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Addressing Social Justice Issues: Implications for the Board

In her regular column on corporate governance issues, Holly Gregory considers the current pressures on companies to address issues of social justice and the key implications for boards.

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The past year brought unprecedented attention to racial inequity and social justice issues. The COVID-19 pandemic and incidents of police brutality underscored broad disparities in the US in access to income, economic opportunity, health care, education, the internet, food and housing security, and legal justice. These issues present a crucial test for corporate commitment to diversity, equity, inclusion, and other social justice issues, and require attention from the board consistent with fiduciary obligations to the company and its shareholders. Shareholders and other stakeholders are looking beyond corporate statements of policy and commitment, and seeking evidence of action.

In this environment, boards and executive leadership need to consider implications for fiduciary oversight of corporate policies and responsive measures. This article addresses:

- The context in which social justice issues arise.
- The board's role in overseeing corporate social justice initiatives.

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- The outlook for disclosure related to social justice issues under the Biden administration.
- Key legal implications in the current risk and regulatory environment.
- Practice pointers for the board.

CONTEXT FOR ATTENTION TO SOCIAL JUSTICE

Interest in the company's role with respect to social justice issues is apparent in several interrelated trends that predate 2020 (see *Box, Trends Shaping Corporate Interest in Social Justice*). However, this interest has accelerated recently because the events of 2020 sharpened the focus on the shared interests of companies and their key stakeholders in the health, economic well-being, and equitable treatment of society's members. In particular, pressures have intensified on boards and executive leaders to integrate environmental, social, and governance (ESG) considerations, with a growing emphasis on the social component, in corporate strategies, operations, risk management, executive compensation incentives, and disclosure.

While matters of social justice present complexities for boards and executive leadership, with concerted energy and focus, significant progress can be made. Individual companies have already responded in a variety of ways. Over the summer of 2020, corporate charitable giving to organizations focused on civil rights and criminal justice reform increased, and several high-profile brands were changed to eliminate offensive messaging or stereotypes. Longer term corporate efforts are focused on improving policies and practices in the workplace, increasing work with minority-owned suppliers, and enhancing efforts to make customer environments and interactions more inclusive.

In addition to individual corporate actions, the Business Roundtable, an organization of CEOs from leading US companies, recently announced corporate initiatives and public policy recommendations (available at *businessroundtable.org*) to advance racial equity and justice by reducing the economic opportunity gap in communities of color, including disparities in access to financial tools, high-quality jobs, education, and health care. Similarly, general counsel of 12 large financial services firms jointly issued an open letter expressing their commitment to actions related to racial and ethnic equity, including a commitment to press their companies and outside law firms for diverse staffing, and advancement of racially and ethnically diverse employees (An Open Letter to the Global Legal Community (Sept. 30, 2020), available at *jpmorganchase.com*).

Search Board Considerations for an Uncertain 2021 for views on the top issues for 2021, including ESG developments.

Trends Shaping Corporate Interest in Social Justice

While the events of 2020 intensified the focus on the role that companies can play in addressing social justice issues, interest in corporate social responsibility was already growing due to a number of converging trends, including:

- The Business Roundtable's issuance of its Statement on the Purpose of a Corporation ((Aug. 19, 2019), available at *businessroundtable.org*), which led to renewed interest in the company's purpose in society and the important question of for whom the corporation is governed.
- Growing acceptance by investors, boards, and executive leadership that positive approaches to ESG issues, such as climate change, board and workforce diversity, and corporate accountability, are associated with greater corporate resiliency and better long-term performance. Companies that score highly on ESG parameters are viewed by investors as a safe haven in challenging economic times, as evidenced by the flow of capital when the market suffered a significant downturn in late February and March of 2020.
- Enhanced focus on the value of human capital and competitive pressures in the market for talent.
- Expanding expectations for voluntary corporate disclosure regarding ESG matters. For example, BlackRock, Vanguard, State Street Global Advisors, and other investors have expressed their expectations that portfolio companies provide more disclosure on their approach to ESG issues, including issues related to workforce diversity, equity, and inclusion.
- Recognition that the Biden administration is focused on these issues and that further regulation, including in the area of disclosure, is likely.

THE BOARD'S OVERSIGHT ROLE

According to the 2021 Edelman Trust Barometer, survey participants in 18 of 27 countries currently trust business more than government, and 68% of the participants expect business leaders to address societal problems (Press Release, 2021 Edelman Trust Barometer Reveals a Rampant Infodemic is Fueling Widespread Mistrust of Societal Leaders (Jan. 13, 2021), available at *edelman.com*). While no single definition applies, the United Nations Principles for Responsible Investment (2006) (PRI) define the "S" in ESG as issues that are related to "the rights, well-being and interests of people and communities" (PRI, Reporting Framework Glossary, available at *unpri.org*). This broadly encompasses how a company is managing relationships with its employees, customers, and suppliers, as well as the communities in which it operates.

In the current environment, boards, senior leadership, and investors are increasingly focused on:

- Employees' health, safety, and well-being.
- Workforce and board diversity.
- Issues of human rights in the supply chain.
- Broader issues of racial and gender equity and opportunity that extend outside of the company to the communities in which it operates.

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Attending to social justice issues does not conflict with directors' and officers' fiduciary obligations. Depending on the circumstances, a strong case can be made that fiduciary obligations require attention to these matters (see Christopher J. Brummer and Leo Strine, Duty and Diversity (Feb. 18, 2021), available at *papers.ssrn.com*).

Search Fiduciary Duties of the Board of Directors for more on fiduciary governance.

While the empirical literature is mixed, there is growing evidence that positive corporate approaches to diversity, equity, inclusion, and other ESG issues are associated with better performance and lower risk, including the risk of legal and regulatory actions against the company and the risk of reputational harm. To mitigate risks and take advantage of opportunities related to diversity and inclusion, directors and officers can take action to ensure that the company complies with laws and regulations, including anti-discrimination laws and related requirements aimed at addressing inequality and encouraging diversity, equity, and inclusion.

In addition, the board's oversight responsibilities for corporate activity in the ESG sphere, including social justice issues, relate to board oversight of corporate performance, risk management, internal controls, and the company's ethical and compliance culture. Directors should consider diversity, equity, and inclusion in determining what they rationally believe is in the best interests of the company and its shareholders. They have wide discretion under the business judgment rule to determine how best to address these issues.

While boards may delegate significant authority on these issues to management, boards need to consider what governance structures and processes will assist the board in providing guidance and fulfilling the continuing oversight obligation. With respect to the structure of their oversight activities, boards need to consider whether oversight for social issues and other ESG issues rests with the full board or whether delegation of aspects to one or more board committees would position the board to be more efficient.

For example, some boards may delegate issues related to workforce diversity and inclusion to the compensation committee, given its human resources focus, or task the governance committee with other corporate social responsibility aspects of ESG. Certain ESG issues that are closely associated with internal controls related to ethics, compliance, and the code of conduct (such as anti-discrimination and anti-harassment policies, workplace safety policies, and whistleblower protections), as well as ESG disclosures, may be delegated to the audit committee. Some companies have more specialized committees focused on ESG-related topics. According to the 2020 US Spencer Stuart Board Index (available at *spencerstuart.com*), compared to a decade ago, more S&P 500 boards have an environment, health, and safety focused committee (11% versus 5%), but fewer have a public policy and social or corporate responsibility committee (8% versus 14%).

Discussions with management focused on the social component of ESG can be structured based on:

- Seeking opportunities.
- Mitigating risks (including the negative impacts of operations).
- Undertaking appropriate positive efforts in line with the company's purpose.

A common understanding, fostered throughout the company, of the company's specific "purpose" or reason for being provides an important frame for these discussions. Boards should engage with senior management to assess the broad effects of their policies and decisions, including how those decisions may affect underserved and underrepresented populations, and what trade-offs are involved. They also need to assess the internal impact of policies and actions, and may need to become more involved in oversight of policies, metrics, and disclosure.

Search The Corporate Purpose Debate for more on the company's role in society.

Oversight of corporate policies and statements on social issues requires careful consideration of the interests of the company. Public statements on matters of social justice and systemic racism can have a positive impact on corporate reputation and on relations with employees, customers, and suppliers. However, they may also alienate some stakeholders or be viewed as inauthentic. In addition, the company needs to be able to back up its statements with real action. Statements that are connected to actions, and commitments that are actionable, are likely to be viewed as more authentic.

If an issue could have a material impact on the business or corporate reputation, the board should be involved in discussions regarding the proposed policies, messaging, and actions. This avoids surprises, positions the board to support management's actions, and ensures that the board has the opportunity to provide oversight with respect to corporate interests and the alignment of policy, speech, and action. The discussion should address the financial impact and risks of both action and inaction, alignment with corporate values (authenticity), stakeholder interests, and any potential controversy. (See Holly J. Gregory, When CEOs Speak Up, NACD Directorship Magazine (Jan./Feb. 2020), available at *sidley.com*.)

To incentivize executive actions aligned with ESG commitments, increasingly boards are considering progress on ESG goals in executive compensation decisions. According to a 2020 study, more than half (51%) of S&P 500 companies include ESG metrics in their executive incentive plans (Robert Newbury and others, New Research Finds Progress on the Use of ESG Incentive Metrics, Willis Towers Watson (Mar. 27, 2020), available at *willistowerswatson.com*). The types of metrics used vary across industries. For example, companies in the energy, utilities, and materials sectors have commonly used safety

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and environmental metrics. Companies in the financial services and information technology sectors have focused on human resources and diversity metrics. While ESG metrics are more often included in short-term incentive plans, ESG metrics should align with the long-term business strategy of the company and its industry. Some companies have announced that they are modifying executive cash bonuses based on whether the executives act in alignment with the company's social and environmental values.

Boards also should attend to their own diversity and inclusion. According to a survey of nominating and governance committee chairs at S&P 500 companies, 61% of those surveyed indicated that they are not satisfied with the current level of racial and ethnic diversity on their board and 76% included increased racial and ethnic representation on the board as a priority (2020 US Spencer Stuart Board Index, at 31, available at *spencerstuart.com*).

DISCLOSURE OUTLOOK

The Securities and Exchange Commission (SEC) under the Biden administration is likely to pay closer attention to ESG issues, including requirements for ESG-related disclosure by public companies. While former SEC Chairman Jay Clayton favored a principles-based disclosure approach focused on materiality, several current commissioners have expressed support for a more prescriptive approach to ensure standardized, comparable, and reliable ESG disclosure, including with respect to diversity-related disclosure.

The principles-based approach is apparent in the SEC's August 2020 amendments to Regulation S-K, which require companies to describe their human capital resources, including any human capital measures or objectives the company focuses on in managing its business to the extent material to an understanding of the company's business taken as a whole. For many investors and market observers, this principles-based disclosure requirement does not go far enough because it does not elicit from companies specific data points about their workforce. As a result, it is anticipated that companies will disclose information about human capital in a variety of ways in terms of topics addressed and metrics used, making it difficult for investors to compare human capital efforts and performance across companies.

With the change in administration, the likelihood has increased that the SEC will develop more specific disclosure requirements on diversity and other ESG factors. For example, in February 2021, the SEC's Acting Chair directed the Division of Corporation Finance to review public company disclosure to assess compliance with the SEC's 2010 guidance on climate change risks. In addition, in March 2021, the SEC announced the creation of a new Climate and ESG Task Force in the Division of Enforcement that will initially focus on identifying "material gaps or misstatements in issuers' disclosure of climate risks under existing rules" (Press Release No. 2021-42, SEC, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021), available at *sec.gov*). Whether or not additional disclosure requirements are imposed, pressures for voluntary disclosure will continue to increase as investors press companies for more information about their ESG approaches and progress on goals.

Search What's Market: Human Capital Management Disclosures for information on recent human capital management disclosures by US SEC reporting companies.

KEY LEGAL IMPLICATIONS

In addition to the business risks associated with missed opportunities and reputational harm, ESG issues pose risks in the areas of shareholder proposals, activism, and litigation.

SHAREHOLDER PROPOSALS

The 2020 proxy season saw a record number of shareholder proposals on ESG issues, and those proposals received record levels of support. The 2021 proxy season likely will be similar, with shareholder proponents of social proposals focusing on disparities between companies' statements on diversity and their practices and disclosure. In 2020, some shareholder proponents made diversity-related proposals at companies where they could point to data (or an absence of data) that showed the companies were not living up to their statements about the importance of diversity.

In 2021, the number of diversity- and workforce-related proposals appears to be increasing, including proposals that request companies report on their:

- Diversity and inclusion, including workforce diversity metrics companies currently supply annually, on a confidential basis, to the federal government on the EEO-1 form.
- Human capital management, including policies on sick leave and mandatory arbitration.
- Human capital risks and opportunities.
- Efforts to protect employees during the COVID-19 pandemic.

In addition, proposals likely will ask boards to adopt policies requiring that diverse candidates be included in any director or executive officer search similar to the approach promoted by the New York City Comptroller (see Press Release, Comptroller Stringer Launches Boardroom Accountability Project 3.0, a First-in-the-Nation Initiative to Bring Diversity to Board and CEO Recruitment (Oct. 11, 2019), available at *comptroller.nyc.gov*).

More proposals connecting the environment and social justice are also likely, such as proposals seeking information about the disproportionate effects of a company's environmental impact on minority and underserved populations. In addition to proposals seeking reports on the physical and regulatory risks of climate change, climate policies, emissions reduction strategies, and climate-related lobbying efforts, a new form of proposal, styled as "say on climate," will ask shareholders for

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an advisory vote to express their approval (or disapproval) of the company's climate plan.

Search Shareholder Proposals Toolkit for resources to assist counsel in assessing shareholder proposals.

SHAREHOLDER ACTIVISM

Shareholder activists will use the heightened investor interest in ESG issues to add momentum to activism campaigns focused on changing leadership or business strategies. Shareholder activists historically have focused, in their activism campaign rhetoric, on traditional financial and governance themes for spurring value creation. Shareholder activists are well aware that investors increasingly view ESG matters as meaningful drivers of value and risk, and will emphasize this in campaigns. For example, in 2021, activists at some energy companies are leveraging environmental-themed critiques of operations to support their campaigns for boardroom change.

Similarly, the incorporation of social justice-related concepts into activism strategies is expected to increase. In the right circumstances, shareholder activists are likely to build social justice critiques of companies into their activism campaign rhetoric, if not as a central campaign pillar, then at least as supporting evidence in the case for change. For example, recent activist campaigns have criticized incumbent directors for failing to diversify the board, and the activists have nominated dissident director candidates with diversity and inclusion credentials. Another tactic is for the activist rhetoric to contrast the contributions and efforts of employees with critiques of the management team as underperforming and overpaid.

In light of these developments, boards and management should consider addressing ESG issues, including diversity, equity, and inclusion, not only because doing so is good for business, but also to preempt potentially potent critiques in a shareholder activist campaign.

SHAREHOLDER LITIGATION

The recent national focus on diversity, equity, and inclusion has created new risks of shareholder derivative litigation and federal securities law claims alleging that corporate actions do not satisfy stated corporate commitments.

Recent shareholder derivative lawsuits have alleged, for example, that directors have violated their fiduciary duties to the company and its shareholders by, among other things, failing to have a sufficiently diverse board in terms of gender, race, or both. Technology companies have been common targets, although lawsuits also have been filed against companies in other industries. These lawsuits serve as the latest example of how mainstream social justice movements can influence trends in shareholder litigation. The timing of these complaints suggests that the allegations are a response to the recent heightened awareness of issues of gender and racial diversity and inclusion.

Search Board Composition, Diversity, and Refreshment for more on board composition and succession.

Search What's Market: US Board Gender Diversity Requirements and Investor Voting Guidelines (2020) for more on board gender diversity.

In the past several years, on a handful of occasions, directors have failed to convince the Delaware courts to dismiss breach of fiduciary duty claims against them premised on a theory of failed oversight regarding mission-critical regulatory compliance risks (for more information, search Board Oversight of Compliance on Practical Law). Where a claim of failed oversight is outside of mission-critical and regulatory compliance risks, as in the diversity context, courts should assess a board's actions or inaction on the basis of its duty of care. While a duty of care failure alone should not give rise to personal liability due to exculpatory charter provisions, directors should ensure that they are meeting that standard, as well as the standard of good faith.

The likelihood that these diversity-based derivative lawsuits will succeed is low. However, boards should monitor developments in this area given the significant costs and reputational issues involved in litigating derivative claims and managing both the related internal pressures and the external fallout.

Federal securities law claims relating to ESG disclosure have been brought under Section 11 of the Securities Act of 1933 alleging material misstatements and omissions in securities offering documents, and the anti-fraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. These claims typically fail, although cases involving statements about cybersecurity, safety measures, and financial and ethical controls in codes of conduct, sustainability reports, and SEC filings have occasionally survived a motion to dismiss.

Shareholder lawsuits, regardless of the merit of the claims, are reminders of the need to:

- Ensure that corporate commitments are followed by corporate actions.
- Carefully draft public communications regarding ESG issues, whether in press releases and ESG reports or in SEC filings, and include appropriate disclaimers.
- Provide proper board oversight.

Litigation risks are manageable and should not impede appropriate ESG actions and disclosure in line with prudent corporate actions and investor expectations.

PRACTICE POINTERS

Consistent with their fiduciary obligations to act in the interests of the company, including the long-term interests of shareholders, boards have a responsibility to address social justice issues that affect the company's performance, operations, risk profile, and relationships with important stakeholders. This calls for more critical, internal evaluation of

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how corporate activities may contribute to, or may ameliorate, adverse social impacts, for example, with respect to racial inequity and underrepresented and underserved communities.

While there is no specific roadmap to follow, the National Association of Corporate Directors (NACD) has recommended that boards and corporate leadership assess the effectiveness of corporate efforts to address diversity, equity, and inclusion, and related corporate social responsibility issues, and consider what additional actions are appropriate (see NACD, NACD Blue Ribbon Commission Report: 2020 Update of the Diverse Board: Moving from Interest to Action (Dec. 17, 2020), available at *nacdonline.org*).

Prudent practices for boards include:

- Considering the structure for ensuring active oversight of diversity, equity, inclusion, and other ESG matters, including whether oversight in this area is a full board matter or aspects are delegated to one or more committees.
- Assessing whether a specific policy or decision advances the company's purpose, and whether it involves potential negative effects or trade-offs.
- Identifying how the company serves the interests of stakeholders and the broader social good through delivery of products or services, as well as opportunities to improve the delivery of the company's products or services to, or develop new products or services for, underserved groups.
- Setting clear expectations about the process to follow when making a public statement regarding ESG issues, including taking a specific position, and that the company will "walk the talk," avoiding taking positions and setting policies that are not followed up with action.
- Discussing with management the key ESG risks facing the company and management's plans to mitigate the risks, including risks related to diversity, equity, and inclusion. In particular, the company should assess racial and gender representation in its workforce, compensation programs, talent recruitment, and opportunities for advancement to protect against discriminatory practices in the hiring, pay, and promotion of employees and their access to training and opportunities.
- Gauging how the board measures up regarding its own racial, ethnic, and gender diversity from a board composition standpoint and in terms of representation in leadership of the board and key committees, and formulating plans to improve.
- Eliminating any unintentionally discriminatory practices in the company's business practices, for example, in the treatment of customers or selection of suppliers, contractors, and advisors. For example, the board should determine whether the company considers diversity and equitable practices in selecting suppliers and advisors, and review how the company uses contingent workers.
- Reviewing any significant changes to the company's disclosure regarding diversity, equity, inclusion, and other ESG matters (both in SEC reports and voluntary reports), and discussing with management related materiality considerations and appropriate metrics. ESG-related disclosure should be accurate and supported by data where possible, with aspirational statements limited to those that are backed by actionable plans and clearly identified as aspirational. Companies should avoid corporate platitudes, virtue signaling, green-washing, and the social equivalent.
- Determining who is accountable for various ESG issues at the management level and whether information from responsible managers is being communicated to a board committee or the board.
- Remaining abreast of developments and trends in:
  - ESG disclosure requirements (through SEC statements and guidance);
  - ESG disclosure by peer companies;
  - investor interests in ESG issues (as reflected in voting policies, shareholder proposals, and priorities expressed in letters to portfolio companies and during engagement); and
  - activities of regulators, proxy advisory firms, and non-governmental standard setters and rating agencies.
- Encouraging management to maintain a clear and consistent communications strategy aligned with corporate values, policies, and actions. Management should foster within the company a culture of ethical behavior, fair dealing, respect for diversity and inclusion, and integrity.
- Considering adoption of ESG metrics and goals as part of executive incentive programs, where applicable. The board should assess executive leadership on their performance in meeting ESG goals and consider additional incentives or metrics to hold them accountable.
- Ensuring that board and committee minutes reflect the attention given to social justice matters.

Efforts to foster positive relationships with key stakeholders, protect the company's reputation, improve the quality of corporate decisions, mitigate ESG risks, position the company for positive long-term profitability, and make appropriate disclosure about the company's ESG risks and initiatives require continued attention and effort, for which a continuous improvement mindset is necessary. PL

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.

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