

Shareholder Activism and ESG: What Comes Next, and How to Prepare

May 27, 2021

The recent successes of shareholder activists against Big Oil¹ this proxy season are one of many signs of mounting and effective pressure from investors on public companies to enhance their performance and disclosures on environmental, social, and governance (ESG) criteria. As ESG rises in prominence among investors, activist shareholders have at their fingertips new and potent themes from ESG's repertoire of concepts and criteria to use in campaigns to change control and strategy at companies. By integrating criticisms of ESG failures into campaign narratives, activists may gain additional traction with institutional investors at the ballot box. This article provides background on the potential for increased integration of ESG in shareholder activism campaigns and offers practical guidance for companies to preempt ESG-themed shareholder activism.

The Promise of ESG

Investors increasingly view corporate attention to ESG criteria as closely linked with business resilience, competitive strength, and financial performance. The world's largest institutional investors and pension funds have stated their faith in the potential of ESG to unlock shareholder value and to make companies and markets more sustainable. Their support has afforded ESG investing and operating principles added legitimacy and credibility.

Institutional investors have, in turn, developed ESG-themed investment products, although comparable products have been in the market with lesser fanfare for many years. 2020 saw a record influx of investor capital in ESG-themed funds, bolstered by the moral prospects of ESG investing in light of the COVID-19 pandemic and positive financial results reported by media organizations and researchers.² It was reported that "sustainable equity funds finished 2020 with a clear performance advantage relative to traditional equity funds." It was further noted that in the same period, "three out of four sustainable equity funds beat their Morningstar Category

¹ Derek Brower & Anjali Raval, Climate Activists Hail Breakthrough Victories over Exxon and Shell, *Financial Times*, May 26, 2021, <https://www.ft.com/content/fa9946b9-371b-46ff-b127-05849a1de2da>.

² See, e.g., Attracta Mooney & Patrick Mathurin, ESG Funds Defy Havoco to Ratchet Huge Inflows, *Financial Times*, Feb. 5, 2021, <https://www.ft.com/content/8e9f8204-83bf-4217-bc9e-d89396279c5b>.

average” and 25 of 26 ESG equity index funds followed by Morningstar “beat index funds tracking the most common traditional benchmarks in their category.”³

Institutional investors have intensified engagement with public companies to advocate for ESG-oriented policies and disclosures. They have also adjusted their proxy voting policies correspondingly. Investor support for ESG-themed shareholder proposals has generally increased in the past five years.⁴ Investors have meanwhile lobbied governments and regulators — in the U.S., particularly Congress and the Securities and Exchange Commission (SEC) — requesting that they impose further requirements on companies to expand their ESG disclosures and deepen their commitments to ESG-oriented operating principles.⁵ Since the arrival of the Biden administration, the SEC and other federal regulatory agencies in the U.S. have given clear signals to the public that they intend to follow suit by issuing regulations and other guidance to facilitate the integration of ESG commitments and disclosures in the market.⁶

Reasons for the Integration of ESG in Shareholder Activism

Shareholder activists may deploy ESG concepts in their campaigns for various reasons. An activist investor might genuinely believe that greater attentiveness to environmental and social factors de-risks operations, makes business more sustainable, and creates opportunities. An activist could believe in a specific ESG value thesis, for example, that a carbon transition plan is necessary for a given company to enjoy sustainable growth. Depending on the fund’s priorities, policies, and agreements with its investors, a fund could be required through contractual obligations to integrate ESG into its investment strategy. In some circumstances, the activist investor may claim to perceive an ethical duty to integrate an ESG concept into its campaign.⁷

Activist investors also understand that certain institutional investors may find an ESG-themed campaign difficult to resist at the ballot box. Activists recognize that certain clients of institutional investors are demanding ESG integration into investment platforms and that institutional investors have in various cases committed to ESG stewardship through their investments.⁸ For an institutional investor to turn its back on an ESG-themed activism campaign

³ See, e.g., Jon Hale, Sustainable Equity Funds Outperform Traditional Peers in 2020, Jan. 8, 2021, <https://www.morningstar.com/articles/1017056/sustainable-equity-funds-outperform-traditional-peers-in-2020>.

⁴ See, e.g., Glass Lewis, 2020 Proxy Season Review, at 2–4; BlackRock Inc., Our 2021 Stewardship Expectations (2021), <https://www.blackrock.com/corporate/literature/publication/our-2021-stewardship-expectations.pdf>.

⁵ See, e.g., SEC, Asset Management Advisory Committee, Potential Recommendations of ESG Subcommittee (Discussion Draft), Dec. 1, 2020, <https://www.sec.gov/files/potential-recommendations-of-the-esg-subcommittee-12012020.pdf>.

⁶ See, e.g., Dieter Holger & Kimberly Chin, SEC Opens Review of Corporate Climate Change Disclosures, *Wall Street Journal*, Feb. 24, 2021, <https://www.wsj.com/articles/sec-opens-review-of-corporate-climate-change-disclosures-11614215912>; Steven Mufson & Juliet Eilperin, Biden Administration Wants the Financial Sector to Face Up to Climate Risk, *Washington Post*, Mar. 17, 2021, <https://www.washingtonpost.com/climate-environment/2021/03/17/biden-climate-change-economy/>.

⁷ Surveys have found that institutional investors point to fiduciary duty as a driver in the integration of ESG into their investment strategies. See, e.g., Rakhi Kumar, Nathalie Wallace & Carlo Funk (State Street Global Advisors), Into the Mainstream: ESG at the Tipping Point, Harvard Law School Forum on Corporate Governance, Jan. 13, 2020, <https://corpgov.law.harvard.edu/2020/01/13/into-the-mainstream-esg-at-the-tipping-point/>.

⁸ See RBC Global Asset Management, 2020 Responsible Investment Survey Key Findings, at 5, <https://www.rbcgam.com/documents/en/other/esg-key-findings.pdf>.

could, in some circumstances, mean running the risk of being criticized for disregarding the financial and ethical priorities of its clients. There is also a public relations dimension at work. Historically, the general public has seldom noticed when a household name institutional investor declines to support an activist campaign that was calling for a sale of the company, changes to capital allocation, or the termination of a CEO. But it is possible that in coming years, the general public will pay attention when the same institution declines to support a campaign that is calling for greenhouse gas reductions emissions targets or another ESG-oriented improvement.

There are also unknowns and potential pitfalls for the integration of ESG concepts into shareholder activism. It remains to be seen which ESG themes will resonate with investors at the ballot box when factored prominently in an activism campaign. It is not clear yet whether activists will incorporate ESG themes as a core pillar of their campaign or if such themes will mainly serve as a supporting campaign theme and a tool to be used when convenient to support a larger purpose, much like calls for declassifying the board alongside of a campaign to replace directors. Activists could potentially harm their campaigns if investors perceive that the integration of ESG themes is disingenuous. Perhaps most significantly, there are open questions as to how shareholder activists can reconcile their relatively short-term investment horizons with ESG theses, which characteristically involve long-term value propositions.⁹

New Themes in Governance Best Practices

Proponents of ESG-conscious operations are elaborating new standards and “best practices” related to corporate governance. Most prominently, ESG-conscious investors are looking into how boards and management teams oversee environmental and social performance, how ESG oversight is allocated among board committees, and whether a board has sufficient expertise in environmental issues and social issues. It is often incorrectly said that the “G” in ESG, for governance, is old news for shareholder activism. This observation is correct insofar as certain governance themes have been present in activist campaigns for a decade or more. Such themes include calling for enhanced director independence, separation of the CEO and board chair roles, declassification of the board, and other measures to increase shareholder rights. The observation is incorrect, however, insofar as part of the “G” in today’s ESG thinking focuses on the governance of environmental and social aspects of a business.

Certain ESG rating organizations are observing how ESG oversight is allocated among the board and its committees and whether a dedicated committee has been established for this purpose. As another illustration of this trend, a recent memo by BlackRock concerning its proxy voting policies stated an expectation that directors on a board will “have sufficient fluency in climate risk and the energy transition to enable the whole board — rather than a single director who is a ‘climate expert’ — to provide appropriate oversight of the company’s plan and targets.”¹⁰ This type of expectation for corporate governance, rooted in ESG thinking, is new and far-reaching compared to shareholder activists’ more traditional governance demands.

⁹ See ISS Special Situations Research, *ESG Contests: Activism’s Holy Grail or Side Show*, March 2, 2021.

¹⁰ BlackRock, Inc., *Climate Risk and the Transition to a Low-Carbon Economy* (Feb. 2021), at 4, <https://www.blackrock.com/corporate/literature/publication/blk-commentary-climate-risk-and-energy-transition.pdf>.

Establishing board and management oversight of ESG to keep up with investor expectations involves a certain amount of chasing a moving target. Investor expectations and company practices around corporate governance are evolving relatively rapidly along with other ESG-related trends. Companies and investors are converging, nevertheless, around certain practices and expectations. Among other things, boards and management teams are increasingly expected to ensure that ESG is a component of strategic decision-making, identify key ESG risks and opportunities, understand differences between the ESG priorities of shareholders and stakeholders, oversee ESG-related disclosures, and determine how board oversight of ESG will be allocated among the board and its committees. There is evolving discussion around the particular appropriateness of audit committee oversight of particular ESG-related matters, such as the identification of material ESG factors and oversight of disclosures and disclosure controls and procedures. Boards are also being expected to appreciate and focus on those aspects of ESG-related oversight that only a board can perform, such as oversight of management, setting executive compensation, and supervision of auditing and internal controls.

Possibilities Ahead

The new age of ESG may bring other innovations in shareholder activism.

Additional corporate disclosures on environmental and social issues can provide shareholder activists with a substantial amount of new material to use in their campaigns. Successive editions of sustainability reports issued by companies over a course of several years will provide investors with an ability to compare ESG performance of individual companies over time and to compare companies' performance. Over 90% of S&P 500 companies and 65% of Russell 1000 Index companies already produce a sustainability report.¹¹ The SEC has signaled that it will likely develop additional requirements for ESG-related disclosures of public companies.¹²

While environmental and climate-related topics are currently the most likely among ESG topics to be integrated into activist campaigns, a further stage in ESG-themed activism is the incorporation of social- and social-justice-related concepts into activism strategies. 2020 was a major year in the United States and worldwide for bringing matters of social justice and public health to the foreground of public interest. These developments led to a burgeoning of discussions regarding the direction of social aspects of ESG, particularly as they relate to diversity and inclusion. Prominent institutional investors have advocated for companies to disclose workforce diversity statistics, California and other states adopted legislation to require or promote gender and racial diversity on boards, and the Nasdaq Stock Market has proposed listing standards designed to increase board diversity. Throughout 2020, leading institutional investors highlighted research showing that diversity in the boardroom and the workforce contributes positively to a company's performance. Meanwhile, the current direction of the Biden administration indicates that it is becoming a business risk for companies to not have processes in place to monitor and ameliorate disproportionate effects of their carbon footprint on

¹¹ Governance & Accountability Institute, Flash Report Russell 1000 (Oct. 2020), <https://www.gai-institute.com/research-reports/flash-reports/2020-russell-1000-flash-report.html>

¹² See, e.g., SEC, Statement on the Review of Climate-Related Disclosure, Feb. 24, 2021, <https://www.sec.gov/news/public-statement/lee-statement-review-climate-related-disclosure>.

minority communities.¹³ It may be expected that related themes will be integrated into future activist campaigns.

Another potential ESG-driven innovation would be for shareholder activists to avail themselves more frequently of the right to solicit proxies at shareholder meetings for their own business proposals. In the United States, the vast majority of shareholder proposals are made pursuant to Rule 14a-8 under the Securities Exchange Act of 1934, which imposes topical limitations on proposals. In contrast, shareholders who solicit proxies for their own proposals have a comparatively free hand to make proposals on the topics of their choice and to say what they want to say about their proposals. Additionally, coupling a proposal to elect dissident directors with an environmental or shareholder proposal could increase the probability that a shareholder activist's proposal to replace incumbent directors would succeed.

Practical Guidance for Public Companies

Pursuing ESG-related goals may have various benefits for a company, among them that good ESG performance creates a line of defense against shareholder activism. Boards of public companies should be establishing oversight of ESG issues as a priority matter, mindful of practices of industry peers and expectations of investors and stakeholders. Companies should review their ESG-related disclosure practices and take steps to ensure that investors or ESG ratings organizations do not deem them laggards. Companies deemed ESG laggards create low-hanging fruit for activists looking for opportunities to work ESG themes into their campaigns to change corporate policy and control.

Recognizing that public companies are variously situated in their approaches to shareholder activism preparedness and ESG policies and disclosures, the following practical guidance is additionally provided for consideration:

- **Public companies should treat activist shareholders with ESG-themed inquiries and criticisms respectfully, just as they would treat “regular” institutional investors seeking routine engagement on ESG topics.** While there may come a time to push back, companies should expect to be in “listening mode” for the first meeting.
- **Companies should work ESG concepts and talking points into their emergency plan for shareholder activism preparedness.** The need to be respectful of investors does not mean companies should be unprepared to respond to criticism, particularly if made in a surprise press release. While finer points can be ironed out once specific criticisms are made, a company should be ready to speak at a high level about material areas of its ESG program in order to respond to public criticism in the same news cycle. If a company does not have any emergency plan for shareholder activism preparedness, it should be in touch with experienced activism defense counsel that has experience with ESG.
- **Companies should be additionally cautious when making changes to governance or policy against the background of an ESG-themed activist campaign.** Boards facing

demands to admit dissident directors commonly appoint directors of their own choosing or adopt new ESG-related policies or measures, prior to the annual meeting and without previewing these actions with the activist. These measures, often calculated to have some defensive value because they address ESG-related concerns of the activist, are often justified because, among other reasons, a company was already in the process of making changes before a dissident campaign arose. In the context of an ESG-themed campaign, however, these measures can backfire. Even if without basis, the activist can portray changes to leadership and policy made against the backdrop of an ESG-themed activist campaign as reactive, hasty, insincere, and incomplete.

- **Companies should have shareholder activism defense counsel review their ESG disclosures.** The focus of a review of the company's ESG profile from the standpoint of shareholder activism preparedness is distinct from a wide-ranging review of the company's overall ESG profile. If a company is already advanced in its ESG policies and disclosures, the goal of this review is not to reinvent the wheel or second-guess existing programs that may be substantial and sophisticated. Rather, the goal is to identify and prepare to preempt ESG themes that may be exploited by an activist campaign, even if (and especially if) the company has addressed those themes through its existing operations and disclosures.
- **Public companies should continuously improve ESG initiatives, oversight, and disclosures as well as ratings with ESG data collection ratings and services.** Most companies are well aware that good performance in these regards helps to avoid unwanted pressure from institutional investors and can create a path to higher liquidity and a lower cost of capital. But ESG scores and reports from the leading ESG data and ratings providers are also roadmaps for activists searching for weaknesses in a company's ESG profile. To the extent these initiatives are lagging, they should be stepped up specifically in the areas that are most susceptible or vulnerable to ESG-themed activist criticism.
- **Companies should stay near the curve, or at least their peers, in making voluntary disclosures in line with one or more voluntary disclosure regimes while being mindful of disclosure-related preferences and demands of leading institutional investors.** ESG data collection and ratings services are effectively monitoring the extent of companies' alignment with voluntary disclosure regimes such as the Task Force on Climate-Related Financial Disclosures, the Sustainability Accounting Standards Board, and the Global Reporting Initiative. As mentioned, disclosure laggards may become easy targets for ESG-themed criticism.
- **Companies should be cautious about internal initiatives to integrate environmental and social information from voluntary reports into regulatory filings.** The coming years are likely to see increasing pressure on companies to integrate information from their sustainability reports into filings with regulators, such as annual reports and proxy statements filed by U.S. public companies with the SEC. The inclusion of ESG-related information from sustainability reports and other thematic ESG reports in regulatory filings creates legal risks and should be pursued only after close coordination within the company among appropriate departments (e.g., the legal department and sustainability team) and in consultation with counsel specialized in securities law and ESG disclosures.

For additional information on the ESG topics covered in this update, see recent publications of Sidley Austin LLP on our practice pages for [ESG](#) and [Environmental Justice](#), including Holly J. Gregory, [Addressing Social Justice Issues: Implications for the Board](#), Practical Law (May 2021); [Eight Key Takeaways from the Biden Administration's Executive Order Detailing Major Domestic and Foreign Policy on Climate Change](#), Sidley Environmental Update, Jan. 29, 2021; Holly J. Gregory, [Board Considerations for an Uncertain 2021](#), Practical Law (Jan. 2021); Heather M. Palmer, Leonard Wood & Samina Bharmal, [Why ESG Considerations Matter For Energy Executives](#), Law360, Oct. 8, 2020; Holly J. Gregory, Heather M. Palmer & Leonard Wood, [Emerging ESG Disclosure Trends Highlighted in GAO Report](#), Harvard Law School Forum on Corporate Governance, July 26, 2020; and [State Street Letter to Boards Reflects Evolving Investor Expectations for Board and Workforce Diversity Data](#), Sidley Environmental, Social and Governance Update, Sept. 9, 2020.

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