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What We Talk About When We Talk About ESG

By Daniel J. Struck
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With apologies to Raymond Carver, when we talk about ESG (environmental, social, and governance) we often find that although we think we all are talking about the same thing, there is little agreement about the proper scope and role of ESG.

Depending on who is doing the talking, ESG may refer to very different things with very different meanings, very different expectations, and very different impacts. Ostensibly ESG refers to a bundle of environmental, social, and governance-related priorities and objectives intended to provide a lodestar helping to guide corporate decision-makers as well as a framework for evaluating corporate responsibility. It is generally assumed that a corporation that acts consistently with ESG principles is a sound investment and has a favorable risk profile.

However, beyond anodyne statements that corporations should be law-abiding and responsible, there is much uncertainty and controversy about, among other things, the specific issues and concerns that make up the constituent elements of ESG, what makes an entity successful from an ESG perspective, how material progress toward the achievement of ESG principles is measured, and whether there is any correlation between successful engagement in ESG initiatives and profitability or reduced corporate risk. There is also uncertainty about the makeup of the regulatory and litigation risks associated with ESG. Given the ambiguities and uncertainties that are inherent in a discussion of ESG, it may well be an impossible task to satisfy every constituency or interested set of stakeholders.

Whose ESG?

ESG has become something of a buzzword in the corporate and investing world. Shareholders and activist investors demand that corporations adopt ESG practices and goals. Corporations are eager to publicize their good citizenship by adopting aspirational ESG goals. Investment advisers and managers continue to roll out funds and other investment vehicles targeting climate-friendly or other ESG-focused companies. Pension and retirement fund managers include ESG responsibility as a factor in their selection of investments. Analytical firms include ESG factors in their evaluations and ratings. Securities regulators have launched ESG task forces charged with developing ESG-related reporting requirements. With this background, ESG initiatives have become a factor in assessing a corporation’s reputation and value.

But the question remains, what is everyone talking about when they talk about ESG? The generic answer is that ESG is shorthand for a collection of factors—E (environmental), S (social), and G (governance)—that are instructive when making investment decisions or evaluating corporate performance and risk. A brief review of publicly available materials from the webpages of several large investment managers that offer ESG-focused funds demonstrates the challenge of finding clarity when discussing ESG. Following is a compendium of the factors included under the ESG-oriented investment umbrella by three investment managers:

E: environmental biodiversity loss, climate change, renewable energy use, reduced carbon emissions, green building, deforestation, native title, pollution, reduced waste, and natural resources

S: social diversity, inclusion, race, gender, human rights, modern slavery/trafficking, supply chain standards, antidiscrimination, bullying, harassment, First Nations people, cultural heritage, health and safety, data privacy, labor management, human capital development, employee relations, and conflict/blood resources

G: governance risk mitigation, shareholder activism, antibribery, anticorruption, accountability, board independence, board diversity, transparency, leadership, corporate governance, executive pay, business ethics, board structure, tax strategy, donations, and political lobbying

The breadth and diversity of issues that can be characterized as ESG priorities pose a host of challenges for corporate boards trying to determine how to respond effectively to the call for greater ESG responsiveness.

Virtually no two lists of ESG concerns or priorities are identical. There is no agreed definition of the precise components of ESG. Indeed, some of the issues identified as ESG priorities are susceptible to different interpretations. Given the issues identified as ESG priorities, some imprecision is inevitable. But due to the sensitive social and political nature of some of the ESG priorities, efforts to adopt ESG goals or to motivate ESG-oriented actions through the selection of investments can engender controversy.

Similarly, because ESG is composed of a basket of diverse issues, measuring success in achieving ESG goals is problematic. How does one compare the relative merits, investment worthiness, or risk profile of two corporations: one of which has established a goal of eliminating its carbon emissions in 10 years and the other that has removed enterprises that rely on child labor from its supply chain? The actions of both corporations further goals that are regarded as desirable and consistent with ESG principles. But who is to say that a promise to eliminate carbon emissions in the future is more or less valuable, or better mitigates enterprise risk, than replacing enterprises that utilize child labor in the supply chain? Further, neither of these examples inevitably has a positive impact: there is no guarantee that a promise made today will be fulfilled in 10 years, and it does not necessarily follow that replacing objectionable suppliers will eliminate supply chain disruptions or improve worker conditions. Even accepting that there is some benefit to largely symbolic ESG actions, attempting to benchmark particular symbolic actions or using the activities described herein as a basis for making investment decisions or assessing enterprise risk is susceptible to criticism and methodological uncertainty. Although there are many analysts benchmarking or grading companies based on their ESG bona fides, any grade in this regard is likely to be based on the biases and assumptions built into the evaluation tool.

One might suggest that making investment decisions or assessing risks based on the extent to which a corporation embraces ESG principles is forward looking. Committing to the elimination of carbon emissions or discontinuing relationships with suppliers that use child labor arguably is an investment in the future.

But even if ESG principles are consistent with long-term investment or risk assessment horizons, it does not follow that making ESG commitments is the same thing as accomplishing ESG goals. It is relatively easy to identify ESG goals, but it is something entirely different to achieve those goals. There is a fundamental difference between identifying areas in which change is appropriate, setting targets or establishing policies, and actually making real change. Too often, ESG efforts are focused more on setting goals or creating policies than on the achievement of those targets or on making sustainable progress. ESG measurements are often process oriented by focusing on establishing policies and procedures. Metrics are necessarily broad because it is difficult to measure actual accomplishment, but process-based success may not track actual performance.

Corporate boards are subject to market pressures to institute ESG measures. But what is the relationship of ESG initiatives to a board’s duty to shareholders? ESG includes multiple, sometimes competing, objectives. There is little guidance as to the preferred formula for instituting ESG measures. It does not necessarily follow that ESG accomplishments lead to better corporate performance or lower enterprise risk. Certainly, acting to limit the impact of climate change or preserving scarce water resources is desirable. But it may be difficult to measure the incremental contribution of the actions of a single actor to a larger goal. Actions that might result in a benefit in 20 years have little value for an investor with a two-year horizon. Indeed, being proactive in instituting ESG initiatives may in some circumstances create additional risk. Actions that a corporate board views as an important ESG initiative might look like a costly boondoggle that is detrimental to the bottom line in the eyes of some shareholders.

Although there is generalized agreement about the types of issues that are included in the ESG conversation, once the analysis turns to particular issues or to the means of reaching a particular target, differences of opinion are likely. Although there may be general agreement that it is beneficial to engage in ESG initiatives, it may be difficult to demonstrate that there is any immediate corporate benefit other than satisfying the requirements of ESG-directed investors. This is the setting in which corporate boards find themselves: there are widespread calls from private and institutional investors and some regulators to adopt ESG initiatives, but what ESG means and the nature of the benefits of ESG are amorphous and open to dispute.

No "Good" Deed Goes Unpunished

It appears to be a common viewpoint that ESG initiatives eventually will equate with a reduction in corporate and management risk because they demonstrate responsible leadership. This may prove to be the case once the meaning and content of ESG become better defined and ESG goals become reality and not merely promises. At present, however, with the uncertainties surrounding ESG initiatives, ESG is often a source of additional risk and new litigation. To date there has been little litigation against perceived ESG laggards. Defying expectations, much of the ESG-related litigation has been brought against entities that have undertaken ESG initiatives. The sources of ESG-related litigation have included controversial ESG actions that allegedly harmed the corporation's share price and reputation, ESG actions that allegedly restrained trade or interfered with shareholder rights, and ESG-related representations and claimed benefits that allegedly exceeded actual performance.

The experience of Unilever and its subsidiary Ben & Jerry's provides an example of the possible consequences of politicized or controversial ESG initiatives. After it was acquired by Unilever, Ben & Jerry's was permitted to maintain an independent board charged with furthering the company's social mission statement. In 2020, the Ben & Jerry's board passed a resolution calling for the end of sales in areas that Ben & Jerry's considered to be illegally occupied by Israel. With the 2021 expiration of a regional licensing agreement, Ben & Jerry's discontinued sales in "occupied Palestinian territory" while continuing distribution in "Israel proper." Unilever and the Ben & Jerry's board soon got into a public spat over the characterization of Ben & Jerry's actions, with Unilever trying to minimize the consequences and highlighting that Unilever and Ben & Jerry's continued to do business in Israel. Negative reactions followed, with protests in Israel and seven U.S. states divesting pension fund holdings in Unilever. Unilever's share price fell by 5% in the aftermath of the negative publicity. A shareholder stock price drop lawsuit followed shortly thereafter. Ben & Jerry's actions, which purported to advance its "social mission" (presumably the "S" in ESG), were controversial. To many observers, Ben & Jerry's actions were incompatible and inconsistent with the appropriate scope of corporate social action. Moreover, for many observers actions that appear to advance the BDS (boycott, divestment, and sanctions) movement carry ugly connotations. Rather than making a corporation a desirable investment and improving its risk profile, controversial ESG actions may engender adverse publicity, substantial controversy, and litigation.

Less controversial ESG initiatives have also been the basis of lawsuits against companies with well-publicized social ESG initiatives, such as Starbucks. The types of claims that have been brought include shareholder claims alleging that ESG-friendly boards are violating their duties to maximize value for the sake of engaging in social initiatives of dubious value; by implementing allegedly discriminatory policies, boards are exposing the corporation to new liabilities contrary to the board's duties to shareholders; and boards are exposing the corporation to federal and state civil rights claims by customers and job applicants that have been discriminated against as a result of ESG initiatives.

To date, so-called greenwashing and similar claims have been the predominant category of claims arising out of ESG efforts. These claims typically concern an alleged discrepancy between a corporation's public statements concerning ESG activities and the corporation's actual actions. The relevant discrepancies can be the result of alleged misrepresentations or misstatements, overly optimistic goals, or the inadequate execution of policies and/or inadequate oversight and supervision.

"Greenwashing" refers to the subset of situations in which an entity exaggerates or paints an overly rosy picture of its environmental initiatives or accomplishments. These claims typically are brought as shareholder or regulatory proceedings. The experience of Wells Fargo Bank with the failed execution of its diversity in hiring initiatives is a prominent recent example of the risks that result when there are discrepancies between aspirational policy statements and actual corporate practice. Wells Fargo announced a broad diversity and inclusion in hiring initiative. After the initiative was launched, reports of fake interviews and the doctoring of interview records began appearing in the media. After initial denials, Wells Fargo acknowledged that fake or back-dated job interviews had been reported in order to satisfy the bank's diversity in hiring requirements. Shortly thereafter, Wells Fargo was sued in a shareholder claim, alleging that Wells Fargo made statements that were materially false and misleading, Wells Fargo failed to disclose that it had misrepresented the extent of its diversity efforts, Wells Fargo conducted fake job interviews in order to feign compliance with its diversity in hiring requirements, Wells Fargo's conduct exposed it to potential enforcement actions, and Wells Fargo's share price and reputation suffered as a result of the bank's actions. Instead of minimizing risk, ESG initiatives, if rolled out poorly, create a new category of potential risk.

Thus far, the expected lawsuits against companies that are sluggish in enacting ESG measures have been relatively limited. But inaction is not a viable alternative. Corporations that do not undertake any significant ESG initiatives face the risk of attacks by activist investors seeking to challenge or replace leadership. Corporations that do not undertake significant ESG initiatives face a risk of disinvestment by failing to satisfy ESG benchmarks established by investment managers or market analysts. Although substantial litigation against perceived ESG laggards has not materialized, that is likely to change once initial climate disclosure rules and regulations are finalized by the SEC because mandatory disclosures—or the failure to satisfactorily comply with those requirements—will provide a convenient basis for litigation.

The litigation that has materialized is largely against entities that have claimed to be proactive on ESG issues but have had difficulty in carrying out their initiatives or have taken controversial actions with an arguably adverse impact on reputation. ESG involves a complex web of competing risks that pose hazards if poor choices are made or claims outstrip performance. Instead of becoming a means to reduce corporate risk, ESG has become a new source of potential liability.

It's Only a Matter of Time Before Regulators Have Their Say

The ESG-related hazards confronting corporations are not limited to market pressures and litigation risks. Federal regulatory agencies have begun weighing in concerning the role of ESG in corporate disclosures and bringing enforcement actions involving allegedly inaccurate or misleading ESG statements.

The SEC has established an ESG task force that is preparing rules governing climate change disclosures. The proposed final rules were scheduled to be released in the fourth quarter of 2022 but have been pushed back until the first quarter of 2023 at the earliest due to recent Supreme Court rulings limiting the scope of agency rule-making powers.

The SEC's ESG task force is also charged with bringing ESG-related enforcement proceedings. The ESG task force is focusing initially on material misstatements concerning climate risks under existing rules. The SEC is particularly concerned with investment advisers that are branding and marketing their funds and investment strategies as ESG directed. It is the SEC's stated intention to hold investment advisers that market their funds as ESG-focused accountable if they do not accurately describe the application of ESG factors in their investment processes. To date, the SEC has brought enforcement actions against a number of advisers and asset managers for marketing funds as ESG focused without adequate policies and procedures in place to ensure that the investments were indeed ESG directed. In a similar vein, the SEC has commenced enforcement proceedings against securities issuers that have announced ESG initiatives but have failed to follow through on those initiatives.

Additionally, the Department of Labor has issued rules permitting ERISA plan fiduciaries to consider ESG factors when selecting investments for retirement funds or exercising shareholder rights such as the authorization of proxy votes. These rules reverse the approach of the previous administration that forbade plan fiduciaries from considering ESG factors when investing plan funds.

To date regulatory enforcement actions have not been focused on corporations or investment managers that failed to undertake any ESG initiatives. Enforcement actions largely have been brought against enterprises that have overstated their ESG achievements or have had poor execution of their ESG initiatives. Although the SEC has yet to promulgate rules providing for ESG-related disclosures, it is clear that the SEC will look askance at allegedly misleading or inaccurate statements concerning the fulfillment of ESG goals or the utilization of ESG factors in making investment decisions.

Watch Out for Cross-Currents

Based on the foregoing, there are:
(1) Definitional issues surrounding ESG initiatives.
(2) Inconsistencies in the evaluation of ESG performance. (3) Disagreements about some of the more controversial expressions of ESG goals.
(4) Concerns about potential discrepancies between ESG promises and performance.

Nonetheless, there is vague general consensus that it is appropriate for corporate boards and management to identify ESG priorities and for investors to include ESG factors in the process of selecting investments. We may not be able to define or evaluate ESG with precision, but generally we know it when we see it.

But this description disregards the substantial cross-current of sentiment that ESG factors have no place in making investment decisions or in setting corporate policy. At least 17 states have adopted or proposed some form of anti-ESG legislation. The state legislation typically bars state governments and public retirement funds from considering ESG factors in selecting investments and/or bars state governments and public retirement funds from doing business with advisers, funds, or corporations that are disinvesting in certain disfavored industries such as fossil fuels, lumber, mining, chemical processing, and firearms.

Not surprisingly, Florida has taken a leading role in opposition to ESG-focused investing. Florida's chief financial officer has directed the divestiture of more than $2 billion in state assets managed by firms that apply ESG considerations in making investment decisions. State fund administrators have been directed to redirect state funds to prioritize the highest return on investment without regard for the "ideological" agenda of the ESG movement. The Florida CFO characterized the practice of considering ESG factors in making investment decisions as an undemocratic "social-engineering project" that is at odds with the responsibility of Florida officials to manage state funds so as to secure the highest possible return on behalf of state agencies and retirees.

Perhaps counting their chickens before they hatch, a group of five Republican senators sent letters four days before the mid-term elections to 51 major law firms informing them that the Senate planned to use its oversight powers to conduct investigations into the "institutional antitrust violations being committed in the name of ESG." The senators suggested that activist investment advisers and their lawyers were engaged in a collusive effort to restrict the supply of fossil fuels in order to drive up energy costs and empower America's adversaries. These injuries, so the senators claimed, were being done in service of the ESG movement's weaponization of American business to reshape society in ways that would never prevail at the ballot box. The senators ended their missive warning the law firms that their clients should preserve documents pending upcoming congressional investigations.

Whether the condemnation of the ESG movement playing out in some state capitols and among some members of Congress is merely posturing or has a material chilling effect on ESG-oriented corporate and investment decision-making has yet to determined. But the tenor of the criticism is indicative of the current unstable environment.

There Are No Clear-Cut Answers When We Talk About ESG

The assumption that companies that are taking ESG initiatives are good risks assumes that the corporate embrace of ESG is an indicator of corporate success or of reduced liability and regulatory risk. Ultimately, that assumption may prove to be accurate. But that conclusion is not clear-cut at present. ESG initiatives may be a magnet for litigation due to controversial choices or unmet goals. Corporate boards and investment managers also must balance the risk of being viewed unfavorably if they do not adopt ESG measures against the risk of disinvestment if they run afoul of investors and state fund managers that view ESG as inappropriate.

Companies eager to demonstrate their ESG bona fides have to beware exposing themselves to accusations that they are exaggerating their ESG accomplishments. Optimistic goals to reduce emissions may be viewed as a material misstatement by regulators or investors if goals are not met. ESG should not just be a marketing tool. If a corporation or fund presents itself as ESG oriented, it is necessary to actually be ESG oriented.

The process of making ESG decisions, the complexity of evaluating the level of commitment to ESG initiatives, and the risks that are associated with ESG initiatives may be more challenging and nuanced than often is assumed. A clear-eyed approach and careful analysis in adopting appropriate ESG goals, as well the commitment to fulfill stated goals, are the bare minimum of a successful ESG program.

There is no guarantee that there will be immediate payoffs or that realistic accomplishments will be viewed favorably by analysts or the investment market. If there is a payoff to ESG initiatives, it most likely will come in the form of leaving an entity better prepared to meet future challenges as the by-product of careful planning and the commitment to continual improvement. In other words, an ESG-friendly culture is not much different than the kind of corporate culture that responsible and healthy boards always have fostered. It may be difficult to define or measure ESG precisely. The definitional and methodological sloppiness associated with much of the current discussion is unfortunate, but a board that is prepared to adapt to ESG demands is one that is prepared for the vicissitudes and changing circumstances that face any business enterprise.

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Daniel J. Struck is a partner at Culhane Meadows PLLC in the firm's Chicago office. As an experienced policyholder attorney, he advocates on behalf of corporate and individual insurance policyholders throughout the United States in contested claims, and counsels clients in complex insurance advisory matters.
