ESG & STAKEHOLDERS
DO STAKEHOLDERS HAVE A ROLE?

• Governance in U.S. is shareholder-centric:
  – Board’s fiduciary duty is to shareholders.
  – Strategy is designed to create shareholder value.
  – Risk management minimizes loss to shareholders.
  – Compensation provides incentive to increase value.
  – Efficient markets transfer assets to those who derive highest value.

• Friedman (1971): The only social responsibility of a firm is to increase profit.
  – Other objectives divert resources to purposes that shareholders have not approved, harming owners, customers, and labor through lost efficiency.

What place do stakeholder interests have in corporate governance?
STAKEHOLDER INTERESTS

• Stakeholders represent all constituents with a direct or indirect interest in the corporation.

• Examples include customers, suppliers, employees, creditors, trade unions, local communities, and local governments.

• They have broad interests: sustainability, reduction in waste or pollution, higher wages, workplace equality, diversity, affordability and access to products, being a responsible counterparty or local citizen, etc.

• Because companies operate in different industries, stakeholder interests vary across corporations.

When we speak of stakeholder interests, we generally refer to the most directly relevant issues for each firm.
STAKEHOLDER INTERESTS

• Various labels have been applied over time:
  – Corporate Social Responsibility (CSR).
  – Socially Responsible Investing (SRI).
  – Environmental, Social, and Governance (ESG).

• Various sources of pressure have arisen over time to encourage ESG:
  – Money flowing into sustainable investment funds.
  – Shareholders sponsoring ESG-related proxy proposals.
  – Institutional investor activism (e.g., BlackRock, Vanguard, State Street).
  – Ratings, indices, and lists (e.g., Barron’s “Most Sustainable Companies”).
  – Employee activism.
  – Third-party activism and NGOs.
Business Roundtable updated its Purpose of Corporation in 2019:

“Since 1978, Business Roundtable has periodically issued Principles of Corporate Governance.... Each version of that document issued since 1997 has stated that corporations exist principally to serve their shareholders. It has become clear that this language on corporate purpose does not accurately describe the ways in which we and our fellow CEOs endeavor every day to create value for all our stakeholders, whose long-term interests are inseparable.”

Expresses new commitments to:

– Deliver value to customers.
– Invest in employees; foster diversity and inclusion.
– Deal fairly with suppliers.
– Support local communities.
– Generate long-term value for shareholders; shareholder engagement.

What are the practical implications of this change?
LEGAL IMPLICATIONS

• Fiduciary duty requires that shareholder considerations are primary.

“[A] clear-eyed look at the law of corporations in Delaware reveals that, within the limits of their discretion, directors must make stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare.” – Leo E. Strine

“I cannot accept as valid … a corporate policy that specifically, clearly and admittedly seeks not to maximize the economic value of a for-profit Delaware corporation for the benefit of its shareholders.” – William B. Chandler

• Boards must evaluate stakeholder needs in the context of shareholder interests.

• Stakeholder initiatives can be pursued if they benefit shareholders.

• A change in corporate law would be required for boards to make decisions that reduce economic outcomes for shareholders to benefit other stakeholders.
**ECONOMIC IMPLICATIONS**

- Do companies harm shareholders by not investing in ESG?

- Key assumption: corporate executives are short-term oriented.
  - Equity incentives and activist pressure encourage focus on short-term.
  - Executives under-invest in business to boost quarterly results.
  - Lack of investment harms business over time through decreased performance, or creates an externality that company is forced to redress.

- ESG advocates believe executives need to focus on long-term stability; by doing so, they will create outcomes that are larger, more equitable and more sustainable.

- Little evidence that short-termism is a pervasive problem in the U.S.
- Stakeholder orientation has the potential to decrease management accountability by lessening financial performance as a disciplining mechanism.

Denis (2019); Jensen (2002); Bebchuk and Tallarita (2020)
WHAT DO DIRECTORS AND EXECUTIVES THINK?

- Directors and executives embrace ESG and are generally satisfied with the job their firms do to meet stakeholder needs.

- Social purpose and profitability are not mutually exclusive (80%); stakeholder interests are critical to long-term planning (89%).

- Few believe shareholders are more important than stakeholders (23%); most are satisfied with their initiatives to meet stakeholder needs (96%).

- Executives believe they are long-term oriented (use 3 year planning period, on average).

- Executives do not believe adopting a stakeholder orientation requires a tradeoff between short-term costs and long-term benefits.
  - They either believe it is costly both short and long terms (i.e., not worth doing); or it is beneficial in both short and long term (i.e., no tradeoff, easy decision to make).

Rock Center (2019); PwC (2019)
Companies are not required under generally accepted accounting principles to disclose their performance in many ESG-related areas.

Some companies consider this information to be proprietary (such as employment practices, environmental performance, etc.).

Other companies voluntarily disclose this information; however, the choice of metrics and the level of disclosure is discretionary.

Without consistent and reliable metrics, it is difficult to assess a company’s commitment to and success in ESG.

Lack of uniform metrics is biggest obstacle directors face in overseeing ESG matters.

ESG disclosure is significantly more prevalent among large companies.

NACD (2019); E&Y (2020)
Examples of voluntary ESG disclosure:

- **Sustainability report**
  Describes the economic, environmental, and social impact of a company’s activities, and the link between corporate strategy and sustainable outcomes.

- **Human capital report**
  Qualitative and quantitative data about a company’s workforce, critical skills, workforce development, diversity, training, HR practices, and trends.

- **Climate change impact report**
  Report on the potential impact of climate change on governance, strategy, and risk management including internal metrics and targets.
  Some companies voluntarily disclose information on stakeholder initiatives.
ESG DISCLOSURE

• The Sustainability Accounting Standards Board (SASB) has developed ESG metrics to allow consistent and comparable disclosure across companies.

• Five areas: environment, social capital, human capital, business model and innovation, and leadership and governance.

• Metrics carry heavier emphasis in the industries where they are most relevant (“materiality map”).

• SASB is a nonprofit organization and not a regulatory agency, so its standards carry no legal requirement.

• Few companies issue SASB reports.

ESG disclosure might benefit capital markets through greater liquidity and lower cost of capital.

Christensen, Hail, and Luez (2019)
ESG RATINGS AND INDICES

• Media organizations rank companies on ESG dimensions:
  – Examples: Bloomberg Gender-Equality Index, Ethisphere Most Ethical Companies, Newsweek Green, etc.

• Third-party agencies rate companies on environmental and social factors:
  – Examples: MSCI ESG, FTSE Russell, Sustainalytics, etc.

How accurate are these ratings, if ESG disclosure is voluntary?

• Research finds low correlation and low predictive power across ESG ratings.
• Ratings diverge because of stark differences in methodology.

68% of the Fortune 100 appear on at least one of 11 media rankings:
• Cisco: 8 lists
• Microsoft: 7 lists
• BofA, HP, P&G, Prudential: 6 lists.

Chatterji, Durand, and Touboul (2016); Berg, Koelbel, and Rigobon (2019)
Larcker and Tayan (2019).
CONCLUSION

• In recent years, there has been tremendous pressure to incorporate stakeholder considerations into business and governance practices.

• Corporate directors and executives embrace this movement but also believe they are already effective in advancing stakeholder interests.

• The legal and economic implications of ESG are unclear.

• Do companies make ESG investments that are costly to shareholders? Can they do so legally? Do these create long-term benefits?

• The relation between ESG and performance is unproven.

• Lack of rigorous, consistent, and reliable metrics makes it difficult to measure ESG effectiveness and its impact on performance.


Ernst & Young. How and Why Human Capital Disclosures are Evolving. EY Center for Board Matters. 2020.

