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Impact Investing

Fixing the S in ESG

How to move from net zero to net impact.

By Jason Saul

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Is the planet really *more important* than the people? According to CNBC, most money managers who use ESG (environmental, social, governance) factors in their investment analysis have focused on the E, or climate change, as their leading criteria for their decisions. But what about the S, or social dimension of corporate impact? As one fund manager put it to me in a recent conversation: "Planet isn't necessarily more important than people, it's just easier to measure. Investors like measuring things that they can put into their models, and carbon is easy to quantify."

No doubt, quantifying social impact is a challenge. A 2021 Global ESG Survey by BNP Paribas revealed that 51 percent of investors surveyed (covering 356 institutions) found the S to be the most difficult to analyze and embed in investment strategies. The report concluded: "Data is more difficult to come by and there is an acute lack of standardization around social metrics.... Investors have been willing to accept data that does little to actually assess the social performance of the companies in which they invest." For most investors, S is merely a check-the-box exercise.

So, what can be done to improve S data?

The Meaning of S

First, we need to better understand how the field currently defines S. Commentators and investors have described S in many different ways: as social issues, labor standards, human rights, social dialogue, pay equity, workplace diversity, access to health care, racial justice, customer or product quality issues, data security, industrial relations, or supply-chain issues. S&P, one of the leading ESG ratings agencies, describes the S in terms of social factors that pose a risk to a company's financial performance.

In a blog post titled "What is the 'S' in ESG?," S&P outlines three types of S issues:

- *How can a company's workforce requirements and composition present problems for the organization in the future? Labor strikes or consumer protests can directly affect a company's profitability by creating a scarcity of skilled employees or controversy that is damaging to a corporation's reputation.*
- *What risks come with the safety implications of a product or the politics of a company's supply chain? Corporations that ensure their products and services do not pose safety risks, and/or minimize the exposure to geopolitical conflicts in their supply chains, tend to face less volatility in their businesses.*
- *What future demographic or consumer changes could shrink the market for a company's products or services? Complex social dynamics, from surges in online public opinion to physical strikes and company boycotts by different groups, affect long-term shifts in consumer preferences. Decision-makers can consider these as important indicators of the company's potential.*

It's all a bit of a hodge-podge. The purported through-line, as S&P puts it, is "relations between a company and people or institutions outside of it." That's a pretty ambiguous definition that can cover a lot of things. One could argue this lack of precision in clearly defining S is a major reason why it's so poorly measured.

But there's a deeper existential issue going on here. Rating agencies like Moody's and S&P view ESG almost exclusively through the lens of materiality (i.e. information that is impactful to a company's financial performance). That makes sense because the bread and butter of those agencies is rating corporate and municipal debt, and the primary concern of any investor with respect to debt is, of course, repayment. Risk analysis focuses on the likelihood of repayment. The problem is, most of the interest in ESG is not from lenders evaluating credit risk; it's from investors evaluating equity risk. And equity investors seek to maximize their returns, not just mitigate their risks. Indeed, simply de-risking ESG exposure is unlikely to help investors make affirmative bets on which companies will outperform the market. As State Street Global Advisors noted, "ESG information tends to be the most effective at identifying poor ESG firms that are more likely to underperform as opposed to predicting future outperformers."

The very nature of social impact isn't just about risk; it's also about prosocial behavior. In other words, a company's actions, policies, and investments can and should positively impact people's lives. Of course, there are social impacts like human rights violations, labor relations, and supply chain risks that can *negatively* impact a company's license to operate and financial stability, and those are important. But there are also many social impacts that can *positively* affect a company's financial performance through competitive advantage, business growth, market relevance, brand purpose, and securing license to operate. Positive social impacts are not accounted for in today's ESG data. Yet, as Larry Fink pointed out in his 2019 letter to CEOs, profits and social impact are "inextricably linked."

Michael Porter, George Serafeim, and Mark Kramer, in a 2019 article titled "Where ESG Fails," argued that "investors who [want to beat the market], as well as those who genuinely care about social issues, have clearly missed the boat by overlooking the significant drivers of economic value arising from the power of social impact that improves shareholder returns."

Solving for S

To be relevant, the ESG field must modernize the way it measures S factors. To do so, we must overcome several key conceptual challenges: standardization, quantification, and reporting.

Standardization. One of the biggest challenges in measuring social impacts has been the absence

of a reliable, quantitative measurement standard. The result is that every company (and NGO) defines, measures and reports every social impact differently. For investors, this results in unreliable, incomparable, and low-value data that cannot be used in financial models. While there have been a few attempts to create frameworks for reporting social impacts, most have fallen short.

The United Nation's SDGs (sustainable development goals) is among the most prominent of these purported frameworks. However, a 2018 KPMG study titled "How to report on the SDGs: What good looks like and why it matters" found that only 10 percent of companies surveyed had set specific and measurable (SMART) business performance targets related to the global goals, and less than one in ten companies (8 percent) reported a business case for action on the SDGs. Why is this the case? SDGs are primarily designed to track national, population-level statistics such as "mortality rate attributed to unintentional poisoning" or "reduce the global maternal mortality ratio to less than 70 per 100,000 live births." SDGs were not designed to be directly attributed to any discrete social program or intervention. In addition, the SDG goals were intentionally designed to advance the UN's agenda of global development by focusing attention on high-priority topics such as over-fishing, poverty reduction, sustainable tourism, clean water and sanitation, reduced illicit arms flows, etc. While these may be important political goals established by the UN, they are not universally relevant to all companies and all communities.

The ESG field needs an objective standard for reporting social outcomes. Outcomes-based standards are designed to measure the quantum of social change that was realized as a result of a program, strategy or intervention. An outcomes-based S standard could be used voluntarily by companies and NGOs to self-select which outcomes they want to report against. Investors could also use outcomes data to conduct more robust social impact analysis. For example, investors might analyze whether the impacts generated were in a company's headquarters community or at large? Or whether the impacts are advantageous to recruitment, business growth, competitive advantage, diversity, innovation, market development or employee health? What "bang for the buck" or ROI did the company generate on the shareholder funds invested? How did this return compare to other companies or to the industry average? Which populations or communities were most impacted? The power of standardized, comparable social impact data gives rise to a whole new level of S analytics that is more incisive, precise and relevant.

Quantification. Once social impacts are standardized and classified, they must be properly quantified. In the E world, independent bodies like Verra define standards for measuring "units" of environmental impact such as greenhouse gas emissions. Verra refers to these standard units as Verified Carbon Units, or VCUs. Rigorous rules and methodologies are established to ensure consistency and reliability of data across heterogeneous projects. For example, a 1.6 MW Bundled Rice Husk Based Cogeneration Plant in India is measured against the same outcome of VCUs as the Afognak Forest Carbon Offset Project in Alaska.

Social outcomes could be quantified in a similar way. Standards should set thresholds for what constitutes a "unit" of impact for outcomes like hunger, education, and employment. Similar to how carbon credits work, an "impact developer" (i.e. company, NGO, or social enterprise) could report data and have their results verified against the standard. For example, a company might claim that it has helped 1,000 families become "food secure" by providing evidence that each family has achieved the threshold level of criteria for that outcome (i.e. ongoing access to healthy, nutritious food, in a reasonable proximity to their home, on a free or affordable basis).

Using such a standard, ESG analysts could easily roll-up and aggregate a company's total impact on society. Investors and other stakeholders could actually assess the level of contribution of a business to a critical social issue. Companies could be compared by industry or across industries. Quantification could also be used to price and benchmark social impact. Imagine being able to put a value on a unit of social impact, and eventually trading social impact credits much like carbon? As Scott Kirby, the CEO of United Airlines noted recently in a CNBC interview: "If you put a price on carbon, the public markets will figure it out." It's time we set a price for S and let the public markets figure that out too.

Reporting. In the traditional ESG paradigm, reporting is all about disclosure of "material" risks. But as many researchers have pointed out, there are both negative and positive aspects of materiality. Some activities create material risks that could negatively impact corporate performance and merit disclosure. At the same time, some corporate activities create material benefits that could positively impact corporate performance. In fact, the view that materiality only means material risk is inconsistent with the way mainstream financial markets define the concept. Relying on a long history of existing legal precedent, the SEC defines information as "material" under its Selective

Disclosure and Insider Trading Rules if there is "a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision. There's no suggestion that only risks or negative factors qualify for disclosure. Indeed, many insider trading lawsuits initiated by the SEC are based on materially-positive information that contributed to substantial financial gains.

To improve S reporting, the ESG field must expand its view of materiality. The Sustainability Accounting Standards Board (SASB) initially created its "Materiality Map" in 2014 to help investors identify ESG issues that could negatively affect a company's financial performance. Today, the ESG market also needs an "Impact Materiality Map" to help investors identify ESG impacts that *positively* affect a company's financial performance. An Impact Materiality Map could help investors determine which social impacts are most strategic and beneficial to companies by industry. For example, improving the STEM education pipeline could materially impact innovation and growth in technology firms. For retail grocers, food security and sustainable agriculture could materially influence topline sales. For financial services companies, financial inclusion can materially expand their customer base and market penetration. For health care companies, social determinants of health can materially influence their cost structure and patient well-being. And so on. These social impacts are every bit as "material" an influence on corporate performance as risky social issues. Positive social impacts can also serve as risk mitigation for risky social issues. Take Diversity, Equity, & Inclusion (DE&I) impacts for example. A company's affirmative investment in DE&I outcomes (not just box-ticking employee numbers) can have a significant impact on mitigating talent loss and reducing risks to company reputation. These impacts are potentially more material than climate change reduction to financial services firms, who already face significant reputational risk in Black communities.

Some social impacts are emerging as universally material to all companies. These can and will change over time, depending on social and political dynamics. Among these "social impact macro factors" are:

1. **Public health and its social determinants.** If the COVID-19 pandemic taught us anything, it's that major public health crises can affect every business, every industry, and every geography. How companies respond to and address public health needs can be hugely

influential over business survival and success. A related issue is health equity, or social determinants of health. The impact of such factors as housing, financial health, and social capital, among others, on chronic illness, employee productivity and consumer health is directly relevant to all companies.

2. **Racial equality.** This is more than just a matter of risk and reputation. To compete and grow, companies must focus on inclusivity in their workforce, respond to racism in society at large and make their products and services equitably accessible to all communities. It affects sales, business partnerships, government regulation, employee performance, and competitive positioning.
3. **Income inequality and financial inclusion.** Of all US households, approximately 44 percent or 50 million people are considered low-income, according to Brookings Institute. That's a pretty massive market segment. Globally, that number is even more significant: 71 percent of the world's population remain low-income or poor, living off $10 or less per day, according to Pew Research Center. To grow and prosper, companies must be able to find ways to include these marginalized populations in the economy and expand the reach of their products and services.
4. **Workforce development.** Developing a diverse pipeline of talent is critical for every industry and every company. It's not just a positive social impact, it's a key barrier to business growth. Cummins, one of the largest diesel engine manufacturers, can't service its customers in Africa without trained technicians. Boeing can't build more airplanes without STEM graduates coming out of the public schools. And according to Generation T (an initiative of Lowe's Companies), more than three million trade skills jobs will sit vacant through 2028, which will significantly affect the growth of their business. Growing the nation's workforce, particularly by including underserved populations, has a direct bearing on the growth of almost every business.

Social impacts can also be more or less "material" for different stakeholders: employees, customers, suppliers, or community members. More analysis of social impact materiality will emerge as this data becomes readily available to the investment analyst community.

The Future of S

The markets have become transfixed with ESG, and the demand for more and better ESG data will only grow in the years ahead. The success of E data has laid the groundwork for a thriving carbon market—especially the *voluntary* carbon market. It has also proven that intangible commodities can be standardized, priced and traded. This can and will lead to greater impact on the environment than mere advocacy or philanthropic efforts. Indeed, more money is traded through markets every *day* than is spent by all world governments every *year*. To function efficiently, markets must rely on simple, consistent, reliable data. But that data has to signal something. Statistics devoid of meaning have no influence. It's time that the markets value S as much as E and G. The only thing that stands in the way is better data.

There are three practical steps that ESG investors, rating agencies, and companies can do to elevate the importance of S to the markets:

First, and most importantly, companies should start reporting S impact data consistently. Standards have to start from the ground-up. There's no need to wait for rating agencies to catch up or standard-setters to adapt. Irrespective of these players, companies have their own independent fiduciary duty to measure and disclose material S information to their shareholders. Companies should start voluntarily measuring and report their S impacts and get independently verified. This data can then be included in a company's own sustainability reports and 10-Ks. It can also be reported proactively to rating agencies like MSCI, DJSI, Sustainalytics, Moody's, and others. The corporate sector will have a lot more influence over what standards are set if they start producing the underlying data now instead of waiting for the world to agree on it.

Second, ESG investors should start asking for S impact data and making it a requirement. Impact investors like Forthlane Partners in Toronto, Baillie Gifford in Edinburgh, and Planet First Partners in London are already asking for this data. But the process is still manual, the data being requested is inconsistent, and the S analysis isn't as directly linked to corporate performance as it could be. By banding together around a standard for S, data will flow more readily and with less burden on portfolio companies. Over time, with leadership, other investors will join and ask for the same standard S data. The funds that start using this data early will gain a significant edge over competitors. And they will also likely attract new capital faster than run-of-the-mill ESG funds that struggle to answer the fundamental question of so many investors these days: "What

impact is my money having?"

Finally, ESG rating agencies, standard-setting bodies, and data providers should align with a specialized S data provider to up-level the value of their data. S impact data is complex; it cannot be simply captured in a one-dimensional box-ticking survey. Reliable, high-quality S data requires specialized taxonomies, questionnaires, and independent verification. This will also create a whole new level of ESG S analysis—that shared value advocates and academic researchers have long argued for. Using this S impact data, rating agencies and others can now begin to evaluate a company's competitive advantage, growth potential, employee resilience, access to new markets, enhanced value chain productivity, and improved operating environment.

As of today, approximately one-fifth (21 percent) of the world's 2,000 largest public companies have committed to meet net zero targets. Reducing carbon emissions and mitigating the risks of climate change for investors is a major accomplishment. But to achieve true sustainability, we must also improve the quality of life for the people who live on this planet. We can't manage what we can't measure. It's time we raise the bar on social impact measurement, create better S data and give the market something to price into their models. It's time to go from net zero to net impact.

Read more stories by Jason Saul.

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Placing an Emphasis on the "S" in ESG

By Meredith Mandell

News Center *Placing an Emphasis on the "S" i...*

It's been on the backburner and it is now coming into full force. A number of social factors can affect a company's performance, including short-term and long-term challenges. While much has been written about other aspects of ESG – for example, a corporation's effects on

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the planet or its internal political functions – social factors are primarily those that impact people working within the company or people and institutions outside of it.

The Push for Corporate ESG

The corporate focus on environmental, social and governance (ESG) activities has been dubbed the "new paradigm for business,"[1] although this value-driven model has been around for decades. For example, the corporate social responsibility movement, a forerunner to ESG,[2] spurred the United States to enact the Comprehensive Anti-Apartheid Act, a 1986 federal law which imposed sanctions and prohibited U.S. nationals from making any new investments in South Africa during the apartheid regime. ESG is sometimes described as a subset of CSR or what others have called the socially responsible investment movement, but ESG is primarily focused on data-driven assessments of a company to predict performance.

For a long time the major focus of ESG activities has been on the environment and climate change. More recently, we see an emerging focus on the "S," or the social component of ESG, including corporate efforts to enhance and advance various forms of social justice

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for corporate employees, customers and the broader community in which the company operates. There can be a disconnect between what companies say and what they actually do in the ESG arena, which poses challenges for corporate communications with regulators, employees, investors and the public, raises the risks of litigation and heightens the need for litigation defense strategies.

Where Is the Recent Momentum on the "S" Coming From?

In no small measure, ESG was given a huge boost by recent social movements. The 2018 #MeToo anti-sexual harassment movement heightened awareness and actions about how women are treated in corporate America. The 2020 Black Lives Matter movement further shined a spotlight about diversity, equity and inclusion in corporate America, as did the Stop Asian Hate movement. As companies spoke out supporting these social concerns, they also built up expectations for what actions companies would take to advance diversity among employees, board members and other corporate constituents. Similarly, in the realm of human rights and health and worker safety, the COVID-19 pandemic has

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increased renewed awareness and attention to worker health and safety.[3]

These widespread social concerns did not go unnoticed by corporate regulators. In June of 2021, SEC Chairman Gary Gensler discussed his agency's interest in rule-making related to public company disclosures about "environmental risk" but also on what he dubbed "human capital disclosure."[4] Gensler focused on the SEC's interest in "human capital disclosure," including "a number of metrics, such as workforce turnover, skills and development training, compensation, benefits, workforce demographics including diversity, and health and safety."[5] In this vein, the Nasdaq Stock Exchange received approval from the SEC to adopt a Board Diversity Rule in August of 2021, which is a disclosure standard designed to encourage a minimum board diversity objective for companies and provide stakeholders with consistent, comparable disclosures concerning a company's current board composition.[6] The Nasdaq rule requires exchange companies to publicly disclose board-level diversity statistics using a standardized template and whether the company has at least two diverse directors and, if not, the reasons why.[7]

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Some state governments have passed ESG regulation, with California notably in the lead.[8] New York, Illinois and Maryland have also passed legislation requiring its companies to publish board diversity data in its annual reports.[9]

In January of this year, New York State Comptroller Thomas P. DiNapoli and the state pension fund announced the filing of shareholder proposals seeking an independent audit of five companies' practices related to racial equity. The proposals call on the board of directors of each of the five companies – Amazon.com Inc., Chipotle Mexican Grill, Dollar General Corp., Dollar Tree, Inc. and Match Group – to commission a racial equity audit analyzing their impacts on civil rights, equity, diversity and inclusion, as well as the impacts of those issues on each company's business. The proposals also request that the audits be publicly disclosed on each company's website.[10]

Institutional investors have played an increasingly large role in pushing ESG forward. As one Forbes magazine commentator put it: "ESG investing is based on the assumption that ESG factors have financial relevance."[11] Arjuna Capital, the second largest institutional investor in Microsoft, recently surprised much of the investing world when it successfully convinced

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Microsoft shareholders to agree with a proposal to push the software-maker to issue a public report on the effectiveness of its sexual harassment policies.[12] State Street Global Advisors, one of the world's largest asset managers, said that, in 2022, it would vote against compensation committee chairs at S&P 500 companies that are not disclosing their federally mandated EEO-1 report data on workforce diversity.[13]

Another way investors have tried to address institutional racism in corporate America is by putting pressure on corporations to select diverse directors.[14] John Streur, president and CEO of Calvert Research and Management, one of the oldest socially responsible investors, wrote in June 2020, amid the protests over the killing of George Floyd, that "[e]nding racism in America is a responsibility of corporations, and corporations must recognize that their current efforts to promote their core values, and diversity and inclusion programs, fall far short of what is needed today."[15] Larry Fink, the chairman and CEO of BlackRock, which manages $10 trillion in investments and is one of the world's largest asset managers,[16] has repeatedly called on investee companies to appoint at least two women to serve on their board of directors.[17] In the 2019 proxy season, BlackRock revealed

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that it had voted against board members at 52 companies in the Russell 1000 with boards that included fewer than two women or no other diverse directors.[18] In his 2022 annual letter to CEOs, Fink defended the push for greater transparency of corporate environmental, social and governance practices in policies in what he described as "[s]takeholder capitalism," which he said was "not about politics. It is not a social or ideological agenda. It is not 'woke.' It is *capitalism*, driven by mutually beneficial relationships between you and the employees, customers, suppliers, and the communities your company relies on to prosper."[19]

Another aspect of the "S" in ESG concerns workers' human rights, with supply-chain sourcing as an example of a hot topic. Just recently, President Biden enacted the Uyghur Forced Labor Prevention Act, a new law intended to combat forced labor in China's Xinjiang region where the Uyghur, a Turkish ethnic group, and other Muslim minority populations reside.[20] The new law will take effect on June 21, 2022 and require companies to present strong documentation to the U.S. Customs and Border Protection that no part of their products contain components sourced or manufactured made with forced labor. [21]

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High Stakes Litigation Risks

Given the increased scrutiny of corporate diversity and human rights, there are a number of areas where "S" litigation may likely increase. While environmental or "green-washing" shareholder suits have been more successful to date than "diversity" lawsuits, that may very well change as the sheer numbers of these suits begin to increase. There have also been some early plaintiffs' successes in the realm of lawsuits attacking "human rights" records and "worker safety" suits that may also serve as models for ESG "social responsibility lawsuits." Further, a number of recent high profile ESG-styled sexual harassment lawsuits against corporate boards have led to notable settlements. And even if some suits did not succeed, the approaches to filing these cases are still in their early iterations, and the current body of case law can illuminate where plaintiffs may strengthen their claims going forward – for example, more recently some plaintiffs have successfully brought false advertising claims alongside securities fraud claims.[22]

Lawsuits Driven by a Lack of Diversity

A lack of gender diversity, tied to allegations of sexual harassment, has spawned ESG-styled shareholder-

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derivative suits in the area of sexual harassment, with some successful settlements that included board commitments around diversity. In the Wynn Resorts Ltd. derivative action – litigation brought by the New York State Common Retirement Fund and the New York City Employees Retirement System – the settlement included an agreement for Wynn Resorts to split the CEO and chair position, make a stated commitment to 50% board diversity, and use a Rooney Rule to require interviews of diverse candidates. (The Rooney Rule is an NFL policy that requires any team with a head coaching vacancy to interview at least one diverse candidate.[23]) In the same vein, in the wake of shareholder actions led by the state of Oregon arising out of allegations of sexual misconduct at L Brands Inc., the newly spun-off Victoria's Secret corporate board is now composed of nearly all-women directors (six out of seven directors) and half of Bath & Body Works Inc.'s independent directors (under the new name of L Brands) are women.[24]

On the other hand, a number of diversity-based actions have failed to proceed past the motion to dismiss stage. In *Ocegueda v. Zuckerberg*,[25] the plaintiff alleged that Facebook lacked diversity at all levels (on its board and executive team and in its

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workplace), that it engaged in discriminatory advertising practices and failed to curb hate speech in violation of the directors' fiduciary duty and the Securities Exchange Act of 1934.[26] The case was dismissed on several grounds, including that statements regarding diversity in the company's proxy statements were "non-actionable puffery" or "aspirational" and that the complaint lacked plausible facts about directors' misconduct.[27]

Likewise, in April 2021, a case against Gap, Inc., claiming the company failed to create meaningful diversity on the board of directors or with the company's leadership roles and made false statements about its diversity and its efforts to create diversity, was dismissed on procedural grounds for failure to abide by a forum selection clause in the corporation's bylaws.[28] Similar lawsuits against Oracle Corporation, Danaher Corporation and 10 of its 12 directors, and OPKO Health's board, which alleged failure to appoint diverse board members or executives, were also dismissed for failure to plead with specificity or other procedural defects.[29] In spite of these wins on the part of the defendants, there is at least one high-profile suit still pending,[30] and the push by federal and state regulators, along with the intensity of feeling by activists and investors

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around boards that are viewed as exclusionary suggest that such lawsuits are not likely to fade away and will continue to be pursued.

Human Rights Issues and Health and Safety Lawsuits

There have been some early successes in the arena of human rights and worker safety. In a recent action against Starbucks Corp.,[31] the plaintiff alleged that, while Starbucks labels its hot chocolate as "made with ethically sourced cocoa," and that the company administers an internal certification program known as "COCOA,"[32] "[n]evertheless, Starbucks is 'fully aware that the farms it sources its cocoa from use child and slave labor.'"[33] The court ultimately denied Starbucks's motion to dismiss and allowed the plaintiff's claims to go forward under California's California Consumers Legal Remedies Act and Unfair Competition Law.[34]

In yet another case, shareholders of Vale S.A., a Brazilian mining company, received a $25 million settlement over claims that Vale and its executives committed securities fraud under Sections 10(b) and 20(a) of the Securities Exchange Act.[35] The court found that the plaintiffs had successfully alleged that defendants materially misrepresented or omitted

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facts in public filings related to the stability and safety of Vale's projects, and that its statements were not simply "puffery."[36]

In January 2019, the National Consumer League announced a settlement of a lawsuit[37] alleging violation of the District of Columbia's Consumer Protection Procedures Act[38] by defendant-retailers Wal-Mart, The Children's Place and J.C. Penney, for failure to audit company suppliers, as the companies had promised, to ensure safe and healthy working conditions for their workers and not utilize child labor. Also in the area of health and safety, in November 2019, California Attorney General Rob Bonta announced a stipulated judgment requiring Amazon to end harmful labor practices that concealed COVID-19 case numbers from workers and to provide key information on workplace protections.[39] As part of the stipulated judgment, Amazon modified its COVID-19 notifications to workers and local health agencies, agreed to submit to monitoring regarding its COVID-19 notifications and paid a $500,000 fine

What Lies Ahead?

Various arms of federal and state governments, activist shareholders and

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institutional investors are increasingly jumping into the fray of greater ESG oversight and regulation.

In litigation, we see that many of the lawsuits filed have been shareholder derivative actions involving federal securities fraud claims, as well as other statutory and regulatory claims premised on such issues as false advertising and consumer protection. While expressions of corporate optimism and puffery may not be actionable fraudulent statements, there is a fine line between puffery and ESG-related disclosures that are materially misleading or false. Specific vulnerabilities have included disclosures or lack of disclosures related to corporate audits and statements made in press releases or on websites, statements made to employees.

While some commentators have suggested that workforce diversity and board diversity litigation is floundering given the spate of recent losses in a number of high-profile cases, we are not convinced that is the case given the push by the federal government and its agencies toward increased scrutiny and regulation. The more that data and disclosures become publicly available, the greater possibility that a plaintiff will be able to meet requisite pleading standards.

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Particularly in the "S" area of ESG, we are seeing an increased concern and use of litigation about "human rights" causes, which has largely covered worker health, safety and anti-exploitation measures. Given the operational and reputational risks at stake, there is a need to take steps to manage pre-litigation risks. Companies should review what they say against what they actually do, scrutinizing both involuntary and voluntary disclosures at all levels – whether in advertising or period reports filed with government agencies or statements to employee – to make sure corporate actions and words are aligned. As one example, a company should consider adding language into their supply chain vendor contracts that expressly states ESG goals, expectations and metrics for compliance. These contracts should also expressly warn vendors that they may be terminated should they fail to adhere to these expectations. Enforcement, of course, must be monitored. Seeking third-party certification of ESG compliance is not without its own litigation risk: activists have sued both those who use certifications and the certifiers.

Overall, we believe that ESG litigation will slowly grow in force and impact, making these risk management activities all the more critical.

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[1] *See* Camilla Christino, *ESG: The New Paradigm for Business*, Timeline Soft Expert Blog, Nov. 29, 2021, https://blog.softexpert.com/en/esg-timeline.

[2] Generally speaking, commentators have described ESG and CSR as related concepts in that they are "both concerned with a company's impact on society and the environment," but different in that CSR is a "business model used by individual companies," whereas "ESG is a criteria that investors use to assess a company and determine if they are worth investing in." James Cook, *What Is the Difference Between ESG and CSR*, Business Leader, Sept. 2, 2021, https://www.businessleader.co.uk/what-is-the-difference-between-esg-and-csr; *see also*, George Kell, *The Remarkable Rise of ESG*, Forbes, July 11, 2018, https://www.forbes.com/sites/georgkell/

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2018/07/11/the-remarkable-rise-of-esg/#575351571695 (describing data-driven nature of ESG when compared to SRI).

[3] For example, Amazon.com Inc. had to apologize in 2021 for falsely denying that their employees were at times forced to urinate in plastic bottles because they did not have adequate time to use the restroom. *See* Audrey Conklin, *Amazon aware that workers allegedly pee in water bottles, documents show; company pushes back*, FoxBusiness.com, Jan. 28, 2021, https://www.foxbusiness.com/technology/amazon-workers-pee-water-bottles. Amazon's full-time warehouse employee injury rate was more than 60% higher than non-Amazon warehouse employee injury rate and twice as high as Walmart warehouse employee injury rate. Niall McCarthy, *Amazon Warehouse Injuries Significantly Higher Than Competitors*, Forbes.com, June 8, 2021, https://www.forbes.com/sites/niallmccarthy/2021/06/08/amazon-warehouse-injuries-significantly-higher-than-competitors-infographic.

[4] *See* SEC Chairman Gary Gensler, Prepared Remarks at London City Week, SEC, June 23, 2021, https://www.sec.gov/news/speech/gensler-speech-london-city-week-062321.

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[5] *Id. See also* SEC Staff Legal Bulletin No. 14L SEC (November 3, 2021), https://www.sec.gov/corpfin/staff-legal-bulletin-14l-shareholder-proposals. In the bulletin, the SEC rescinded previous guidance on shareholder proposals and revised the standards for the ordinary business exception in Rule 14a-8(i)(7) and the economic relevance section of Rule 14a-8(i)(5) to limit the ability of corporations to exclude ESG proposals by shareholders from the proxy-voting process, paving the way for an increased number of "S" shareholder proposals in the coming year.

[6] NASDAQ's Board Diversity Rule: What NASDAQ-Listed Companies Should Know (October 21, 2021), https://listingcenter.nasdaq.com/assets/Board%20Diversity%20Disclosure%20Five%20Things.pdf.

[7] *Id.*

[8] California has requirements about women on public company boards and directors from underrepresented communities. *See* Cal. Corp. Code §§ 301.3, 2115.5); Cal. Corp. Code § 301.3(A)-(B); Cal. Corp. Code § 301.3(E)(1).

[9] *See* 805 Ill. Comp. Stat. Ann. 5/8.12 (requires companies to publish data regarding female, minority and LGBTQ

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directors); N.Y. Bus. Corp. Law § 408 (requiring corporation's biennial statement to disclose the total number of directors and the total number of female directors and requiring that the state prepare a study from this data looking at the change in board gender composition from prior years and the aggregate percentage of women directors on all boards); Md. Code Ann., Tax-Prop. § 11-101(c) (requiring that domestic stock corporations with total sales exceeding $5,000,000 and tax-exempt domestic nonstock corporations with operating budgets exceeding $5,000,000 must comply with a gender diversity reporting requirement to state's Department of Assessments and Taxation).

[10] *See DiNapoli Calls on Major Corporations To Conduct Racial Equity Audits*, Office of the New York State Comptroller Press Release (Jan. 19, 2022), https://www.osc.state.ny.us/press/releases/2022/01/dinapoli-calls-major-corporations-conduct-racial-equity-audits.

[11] Kell, *supra* note 2.

[12] Jordan Novet, *Microsoft Hires Law Firm To Review Sexual Harassment Policies, With Report Due in Spring*, CNBC.com, Jan. 13, 2022,

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https://www.cnbc.com/2022/01/13/microsoft-hires-law-firm-to-review-sexual-harassment-policies.html.

[13] Guidance on Enhancing Racial & Ethnic Diversity Disclosures, State Street Global Advisors (January 2021), https://www.ssga.com/library-content/pdfs/asset-stewardship/racial-diversity-guidance-article.pdf.

[14] This is an example of how the "S" or social aspect of ESG blends and overlaps with the corporate governance side or the "G" in ESG. Notably, while this article is focused on "S" there is some inevitable overlap between "S" and "G."

[15] John Streur, *Corporations and Investors Must Do More to Combat Racism*, Calvert Impact Blog (June 2, 2020).

[16] Andrew Ross Sorkin and Michael J. de la Merced, *It's Not 'Woke' for Businesses to Think Beyond Profit, BlackRock Chief Says*, N.Y. Times, Jan. 17, 2022, https://www.nytimes.com/2022/01/17/business/dealbook/larry-fink-blackrock-letter.html.

[17] *See, e.g.*, Vanessa Fuhrmans, *How To Get More Women in the Boardroom? Some Try Blunt Force*, Wall Street J., April 25, 2018, https://www.wsj.com/articles/how-to-get-more-women-in-the-boardroom-some-try-blunt-force-1524648602.

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[18] BlackRock Investment Stewardship 2019 Annual Report, BlackRock (Aug. 2019), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf.

[19] Larry Fink's 2022 Letter to CEOs: The Power of Capitalism, BlackRock, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

[20] Lydia Beyoud, *U.S. Crackdown on Forced China Labor Risks Supply Chains Snarls*, Bloomberg, Jan. 27, 2022, https://news.bloomberglaw.com/esg/china-forced-labor-law-risks-snarling-supply-chains-esg-goals.

[21] *Id.*

[22] *See, e.g., infra* Myers n.30.

[23] *See, e.g.*, Press Release regarding Wynn Resorts, Ltd. Derivative Litigation (August 2, 2021) (announcing $90 million settlement of derivative suit rising out of allegations that Steve Wynn engaged in a longstanding pattern of sexually harassing and assaulting Wynn employees on company property), https://www.cohenmilstein.com/case-study/wynn-resorts-ltd-derivative-litigation.

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[24] *See* Kevin LaCroix, The D &O Diary (August 2, 2021), https://www.dandodiary.com/2021/08/articles/director-and-officer-liability/l-brands-establishes-90-million-fund-in-sexual-misconduct-derivative-suit-settlement (noting that L Brands agreed to a settlement of litigation arising from sexual misconduct allegations which will require it to adopt management and governance measures, to which it will commit $90 million of funding over the course of five years).

[25] 526 F. Supp. 3d 637(N.D. Cal. 2021).

[26] *Id.* at 641. Specifically plaintiffs file claims under § 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a), and SEC Rule 14a-9, 17 C.F.R. § 240.14a-9.

[27] *Id.* at 651-652.

[28] *Lee v. Fisher*, 2021 WL 1659842 at *6 (N.D. Cal. Apr. 27, 2021).

[29] *See Klein v. Ellison*, 2021 WL2075591 (N.D. Cal. May 24, 2021); *In re Danaher Corp. S'holder Derivative Litig.*, 2021 WL 2652367 (D.D.C. June 28, 2021; *Lee v. Frost*, WL 3912651 (S.D. Fla. Sept. 1, 2021).

[30] *See Foote v. Micron Tech., Inc.*, No. 1:21-cv-00169 (D. Del. Feb. 9, 2021)

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(motion to dismiss still pending involving shareholder derivative complaint filed against Micron Technology asserting claims for breach of fiduciary duties – good faith, loyalty, reasonable inquiry, oversight, and supervision – unjust enrichment, waste of corporate assets, abuse of control, gross management, and violation of §14(a) of the Securities Exchange Act and SEC Rule 14a-9, arising from allegations regarding Micron's lack of diversity, equality and inclusion and false statements on diversity).

[31] *Myers v. Starbucks Corp.*, 536 F. Supp. 3d 657 (C.D. Cal. 2021).

[32] *Id.* at 662.

[33] *Id.*

[34] *Id.* at 667.

[35] *In re Vale S.A. Sec. Litig.*, 2020 WL 2610979 (E.D.N.Y. May 20, 2020).

[36] *Id.* at *1.

[37] *See Statement on Resolution of Lawsuit Against Walmart, JC Penney, and The Children's Place, National Consumers League*, https://nclnet.org/archive-pages/resolution_walmart; *see also Nat'l Consumers League v. Walmart Stores, Inc.*, No. 2016 CA 007731 B, 2016 WL 4080541 (D.C. Super. Ct. July 22, 2016). The settlement was struck after a court

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partially denied the defendant-retailers motion to dismiss.

[38] *Id.* at *10-11.

[39] *See In Nationwide First, Attorney General Bonta Secures Judgment Requiring Amazon to Comply with "Right-to-Know" Law to Help Protect Workers Against Covid-19*, California Attorney General's Office Press Release (November 15, 2019), https://oag.ca.gov/news/press-releases/nationwide-first-attorney-general-bonta-secures-judgment-requiring-amazon-comply.

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