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Clients: How Risky Is a Shift in Your ESG Approach?

Attention to ESG has become political. Some states with conservative administrations have taken steps to inhibit attention to ESG by, among other things, precluding investment of state employee pensions in certain funds or with certain fund managers who have increased their emphasis on ESG as an investment criterion.

By David G. Mandelbaum | **November 10, 2022** | **The Legal Intelligencer**

For some years now, many businesses have attended carefully to their performance on environmental, social, and governance dimensions. Some investment banks have established funds composed of securities issued only by companies with suitable ESG performance. Some institutional investors, like pension funds, have insisted that their portfolio only include stock in corporations with high ESG ratings. That, of course, has led corporations to look for ways meet that investor demand.

The theory behind attention to ESG—like the theory behind attention to "sustainability" of the past several decades—is that conventional financial accounting gives short shrift to risks and opportunities posed by long-run environmental, social, and governance issues, often treating them as externalities. Using conventional measures, a business may not be able to account currently for longer run risks of climate change and greenhouse gas regulation, cleanup liability for presently unregulated chemicals it uses, disruptions due to social inequities in its labor force or communities, and the like. Accordingly, so the theory

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goes, measuring and reporting performance on those sorts of dimensions has value to management, to investors, to employees, to customers and to other stakeholders.

But this is 2022. Attention to ESG has become political. Some states with conservative administrations have taken steps to inhibit attention to ESG by, among other things, precluding investment of state employee pensions in certain funds or with certain fund managers who have increased their emphasis on ESG as an investment criterion.

The whole "Anti-ESG" movement may induce businesses to change the attention they give to ESG concerns. That, after all, is the point. Some would say that only managements that focus on maximizing profit using conventional measures or current stock price truly serve investor interests. Therefore, only those businesses are proper investments. But others would say that inattention to ESG exposes the business to serious compliance, financial, and reputational risks, and therefore only businesses with aggressive ESG programs are appropriate investments, particularly in the long-term.

This column will not wade into that debate other than to observe that it exists. Also, readers may want to note that this column is appearing shortly after the mid-term election, and the political alignment affecting client decisions may have shifted. This is being written before Election Day.

However, lawyers advising clients on these issues have to worry about the risks that follow when a client changes its approach. If a client never has a problem with environmental compliance, unexpected environmental regulatory exposure, diversity or inclusion problems, neighborhood relations problems, foreign corruption problems, or any of the other issues subsumed in ESG, then changing an ESG program cannot really be said by anyone to have itself caused or contributed to any bad outcome. No one will be able to say that a change in attention to environmental compliance caused a violation, for example, because environmental compliance for that business does not really matter. But one reason for a business to have an ESG program is because risks to that business of those bad outcomes are real. So if something bad does happen, a client may complicate its defense of enforcement or litigation, and its valuable reputation, by having preceded that bad outcome with a reduction in attention to ESG. Now that may not be universally true, and so one may want to be precise about which layer of an ESG program the client contemplates slowing or reducing. ESG has several of those layers. At the top, a business typically produces a report that describes its performance on a set of ESG metrics. Indeed, businesses often develop, or enlist a consultant to develop an ESG "score," sometimes based on one of a set of rapidly evolving private standards for those reports. The score takes incommensurate things—notices of violation of environmental regulations, greenhouse gas emissions, pay disparities, racial and gender equity in hiring, and so forth—and puts them on a single scale.

Beneath that layer, the business has to have internal reporting and accounting systems in place so that it knows what the business is in fact doing. Once the enterprise gets to any real size, there has to be a way to know its EHS compliance history, for example, that is more reliable than asking the EHS director what he or she can recall on any given day.

Beneath that layer is where ESG actually gets done. Businesses must develop and execute systems and procedures not only to account performance, but to achieve it. That is really what the report at the top is intended to describe, although it is several layers and probably a scoring system away. Indeed, it may be prudent to have effective ESG systems up and running first, along with the desired performance, before emphasizing the reporting phase of the process. So if a client stops using an ESG scoring system that gets it crosswise with a state pension fund that owns a lot of its stock, one might argue that shift was entirely unrelated to any later compliance lapse or other problem. While it might be cynically viewed as a concession that ESG scoring was just window dressing, one would be arguing that the plant manager, HR director, or

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foreign sales representative really was not driven by the (now absent) ESG score when he later allowed a violation to occur.

But if an enterprise intentionally reduces its efforts to understand at a management level what the performance looks like at each operation, it may wish to do so with some care. Later, if a problem occurs, will a government agency or private plaintiff be able to say that the change in attention to accounting or monitoring affected operational performance? Will that agency or plaintiff (or, perhaps key customer or financial stakeholder) be able to say that the reduction in accounting or monitoring effort reflected management indifference? A client may wish to be thoughtful about the changes it makes and how it communicates about them.

And it is familiar, at least to environmental lawyers, that cuts to actual compliance budgets and oversight are bad facts in enforcement or litigation after some noncompliant event. The company that cuts its maintenance budget six months before a catastrophic equipment failure causing a release can expect criticism. So, decisions like that are often taken with great care and contemporaneously evaluated for any additional risk that they pose.

Now you may be asking yourself what all this has to do with what you thought ESG was about: the greenhouse gas emission accounting and reporting rule proposed by the Securities and Exchange Commission (SEC). ESG is much broader than that proposed rule; the rule, however, has the feature of being a proposed regulation. It would, if adopted, have clear (or at least clear-ish) requirements. ESG programs are often less prescriptive, and therefore less comfortable for lawyers.

However, the Anti-ESG agenda will not affect corporate compliance with the SEC rule if the SEC rule is adopted. Clients will be thinking, if at all, about changing what they are doing on other aspects of their ESG programs. Those other aspects, and not the SEC rule, may be the ones that get drawn into facility- or company-specific enforcement or litigation.

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