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ESG in 2021—The Role of Board Oversight of Corporation Political Spending

Environmental, social and governance (or ESG) issues have been hot topics and buzzwords in corporate governance for well over a decade and these issues have increasingly grabbed the attention of corporations and their boards of directors. However, the unprecedented events that marked 2020 and that have continued into 2021 have brought front and center the need for corporate boards of directors to take their oversight of ESG issues seriously. Pressure from institutional investors, such as BlackRock, Vanguard, and State Street, has contributed to such increased focus and urgency, but so has pressure from environmental groups, employees, customers, and other corporate "stakeholders." For example, State Street has announced that it will start voting against the boards of companies that underperform their peers when it comes to ESG standards.[1]

In light of the riots and attack on the U.S. capitol on January 6, 2021, and the role that certain politicians played in such event and the circumstances surrounding it, it is clear that the boards of directors of U.S. corporations need to put a spotlight on another item in their ESG oversight—political activity, political donations, and lobbying activities.

Background: What is ESG?

> ***"Environmental, social and governance (ESG) issues are increasingly seen by shareholders as a window into the future."[2]***

In the past few years, ESG and board oversight of ESG came to the forefront of corporate governance. Let's start with why investors care about ESG issues.

Investors care about ESG because it has become a key component in managing corporate risk and understanding opportunity. As Larry Fink stated in his famous letter to CEOs at the outset of 2020, there is increasing awareness that "climate risk is investment risk."[3] In his letter, Mr. Fink questioned what would happen to the 30-year mortgage if lenders could not estimate the climate risk over such a period. Similarly, what would be the impact on inflation with increased drought and flooding?

While the letter was focused on climate change, 2020 and the beginning of 2021 have thrown into sharp relief that there exists a growing awareness that many issues, whether it be sustainability, diversity, or racial justice, all pose risks, and present opportunities, to companies. Quite simply, Mr. Fink was arguing that the companies that are the best at grappling with such risks would, in turn, be the best investments. Clearly, however, it is just not investors who are interested in such issues. The fact is, in 2021, these issues are important to employees, customers, suppliers, regulators, and the other constituencies that comprise a company's "stakeholders."

Why Should Boards Care About ESG?

> ***"The board of directors' most important function is to approve or send back for amendment management's recommendations about the future direction of the corporation."[4]***

Which brings us to the role of the board. State law requires the board to manage and direct the affairs of a company.[5] What that means is, ostensibly, fairly straight-forward: while it may be management's job to create the strategy around risk and opportunities, the board's responsibility is one of oversight. The board is charged with overseeing both the creation and implementation of such strategy and the company's risks and risk management. This is why ESG has come to the forefront of corporate governance efforts—with the growing focus on ESG matters (and what those ESG matters entail and mean for the future of a business, its industry, its growth, and/or its customers), ESG represents potential or actual risk a company faces and, accordingly, comes within the purview of a board's oversight responsibilities.

But What Do Politics Have To Do With It?

Put otherwise—**Why should political activity, political donations, and lobbying activities move to the forefront of board oversight?**

First, because in supporting a legislator, the corporation is viewed as supporting and enabling the positions such legislator takes, not on particular issues important to the corporate donor, but generally.

Since January 6th, a growing list of major U.S. companies (including Amazon, American Express, AT&T, Disney, Dow Chemical, Marriott, Master Card, Verizon, and Wal-Mart) have announced that they have cut off PAC donations to federal legislators who voted against certifying the 2020 presidential election results. Other corporations (including 3M, Bank of America, Citigroup, Coca-Cola, Deloitte, Facebook, Ford, Goldman Sachs, Google, JPMorgan, Microsoft, Target, and Visa) have announced that they are suspending all donations to politicians, and others have publicly announced that they are reviewing their contributions in light of the events on and surrounding January 6th.

These corporations faced either potential or actual backlash by employees and customers and the public at large with regard to their support of such legislators. Further, as more information has unfolded about the shocking events of January 6th (and the indication that further damage may have been planned and, further, both the U.S. capitol and state and local governments remain under threat of violence) and the role certain legislators may have played in such events, the potential for such backlash and ramifications has not been diminished. If a corporation's management wants to support specific candidates or legislators on behalf of the corporation, it is the board's role to evaluate the risks of such a course of action, and ensure that controls are in place to manage risk associated with supporting such individuals.

Second, in supporting candidates or legislators, the corporation faces an "image" issue during a time where the public is scrutinizing the relationship among corporations and lobbying.

The tenor and public perception around U.S. politics has changed significantly since 2016. While not a new sentiment by any means, increased wariness around the influence of large corporations and lobbying efforts have changed the risk calculus for corporations. Many people, regardless of political affiliation, believe that large corporations and their lobbyists have a pervasive and corrupting influence on our political system. In a New York Times piece published on January 12, 2021, Andrew Sorkin argued that the public views PAC donations as a bribe which undermines "the credibility of the company and the politician taking it."[6] This skepticism around the intersection of politics and corporations may extend beyond political donations, as well—Mr. Sorkin also points to the example of IBM, because while it does not donate to candidates, as a result of its size and influence, still has a seat at the table and an influence on governmental issues that affect it and its business. Regardless of political beliefs or views on the impact of corporate donations, for a corporate board fulfilling its obligation to oversee a company's risks, the question becomes, what is the corporation getting by supporting specific candidates or PACs, and do the potential benefits outweigh the risks?

Third, the corporation's investors care.

Political activity, political donations, and lobbying activities of corporations are not new concerns for investors. Lobbying spending / disclosure around lobbying have, for the past 10 years, been on the "top 10" list of most frequent shareholder proposals. The 2020 proxy season saw in the neighborhood of 60 shareholder proposals regarding lobbying and political activity and, according to proxy advisory firm Glass Lewis, in 2020, these proposals received an average of 36% support[7].

Shareholder proposals in this area generally focus on asking companies to disclose their lobbying / political spending (including the amounts given and to whom), and the company's policies and procedures and board's oversight of political spending.

While the deadline for submitting shareholder proposals under Rule 14a-8 has likely passed for a number of companies with December 31st fiscal year ends, in light of the events of January 6th, we would expect to see a sharp uptick in shareholder proposals for annual meetings being held later in the 2021 proxy season cycle.

Fourth, corporations face increasing risk of litigation.

2020 also saw the burgeoning of a new type of shareholder derivative litigation—lawsuits against public companies where the shareholder plaintiffs claim the public company's directors

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have breached their fiduciary duties in failing to effect diversity at the board and management level, despite such companies' disclosed commitment to diversity. Put otherwise, these lawsuits are holding corporations accountable where their disclosures around the importance of, and commitment to, diversity fall short of their actual practices.

The events of 2020—the occurrence of a health crisis of a magnitude not seen in over 100 years, severe economic disruption, and the awakening of many to the realities of racial injustice in the U.S.—prompted many corporations to meaningfully speak out on social injustices for the first time. We also saw in 2020 increasing corporate disclosure on environmental goals and commitments. To the extent that legislators supported by a corporation espouse agendas are contrary to a corporation's statements on social justice or environmental commitments, investors may look to hold those corporations accountable if their words were saying one thing and their money was supporting politicians in opposition.

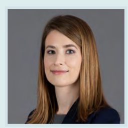
What should the board be doing at this moment?

- Short term, if your corporation made a donation to a legislator who voted against certifying the election results, management should be preparing (with board supervision) for questions from journalists, employees and customers. Similarly, the corporation (with oversight from the board) will need to articulate a future course of action with regard to continuing to, or ceasing to, donate to such legislators.
- Longer term, management, again with board oversight, should:
  - develop strategies around corporate political activity, political donations and lobbying activity (e.g., do they align with corporate strategy and goals to be achieved?);
  - evaluate and implement controls to manage the risk incumbent in such activities (e.g., does the corporation know the candidates it is supporting, or where PAC donations are going?);
  - evaluate if legislators being supported "mesh" with the corporation's other ESG efforts (e.g., if sustainability has become a core corporate strategy, what does it mean to support a candidate who denies climate change?);
  - understand that statements about ESG issues should be treated exactly the same as all other statements about the corporation and its business (e.g., is it forward looking, is it factual, were proper disclosure protocols followed?); and
  - develop communications strategies for use when issues inevitably arise.

As the world continues to grapple with the COVID-19 pandemic, investors and corporate stakeholders have not let up on pursuing ESG initiatives and looking to corporations to hold themselves accountable for their influence on ESG matters. While the last 12 months have seen individuals and corporations grapple with one crisis after another, corporate boards of directors should remain vigilant in their oversight of the ever-developing ESG risks.

Additional Information:

For additional information, please contact:



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[1] *State Street vows to turn up the heat on ESG Standards*, The Financial Times Limited (FT.com), January 28, 2020.

[2] ESG Oversight: The Corporate directors guide, https://www.pwc.com/us/en/services/governance-insights-center/library/esg-corporate-directors-guide.html.

[3] *A Fundamental Reshaping of Finance*, https://www.blackrock.com/us/individual/larry-fink-ceo-letter.

[4] *The Board's Most Important Function*, William W. Wommack, Harvard Business Review, September 1979.

[5] For example, please see 8 Del. C. §141(a).

[6] *'An Epiphany Moment' for Corporate Political Donors May have Arrived*, Andrew Ross Sorkin, January 12, 2021.

[7] *2020 Proxy Season Review—Shareholder Proposals, Glass Lewis*, https://www.glasslewis.com/wp-content/uploads/2020/09/2020-Proxy-Season-Review-Shareholder-Proposals.pdf