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Boardroom Hot Topics: ESG, Purpose And Stakeholders

By **Valeska Pederson Hintz and James O'Grady** (February 20, 2020, 5:36 PM EST)

In 2019, investors saw the bizarre and unprecedented unraveling of WeWork Co. Inc. in the lead-up to its abandoned initial public offering. A series of related-party transactions suggested a lack of internal controls and inadequate oversight of WeWork's CEO, Adam Neumann.

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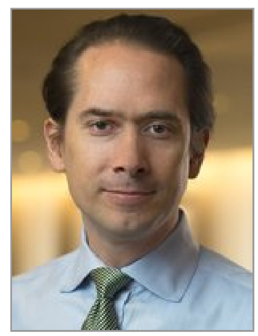
Some of the more egregious transactions included Neumann's personal ownership of buildings leased by WeWork, the purchase by WeWork of the trademark to the word "We" from a company controlled by Neumann, several of Neumann's family members doing business with or being employed by WeWork, and several low-interest loans extended to Neumann by the company.

Losses by SoftBank Group Corp.'s Vision Fund on its investment in WeWork caused SoftBank to scale back its high-risk investment strategy and undertake a new focus on improving corporate governance at its portfolio companies.



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In November 2019, the Wall Street Journal reported that some of Silicon Valley's highest valued unicorns had collectively lost about $100 billion in value in 2019 alone, forcing some private company executives to focus on profitability over growth and improve corporate governance. The emphasis on profitability and stricter governance over high growth is a big change for SoftBank and for Silicon Valley.

Poor corporate governance and lack of effective board response to stakeholder concerns has been a recent headline. The financial markets have been taking governance matters into consideration in valuing companies. In the current environment, poor corporate governance is unsustainable regardless of where a company is in the corporate life cycle.

Your board should be discussing relevant corporate governance topics and trends.

Investors care about ESG considerations.

Environmental, social and governance, or ESG, considerations have been trending in recent years with commentators questioning whether ESG is the flavor of the month and would lose traction with institutional investors.

However, Blackrock Inc. CEO Larry Fink recently wrote his 2020 letter to CEOs on the theme "climate risk is investment risk."

Fink revealed that climate change is the top issue raised by BlackRock clients around the world, and that significant reallocation of capital is anticipated in response to climate risks sooner than most anticipate. In his letter, Fink announced that BlackRock will make investment decisions with environmental sustainability as a core goal.

He also announced initiatives aimed at placing sustainability at the center of the asset manager's investment approach. These initiatives would include voting against management teams that fail to make progress on sustainability; exiting investments with high sustainability-related risks; making sustainability integral to portfolio construction and risk management; and pressing companies to disclose plans "for operating under a scenario where the Paris Agreement's goal of limiting global warming to less than two degrees is fully realized."

Fink's annual letter has increased the attention on ESG issues and reflects the sophisticated, number-crunching demands of institutional investors linking sustainable operations and climate change to long-term value creation.

Human capital is another area of focus. Key categories of information include workforce demographics, stability, composition, skills and capabilities, culture and empowerment, health and safety, productivity and compensation, as well as human rights commitments and their implementation.

Recently, the U.S. Securities and Exchange Commission issued a proposed rule to modernize certain public company disclosure requirements related to the description of the business to include human capital resources as a disclosure topic.

In discussing the proposed rule, the SEC staff acknowledged that the current disclosure rules were drafted when companies relied significantly on property, plant and equipment to drive value. At that time, just disclosing the number of employees was sufficient information for making an investment decision. However, now human capital and intellectual property frequently represent an essential resource and driver of performance for many companies.

In order to ensure investors continue to have sufficient information to make investment decisions, the SEC proposed requiring companies to provide a description of human capital measures or objectives on which management focuses in managing the business, such as those that address the attraction, development and retention of personnel.

Another important ESG issue is diversity in terms of gender, race and experience. Diversity is important with respect to a company's employees, management and board.

In January, David Solomon, the CEO of Goldman Sachs Group Inc., one of the largest underwriters of initial public offerings, said that, starting on July 1 the bank will no longer take companies public in the U.S. and Europe if they do not have at least one diverse director on their board, with a focus on women. By 2021, the bank intends to raise the threshold to two diverse directors.

Although most investor scrutiny for ESG performance is being felt by large-cap public companies, these companies are increasingly passing their sustainability-related demands onto private companies and small-cap public companies that are their suppliers, partners and acquisition targets.

Private companies and small-cap public companies should also keep in mind that ESG issues are not just a focus of investors. Customers and employees are increasingly considering ESG issues in determining whether they would like to enter a business relationship with a company.

According to a recent Deloitte survey, 42% of the respondents said they have started or deepened existing business relationships because they believed a company's products or services had a positive impact on society or the environment.

Another recent study showed that 64% of millennials consider the social and environmental commitments of the companies for which they are considering working, and will not take a job with a company lacking strong corporate social responsibility values.

Given increased interest from investors, customers and employees in ESG issues, directors and senior management should be prepared to engage in conversations on these issues. Senior management at public companies must be ready to present the board with strategies for addressing ESG issues, particularly with respect to environmental sustainability and human capital.

According to the Harvard Law School's 2019 proxy season preview, the 2019 proxy season was thethird consecutive year in which environmental and social-related proposals accounted for the majority of shareholder proposals, and many pushed for company action on ESG disclosures, strategies and goals.

Companies should be actively engaging with their stockholder base to determine what issues are important to them. Management of public companies and large private companies should anticipate investor requests for information on the company's sustainability strategies and goals and, in the technology space, on the company's human capital strategies and goals.

Public companies must also consider how to best disclose their ESG efforts and whether to use a recognized disclosure standard, such as the Global Reporting Initiative, the Sustainability Accounting Standards Board and the Task Force on Climate-Related Financial Disclosures.

Many large, public companies post stand-alone sustainability reports to their websites or include sustainability data in their proxy statements or other filings and investor documents. Public companies will also need to start preparing for the new human capital resources disclosures, to the extent those disclosures would be material.

Management should start discussions with the board in upcoming meetings about what they have been focusing on: employee turnover, difficulty filling open positions, skill sets, diversity initiatives, etc.

If ESG issues are critical to a company's business, the board should ensure proper oversight of the company's progress on these issues. The board may also want to consider whether it is appropriate to subject ESG disclosures to internal controls or to require sustainability reports to undergo an audit.

You may need to focus on a broader set of stakeholders.

The corporate purpose of solely earning profits to benefit shareholders is being questioned by corporate America. In August 2019, the Business Roundtable released the "Statement on the Purpose of a Corporation," which was signed by 180 CEOs pledging a corporate commitment to deliver value to all stakeholders, including customers, employees, suppliers, communities and stockholders.

This emphasis on delivering value not only to stockholders but to a broader group of stakeholders has been gaining support from institutional investors for some time.

In January, Airbnb Inc., a Silicon Valley unicorn expected to go public in the near term, announced its intention to be among the first of the true 21st century companies and set forth its five-step road map for benefiting all stakeholders:

- Identify stakeholders;
- Establish principles and metrics for serving stakeholders;
- Update corporate governance and compensation;
- Report on progress; and
- Share success.

Airbnb monitors typical metrics and key performance indicators, such as generally accepted accounting standards, or GAAP, revenue; earnings before interest, taxes, depreciation and amortization, or EBITDA; and gross booking value. The company additionally monitors metrics like the carbon footprint of travel facilitated by the Airbnb platform to monitor benefit provided to its communities; host earnings over time to monitor benefit provided to its hosts; and the number of personal safety incidents to monitor benefit provided to its guests.

To ensure it made good use of these metrics, Airbnb established a stakeholder committee of the board and tied employee bonuses to performance of the stakeholder metrics and social goals. To report on the company's progress, management intends to host a stakeholder day, which will offer programming for all of Airbnb's stakeholders.

Directors and management should give serious consideration to identifying the broader purpose of their company and the constituencies to which their business should focus on providing value. More and more customers, employees, policymakers and investors are demanding that corporations, stewarded by their boards, make positive contributions to society and benefit all stakeholders.

What is the purpose of your company? Who are your stakeholders?

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