

# NAVIGATING THE FIGHT OVER

# ESG

A GUIDE FOR DIRECTORS.

BY RUSS BANHAM



**B**ill Dozier believes the “euphoria” surrounding the ESG movement is fading fast as a recession nears and investors question corporate spending on superfluous activities that don’t maximize shareholder returns. “We’ve had laws on the books for decades regarding air and water quality, land use and discriminatory hiring processes,” says Dozier, a board member at the independent energy company Evolution Petroleum. “Companies continue to respond to them and work under these controls; we don’t need reporting regulations on top of them.”

At the Houston-based company, which owns onshore oil and natural gas properties in Texas, Wisconsin and

Wyoming and generated \$108.9 million in 2022 revenues, Dozier bristles at the notion that ESG is good for shareholders and other investors. “A small group of ESG activists is trying to create this phenomenon that businesses are evading longstanding laws, which is not true,” he says. “Governance is important for corporate performance, but the E and the S don’t generate profits. There’s no shareholder return.”

In November, a commissioner at the Securities and Exchange Commission projected that ESG regulatory reporting costs for public companies would increase from \$2 billion last year to \$8.4 billion this year. The spending increase during difficult economic times sounds another note for the growing chorus of anti-ESG politicians and business lead-

ers opposed to pressuring corporate America to support a spread of “liberal values” in society.

Republican politicians like Gov. Greg Abbott of Texas, former Vice President Mike Pence and Gov. Ron DeSantis of Florida argue that government and voters—not businesses—should address external non-economic environmental and social issues that have little or nothing to do with the need for public companies to increase shareholder value. They also sharply criticize ESG as an investing strategy, particularly by large asset management firms like BlackRock, whose CEO, Larry Fink, is a pioneer in promoting ESG investing and stakeholder capitalism, the idea that customers, employees, suppliers, communities, society and the planet must be considered in all business decisions.

The anti-ESG assertions by some politicians appeal not just to their voting base: A September 2022 survey by CNBC of CFOs at top U.S. companies, half of them in the Fortune 500, found 55 percent opposed to the implementation of the SEC’s climate disclosure rules, with 35 percent “strongly” opposed. A lack of a clear correlation between climate data and financial statements was cited by the finance chiefs as a “critical issue.”

Opponents of ESG-related investing had their arguments bolstered in February when Vanguard CEO Tim Buckley—hardly a firebrand of the right—pulled the company out of the \$59 trillion Net Zero Asset Managers initiative. “Our research indicates that ESG investing does not have any advantage over broad-based investing,” he told the *Financial Times* in an interview.

Although nearly three-fourths of investors (73 percent) in a 2022 survey by EY said ESG oversight had become a more important factor in how they evaluated and voted on board directors, this year may well play out differently. A report by proxy advisory firm Glass Lewis & Co. cites a “marked increase” in the number of anti-ESG shareholder proposals critical of companies’ ESG efforts, rising from nine

in 2021 to 45 in 2022, more than the past three years combined.

Alex Wolff, who sits on the board at Frontier Airlines, says if a company is doing well, “it has the luxury to delve even deeper into ESG, but if they are struggling or the economy is contracting, it’s not unusual that investors quickly revert to core financial considerations. It’s not that companies lose interest in ESG, it’s that there are other things to focus on.”

As companies shift their focus to financial stability, they may modify their priorities. An October 2022 survey of CEOs by KPMG found that 59 percent plan to pause or reconsider their organization’s ESG efforts as they adjust for a recession.

“It’s okay to dabble with ESG when times are good, but a recession front-burners [the question of] why you’re spending money you may not need to be spending,” says Michael Burdick, a board member at IntelliShift, DocGo and Five9. “Boards that supported and promoted ESG strongly better be prepared to explain to investors what the company’s investments in ESG have accomplished and why they continue to see it as a top priority.”

#### TAKE YOUR PICK

For board members mired in complex and confusing ESG standards, metrics and reporting regimes, the crossfire is making an already tough job tougher, say proponents. “Ultimately, we’re at a pivotal moment in history where ESG concerns have never been more important,” says Kristen Sullivan, U.S. sustainability and ESG services leader at Deloitte.

She insists that ESG aligns with the board’s fiduciary responsibility and that understanding and overseeing the impacts and dependencies on the environment and society “is core to strategy and risk oversight.” This, she says, includes navigating disruption and “recognizing inaction can translate to higher costs, revenue erosion and increased cost of capital.”



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But even among those who support ESG efforts, many have found it challenging to make a clear link between ESG data and reported outcomes. A June 2022 survey by Workiva of more than 1,300 senior executives, for whom ESG reporting is their main or secondary job responsibility, reports that 72 percent of the respondents believe ESG had a positive impact on recruitment and customer retention. Yet, nearly an equal number (70 percent) said they lack confidence in the ESG data reported to stakeholders.

Meanwhile, several companies have been pilloried in the press for their ESG support. In letters to Apple and Disney, prominent anti-ESG activist Vivek Ramaswamy chastised the companies for engaging with racial equity and LGBTQ issues, respectively. Companies that fail to make the grade on ESG receive their share of mainstream media criticism, too. After Tesla was eliminated from the S&P 500 ESG Index for reported racial discrimination, poor working conditions and the lack of a low-carbon strategy, CEO Elon Musk tweeted that “corporate ESG is the Devil Incarnate.”

ESG opponents are not, of course, against company actions that result in cleaner air and water or more equitable

hiring across different groups of people; their argument is that the cost of these goals must be balanced against the fiduciary duty of companies to maximize shareholder value. ESG proponents argue back that these efforts do just that, enhancing long-term value creation by mitigating material risks. In fact, 70 percent of CEOs surveyed by KPMG in 2022 said that ESG improves financial performance.

### CLASHING FORCES

Regardless, companies can expect even more probing shareholder questions about the return on investment in ESG initiatives. Opponents have launched a frontal assault not just against companies but also Wall Street and federal agencies. Expectations are for the Republican-led House, for instance, to take on the SEC’s pending climate disclosure rules, which, among other obligations, require board members to track corporate progress toward reducing harmful emissions.

States have put forth their share of anti-ESG measures, restricting pension plans from using ESG as a lens in evaluating investments. In October 2022, Louisiana’s treasurer liquidated nearly \$800 million in investments with

## Five Ideas for Boards

*ESG has become an amorphous catch-all for many disparate operational practices, as well as an investor and government mandate that can seem impossible to navigate. As your board wrestles with all-things-ESG, some ideas to consider:*

**ESG rebranding.** To dodge the politics—internal and external—consider killing off the acronym in your company and refocusing on the merits and value creation of actual initiatives. No one is going to fault a company for truly being more green, diverse or better governed if it demonstrably helps TSR.

**Data is more important than ratings.** There are too many ESG standards, metrics and ratings firms, resulting in disparate opinions. Better to cite actual financial value and outcomes of programs, backed up with accurate data.

**ESG ROI.** Recession or no recession, moving forward, boards should ensure that the companies they serve demonstrate the return on ESG investments and related shareholder value.

**Skin in the game.** If the CEO champions the long-term strategic value of ESG, then the board should consider building credibility by tying the chief executive’s compensation to ESG performance.

**Greenwashing.** Many companies are boasting about their ESG gains, with a growing number getting called out for overstating the case. Regulators are expected to force their hand in 2023. (See *How Green Is My Company Really?*, p. 38)



**What's good for employees, the corporation and the economy is now branded as woke."**

**—Barbara Lang, Director, Piedmont Office Realty Trust**

ESG-advocate BlackRock to “protect” the state treasury “from ESG,” Treasurer John Schroder stated in a letter to Larry Fink. Since then, South Carolina, Utah, Arkansas, Missouri and Florida—all led by Republicans—have also divested from BlackRock.

Florida pulled \$2 billion from the BlackRock, the biggest divestment to date. “Using our cash to fund BlackRock’s social engineering project isn’t something Florida ever signed up for,” the state’s CFO said in a statement. “[ESG] has nothing to do with maximizing returns.”

At last count, at least 19 states have proposed legislation, regulations or policies prohibiting the use of ESG criteria in investment decisions. Aware that the GOP had painted a target on his back, Fink told Bloomberg in January that the attacks had become personal. “It’s not business anymore,” he says. “They’re trying to demonize the issues.”

**WHAT’S IN A WORD?**

The war over ESG has made the acronym toxic to many. So why not lose it? Companies with laudable human capital programs, diverse board composition and reductions in greenhouse gas emissions may benefit by managing them sans the abbreviation.

Even longtime ESG proponents see potential value in dumping the acronym. “It’s just become so polarizing,” says Marija Kramer, managing director and head of ISS Corporate Solutions, a subsidiary of proxy advisory firm Institutional Shareholder Services. “Breaking it down into its components, focusing on what is material to shareholders in the E, the S and the G, could be a way to make this less politically charged.”

“ESG has a branding problem,” says Courteney Keatinge, senior director of ESG research at proxy advisory firm Glass Lewis & Co. “Right-wing politicians have latched onto ESG to criticize businesses as ‘climate activists,’ when the truth is that a well-designed ESG climate strategy is aligned with a company’s long-term financial and operational success.”

Several board members also brought up the acronym as an issue. “For one thing, it makes it appear that other important board subjects like cyber risks

are excluded,” says Susan Skerritt, former CEO of Deutsche Bank Trust Company, Americas and a board member at IG Group, Tanger Outlets, Community Bank System and Falcon Group. “Cyber risk falls under the G, where it gets lost. The E, meanwhile, has a different impact depending on a company’s industry. And the S is really human capital, which is absolutely crucial to the long-term sustainability of all organizations.”

Sharing this view is Lisa Greer Quateman, who sits on or chairs the audit, nom/gov and risk committees at Western Asset Mortgage and Sherzer International, among other corporate boards. “Companies need to look beyond the acronym at the underlying business issues denoted—the importance of longer-term environmental issues to financial and operational objectives, what good governance really is and means, and why fair and equitable human capital management is essential to all businesses,” Quateman says.

Robert Hartwig, a professor of finance at the University of South Carolina, finds value in separating the S from the E and the G. “There is less subjectivity in the E component, as emissions can be measured more objectively than [the effectiveness of] different DEI programs or governance,” says Hartwig, who leads the school’s Risk and Uncertainty Management Center.

“Environmental sustainability also has a multi-decade head of steam behind it, occupying the agenda at places like Davos for many, many years, whereas social issues like human rights, diversity and income equality that are the focal point of accusations of wokeness are relative newcomers,” Hartwig says. “It will take time for the S and G to gain the same momentum.”

Barbara Lang, who serves on the board at Piedmont Office Realty Trust, also perceives a benefit in extricating the S from ESG as a separate initiative. “The S has become political football more so than the E or the G, which is unfortunate,” she says. “What’s good for employees, the corporation and the economy is now branded as woke. Who wouldn’t want a more diverse and inclusive workforce that is representative of the communities we make our



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—Lisa Greer Quateman, Director, Lyles Diversified, Western Asset Management, ITR Concession Company, Scherzer International, Voyager Advisory

money from? Whether we’re headed for a recession or not, that’s a shortsighted view that’s bad for business.”

“The politicization of ESG tends to focus primarily on the S,” agrees Quateman, who suggests “removing the S and replacing it with employee retention and training. It would be difficult for state policymakers not to support that [wording], as they’re all vying to attract businesses to their states. They’d be shooting themselves in the foot.”

Skerritt sums up by pointing out, “In this politically divided country, the

anti-woke response to ESG is not terribly surprising. We might be better off blowing up the acronym and focusing on the E, the S and the G as separate board topics.”

At least one CEO may agree that the acronym has run its course. At a CEO dinner at a recent World Economic Forum, James Quincey, Coca-Cola’s CEO, reportedly said ensuring that ESG is embedded into business strategy is more important than what it’s called. “I’m just going to stop saying ‘ESG,’” Quincey quipped.

## Every Company is Different

*Board members are squeezed in the middle of countervailing ESG forces, trying to fairly assess both sides’ aims and criticisms. Corporate governance experts at multinational law firm Skadden, Arps—partners Marc Gerber and Richard Grossman—offer their perspectives and guidance on how to focus on issues that are material and not split hairs.*

**The politicization of ESG has resulted in calls to blow up the acronym and focus on managing the material risks of the E, the S and the G as separate priorities. Is that a good idea?**

**Marc Gerber:** I can see why the idea emerged. Board directors could then think through which ESG factors are relevant to the business. For some companies, the E might be more important, whereas for others the S should be more in view. One way to make this determination is to look at each of the items through the lens of shareholder value. If you can’t see a connection, the topic may not be relevant. Insofar as killing off the acronym or using a different acronym, it won’t change the politicization of ESG, whatever you call it.

**Richard Grossman:** What Marc just said is correct, insofar as Delaware law on shareholder primacy. If something is irrelevant to your business and doesn’t contribute to shareholder value, a director need not spend time on it. If a company has a workforce where specific social issues matter, they should pay attention to them. If not, there are other things to focus on. Regarding the acronym, in the politicized world we live in, it’s not surprising that Corporate America is not immune from the fallout.

**What’s your view of the criticism that ESG ratings are subjective?**

**Gerber:** Companies and boards do struggle with the variety of ESG ratings out there, that’s true. They’re different in many cases because the underlying criteria can be measured in different ways and analyzed accordingly. Consequently, the same company can do very well on one score and poorly on another. That

gives activists on both sides of the ESG topic opportunities to find whatever rating best supports their viewpoint.

**Social issues like diversity, inclusion, philanthropy and human rights abuses seem to be the focal point of anti-ESG proponents. Does that align with your perspectives?**

**Gerber:** Part of the problem is there is no limit to what the S can be. I read this morning that a number of companies received shareholder proposals on the abortion question. For a company that focuses on female consumers, perhaps this could be a significant issue that ties to shareholder value. For others, it may not. Every company is different; why paint them all with the same broad brushstroke?

**Grossman:** This goes beyond the S. The fact is there is no one-size-fits-all approach to ESG. Unadjusted pay equity is a case in point. It doesn’t make sense to look at this through one lens, given different industries and competitive peers. A high-tech company with sophisticated software engineers is different than a warehouse operation with hourly workers. The question again, in this context, is, does the issue have a nexus to shareholder value?

**Should directors get out in front of these issues publicly?**

**Grossman:** I would not advise individual board members to speak on these issues. They can get into trouble, as their fiduciary duty requires them to be objective, acting solely for the benefit of the company and shareholders. Public declarations on ESG should come from investor relations and the press department, obviously with direction from the board.

**Gerber:** To the extent there is a nexus between an ESG issue and the company’s business strategy, growth and risk mitigation, it is up to the particular board committee overseeing the issue to advise on whether the company should take a view on the subject. —RB



## RATING SUCCESS

Eliminating the acronym, of course, won't fix what most directors would agree actually ails ESG. Scoring methodologies that differ markedly in many cases are a case in point. "ESG ratings are highly subjective," says Hartwig. "If you look at Moody's credit ratings or S&P's credit ratings, they are highly correlated. When you use one or the other to evaluate credit risks, you get pretty much the same answer."

Use two or more different ESG ratings firms and "there is nowhere near the same correlation," he adds. "The wide variance of ESG ratings should give pause to board members, since companies can go shopping for the highest rating."

Several published reports support his contention, unearthing disparities in ESG ratings based on a company's size, industry sector, geographic breadth and other factors that have nothing to do with ESG. For example, companies with greater market capitalization "scored higher on ESG ratings than smaller peers," a study by the American Council for Capital Formation notes.

That's a problem, Quateman agrees. "There are too many ESG rating agencies, each with their own measurement methodologies," she says. "I'm surprised we've not seen more consolidation [in the ratings industry]."

Other interviewees downplayed the dilemma. "Ratings sometimes take on excess value in discussions because they're tangible," says Jamie Gamble, managing director at PwC. "One of the hard things dealing with all these new metrics is that they're new. Lacking years of experience understanding what they mean, [companies] grab onto a number and only want to know if it goes up or down. Setting priorities on the basis of getting a higher rating is almost always a bad idea."

The task before board members, he says, "is to ask what role does this rating play in our strategy insofar as our stakeholder communications? Is it meaningful or not? Will it drive value, or is it just a distraction?"

Lang shares a similar perspective. "I agree that there are too many rating agencies, with the different outcomes giving politicians something to criticize ESG

[for]," she says. "Rather than promote a high ESG rating versus one's peer competitors, point to verifiable internal ESG data where you're making worthwhile progress toward shareholder value, what you're doing to be best in class."

Companies should be explicit about the short-term return on specific investments in an ESG initiative, such as how a more diverse team of people spearheading a particular project resulted in a more innovative, productive and profitable outcome, as well as the projected long-term financial value of ESG, such as how a gradual move toward commercial electric trucks will reduce overall energy expenses by 2035. In either case, the important aim is to tie an ESG initiative to a return on investment, Keatinge says.

"Otherwise, you're only fueling the backlash that ESG is a hodgepodge of cost centers," she explains. "Corporations are not NGOs, whose sole purpose is to improve the environment and save people's lives. You're offsetting greenhouse gas emissions not because it's a nice thing to do, but because it's good for the company. A discernible ROI needs to be evident in every ESG decision."

Making this linkage requires accurate and verifiable financial data, something the board should press senior management to provide, says Skerritt. "I chair the audit committee on a couple of boards; we make it clear that the data used in the ESG reporting must be supported by factual evidence. We want to know where it came from, how it was measured and to verify the soundness," she explains. Failing this test will only invite more criticism that ESG is "something touchy-feely with no financial value."

Kramer from ISS agrees that board members must hold management's feet to the fire on the veracity and value of ESG disclosures. "It's the board's fiduciary duty to understand which ESG risks are material and how they are being effectively addressed," she says. "Shareholders want assurance that companies have applied a commonsense lens to material risk exposures."

Her advice: "Stop talking about 'ESG strategy.' Instead, talk about the fact that these are material risks to the core business, and here is how we are managing them to generate greater shareholder value."



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While Gamble says it's "not easy to translate how ESG hits the bottom line, you still have to try. Having a strong process in place to do this is the best response to an activist investor, either pro or con. The goal of the process is to evaluate which sustainability decisions are most important to the company and its stakeholders, like customers, employees and communities. If the decision does not have a significant effect or it is not something that will drive the business forward, pass."

#### **FROM THE TOP**

In the current political climate, board members must prepare for the possibility of an anti-ESG investor challenging the corporate ESG strategy. In advance of this prospect, it makes sense to have a select group of board members, such as a lead director or the chair of the nominating and governance committee, to be a focal point of communications with shareholders, Skerritt says, adding that the person needs to be extremely conversant about the company's policies and procedures.

"We're at a stage where directors can play more of a measured and careful role in direct communications with certain stakeholders, including shareholders," she says. "If an activist investor critical of the role ESG plays at the company surfaces, the board member is ready to articulate how ESG informs short-term and long-term strategy to the betterment of shareholders."

Hartwig agrees. "Board members must be prepared to be attacked at any moment by an activist investor seeking higher returns and singling out ESG as a key factor in why returns are lagging," he says. "Directors would be remiss not to already have on the shelf a shareholder justification for every ESG-related expenditure, including those where the returns are not immediate."

Proponents go so far as to say that executive comp should be tied to ESG-related metrics. Hartwig says that "to make ESG credible to the investor community," boards should "explicitly include in the CEO's compensation package a component directly related to achieving specific ESG performance criteria."

Not only does this send a message

that the CEO champions the shareholder value of the company's ESG agenda, says Hartwig. "It counters accusations of corporate greenwashing.... CEOs need to put their money where their mouths are."

Lang is also a proponent of the concept. "Compensating the CEO on ESG measures that suggest a job well done is the right thing to do," she says. "On one of the boards on which I serve, ESG performance is one of the mix of measures within the CEO's compensation package. It suggests to the external world that ESG is especially important to the company's strategy."

Asked if boards should pursue a compensation linkage to ESG, Wolff says, "I could see an incentive metric for compensation on employee diversity. These things are probably exercises that every serious board is undertaking or needs to undertake."

Gamble suggests that if an ESG strategy is particularly crucial to the long-term "thriving of the business, then it makes a lot of sense for the board to tie the entire senior management team's compensation to these performance metrics, starting with the CEO."

Several directors express the view that once the dust settles after a battle royale over the value or detriments of ESG investing and initiatives, a more assured and strategically focused ESG agenda will materialize. Although compromise between the opposing forces is unlikely, if not far-fetched, fierce debate fuels the examination of all sides of an issue, culminating in more reasoned approaches.

"The pendulum did swing very far to the left on ESG for a couple years from a shareholder perspective," Keatinge from ISS acknowledges. "The SEC's disclosure rules last year then pushed it to the right, which was clear in all the anti-ESG proposals. It's now coming back towards the middle."

But Burdick, for one, remains skeptical. "Not everybody is in the 'gung ho' ESG boat, Larry Fink-style," he says. "There's a lot to be said for doing the right thing—as long as you're producing returns for investors." **CBM**

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