C O M M E N T

DIRECTOR ENGAGEMENT: NECESSARY FOR ESG SUCCESS

by Todd Phillips

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Leo Strine, Kirby Smith, and Reilly Steel make an important contribution to the corporate governance literature. In their article, Caremark *and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective* Caremark *and EESG Strategy*,[1] they make the compelling case that *Caremark*'s obligation that directors "be reasonably informed concerning" the activities of their corporations—and be subject to legal liability if they are not—provides a foundation upon which directors can and should inform themselves as to whether their companies are acting in ESG-forward or otherwise ethical manners.[2]

While Strine, Smith, and Steel include discussions of *Caremark* liability and associated legal gloss, the practical "takeaway" from their article is that directors must be engaged with their companies' ESG (or, as the authors write, EESG)[3] efforts, addressing those matters that pose moral risk to their firms as well as those that only pose legal ones. And importantly, director engagement on ESG should not just be something that corporate boards implement, but that shareholders should be demanding.

I. Informed Corporate Directors

Both primary theories of corporate governance today—whether to be operated in the interest of stakeholders or shareholders—require directors to be informed as to their corporations' activities. Under "stakeholder capitalism," a company should operate in manners that benefit all it affects. For example, a 2019 letter from the Business Roundtable and signed by the CEOs of some of America's largest corporations made "a fundamental commitment to all of our stakeholders," including customers, employees, suppliers, communities, and shareholders.[4] However, the perhaps most significant criticism of stakeholder capitalism is that it "means reducing CEOs' responsibility to shareholders, not increasing their responsibility to workers or society or anyone else."[5] Accordingly, for stakeholder capitalism to be effective, chief executives must not be given carte blanche and directors must provide appropriate oversight that ESG commitments are being fulfilled.

The other theory of corporate governance is "shareholder primacy," meaning that a company should operate solely to benefit its investors. Although this has traditionally meant a focus on profits (Milton Friedman famously wrote, "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits")[6] this is not necessarily the case as shareholders increasingly care about investing in corporations that are stewards for ESG values. Today, investments in ESG funds total roughly $8 trillion worldwide with inflows only growing[7] and the largest shareholder of public companies, BlackRock's Larry Fink, annually writes to corporate executives encouraging them to "act as a powerful catalyst for change."[8] Clearly, whether because they believe companies that have ESG focuses will be more profitable than those who do not,[9] or because they generally want their companies to act more ethically without regard for profit,[10]

Editors' Note: All opinions are the author's own and not of any affiliate or employer.

1. Leo Strine et al., Caremark *and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective* Caremark *and EESG Strategy*, 106 Iowa L. Rev. 1885 (2021).
2. In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).
3. EESG stands for "employee, environmental, social, and governance." Strine et al., *supra* note 1, at 1885.
4. Business Roundtable, *Statement on the Purpose of a Corporation* (last updated July 2021), https://s3.amazonaws.com/brt.org/BRT-StatementonthePurposeofaCorporationJuly2021.pdf (emphasis removed).
5. Matt Levine, *Money Stuff: When Can Bond Investors Lie to Banks?*, Bloomberg (Apr. 13, 2020), https://www.bloomberg.com/news/newsletters/2020-04-13/money-stuff-when-can-bond-investors-lie-to-banks (emphasis removed).
6. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times Mag. (Sept. 13, 1970).
7. Evie Liu, *ESG Investing Could Quadruple by 2030*, Barron's (Dec. 3, 2021), https://www.barrons.com/articles/esg-investing-outlook-2030-51638493803.
8. Larry Fink, *Larry Fink's 2022 Letter to CEOs: The Power of Capitalism*, BlackRock (2022), https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.
9. *See* Jon Hale, *Sustainable Equity Funds Outperform Traditional Peers in 2020*, Morningstar (Jan. 8, 2021), https://www.morningstar.com/articles/1017056/sustainable-equity-funds-outperform-traditional-peers-in-2020.
10. *See* Lauren Migaki & Andee Tagle, *Understanding the Promises and Limits of Ethical Investing*, NPR (Jan. 22, 2022), https://www.npr.org/2022/01/11/1072207126/ethical-investing-with-esg-funds.

shareholders are taking ESG investing seriously. As shareholders' representatives, directors should ensure their companies are taking ESG seriously as well.

Directors owe a fiduciary duty to their corporations,[11] and a failure to provide oversight of their firms' activities can have catastrophic consequences.[12]

And whether because it is right by stakeholders (as Strine, Smith, and Steel argue) or right by shareholders, directors—especially independent directors—must provide oversight of their firms' ESG efforts.

II. Effective Board Oversight of ESG

Once a board has determined it has a role to play in supervising and directing its firm's ESG activities, the next question is how to effectively make that oversight a reality. Although most companies and all publicly traded companies maintain board audit committees,[13] and although "most companies seem to be keeping primary responsibility for compliance in the audit committee," Strine, Smith, and Steel recognize that "audit committees' core responsibilities [are, currently, largely] in accounting and financial compliance, prudence, and integrity" and that audit committees are "already the most burdened board committee."[14] Left unsaid is also that placing ESG oversight in the audit committee seemingly absolves directors who do not serve on that committee from ESG responsibilities.

Strine, Smith, and Steel articulate a better way. "[R]ather than solely vest[ing] in the audit committee" responsibility for oversight of a company's entire risk, compliance, and associated ESG efforts, that function should be "thoughtfully allocated among the board's committees" with that allocation "track[ing] the skills needed to do the task well and mirror the way the task is allocated at the management level."[15] The audit committee should likely focus on matters of accounting while other committees take on risk, compliance, and ESG oversight.

Strine, Smith, and Steel are quick to note that there should not just be a risk committee, a compliance committee, and an ESG committee. Those committees should be focused on business lines. Directors must "identify how the company makes money" and use that as a basis to set up board committees.[16] Strine, Smith, and Steel note that important committees could include an environment or a food safety committee, with responsibility for the "risk management, compliance, and EESG functions addressing" that business line, in addition to traditional nominating and governance committees and compensation committees.[17]

With that responsibility allocated, directors then need to get to the business of overseeing their company's ESG efforts. Strine, Smith, and Steel recommend that directors "consider the company's material sources of business and their impact."[18] Each board committee "must carefully address the relevant regulatory regimes that constrain the company's conduct, consider the reasons why that is so, and identify the stakeholders whose interests the law seeks to protect."[19] They should also take into consideration third-party criteria, protocols, or frameworks,[20] as well as their company's own ESG policies and values. In light of proliferating ESG standards, Strine, Smith, and Steel explain that it is ultimately up to a "company's management and board to exercise judgment and to carefully select the EESG standards it believes are the most relevant, informative, and credible."[21]

Next, board committees must determine how they are going to measure their firms' performance in meeting its ESG goals and how they will obtain that data. As the adage goes, you get what you measure, and directors must use their business judgment—with reliance on third-party standards and frameworks if applicable—to determine what their goals are and how to adequately measure whether those goals are being met. Fortunately, as Strine, Smith, and Steel note, "[a] substantial amount of the relevant data required for robust EESG reporting [and evaluation] is already required to be collected by government regulation or as part of the company's legal compliance monitoring program."[22]

Finally, directors and boards as a whole must "determin[e] what expertise is needed to implement the company's compliance and EESG plan," including at the management and board levels.[23] Strine, Smith, and Steel note that legal requirements have effectively ensured that audit committees are "comprised solely of directors who consider themselves financially expert,"[24] and there is no reason that the members of other committees should not similarly have expertise, such as in "environmental, food safety, data security, drug efficacy, plant and production safety measures, [and] privacy protections," among oth-

11. Principles of Corp. Governance §4.01(c) (Am. Law Inst. 2008).
12. *See, e.g.*, Ron Leuty, *"Ultimately, Elizabeth Made the Decisions": A Look Inside Theranos' Ineffective Board*, S.F. Bus. Times (Aug. 7, 2018), https://www.bizjournals.com/sanfrancisco/news/2018/08/07/theranos-elizabeth-holmes-board-kovacevich-shultz.html (describing how the board of Theranos Inc. considered themselves "to be a collection of advisers, not one with traditional fiduciary duties" who did not understand the company's technology, and how that contributed to the company's downfall).
13. *See* Strine et al., *supra* note 1, at 1897-98.
14. *Id*. at 1915-16, 18.
15. *Id*. at 1917-18.
16. *Id*. at 1909.
17. *Id*. at 1918.
18. *Id*. at 1910.
19. *Id*.
20. *See, e.g.*, The Greenhouse Gas Protocol, https://ghgprotocol.org/; Principles for Responsible Investment, https://www.unpri.org/.
21. Strine et al., *supra* note 1, at 1913.
22. *Id*. at 1910. Part of this is a result of *Caremark*. Because directors have the ultimate responsibility for stewarding their corporations, *Caremark* held that directors must "assur[e] themselves that information and reporting systems exist in the organization that are reasonably designed to provide to . . . the board itself timely, accurate information sufficient . . . to reach informed judgments concerning both the corporation's compliance with law and its business performance." In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996). Resultingly, many firms maintain data reporting requirements to ensure that directors fulfill this responsibility.
23. *Id*. at 1913.
24. *Id*. at 1915. *See also id*. at n.87 (noting that the Sarbanes-Oxley Act of 2002 and the NYSE and NASDAQ listing rules generally require audit committees to be financially literate and at least one member to be an accountant).

ers.[25] Only with directors (and managers) with varied expertise will companies be able to adequately assess and effect change in their ESG efforts.

III. Conclusion

ESG has traditionally been the province of divisions dedicated to diversity, sustainability, ESG generally, or even investor relations, making companies' ESG efforts somewhat of "a 'check the box' exercise or an inconsequential appendage to core business concerns."[26] Although no effort to implement ethical decisionmaking should be discounted, all employees, managers, directors, and shareholders must be involved in ensuring ESG is fully considered and realized. Strine, Smith, and Steel make a compelling argument not only for why corporate directors especially must be engaged and why *Caremark* provides the foundation for board oversight of ESG, but also for how directors can oversee ESG effectively. Directors and shareholders must begin pushing to implement their recommendations in companies large and small.

25. *Id*. at 1916.
26. David A. Katz & Laura A. McIntosh, *Integrating ESG Into Corporate Culture: Not Elsewhere, but Everywhere*, Harv. L. Sch. F. on Corp. Governance (Mar. 29, 2021), https://corpgov.law.harvard.edu/2021/03/29/integrating-esg-into-corporate-culture-not-elsewhere-but-everywhere/.