Harvard Law School Forum on Corporate Governance

Board Memo 2022: Sustainability and Beyond

Posted by Pamela Marcogliese, Sebastian Fain, and Elizabeth Bieber, Freshfields Bruckhaus Deringer LLP, on Saturday, January 15, 2022

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More from: Elizabeth Bieber, Pamela Marcogliese, Sebastian Fain, Freshfields

Editor's Note: Pamela Marcogliese and **Sebastian Fain** are partners and **Elizabeth Bieber** is counsel at Freshfields Bruckhaus Deringer LLP. This post is based on their Freshfields memorandum. Related research from the Program on Corporate Governance includes **The Illusory Promise of Stakeholder Governance** (discussed on the Forum **here**) and **Will Corporations Deliver to All Stakeholders?**, both by Lucian A. Bebchuk and Roberto Tallarita; **For Whom Corporate Leaders Bargain** by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum **here**); and **Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock** by Leo E. Strine, Jr. (discussed on the Forum **here**).

As 2022 approaches, companies are confronting an ever-expanding list of internal and external pressures on their business from a strategic, operational, governance, stakeholder and regulatory perspective. Well-advised boards of directors and management teams will need to prepare for and navigate traditional as well as evolving areas of focus in order to successfully execute on the company's strategy. As you consider the opportunities ahead, while anticipating the inevitable challenges, we invite you to review the themes we expect to be prevalent in 2022 and beyond.

Environmental, Social and Governance will continue to permeate board agendas in 2022

ESG considerations are continuing to increase in importance and are permeating additional areas of the board's oversight framework. In 2021, more and more companies released sustainability reports tied to and benchmarked against global reporting frameworks. Many companies also re-evaluated their ESG agendas and improved the disclosure of their strategic ESG priorities in their sustainability reports and stakeholder engagement, including with respect to the calculation, verification and oversight of ESG-related metrics.

While companies grappled with these internal considerations, the first proxy fight was won on an ESG thesis at a large cap company. In addition, the number of ESG-linked shareholder proposals – and the number of disparate ESG topics – rose, and the support from various shareholders increased expectations regarding ESG engagement and communication, including from shareholders that previously paid minimal attention to such considerations.

ESG-related risks were prioritized by many companies, and board oversight and management mitigation of those risks were frequent topics on boardroom agendas in 2021. We expect this trend to accelerate in 2022.

Many companies are continuing to increase their risk oversight and analysis with respect to ESG considerations, from identifying and planning for long-term financially material risks, to identifying and raising to the level of board oversight risks in the supply chain, to taking steps to understand risks that, on their own, may not be financially material but could have an outsize reputational or business impact and should be considered by boards and committees. For boards of directors experiencing "ESG fatigue," aligning ESG considerations with traditional areas of board oversight – including with respect to risk management – can mitigate the propensity to merely check the box on these issues.

In ***SEC Modifies Shareholder Proposal Rules, Making it More Difficult for Companies to Exclude ESG Proposals***, we address how a new SEC staff legal bulletin will likely encourage more ESG-related shareholder proposals, particularly in the areas of climate change and human capital management practices, and make it more difficult for companies to seek to exclude these proposals from their proxy statements.

Because many of these issues can also have a broad reputational impact and will be of interest to a wide set of stakeholders, proper messaging is critical (including the decision whether to publicly oppose the request). Companies need to carefully consider the ESG topics that are integral to their broader business strategy and clearly communicate to their various stakeholders in a consistent manner. This includes:

- reviewing their sustainability report and Exchange Act disclosures to ensure that the disclosure covers issues that are material or significant to the company, and, to the extent metrics are used, they are accurate, vetted and well-defined;
- reviewing talking points for shareholder engagement to confirm that the messaging is consistent and focused on material issues; and
- ensuring the right framework is established internally – that the right oversight levels and reporting lines exist, that the company has a mechanism for understanding and incorporating stakeholder interests and feedback centrally, and that the company is generally approaching ESG considerations in an organized and well-delineated fashion.

This review of a company's strategic ESG priorities will also be relevant for companies considering the use of executive compensation to incentivize attainment of ESG objectives by incorporating ESG goals into their executive compensation programs. Companies will need to determine which metrics fall within those strategic priorities.

In ***Tying ESG to Executive Compensation***, we describe the current trend of using these types of metrics as part of individual performance assessments or as part of a scorecard in combination with other goals, rather than as individually weighted goals. We also caution companies that they should choose appropriate metrics that are tied to their strategic priorities and measurable over the applicable period, and highlight several other developments in executive compensation that may affect companies' compensation practices, notably that:

- while ISS took a softer approach in 2021 to the use of discretion under cash incentive programs, we expect that, for 2022, ISS will be less flexible and will expect companies' cash incentive programs to return to "normal," with payouts that are more closely tied to pre-established goals; and
- as part of the reopened comment period for its proposed 2015 clawback rule, the SEC has, among other things, asked for comments addressing its proposed expansion of the level of accounting restatement that would trigger a recovery of compensation. If the rule is adopted, broadening the proposed definition of "accounting restatement due to material noncompliance" would significantly expand the situations under which boards will need to attempt a clawback or disclose why attempting a recovery is not feasible.

The activism landscape is particularly ripe for theses with an ESG focus. In ***Activism in 2022: A Pivotal Time Dividing the Well-Prepared and the Less-Prepared***, we remind boards that 2021 saw the first ESG-focused successful proxy contest – which underscored the view of many stockholders that ESG issues are inextricably linked to the board's strategy – and we assume more activists will likely try to follow suit.

As we note above, boards of directors and management teams will need to prioritize engagement with stockholders (including as they relate to ESG), lest other actors – including activists – make compelling arguments that put the board in a defensive posture filling gaps that could have been constructively addressed on a clear day.

The credit markets have also turned their attention to ESG matters. In ***The Impact of ESG on the Credit Markets***, we describe how numerous lending institutions – including banks, credit funds and alternative capital providers – have adopted non-uniform policies restricting their own ability to engage in certain lending transactions with entities that perform poorly from an ESG compliance perspective.

To minimize any impact on their access to capital or avoid an increase in the cost of capital from poor ESG practices, boards should be mindful of the following trends:

- companies facing ESG-related challenges that are planning to seek a maturity extension or a restructuring of an existing credit facility should expect that their lenders will require higher levels of ESG compliance and reporting going forward;
- if a company that has poor ESG compliance scores fails to demonstrate improvement, it is likely to face a higher cost of capital on its financings in the short term and may well have difficulty obtaining financing in the future; and
- boards should consider having their management teams evaluate their business counterparts and supply chain partners to determine the extent of such parties' ESG compliance, because there is an emerging negative knock-on effect for ESG-compliant companies that do business with those that perform less well.

On the world stage, in ***What Happened at COP26 – and What it Means for Business***, we describe some of the key outcomes from the latest UN Conference of the Parties in Glasgow (the gathering of 196 nations to advance the goals of the Paris Agreement), particularly the continued focus on moving the global community toward stronger climate action and "keeping 1.5C alive." The conference resulted in several achievements that have been shaped by, and will have clear impact on, the business community.

As a result of these broader macro-trends, boards will need improved data collection and analysis to better assess climate-related financial risks to assets and operations of the companies they serve. This data will also be relevant to determining how COP-related regulatory reforms could affect valuations. However, with all regulatory movement comes heightened risk of litigation. To mitigate these risks, boards should also engage in a litigation horizon-scanning exercise to identify which post-COP regulations provide additional sources for claims by investors or other stakeholders.

While we expect the M&A landscape will be robust in 2022, transactions will continue to be fraught with business, regulatory and other challenges that will require careful planning and sound advice

In ***Key M&A Trends for 2022***, we describe our expectation that M&A will continue to be robust in 2022. The market is buoyed by PE sponsors and SPACs hunting for deals, while strategics continue to both optimize their asset mixes by selling or spinning off businesses that are not in line with their corporate visions, and by making acquisitions where organic growth is not possible. There may also be headwinds that drag on M&A, including the potential for higher interest rates, increased regulation, challenging macroeconomic factors (such as inflation and continued supply chain issues) and the uncertainty associated with all of these factors.

To this end, in particular, corporate boards and dealmakers should be prepared for the following key opportunities and challenges:

- the technology sector will continue to spur significant deal activity, with technological innovators making attractive targets both for consolidation within the sector and for non-tech acquirors looking to add capabilities;
- increasingly active competition and foreign investment regulators will pose greater challenges to deal certainty, requiring parties to carefully craft provisions for regulatory efforts and related risk sharing; and
- ESG will continue to be front of mind for the investor community and for boards, driving the types of deals that are done and requiring additional attention to ESG-related risks in transactions.

Indeed, the antitrust approval process globally will remain challenging heading into 2022 and will require dealmakers to engage in careful planning to minimize the risk of unnecessary delays or unwelcome outcomes.

To successfully navigate the challenges of the new regulatory landscape, in ***The Antitrust Outlook for the Year Ahead*** we describe the areas that boards should focus on, including:

- the fact that new leadership at the DOJ and FTC have promised to increase their scrutiny of transactions while at the same time the agencies are receiving a record number of pre-merger filings and are facing significant staff and resource constraints. Boards and dealmakers should therefore allow for longer review periods and be prepared for non-traditional questions and theories of harm from the antitrust authorities;
- the changing regulatory landscape means that the antitrust authorities may place a higher bar on what remedies are sufficient to address their concerns. To narrow the scope of disputes with the DOJ or FTC, boards and dealmakers should consider proactively resolving obvious competition issues outside the regulatory process; and
- in light of calls by the DOJ and FTC to increase antitrust enforcement, boards and dealmakers should signal that they have the time and resources to successfully litigate a merger challenge. Maintaining a credible litigation threat will incentivize the DOJ and FTC to not unnecessarily prolong their investigations and to seriously consider remedy proposals.

In ***Activism in 2022: A Pivotal Time Dividing the Well-Prepared and the Less-Prepared***, we note that market dynamics and regulatory changes are likely to have an impact on transactions where activists have emerged, privately and publicly. Activists increasingly have inserted themselves in dealmaking, in pushing companies to pursue transactions, and in challenging announced transactions either to scuttle the deal entirely or to extract additional value.

The level of activism increased compared to the past year, and current levels of public and private activism indicate a further escalation. This level of activity and propensity for M&A-related activism is likely to also be fueled by the growth in public companies, particularly the spate of de-SPAC'ed companies that emerged throughout 2021.

Significantly, the proxy contest dynamic will undoubtedly be impacted by new SEC rules requiring companies and activists starting August 31, 2022 to use a universal proxy card that identifies all nominees for election as a director at an upcoming shareholder meeting.

Global geopolitical dynamics will also contribute additional complexity to historic operating models as well as deal execution. In 2021, the US—China trade war escalated as each side deployed a variety of newly developed regulatory and enforcement tools alongside more traditional economic measures to gain a geopolitical advantage.

As we describe in ***US—China Tensions Will Continue to Heighten Regulatory and Enforcement Risk***, boards can expect the following dynamics to impact their transactions in 2022:

- sustained tension between Washington and Beijing as both sides strategically deploy their expanding array of economic, political, and legal tools, with potentially significant impact across a wide range of industries and financial markets; and
- increased US and non-US extraterritorial enforcement activity, with particular focus on economic sanctions, export controls, investment restrictions, supply chain restrictions, and anti-corruption initiatives.

Companies should consider their range of activities that have a nexus with China that could be affected by these regulatory priorities (including, for example, manufacturing, supply chain, sales, and investment interests) and assess whether any steps should be taken to mitigate legal, regulatory, operational, and reputational risk.

New developments in litigation and increasing enforcement scrutiny will require boards to be very focused on risk

In ***Trends in Delaware Litigation that will have an Impact in 2022 and Beyond***, we describe two cutting-edge developments in Delaware law from 2021 that boards should factor into their deliberations going forward. First, the Delaware judges adopted a welcome streamlined test for demand futility that will impact all derivative cases against Delaware companies. Second, through recently decided cases concerning material adverse effect (MAE) clauses and ordinary course covenants in light of the COVID-19 pandemic, they reaffirmed the Delaware Courts' reluctance to permit parties to terminate deals based on unfavorable post-signing events while also reaffirming their enforcement of parties' intents in their covenants.

In light of these decisions, when entering into agreements that contain MAE clauses, companies should:

- ensure that the MAE clause, including any carve-outs and "disproportionate impact" provision, is adequately clarified;
- remain mindful of the types of actions that might breach an ordinary course covenant;
- ensure that agreements contain a sufficiently specific remedies provision; and
- remain mindful of the reluctance of Delaware Courts to permit termination on the basis of an MAE.

On the enforcement front, companies should expect increased scrutiny and activity by regulators, particularly as the Biden administration has made clear that anti-bribery and corruption (ABC) and anti-money laundering (AML) are not just priorities, they are "core national security interest[s]."

In ***The Next Year* in *Global Investigations – A Renewed Focus on Corruption and Money Laundering***, we urge boards to re-evaluate their companies' ABC and AML compliance programs and ensure those companies are taking reasonable steps to:

- align ABC programs with revised DOJ expectations in the recent Guidance on the Evaluation of Corporate Compliance Programs and the recent FCPA Resource Guide, including the importance of "investigation, analysis, and remediation";
- align AML programs with the emerging risks highlighted in the FinCEN Priorities, including illicit transactions related to cybercrime and domestic terrorism. In doing so, boards should consider strategies to engage with regulators when such issues arise; and
- confirm that compliance programs operate effectively and as they are designed to do in a post-COVID-19 era. Amid changing working conditions, compliance teams may need to update risk profiles, pressure-test programs, and adapt employee guidance for new operating paradigms.

On the arbitration front, in 2021 we saw an unprecedented volume of cross-border disputes. We expect this trend to continue in 2022 and beyond, driven by high levels of M&A and other deal-making that form new cross-border relationships, some percentage of which will not proceed as planned, and ongoing disruptions in global supply chains that compromise parties' abilities to perform their contractual obligations.

To ensure that their companies are well positioned to enforce their contractual rights, we describe in ***International Commercial Arbitration – Managing the Boom in Cross-Border Disputes*** three factors that boards should consider in cross-border agreements:

- requiring that disputes be resolved in international arbitration rather than national courts. Arbitration results in an award that, unlike a court judgment, can be readily enforced anywhere in the world with limited review by local courts;
- selecting a well-established seat of arbitration such as New York, London, Paris, Singapore or Hong Kong. In these venues, the courts reliably apply the New York Convention to protect favorable awards from being set aside; and
- requiring the confidentiality of any proceedings to protect commercially sensitive information and reduce reputational risk.

The development of new technologies and new regulations focused on data and privacy will present increasing challenges

In ***Outlook on Privacy and Cyber Security for the Year Ahead***, we warn boards they should expect a new raft of state data protection laws, heightened regulatory scrutiny of privacy and cyber security practices, and an ever-increasing list of business and legal risks posed by ransomware and other cyber attacks in 2022. To prepare, boards should:

- work toward establishing a regular record that documents their oversight of the company's cyber risk and its data compliance practices;
- review with management the company's privacy compliance policies, procedures, personnel and resourcing to ensure its ability to meet increasingly complex multijurisdictional obligations; and
- review with management the company's disclosure controls and procedures to ensure that material cyber incidents are adequately addressed to satisfy SEC disclosure obligations.

The pace of technological change and the development of new technologies has also given boards a lot to focus on. For example, in ***Board Consideration of AI and Other Autonomous Computer Systems***, we remind boards that the traditional fiduciary duties and oversight responsibilities apply to automated algorithms, artificial intelligence, machine learning and other novel technologies.

In this context, we describe the need for boards to:

- create a bespoke risk assessment of the various technologies their companies are considering or already using;
- if any of the technologies will be "mission-critical" for the company, ensure that internal controls are designed to address them and that any deficiencies in the controls are shared with the board on a timely basis;
- actively monitor the implementation and functioning of the technologies and possess the relevant technical literacy to evaluate relevant information provided by management and third parties; and
- refresh this assessment periodically, with the assistance of counsel, to ensure the protocols in place are up to date.

Companies will also need to address how to operate within a changing environment for global taxation and changing interest rates for floating rate debt

In ***OECD Agreement May Increase Global Effective Tax Rates for IP-Intensive Multinationals***, we describe the new two-pillar international tax rules that OECD members agreed in October 2021 that increase global effective tax rates. Pillar One works by allocating part of a multinational enterprise's (MNE's) profits to market jurisdictions, which would tax this amount even if the business concerned does not have a physical presence in that jurisdiction.

Pillar Two would achieve a global minimum tax rate of 15 percent in part by requiring countries in which MNE parents are resident to impose a top-up tax on offshore subsidiaries taxed at locally lower rates. Multinational corporate groups, particularly in tech and other IP-intensive industries, should prepare for these changes in international tax rules that will significantly increase global effective tax rates and work with tax counsel to carefully review, and assess the impact of, the application of the new tax rules to their operations.

Finally, the much-anticipated move away from the London Interbank Offered Rate (commonly known as LIBOR) is finally here! Beginning January 1, banks are no longer permitted to enter into agreements to provide loans that accrue interest based on LIBOR, meaning 2022 will be the year that companies start to learn to manage debt in a post-LIBOR world (note: existing loan agreements can continue to provide LIBOR-based loans until June of 2023).

In ***Post-LIBOR: The Brave New World for Floating Rate Debt***, we describe some key issues that companies should keep in mind for the remaining weeks:

- companies' cost of borrowing may appear to increase, and companies should notify key stakeholders (shareholders, other lenders and credit rating agencies) of this possibility early if the business expects to raise debt financing;
- it may be possible to lock in a slightly lower rate, so companies' treasury teams should engage with their lender banks to plan for this transition and discuss the appropriate adjustment – even if the company is not refinancing in the near term; and
- senior leaders may have less visibility on the company's future interest expense – boards may want to note this in budgets and forecasts until the company's treasury team is comfortable with the new reference rate.

The landscape in 2022 will be full of opportunities. While COVID-19 will continue to have an impact, many companies are becoming better at managing and executing through its challenges and uncertainties. Nonetheless, as a post-COVID world emerges, it is widely acknowledged that there will be no "return to normal," as the pandemic has shown key economic areas—supply chain and human capital management among others—that will need significant reconsideration going forward.

While at the same time, shifting legal and regulatory landscapes and focuses require significant adaptation. This puts management teams and boards on the frontlines of an uncharted business and economic horizon that will be characterized by novel challenges, whether from a commercial, regulatory or litigation perspective. Companies that engage in careful preparation, with attentive board oversight and the assistance of creative legal advice, will find ways to mitigate headwinds, capitalize on these opportunities and thrive.