ESG SPOTLIGHT

How a Bursting Bubble Opened a Door for a Corporate Lawyer with a Cause

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As Environmental, Social, and Governance standards continues to take center stage at many organizations, Ethisphere spoke with **Susan ("Suz") Mac Cormac**, Corporate Partner, Morrison & Foerster, about ESG's evolution and why lawyers will need to step up in this area in the coming year.

What are some general trends you are seeing on the ESG front?

Until about 10 years ago, I would respond to queries about whether board members would be breaching their fiduciary duties if they prioritized ESG; there was a common misconception that there would always be a trade-off between doing good and generating profit for shareholders. The good news is this conception has largely been debunked. There has been a sea change and most investors, boards, and management now believe that they must embrace ESG not just because it is the right thing to do but because it is critical to the financial success of their business and investments. Most law firms have established ESG practices over the past two years and are advising companies and investors on ESG as an extension of their compliance and environmental practices.

While there is certainly a strong compliance element of ESG (see below) and for the past 10 years we have been advising companies and investors to consider ESG as part of legal compliance (with anti-corruption) and also ERM (enterprise risk management), companies and investors will continue to lag behind their competitors if they fail to consider ESG as critical to their governance practices, corporate form, and investment. Markets and investment climates are shifting very quickly, and companies need to ensure that they are not only looking backwards (compliance with current regulation) but also adopting practices and structures that enable them to see around corners and prepare for what is coming next.

In terms of trends, those companies that already have strong compliance in ESG are adopting new corporate forms. Many are embracing hybrids, leaving behind the private foundations ("philanthropy 1.0") in favor of public charities and donor-advised funds (DAFs) not only for giving but also to expand their operations into lower-margin, higher-impact areas that are accretive to their revenue base ("philanthropy 2.0"). Others are converting to Delaware public benefit corporations (PBCs), with dual fiduciary duties to pecuniary interests of shareholders and a defined public benefit as set forth in their charter. Boards and management of PBCs must also consider the impact of their operations on stakeholders in addition to shareholders. Over the past two years, PBCs have flooded the public markets; one publicly traded PBC has turned into 14, with hundreds of successful private PBCs waiting in the wings.

Investors, on the other hand, are not only establishing impact and climate funds, aggregating mainstream capital to invest in ESG that drives returns; they are also focused on ESG in their mainstream funds. This is infused in deal selection, diligence, provisions in transaction documents, and portfolio company management. Some of this is compliance-focused, but the leading fund managers view ESG as a way to improve operations and generate greater returns from their portfolio companies. A new development has been the shift of institutional investors focus to ESG and governance at the level of the asset manager itself, not only its portfolio companies.

Asset managers—and the institutional investors that they serve—are also looking beyond the traditional limited partner/general partner (GP/LP) structure to new corporate forms to aggregate capital like the permanent asset vehicles embraced

by Generate Capital and Sequoia that arguably provide them with a greater ability to focus on impact, sustainability, and ESG. Those managers that emphasize impact over returns are establishing more "stacked deck" funds and utilizing public benefit limited liability companies (PB LLCs) to aggregate a wide range of capital with different return profiles (from foundations, family offices, government, and mainstream providers).

Finally, investors and companies are embedding ESG into investment terms themselves, with the rise of sustainable development goals and other ESG performance-linked bonds in the public markets to performance-based and FAIR instruments in the private markets. ESG and impact terms are moving from side letters to the investment documents themselves, together with provisions that incentivize compliance with ESGrelated covenants and tie compensation to performance on ESG goals.

What are your thoughts on where compliance and ESG intersect?

ESG as a framework is extremely broad. There are elements that are certainly right in the wheelhouse of compliance leaders who already have considerable experience in areas like anti-corruption, bribery, privacy, and cyber-security. Those specifically include human rights and carbon emissions. However, I think it is a mistake to view ESG as purely a compliance exercise (for companies) or diligence exercise (for investors). As a compliance officer at a company, I would first confirm which elements of ESG are either subject to regulation or are material to your company/industry (using SASB or similar guidelines). Second, I would then establish an ESG working group, including compliance with an internal lead for each of the relevant ESG areas and each of the company's business lines to ensure that there is focus and coordination. Third, I would clearly identify which areas of ESG give rise to legal/compliance risk now (e.g., privacy, human rights), which may not be subject to regulation now but likely will be soon and, in the interim, can give rise to reputational and operational risk (e.g., climate emissions, DEI) and which are directly tied to operations (e.g., climate risk, product life cycle). Fourth, with the ESG working group, the compliance leader can map out short, medium, and long-term goals together with an assessment of how they will be measured, bench-marked, and reported both individually and in connection with financial results. And finally, I would consider how to ensure that the ESG mapping is integrated with the strategic plan of management and with governance at the board level.

Why is ESG measurement and benchmarking so important?

Many companies and investors are making climate commitments—particularly around becoming "carbon neutral" or "net zero"—by a certain date. The biggest issue is that there is not a clear path to net zero at this time, as it requires an overhaul to operations not just for the company but for all other companies with which it does business. Further, asset managers are responsible not just for their operations as fund managers but for all of their portfolio companies. As companies embrace the net zero agenda--I recommend following Glasgow Financial Alliance for Net Zero (GFANZ)—they will not be permitted to utilize carbon credits or offsets. Therefore, there will need to be an acceleration of technology solutions to eliminate emissions in all areas of their operations, from transportation of people and goods to manufacturing.

Measuring and reporting on progress made toward these goals is critical, together with having good data to be able to benchmark. There are two emerging trends when it comes to reporting. First, the regulatory bodies and stock exchanges are finally getting into the act by promulgating ESG reporting requirements in their jurisdictions (although the SEC, NYSE, and NASDAQ are still behind many other countries). Second, after years of wading through an alphabet soup of guidelines and standards for ESG reporting, companies should be encouraged by the work of the IFRS Foundation in forming the International Sustainability Standards Board (with representation from all of the major players in ESG reporting including SASB, GRI, CDP). There is hope that uniform standards for ESG reporting are close at hand.

What are some ESG challenges foresee?

Greenwashing is a significant risk. As we do not yet have uniform and comprehensive standards for measuring, benchmarking, and reporting on ESG, to date, companies and investors have been able to pick and choose what they report and how they report to paint the rosiest picture of their company and/or investments. Separating the wheat from the chaff has been difficult for investors, LPs, and consumers alike. Developing uniform standards to measure what "success" in ESG looks like is difficult (although progress has been made as noted above) and will take time, which should not come as a surprise; it has taken a hundred or more years to refine financial accounting and reporting.

The risks of green-washing and/or falling short of publicly touted goals increase significantly every week. Regulators (like the SEC) are investigating "green" claims made by asset managers. The FTC is initiating enforcement actions under the Green Guide and NGOs (like Greenpeace) are wielding litigation as a very effective tool against companies for failing to live up to commitments. This is all in addition to serious reputational risk and market risk from shareholders, consumers, and employees.

With this in mind, companies facing real risk from regulators or shareholders may feel that it is safer to do less and say nothing, but that may end up hurting them in the long run.

There are also considerable challenges that arise from muddled terminology and unclear definitions in the ESG field. Many people conflate ESG, CSR, sustainability, impact investing, and negative screen. "Impact" itself is used by foundations to advance SDG goals and by private equity funds to maximize returns (and all investors in between). Companies confuse CSR with ESG and Sustainability and often pigeonhole ESG efforts in departments that are not directly tied to operations or the strategy of the company as a whole. The lack of clarity for these terms will hinder development of the effective ESG tools and efforts and lead to more greenwashing.

How can companies navigate the human rights landscape in 2022?

One best practice should be to adopt an integrated compliance program for anti-corruption, privacy, climate, and human rights to provide effective monitoring of global operations. Companies need to ensure that their suppliers are not only in compliance with the law but also are providing data required for commitments made related to human rights and climate. And finally, I believe that companies should consider partnering with NGOs (like BSR) that have been working in "S" as it relates to human rights for 25 plus years (as opposed to expensive generalist strategic consultants) to evaluate risk and develop the most cost-effective strategy.

About the Expert

Susan ("Suz") Mac Cormac *is a Corporate partner at Morrison & Foerster in San Francisco and chairs the Energy and Social Enterprise and Impact Investing practices. Her practice focuses on late-stage financings, secondaries, and other corporate transactions for investors, such as SoftBank and Temasek, and on investments for some of the top investors dedicated to impact, from "impact first" foundations to family offices to private equity funds. Learn more about Suz and her work here.*