proposed, companies may need to examine their planning process to confirm whether disclosure is required, as the SEC's commentary on this new disclosure notes, rather expansively, that disclosure must disclose "if a registrant uses scenario analysis *or any analytical tools* to assess the impact of climate-related risks." (emphasis added). Internal audit functions should remain cognizant of different planning exercises outside of the established financial process, for instance, where individual business units may engage in climate analysis.

Companies that have adopted a transition plan (broadly defined to include strategies and implementation plans to reduce climate-related risks) will also be required to disclose such plans in public filings. This will include transition risks such as laws, regulations or policies restricting GHG emissions, conservation laws, regulations and policies, the imposition of a carbon price and changing demands or preferences of consumers, investors, employees, and businesses. Companies have the option to, but are not required to, disclose climate-related business opportunities. In addition, disclosures regarding transition plans will need to describe actions taken during the year to achieve the plan's targets or goals. As with scenario analysis, internal processes may need to be re-evaluated to ensure that relevant planning exercises are adequately disclosed.

The proposed disclosure requirements regarding carbon prices and transition planning may also warrant close attention. Companies that use an internal carbon price would be required to disclose the price per metric ton of carbon dioxide equivalent, the total price and an estimate of how it will change over time, and the scope of measurement of carbon dioxide equivalent (if different from the scope used for emission disclosures).

* * * *

The details of these proposed rules, and their intersection with existing auditing and reporting functions, require significant attention and care. As climate-related disclosure moves from a theoretical exercise, or, more recently, investor-driven voluntary disclosures, to exacting regulatory requirements, boards and their audit committees will need to consider how their existing roles should evolve in this new, carbon-conscious landscape. While the proposed rules would not be effective until fiscal year 2023 at the earliest, audit committees may wish to take the opportunity now to begin discussions with the company's legal and internal control functions, along with external auditors, on climate-related disclosures.

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International
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Practical cross-border insights into ESG law

Environmental, Social & Governance Law 2023

Third Edition

Contributing Editors:

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Seeing Around Borders: Is Geopolitics the Next Big ESG Risk?

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Introduction

With the world emerging from years of pandemic lockdowns, the start of 2022 saw the dramatic emergence of a new systemic risk that had long been simmering under the surface: geopolitics. Russia's invasion of Ukraine in February exposed Europe's energy insecurities and sent shockwaves through the global energy and food markets. More recently, alarm bells have sounded over the future of Taiwan as tensions between China and the United States escalate to levels not seen in decades. In the Middle East, efforts to revive the Iran nuclear deal remain stalled, further complicated by the ongoing global energy crisis.

Elsewhere, the neoliberal order of the past half century appears to be inexorably threatened by tightening borders and tariffs, fanned by increasing discontent over economic and social inequities. The growing macroeconomic headwinds facing the global economy may further sow domestic discord that could leave a lasting impact on geopolitics. Meanwhile, the rising costs of climate change have begun to raise questions – and expose growing tensions between the global north and south – over who should bear these costs and who has access to natural resources.

Against this backdrop, regulator and investor focus on ESG has continued apace. On the regulatory front, the U.S. Securities and Exchange Commission (SEC) released several proposed new rules aimed at promoting consistent, comparable and reliable information for investors concerning environmental, social and governance (ESG) factors. In March 2022, the SEC proposed amendments to Regulations S-K and S-X to require new climate-related risk disclosures in registration statements, annual reports and audited financial statements of domestic and foreign issuers. The proposed rules will require disclosures regarding board and management oversight and governance of climate-related risks and how physical and transition risks are likely to manifest over the short, medium and long term. In May, the SEC proposed additional rules requiring investment funds to provide specific disclosures regarding their ESG investment strategies in fund prospectuses, annual reports and adviser brochures.

In Europe, the forthcoming Corporate Sustainability Reporting Directive will continue to expand the scope and depth of ESG-related disclosures, including disclosures of risks that may affect both the company and its stakeholders as well as mitigation efforts. The United Kingdom's Financial Conduct Authority has also mandated disclosures aligned with the recommendations of the Task Force on Climate-Related Financial Disclosures, which addresses board and management oversight and management of climate-related risks. The stakes for companies also continue to increase among investors: the 2022 proxy season saw record numbers of ESG-related shareholder proposals; and, while there are growing voices questioning whether ESG protects corporate value, the world's largest investors have continued to support and encourage efforts to pursue a low-carbon transition.

Looking ahead, shifting geopolitical sands could well disrupt companies' plans and strategies for decarbonising their value chain, while also creating new enterprise risks. To date, boards and management have borne the burden of mounting investor and regulatory expectations regarding the oversight and management of ESG risks. The impact of geopolitics on business will likely join this growing agenda.

This chapter is divided into two parts: the first highlights some of emerging risks arising from today's geopolitical trends that could impact companies across all industries; while the second sets forth approaches and strategies that boards and management can adopt to ensure timely identification, oversight and mitigation of geopolitical threats to business.

Emerging Risks to Business

New barriers and rules, domestic and global, will be erected

While the decades following the fall of the Berlin Wall saw the gradual elimination of trade borders, the coming decades could see new iron curtains fall across the globe as cooperation gives way to protectionism fuelled by geopolitical rivalry. The most dramatic curtain to drop thus far has been in the form of Western sanctions levelled against Russia following its invasion of Ukraine, which have all but cut off financial activity between Russia and the West.

What was perhaps even more notable was the ferocious pace at which Western companies, under pressure from their constituencies at home, withdrew their business activity from Russia: for many, the reputational and regulatory risk was enough to trigger a withdrawal from Russia before sanctions kicked in. The implications of the Western sanctions against Russia are extensive, as it is a major global exporter of gas, potash and minerals such as palladium, platinum and nickel, as well as wheat and fertiliser. Russia also holds significant sway in global energy transition efforts and in food security, the full consequences of which could be long-term and far-reaching.

The ongoing sanctions against Russia form part of a re-emergence of great-power rivalries that threaten to create a far more volatile and uncertain political and regulatory environment for businesses globally. The U.S.–China trade war is no longer merely a question of economic policy, but rather of competing values and political systems – President Biden has gone so far as to describe it as "a battle between the utility of democracies in the twenty-first century and autocracies".

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Last year, the Biden Administration signed into law the Uyghur Forced Labor Prevention Act and has urged other Western allies, including the European Union, to pass similar legislation. Such a move illustrates the entanglement between ESG issues and geopolitics: while the Act seeks to address longstanding human rights abuses embedded in global supply chains, it is politically charged and has also created new supply chain uncertainties and compliance challenges for businesses. The Act also underscores a growing appetite among some global players to override financial expediency in favour of advancing political and social agendas through policies that directly impact businesses.

The COVID-19 pandemic also served as a stark reminder of how quickly walls can be erected. According to a World Bank study, between late January and mid-May 2020, 86 countries, including Brazil, India, Japan, Norway, Pakistan, Russia, South Africa, the United States and others, imposed export bans and restrictions of medical supplies to meet rising domestic needs. A further 27 countries, including Belarus, Egypt, El Salvador, Indonesia, Jordan, Kazakhstan, Romania, Russia, Serbia, South Africa and Turkey, imposed export controls on food. Since the start of Russia's invasion of Ukraine, 34 countries have imposed restrictive export measures on food and fertilisers.

The new barriers that have been erected in recent years are unlikely to dissipate as geopolitical tensions among the global powers continue to divide countries into opposing camps. New spheres of influence grounded in multilateral organisations and initiatives such as China's Belt and Road Initiative and the Shanghai Cooperation Organization are creating new economic and political alliances that could shape future access to markets and business norms. Moreover, as populism continues to gain traction among democracies, policy outcomes could become more extreme. All this uncertainty, in effect, will impose new and unpredictable costs on businesses.

Past assessments of risks and opportunities of doing business in different markets will need to be reassessed, and some long-term expansion strategies may need to be altered, paused or abandoned. Businesses will need to weigh the risks of being caught in the crossfire of geopolitical tensions against the *de facto* reputational, legal and financial taxes associated with operating in countries with weak rule of law, human rights abuses and autocratic governments. The sheer number of Western companies that have exited or suspended operations in Russia underscores the fact that safety cannot necessarily be found in numbers – companies will need to have their own entry and exit strategies, and be prepared to take prompt action and incur losses.

Energy transition pathways may become more precarious

A key near-term impact of geopolitics will be on energy transition plans. While the war in Ukraine has redoubled the urgency to reduce dependency on fossil fuels, the Catch-22 is that the green transition will likely depend on resources from the same handful of countries with which the West is increasingly cautious of doing business. At the heart of many greenhouse gas emission reduction plans and net-zero targets is reliance on renewable technology that is dependent on key critical minerals such as copper, lithium, nickel, cobalt and rare earth elements. According to the International Energy Agency (IEA), today's supply and investment plans for many critical minerals fall well short of what is needed to support an accelerated deployment of solar panels, wind turbines and electric vehicles.

It is estimated that over the next two decades, clean technologies will account for over 40% of global demand for copper and rare earth elements, 60–70% for nickel and cobalt and approximately 90% for lithium. Aggregate demand for such minerals is also expected to increase dramatically: the IEA estimates that cobalt demand could be six to 30 times higher than today's levels depending on assumptions about the evolution of battery chemistry and climate policies, while rare earth elements may see three to seven times higher demand in 2040 than today, depending on the choice of wind turbines and the strength of policy support. Such increases in demand could be heightened by the pace of energy transition. Current estimates are based on efforts to meet the Paris Agreement's goal of limiting global warming to two degrees Celsius, and an accelerated pathway could further exacerbate demand.

The rapidly rising demand for raw minerals to supply the global energy transition will inevitably clash with geopolitical interests: the production of key minerals is currently more concentrated than that of oil or natural gas. The world's top three producers of lithium, cobalt and rare earth elements account for more than three-quarters of global output, and concentrations for other in-demand minerals are higher still. It is estimated that the Democratic Republic of the Congo (DRC) and China are responsible for some 70% and 60%, respectively, of global production of cobalt and rare earth elements, while Australia accounts for over 50% of global production of lithium.

China also currently maintains market dominance in the processing operations for such minerals: China's share of refining is around 35% for nickel, 50–70% for lithium and cobalt, and nearly 90% for rare earth elements. Chinese companies have also made substantial investment in overseas assets in Australia, Chile, the DRC and Indonesia. Further complicating supply availability are long ramp-up times, which can be over 16 years from first discovery to production; and uncertainty regarding declining resource quality and the environmental and social impacts of resource extraction, particularly risks relating to water availability, adverse impacts on local communities and human rights and labour violations.

The global energy transition, in short, is riddled with potential uncertainties and risks. The foundations of this transition are particularly fragile because a small handful of countries hold the keys to averting a global climate crisis and demand is likely to far outstrip supply in the near to medium term. Companies will need to prepare their carbon transition plans to be able to adapt to risks such as a breakdown in global trade triggered by geopolitical rivalry, protectionist policies and increased regulations around supply and access to in-demand resources – all of which could significantly impact the cost and timing of transition pathways. Identifying key vulnerabilities, taking time to shore up supply chains, diversifying risk where possible and enhancing circular product design and recycling are among the steps companies can take to plan for the challenges ahead.

Indeed, as pressure for companies to roll out net-zero targets continues to mount, disclosure and transparency will also become critical for companies looking to manage the reputational and legal fallout from unexpected changes and delays to transition efforts. Investors and stakeholders will need to be educated about the particular uncertainties and complexities facing the business so that they can develop nuanced and reasonable expectations of management and the board.

Key technologies may be hoarded, not shared

In an increasingly polarised world, technological competition will increasingly become a matter of national security and a source of geopolitical rivalry. Areas such as artificial intelligence (AI), blockchain technology, semiconductors and 5G capabilities are already on the frontline of geopolitical competition. Technological

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dominance in these areas has become critical because of the tremendous economic opportunities they present and because such technologies are of dual use, i.e., they have both civilian and military capabilities. The clean tech sector, which is closely tied to technologies such as semiconductors, the Internet of Things and quantum sensors, is poised to join this new space race.

The potential national security threat of technological superiority has already been laid bare: China has used Huawei, a leading supplier of 5G technology, as a means to collect sensitive national security, foreign policy and intellectual property information around the world. In recent years, Huawei was caught spying on the African Union, convicted of stealing software codes from U.S. companies, indicted by the U.S. Department of Justice for the theft of U.S. company trade secrets, and assessed to be capable of gathering user data from mobile phones at scale using its equipment deployed in the Netherlands and Belgium. As modern warfare shifts from land and sea into the cyberspace, global military leadership and technological superiority increasingly go hand in hand. As such, even among allies, there may be increased sensitivity toward the sale or transfer of highly sensitive technologies.

There is already evidence that policymakers are adopting a cautious and protectionist approach to key technologies. Such anxiety is clear in the semiconductor and 5G industries, where there have been calls for the United States to accelerate domestic technologies to reduce its reliance on technologies and equipment imported from China and Taiwan. A report released by the RAND Corporation this year noted that the "competitive landscape in U.S. telecommunications has traditionally been viewed through the lenses of economics and technology, but security issues have become a third major concern".

Of particular concern is the fact that currently more than 80% of microchips produced come from Asia, and a growing number are made in China. Current projections are that by 2030, the United States will make less than 10% of the world's microchips, while China and Taiwan together will make more than 40% of them.

The RAND report noted that competition over 5G technology is intertwined with cybersecurity and the integrity of next-generation cellular networks. It called on the U.S. government to: take protectionist measures, including continuing to sanction Huawei, sponsoring research on 5G and other advanced wireless communication technologies, advanced semiconductor fabrication methods and tools; examine Chinese 5G patents; and protect U.S. technology through patents.

In the clean tech space, the possibility for geopolitical rivalry is heating up. In recent years, China has established itself as a leader in clean tech up and down the value chain: China accounts for a majority of newly installed wind power infrastructure, with seven of the world's 10 largest wind turbine manufacturers being Chinese state-backed enterprises. China also dominates global production of photovoltaic cells, including over 95% of the production of solar-related silicon wafers and 79% of PV cell manufacturing.

Such manufacturing dominance is coupled with parallel dominance of supply chains and raw materials as well as robust investment in research and development (R&D): according to a study by the United Nations Environment Programme, between 2010 and 2020 China outspent the United States in R&D by a margin of two to one. While China has leveraged its clean tech expertise and leadership to expand its sphere of influence into developing economies, it remains to be seen how clean tech will be accessed by and shared with the West. Given how the 5G rivalry has thus far played out, it is unclear what range of permissible clean tech could be freely traded, or whether such technologies could instead be weaponised for political purposes.

For businesses, the intersection of innovation and geopolitics presents both risks and opportunities. In recent months, former Google CEO Eric Schmidt has joined forces with Peter Thiel, a co-founder of PayPal, and a slew of former government officials, including Ashton B. Carter, former Secretary of Defense, and H.R. McMaster, former National Security Advisor, to create America's Frontier Fund, a venture fund dedicated to investing "for the national interest". Opportunities for public-private collaboration may expand as policymakers recognise the need to reduce technological dependency on geopolitical rivals. However, for businesses that are dependent on technology to facilitate their carbon transition, it will be necessary to consider how it can be reliably sourced and how potential security risks and heightened regulatory scrutiny around its use can be mitigated.

Cybersecurity threats will continue to grow

Cybersecurity risk has continued to increase in recent years amid tensions with Russia and China, and as competition for cutting-edge technology intensifies. To underscore this threat, the Biden administration has already issued multiple Executive Orders declaring cyber threats a "top priority and essential to national and economic security". The importance of managing burgeoning cybersecurity risks cannot be underestimated – a single attack can affect all aspects of a business and failure to adequately identify, control and mitigate such risks can be devastating to a company's reputation, and have massive legal, regulatory and financial repercussions.

To date, there have already been multiple instances of cyberattacks that can be traced back to foreign state interference: in March 2022, President Biden issued a public warning that Russia was considering conducting cyberattacks against U.S. entities and U.S. critical infrastructure, as part of Russia's response to Ukraine-related sanctions. This risk came to fruition in a destructive malware operation targeting multiple organisations in Ukraine in January 2022, and in a crippling cyberattack against Toyota following Japanese condemnation of Russia's invasion of Ukraine. Incidents such as these underscore the imperative that companies diligently consider cybersecurity risks, mitigate vulnerabilities, engage in active and multi-layered defence, leverage law enforcement resources and third-party specialists identified in advance, plan for a robust and rapid incident response and consider securing appropriate insurance coverage.

Geopolitics threaten to further complicate an already tangled web of vulnerabilities that have arisen as a result of the mass shift to remote working arrangements, the embrace of cloud-based operations, an increased reliance on virtual commerce spurred by the pandemic, and the proliferation of the Internet of Things. At the same time, legal and regulatory demands on companies to safeguard consumer data, protect against intrusions, and make related disclosures to government agencies, stockholders and the public have increased in recent years.

The EU's General Data Protection Regulation (GDPR), which took effect in 2018, has transformed the data-handling obligations of companies whose operations have even a minimal European nexus, as has domestic legislation like the California Consumer Privacy Act (CCPA) of 2020 and the Virginia Consumer Data Protection Act of 2021. The SEC is also poised to adopt new cybersecurity disclosure rules that would, as a practical matter, require continuous monitoring and reporting of potential cybersecurity threats.

Federal and state agencies in the United States have also made cybersecurity a focus, bringing attention-grabbing enforcement actions for failure to abide by their overlapping webs of requirements. In November 2020, a little over a year after its historic data privacy settlement with Facebook, the Federal Trade Commission (FTC) announced a settlement with Zoom for alleged misrepresentations to consumers about encryption levels and vulnerability of its software to remote video surveillance. This settlement

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is just one illustration of the FTC's increased enforcement activity in the data privacy and protection arena – a trend likely to persist despite a recent Supreme Court decision cutting back the agency's ability to pursue disgorgement and restitution remedies.

How Boards and Management Can Adapt to Geopolitical Threats

Boards and management will continue to face increased pressure from investors and stakeholders to demonstrate that they are taking steps to prepare their businesses to deal with the uncertainties wrought by the new geopolitical environment. Directors should – through their risk oversight role – collaborate with management to integrate geopolitical considerations into enterprise risk management processes, contingency plans and longer-term strategic decision-making.

More broadly, directors should satisfy themselves that the risk management policies and procedures designed and implemented by the company's senior executives and risk managers are consistent with the company's strategy and business purpose; that these policies and procedures are functioning as directed; and that necessary steps are taken to foster an enterprise-wide culture that supports appropriate risk awareness, behaviour and judgments about risk, and that recognises and appropriately addresses risk-taking that exceeds the company's determined risk appetite. Unlike other risks, geopolitical risks can be difficult to directly mitigate, and risk management strategies will need to focus on developing operational agility and longer-term resilience.

Advance preparation will be key

Geopolitical risks can affect a business in a myriad of ways. Capital controls, capital flight, currency devaluation, trade embargos, infrastructure loss, credit default, supply chain disruptions, asset expropriation, price and production controls, regulatory changes, strikes, conflict and terrorism are among the many ways geopolitics can undermine or halt business operations. Well-functioning boards will be familiar with the type and magnitude of the company's principal risks, especially concerning "mission-critical" areas for the business and the sector, and should be kept apprised periodically of the company's approach to identifying and mitigating such risks, instances of material risk management failures, and action plans for mitigation and response.

Directors should consider whether management is casting a broad net when assessing potential geopolitical impacts, which may also include potential opportunities. Developing an understanding of management's assumptions, identification, assessment and quantification of risks should be part of the board's oversight agenda.

As part of their preparations, boards should engage in director training to build on existing skills and leverage management and advisor expertise to develop a working knowledge of key emerging issues. In addition, the recruitment of new directors should address any potential knowledge, skill and background gaps. While some companies may decide it is necessary to seek directors with climate, cybersecurity or human capital experience, many others may conclude that it is more appropriate to further educate existing board members. Directors may also want to consider the appropriate allocation of oversight responsibilities among the board and its committees, including whether dedicated *ad hoc* or formal committees may be necessary to focus oversight on particular risks or potential scenarios.

Pay attention to evolving expectations on fiduciary duties

In the United States, the Delaware courts have taken the lead in formulating legal standards for directors' risk oversight duties, particularly following *In re Caremark International Inc. Derivative Litigation*, the seminal 1996 decision addressing director liability for the corporation's failure to comply with external legal requirements. Delaware courts in the *Caremark* line of cases have held that directors can be liable for a failure of board oversight only where there is "sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists" or a culpable failure to monitor an existing system resulting in a disregard of a pattern of "red flags".

Delaware Court of Chancery decisions in the decades following *Caremark* regularly dismissed shareholder suits claiming such a total failure of oversight responsibility. More recent rulings, however, show that the risk of exposure for failure of oversight is real, and the subject matter of fiduciary duty suits is no longer confined to instances of financial malfeasance. It is notable that two of the most recent *Caremark* claims have centred on the board's oversight of cybersecurity.

In *Firemen's Retirement System of St. Louis v. Sorenson*, the Court of Chancery dismissed a derivative claim seeking to hold the directors and officers of Marriott International liable for a data breach that affected millions of guests, concluding that the allegations failed to demonstrate that the directors had "completely failed to undertake their oversight responsibilities, turned a blind eye to known compliance violations, or consciously failed to remediate cybersecurity failures".

The court also reaffirmed that "the difference between a flawed effort and a deliberate failure to act is one of extent and intent" – with a *Caremark* claim requiring the latter. The court did warn, however, that high risk of cybersecurity threats "increasingly call[s] upon directors to ensure that companies have appropriate oversight systems in place", and that "corporate governance must evolve to address" these risks. Similar breach of fiduciary duty claims were brought against the board of SolarWinds after it was targeted by Russian hackers in 2020.

Specific recommendations

It is almost inevitable that even the best-run companies will face losses arising from geopolitical shocks – but in the aftermath of such shocks, the best-run companies and their leadership will also be able to respond decisively and effectively and limit losses. Below are specific actions that boards and appropriate board committees may consider as part of forward-thinking efforts to manage geopolitical risks:

- review with management the categories of material geopolitical risk the company faces, including risk concentrations and risk interrelationships, as well as the likelihood of occurrence and the potential near-, medium- and long-term impact of those risks on business and strategy;
- review with management the company's risk management monitoring and reporting processes, including whether these processes are sufficiently robust and holistic to encompass geopolitical risks;
- recognise that geopolitical shocks will continue to test corporate purpose and values, and may require, in certain scenarios, advance assessments of the stance the company is willing to take and the responsibilities it is willing to assume (including with respect to various stakeholders);

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- ensure that consideration of geopolitical risks is integrated into crisis management plans and business contingency plans; and
- review the skills, professional experience and practices that are required by the board to effectively oversee geopolitical risks, in order to assess whether the current mix is sufficient and identify selection priorities to be used as part of the board recruitment and refreshment process.

Conclusion

Businesses around the world are entering a new era of uncertainty. The business environment has shifted markedly in the wake of deteriorating Sino-American relations and Russia's war in Ukraine. Such unpredictability appears unlikely to abate anytime soon and the degree of global cooperation and open borders seen in the decades following the fall of the Berlin Wall may be coming to a close. Businesses operating in this environment will need to be remain alert and be ready to adapt.

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Wachtell, Lipton, Rosen & Katz is based in New York, New York. We have supported stakeholder governance for over 40 years – first to empower boards of directors to reject opportunistic takeover bids by corporate raiders, and later to combat short-termism and ensure that directors maintain the flexibility to invest for long-term growth and innovation. We continue to advise corporations and their boards that – consistent with Delaware law – they may exercise their business judgment to manage for the benefit of the corporation and all of its stakeholders over the long term.

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Annual Meetings and Activism in the Era of ESG and TSR

During the past five years we have been experiencing: (1) activism seeking greater total shareholder return or a price enhancing transaction or the abandonment of a merger or other financial transaction, (2) activism to achieve a change in management to accomplish the activist's objective, either TSR or ESG, and (3) activism to seek both TSR and ESG with the activist seeking to leverage one to achieve the other. The proxy advisors, Institutional Shareholder Services and Glass Lewis, have taken various positions in proxy solicitations raising these issues, sometimes inconsistent and sometimes using their Say on Pay vote or withholding a vote for one or more directors to show their position on an issue. The major asset managers have also taken various positions and, with increasing frequency, have been supporting activists. In large measure, the proxy advisors and the major asset managers, especially, BlackRock, Vanguard, State Street, Fidelity and T. Rowe Price, together vote or influence the vote in manner sufficient to determine every significant proxy contest.

This proxy season, now coming to an end, has numerous examples of the key ESG issues, climate, environment, diversity, executive compensation, and employee working conditions and compensation and the TSR issues. What is particularly striking is the large number of "surprises" where proxy contests were lost due to failure to effectively present an issue or failure to ascertain, and where appropriate change, the views of the voters in advance of the meeting. Activism will continue to grow. To avoid surprises, careful review of this season's proxy voting and effective engagement, well in advance of next season, with the proxy advisors and asset managers is essential. Also essential is a team of outside advisors and corporate officers to plan the premeeting investor engagement and the presentation of the issues to be voted upon.

Edward D. Herlihy Martin Lipton

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March 25, 2022

Board Oversight of ESG: Preparing for the 2022 Proxy Season and Beyond

Last year's proxy season saw investor support for an unprecedented number of ESG proposals, on issues ranging from climate change to human capital management to diversity, equity and inclusion. Proxy advisory firms increasingly recommended that shareholders vote for such proposals. We also saw the emergence of ESG-driven withhold campaigns targeting individual directors. This upcoming 2022 proxy season will likely remain hotly contested as investors, proxy advisors and other stakeholders further scrutinize companies' ESG credentials. The Securities and Exchange Commission's recent guidance limiting exclusion of Rule 14a-8 proposals and proposed new rules on climate-related disclosures, and the new ISS and Glass Lewis proxy voting guidelines on climate, board and workforce diversity and "responsiveness" will continue to lend support to ESG-related shareholder proposals. As a result, companies and major institutional investors will need to continue to focus on the relevance, impact and risks of a proposal on an individual company.

Boards now face heightened expectations for how they oversee ESG, with some investors prepared to hold directors, particularly committee chairs, directly accountable (through director specific withhold / against votes and targeted public commentary) for a company's perceived ESG underperformance, shortfalls versus peers or failures of oversight.

We set forth below some key considerations for companies and directors as they continue to prepare for the upcoming proxy season and beyond:

1. The board is a core part of a company's ESG narrative. Over the past year, we have seen the growing integration of ESG into corporate communications and disclosures, whether it be discussion of ESG in earnings calls, transaction announcements, 10-Ks, proxy statements or press releases. Companies are also increasingly taking a fresh look at how the business of the board is allocated, organized and prioritized across the full board and individual board committees, especially as it relates to ESG matters. The proxy season has become another opportunity for companies to convey their ESG positioning and progress to investors, including especially the board's involvement with those items. Investors want to understand with which ESG issues the board engages, what efforts have been made to identify ESG risks and opportunities that are significant to the company, whether and how often the board is getting updates from management on ESG matters, and whether ESG considerations have been woven into key strategic decision-making. Investors are looking for boards that comprehend and are

transparent with their company's progress, targets and aspirations on ESG. Directors and management teams that are able to tell their company's ESG story can demonstrate the scope of their ESG oversight and confirm that the board is equipped to oversee and address material ESG issues.

2. Understand what is material and why. Materiality as it applies to ESG continues to be debated, with the EU and certain ESG disclosure frameworks used by investors calling on companies to consider material impacts on stakeholders alongside the financially material impact of ESG items on the company, while the SEC (and U.S. securities law) continues to view materiality through the lens of a reasonable investor. Directors should understand how their company has assessed materiality, including whether it has done a materiality assessment that considers issues from long-term and downside risk perspectives, and be conversant, in particular, with the ESG issues have been identified as material to the short-, medium- and long-term financial health of the company's business.

3. Seek quality data. While ESG data has proliferated in recent years, investors continue to voice concern regarding the quality of the data that is publicly available. When overseeing their company's ESG disclosures, directors may wish to consider with management whether the data disclosed would be decision-useful and comparable for investors and whether there is an appropriate balance between quantitative and qualitative disclosures. Directors should also consider whether sufficient processes and internal controls are in place for tracking and reporting key ESG metrics, bearing in mind that the SEC has indicated it expects ESG metrics to be treated with a comparable degree of scrutiny as financial metrics. In engagement sessions with investors, a company may find it useful to inquire as to perceived data gaps that may be holding back investment or other specific concerns in the company's sourcing, confirmation or choice of ESG data. Whether or not a company is externally disclosing ESG data, directors are increasingly seeking to understand and receive material ESG data to support their decision-making, and companies are working on accommodating this desire.

4. Search for blindspots. Integrating ESG issues into business decisions will also require boards and management to regularly assess potential blindspots, given the multi-faceted nature and impact of many ESG issues: for example, the net zero transition raises questions regarding timing, feasibility, expectations regarding technological solutions, access and affordability. Diversity, equity and inclusion affects not just a company's workforce but also customers and suppliers. Cybersecurity and data privacy implicate operational, product and service safety and consumer welfare issues. More recently, the Russian war in Ukraine has exposed geopolitical blindspots in risk management practices and medium- to longer- term consequences of the war may require many companies to conduct a more fulsome

review of their global business activities and supply chain dependencies. As the war continues, the consequences on companies' near-term energy resilience and medium to long-term transition plans should also be closely monitored. Boards and management should recognize that ESG issues will continue to evolve and look for ways to identify and adapt to changes.

5. Focus on goals and progress; not ratings. While ESG ratings may in some cases be useful to help companies hone in on potential opportunities, they are, at best, a historical snapshot, and because of their reliance on publicly disclosed data (and sometimes inconsistent methodologies), may not provide a full or useful picture of the company's comparative ESG performance. The different proprietary methods to assess ESG performance can also result in inconsistent outputs. The ultimate test of a company's ESG performance is whether it can sustainably generate return over the long-term. Each company will need its own strategy for doing so, and management and directors should remain focused on evolving and adapting the business while recognizing the limitations of ESG ratings.

6. Demonstrate accountability and credibility. When companies commit to net zero, diversity and other ESG targets, investors and other stakeholders look for evidence of accountability and credibility. Boards can help management parse between goals that have achievable pathways and those that are still aspirational. Particularly where targets include commitments over multiple decades, boards should increasingly appreciate that they will be expected to monitor progress and consider interim reporting and goal-setting. Compensation committees should also be judicious when approving the addition of ESG metrics into executive compensation plans and engage on the metrics being used, and companies will increasingly be considering financing solutions linked to ESG metrics. Companies should prepare for enhanced pressure for independent or other third-party verification of the measurement of performance against metrics.

As ESG issues continue to evolve, expand and become increasingly integrated into business strategy and decision-making, boards will continue to adapt their oversight—and even board evaluation and recruitment processes—to align with business needs and investor, stakeholder and regulator expectations.

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