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Three Reasons Boards of Directors Should Oversee Sustainability Factors

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Article Highlights:

- In today's business environment, sustainability is about environmental, social, and governance issues that are connected to the company's financial and operational performance.
- Information on sustainability will help the board understand, prioritize, and monitor these risks, thus helping the board fulfill its risk oversight responsibilities.
- Sustainability is a critical boardroom topic. Environmental, social and governance issues, sometimes considered non-financial factors, are like financial factors in that they have tangible effects on the business.

Sustainability has been identified as one of the top corporate governance issues by the American Bar Association's Corporate Governance Committee. Likewise, the National Association for Corporate Directors (NACD) and EY have written a white paper on board oversight of sustainability issues. Not surprisingly, these days many corporate directors are asking: What is sustainability, and why does it matter for me as a board member?

In 1987, the United Nations' World Commission on Environment and Development defined sustainability as "... development that meets the needs of the present without compromising the ability of future generations to meet their own needs." At the company level, sustainability is about the company's ability to operate profitably over time in the face of changing conditions. Examples of such changes include increasing investor interest in information about non-financial factors that affect the bottom line, scarcity of critical business inputs such as water and natural resources, the potential for legal and regulatory measures concerning carbon emissions, the greater importance of intangibles in a company's market value, and the disclosure of non-financial information to the capital markets.

In today's business environment, sustainability is about environmental, social, and governance issues that are connected to the company's financial and operational performance. The Sustainability Accounting Standards Board (SASB) has identified and gathered evidence on five broad categories of sustainability factors that, depending on the industry, impact financial and operational performance: Environment, Social Capital, Human Capital, Business Model and Innovation, and Leadership and Governance. Sustainability is about the non-financial factors that affect the company's ability to create value over the long-term as its non-financial operating environment changes. This impact is why board members should – and must – pay attention to these factors that implicate their responsibilities. Specifically, sustainability has consequences for a director's responsibilities with respect to three critical areas: risk oversight, strategy and value creation oversight, and his or her fiduciary duties.

Sustainability is a risk issue

Companies face multiple sources of risk related to sustainability factors, and therefore boards should increase the time they spend understanding material sustainability risks to the company. From a securities law perspective, material sustainability risks are those risks that a reasonable investor would consider important in making investment and voting decisions. Indicators of a material sustainability risk include legal and regulatory trends, industry norms around the management and disclosure of those risks, stakeholder concerns and social trends, opportunities for innovation on the sustainability risk, and evidence of financial impact and risk on the company.

For example, SASB has found evidence that counterfeit drugs are likely to be a material risk for pharmaceutical companies, with over $431billion in annual counterfeit drug sales globally. In addition to causing more than 100,000 annual deaths, counterfeit drug sales harm the revenues, reputation, and brand of pharmaceutical companies. How is the company tracing its products through the supply chain to prevent counterfeiting?

For commercial banks, one risk issue is how the bank integrates environmental, social, and governance factors in its credit risk analysis. What is the dollar amount of loans made to companies engaging in carbon-intensive projects? This information provides insight into the riskiness of the bank's loan portfolio because the hydrocarbon assets in those projects could become stranded. Stranded means impaired, devalued, or never utilized because of the growing view among mainstream investors that carbon exposure is a substantial investment risk and because of policy developments such as the US-China agreement to limit carbon

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emissions.

As institutional investors such as pension funds and university endowments increasingly ask companies for sustainability information, companies face pressure to disclose the information in sustainability reports and Securities and Exchange Commission filings (e.g., the Form 10-K). Disclosure in either type of document creates potential legal exposure for directors, depending on what information is disclosed (e.g., which factors and which metrics for those factors), what definition of materiality is used (e.g., securities law definition or a proprietary definition from a sustainability organization), and what level of information is disclosed (e.g., boilerplate or useful to investors and in conformity with the securities laws). The board therefore needs to truly understand and be strategically involved in determining where the company discloses sustainability information, the process the company uses for disclosing that information, and what specific information is disclosed.

Because of the implications for business performance and legal risk, the board should ask management for substantive information on sustainability risks, and management should take a leadership role in providing the board with thoughtful and timely information on sustainability risks. The information should preferably be quantitative and accompanied by a discussion about company-specific consequences of performance on the risks. This information will help the board understand, prioritize, and monitor these risks, thus helping the board fulfill its risk oversight responsibilities.

Sustainability is a strategy and value creation issue

At the same time, some sustainability factors have strategy and value creation consequences. Indicators of a material strategy and value creation issue include legal and regulatory trends, industry norms and competitiveness in the performance and disclosure of those sustainability factors, stakeholder concerns and social trends, opportunities for innovation on the sustainability factor, and financial impact and risk. For software and information technology services companies, intellectual property protection and competitive behavior is likely to present a material strategic concern because patent disputes involve high stakes. How much patent litigation is the company involved in, both as the plaintiff and the defendant, and what is the company's potential liability and upside in those disputes? Based on this information, Is an adjustment in the company's intellectual property strategy warranted?

For automobile manufacturers, building cars that increase fuel economy and decrease use-phase emissions is a strategy that can help the company capitalize on legal and consumer trends regarding fuel economy and emissions. Regulators are imposing ever more stringent fuel economy and emissions requirements on cars, and the market for electric, hybrid, and fuel efficient-cars is growing as consumers become concerned about volatile gas prices.

Although the board does not solely create nor execute strategy, the NACD has explained that the board is responsible for overseeing and advising on the company's ability to create value over the long-term. Information that the board requests from management is particularly useful if it is quantitative, or qualitative as appropriate, and complemented by a company-specific discussion. This information will help the board understand and monitor the strategy and value creation factors.

Sustainability is a fiduciary duty issue

Board members have two primary fiduciary duties to the corporation: the duty of care and the duty of loyalty. To the extent that sustainability factors impact financial and operational performance, these fiduciary duties are implicated. Unless the board breaches either or both of these duties, the business judgement rule will be considered applicable by a court.

The duty of care means that a director must have adequate information to permit him or her to make decisions as a reasonable person in his or her position would. Whether a sustainability factor presents a material risk or strategic opportunity, the board should ask management to provide a sufficient quality and quantity of information so that the board may fulfill its duty of care.

However, many boards and companies are not sure what sustainability information matters to financial and operational performance. One useful test is that the information should focus on the factors that are likely to constitute material information as defined by the securities laws. SASB's standards are designed to identify the industry-specific sustainability factors that meet this criterion. With an average of five factors and thirteen metrics per industry, SASB offers board members a compact set of information to digest. Boards should therefore consider asking management for information on the factors and metrics contained in the SASB standards for the

The duty of loyalty means that a director must act solely for the benefit of the corporation, and not such that his or herself-interest conflicts with the corporation's interest. Except in a limited number of change of control situations, corporate law does not compel directors to weigh short-term shareholder value over long-term shareholder value. In fact, Delaware cases give directors the discretion to oversee the corporation in a way that does not necessarily maximize current stock price. Directors are permitted to forsake short-term value in pursuit of long-term value for shareholders, so long as the decision is in the best interest of the corporation and the duties of care and loyalty are satisfied.

This reasoning runs parallel to the duty of loyalty of fiduciary investors, such as pension funds and endowments. Fiduciary investors cannot favor the interests of current beneficiaries over the interests of future beneficiaries. Although directors are not required to treat short and long-term shareholders equally, they are given the freedom to do so or to favor long-term shareholders over short-term shareholders.

Conclusion

As sustainability increasingly enters the boardroom conversation, it is helpful to recognize that these non-financial factors are like financial factors in that they have tangible effects on the business. The challenge is for directors to make them a priority and to stay knowledgeable about the oversight of sustainability factors most likely to materially impact companies in their industry. The SASB standards are a useful tool to identify and measure those factors. Overseeing sustainability factors will uncover both risk and opportunity for the company, while obtaining and considering information on these factors will help directors satisfy their fiduciary duties.

About the Author

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Douglas Park leads the development of SASB's positions on legal and regulatory matters and engages with lawyers, governance professionals, board members, and others on these issues. Before joining SASB, Doug advised executives, board members, and investors on corporate governance, corporate and securities law, and strategy. He has litigated securities cases and consulted to companies on organizational behavior.

Doug has been an assistant professor of management at the Hong Kong University of Science and Technology, School of Business and Management, where he taught Strategy and Organization Theory and received several citations for teaching excellence. He has also taught at the Stanford University Continuing Studies Program.

He serves as Chair of the American Bar Association's Corporate Social Responsibility Disclosure and Reporting Committee, a Member of the Sustainability and Governance Subcommittee, and a Member of the Evaluation Committee of the BlackRock/NACD Corporate Governance Innovation Challenge. Super Lawyers named Doug a Rising Star in Corporate Governance and Compliance.

Doug holds a JD from University of Michigan Law School, a PhD in Business from Stanford Graduate School of Business, and an AB magna cum laude with highest honors in Sociology from Harvard College.

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