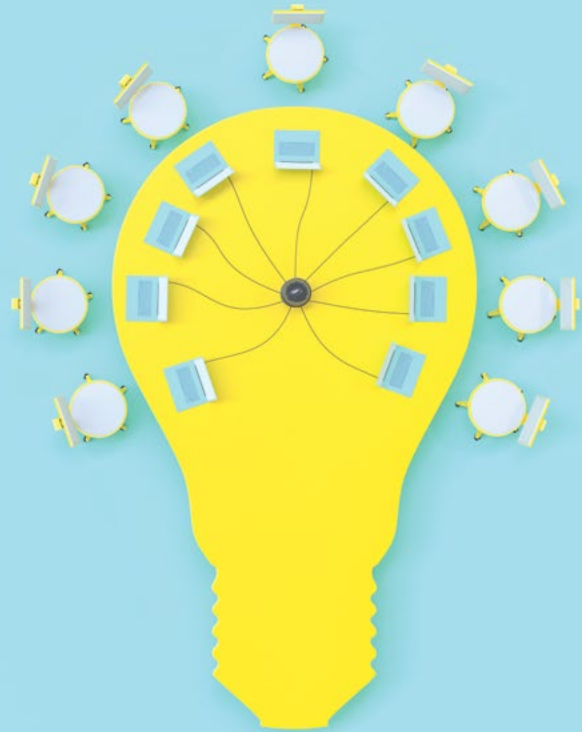

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ESG-Driven Divestments

In his regular column, Frank Aquila drafts a memo to a board highlighting key issues and recent developments for a board to consider when facing pressure from investors and other stakeholders to engage in divestments or similar transactions based on environmental, social, and governance (ESG) concerns.

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MEMORANDUM

TO: The Board of Directors
FROM: Frank Aquila
RE: ESG-Driven Divestments

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As we have discussed, the Board of Directors is facing pressure from certain investors and other stakeholders to consider divestments and similar transactions for ESG-related reasons. In particular, these stakeholders have expressed that some of the Company's current business lines and investments are inconsistent with the Company's corporate social responsibility and long-term sustainability goals.

As the focus on ESG continues to grow among investors, lawmakers, regulators, and other stakeholders, much of the recent discussion has focused on disclosure, especially in light of recent Securities and Exchange Commission (SEC) rulemaking. However, stakeholders have used various means for many years to exert pressure on companies, often in connection with sociopolitical issues, to divest businesses or investments. The pressure to divest generally consists of shareholder demands on a company either to divest certain assets or business lines, or to exit its investment in or involvement with specific industries, entities, or countries. In the last decade, one focus of ESG-driven divestment has been climate change, and companies, including those in the energy and financial sectors, responded by pledging to divest oil and gas or coal assets to meet their net-zero goals. US companies have also faced pressure from activists and other stakeholders to divest from companies that manufacture guns or use prison labor.

In the spring of 2022, ESG-driven divestment came to the forefront of corporate decision-making in light of the international sanctions imposed on Russia. Some of the world's largest companies, including BP plc, Shell plc, Exxon Mobil Corp., Apple Inc., McDonald's Corp., and Starbucks Corp., all announced they were either divesting their Russian operations or suspending business in Russia. Large US financial institutions also announced they would begin the process of winding down business in Russia, and even the largest US institutional investors, including Vanguard and BlackRock, suspended the purchase of Russian assets in response to Russia's war against Ukraine.

These decisions were made and implemented at unprecedented speeds, even as some of these companies acknowledged the divestments would result in an adverse financial impact in the near term. Among other things, the corporate response to the war in Ukraine further highlights a board's need to closely monitor ESG developments and adjust its corporate strategy nimbly to ESG issues. Moreover, the speed at which a board may have to respond to ESG issues emphasizes the need for boards to develop a clear understanding of their duties and responsibilities in the face of these issues well before they arise.

This memorandum provides a high-level overview of the important issues that should guide the Board's discussions when considering ESG-driven divestments and similar transactions, including:

- Recent developments and trends.
- The Board's fiduciary duties.
- The governance framework and Board oversight of ESG issues.
- Internal and external sources of ESG expertise.
- Disclosure and messaging considerations.

1. RECENT DEVELOPMENTS AND TRENDS

ESG-related pressures can come from a variety of sources, including shareholder activism, legislative and regulatory developments (such as recent SEC proposals regarding ESG disclosure), and key stakeholders other than shareholders.

A. SHAREHOLDER ACTIVISM

ESG-focused funds currently account for over 10% of worldwide fund assets under management, have performed well in recent years, and are popular with investors. As these funds continue to grow, activist campaigns have begun to focus on ESG concerns and may increasingly center on these issues in the future. Activist investors have already successfully linked financial performance to a company's climate-related strategies. For example, Engine No. 1, despite being a newly formed fund and owning only 0.02% of Exxon's shares, successfully installed three directors on the board of Exxon in a proxy contest launched in December 2020 under the stated goal of pushing Exxon to reduce its carbon footprint. The successful Engine No. 1 campaign comes in the midst of mounting concerns among Exxon's investors about climate change and Exxon's strategy regarding climate change. Engine No. 1 partnered with major pension fund CalSTRS and received support from other large and historically passive institutional investors that signaled their willingness to partner with activist investors on ESG issues.

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Shareholder campaigns have continued to focus on ESG-driven divestments in recent months. For example, Sierra Club Foundation and Trillium Asset Management are among a group of proponents that filed nine resolutions (available at *iccr.org/2022-climate-finance-resolutions*) with six major US banks in December 2021 requesting that the banks ensure their financing does not contribute to new fossil-fuel supplies, and that some of the banks provide an audited report on whether and how fulfilling the scenario of net-zero emissions by 2050 may affect assumptions in financial filings. Activist hedge fund Third Point outlined in an October 2021 investor letter (available at *thirdpointlimited.com*) reasons for Shell to break up into stand-alone companies, including one with Shell's liquefied natural gas, renewables, and marketing businesses and one with its legacy energy business. Third Point stated its belief that Shell cannot attract investors because it has "too many competing stakeholders pushing it in too many directions, resulting in an incoherent, conflicting set of strategies attempting to appease multiple interests but satisfying none."

Search Activist Investor Wins At Least Two Exxon Board Seats Over Climate Change Concerns for more on the Engine No. 1 proxy contest.

B. LEGISLATIVE AND REGULATORY DEVELOPMENTS

The Biden administration has been focused on ESG issues, in particular, climate change. The administration has announced several executive and regulatory actions under its "whole-of-government" approach to addressing climate change and achieving net-zero emissions across the US economy by 2050. The administration has also been advancing its initiatives through funding allocated under the Bipartisan Infrastructure Law enacted in November 2021, as well as federal procurement policies that reward domestic producers of clean hydrogen.

Recent SEC proposals to expand disclosure requirements may amplify ESG-related pressures by giving stakeholders greater access to information and the ability to target perceived underperformers. For example, on March 21, 2022, the SEC proposed climate-related disclosure requirements that would require US public companies and foreign private issuers to provide granular disclosures on greenhouse gas emissions, climate-related risks, and business impacts, as well as climate-related governance and risk management. The expanded disclosures could lead to greater divestment pressure on perceived weak-performing companies and pressure on those who provide funding to or invest in these companies.

In addition to the SEC rulemaking, the Commodities Futures Trading Commission (CFTC), the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Financial Stability Oversight Council (FSOC) have each recently warned that climate change threatens US financial stability. While these efforts do not expressly require divestment of high-emission businesses, assets, or investments, they may cause many companies (including financial institutions) to carefully reconsider whether they would be perceived as underperforming their peers due to their investments in or operations of these businesses or assets.

On the other hand, state and federal governmental entities have prohibited companies from divesting assets or investments in certain industries for ESG reasons. The OCC announced in January 2021 that it would not move forward with the publication of a fair access rule, which would have prohibited large OCC-regulated institutions from denying financial services to corporate entities, businesses, nonprofits, or individuals solely on a subjective basis, such as refusing to provide credit to oil exploration firms. However, similar fair access bills have been introduced in the US Congress and in various states.

If a company decides to divest from the fossil fuel industry, it might face difficulties doing business with various state and local governments or be subject to the penalties outlined in state laws. For example, in May 2021, 15 state treasurers sent a joint letter (available at *wvtreasury.com*) to John Kerry, the Special Presidential Envoy for Climate, expressing concern with reports that the federal government was privately pressuring US banks and financial institutions to refuse to lend to or invest in coal, oil, and natural gas companies. The letter indicates that those states will give significant weight to the fact that an institution engaged in lending practices that they perceive to be antagonistic to the energy industry before entering into or extending any contract. Additionally, North Dakota, Oklahoma, and Alaska have adopted or proposed laws or policies limiting transactions with companies that have called for divestment from the fossil fuel industry. Texas Senate Bill No. 13 (codified at Tex. Gov't Code Ann. §§ 809.001–809.102, 2274.001–2274.002), effective September 1, 2021, requires the state comptroller to maintain a list of

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companies that divest from fossil fuels, threaten them with divestment of state resources if they do not cease their boycott, and then act on that threat if the companies do not comply.

Search Biden Administration Energy and Climate Change Policies and Regulations: 2022 Tracker for more on key actions and initiatives on climate, energy, and environmental issues.

Search Key Developments in ESG and Climate Disclosure Tracker for more on SEC guidance and rulemaking on ESG issues, including the proposed climate-related disclosure requirements.

C. KEY STAKEHOLDERS

Employees, customers, business partners, and the general public may all compound the pressure a board faces to make ESG-driven decisions, including to divest. If a board fails to address demands from employees and the communities in which the company operates, the company's relationships with these constituents are likely to suffer. This may have a meaningful impact on the company's ability to retain and attract talent, particularly in light of the Great Resignation and the current state of the labor market. Reputational harm may also result from a failure to respond to ESG developments. For example, Nestlé S.A. faced outrage from customers, employees, and the general public when Ukraine's president, Volodymyr Zelenskiy, accused Nestlé of not living up to its "Good Food, Good Life" slogan because it did not initially suspend operations in Russia.

Failing to respond to stakeholder concerns might also prevent companies from doing business with commercial counterparties that have adopted certain ESG requirements. For example, a recent survey of 100 leading UK retailers revealed that 48% of them include sustainability obligations in their agreements with third parties (Emma Flower, TLT LLP, Sustainable Contract Clauses for Retailers (Dec. 6, 2021), available at *tltsolicitors.com*; TLT LLP, Retail Agility: Sustainability Matters (Dec. 2021), available at *tltsolicitors.com*). If a company continues to operate in industries or business lines that do not comport with the ESG requirements, they may lose opportunities to work with important counterparties.

Search Memorandum to Board: ESG Developments and Considerations and Memorandum to Board: Issues to Consider When Preparing for Shareholder Engagement on Sensitive Social Issues for more on engaging with shareholders and other stakeholders regarding ESG issues.

Search Corporate Social Responsibility and the Supply Chain for more on ESG and commercial counterparties.

2. FIDUCIARY DUTIES

In deciding whether to engage in an ESG-related or other divestment, directors must ensure their actions align with their fiduciary duties. Directors of a Delaware company, such as the Company, owe fiduciary duties of care and loyalty to the company and its shareholders. Under current Delaware jurisprudence, directors' duties run to the company and its shareholders, and not to other stakeholders. Delaware is not one of the 44 US states with constituency statutes, which permit directors to consider the interests of non-shareholder constituencies. When making corporate decisions regarding ESG divestitures, directors should be mindful that Delaware courts have repeatedly characterized directors' fiduciary duties as the responsibility to "promote the value of the corporation for the benefit of its stockholders" (*eBay Domestic Hldgs., Inc. v. Newmark*, 16 A.3d 1, 34 (Del. Ch. 2010)).

Therefore, the question the Board must ask itself when deciding whether to approve a proposed divestment is whether the transaction would promote the value of the corporation for the benefit of its shareholders. In making this decision, it is crucial for the Board to consider both near-term and long-term implications of the proposed transaction on the company's value. In the near term, an ESG-driven divestment could lead to a drop or an increase in share prices, depending on how it is perceived by investors and the stock market more broadly. For example, BP's US-listed shares dropped 8% when the company announced that it would divest its 20% stake in Rosneft (a Russian state-owned enterprise), whereas the stock market has generally responded positively to certain divestitures in the global brewing

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industry. However, a board should also consider that, over a longer horizon, divestments may reduce the diversity of a company's investment and business portfolio, which may increase a company's risk profile.

In addressing its fiduciary obligations, the Board should monitor developments regarding:

- The shareholder primacy theory of corporate governance, which prioritizes shareholders' interests.
- *Caremark* claims in the ESG context.

Search Fiduciary Duties of the Board of Directors for more on directors' fiduciary duties.

A. SHAREHOLDER PRIMACY

Delaware courts have long held that "stockholders' best interest must always, within legal limits, be the end. Other constituencies may be considered only instrumentally to advance that end." (*In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 37 (Del. Ch. 2013) (quoting Leo E. Strine, Jr., *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, 47 Wake Forest L. Rev. 135, 147 n.34 (2012)).) This idea that shareholder interests should be the principal focus of directors' corporate decisions is a central tenet of Delaware law. For example, in *Frederick Hsu Living Trust v. ODN Holding Corp.*, the plaintiff alleged a breach of the directors' duty of loyalty because the directors, among other things, divested three of the company's four business units to raise funds for the future redemption of preferred stock, allegedly benefiting the company's preferred shareholders at the expense of the common shareholders. Refusing to dismiss the claim, the court found that it could be reasonably inferred that the actions taken by the board breached the directors' fiduciary duty of loyalty because they benefited constituencies other than shareholders in the aggregate, in their capacity as residual claimants, and were not undertaken for the purpose of long-term maximization of the corporation's value for the benefit of the residual claimants. (2017 WL 1437308, at *15-36 (Del. Ch. Apr. 24, 2017).) Ultimately, after a trial, the court determined that the defendants owed fiduciary duties to the company and the common shareholders and that the entire fairness standard of review of their conduct applied. The court considered the fairness of the entire divestment process and the fairness of the prices in the transactions as a whole and found that the defendants had acted fairly because they left common shareholders in as good a position as they would have been in if the company had followed a long-term growth strategy. (*Frederick Hsu Living Tr. v. Oak Hill Capital Partners III, L.P.*, 2020 WL 2111476, at *35-43 (Del. Ch. May 4, 2020).)

Frederick Hsu Living Trust and other recent Delaware cases highlight that shareholder primacy continues to drive Delaware jurisprudence, even as other countries and US states move to allow companies to consider the interests of their non-shareholder constituencies, such as employees, suppliers, customers, and local communities (for example, Companies Act, 2006, c. 46, § 172; Conn. Gen. Stat. Ann. § 33-756(g); 15 Pa. C.S.A. § 1716(a)). Accordingly, if the Board decides to divest in response to or in anticipation of ESG-related shareholder engagement, the Board must carefully assess whether the specific ESG divestment under consideration would ultimately promote shareholder value. Basing ESG divestments on an analytical framework rooted in long-term shareholder value will assist directors in ensuring that they are fulfilling their fiduciary duties. When evaluating important ESG issues, an informed and well-documented decision-making process can assist the Board in defending against potential claims that directors improperly allocated corporate resources to advance their own ESG agenda without regard to shareholder value.

If a board takes these steps, it is unlikely that a Delaware court would second-guess the Board's business judgment, even if there is an adverse market response in the near term or the immediate beneficiaries of the decision to engage in a proposed transaction are non-shareholder constituencies (see, for example, *eBay Domestic Hldgs.*, 16 A.3d at 33). There are many valid reasons for a company to engage in ESG-related divestitures, including to enhance goodwill associated with the corporate brand, lower costs associated with employee turnover, increase sales by generating positive publicity, and reduce the likelihood of boycotts of the company's products or services.

However, the Board should continue to monitor legal developments at the state and federal levels, especially certain proposed legislation that may erode Delaware law's long-standing commitment to shareholder primacy. There have been legislative efforts at the federal level on corporate responsibility

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to stakeholder constituencies. Recent Delaware decisions, which highlight the importance of long-term value creation over short-term economic gains (see *In re Rural Metro Corp.*, 88 A.3d 54, 80–81 (Del. Ch. 2014); *In re Trados*, 73 A.3d at 37), could likewise indicate that Delaware boards' fiduciary duties may require them to consider impacts on non-shareholder constituencies because those impacts may be linked to long-term sustainability.

B. *CAREMARK* CLAIMS

In light of the complexity and rapidly evolving nature of ESG issues, as well as several *Caremark* claims that have survived a motion to dismiss in Delaware courts, the board of a Delaware company should take special care to ensure that the company has an effective oversight framework in place for addressing ESG risks and responding to ESG issues and that the directors actively monitor those risks and issues and the framework.

A director's duty of oversight stems from the duty to act in good faith and be "reasonably informed concerning the corporation" (*In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996)). Directors expose themselves to *Caremark* liability for failure of oversight if they either:

- Failed to implement any information and reporting systems and controls.
- Implemented these systems and controls but consciously failed to monitor or oversee them so the directors cannot be kept informed of risks or issues that arise.

(*Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).)

In *Marchand v. Barnhill*, the Delaware Supreme Court found that a board had failed to establish appropriate oversight procedures for a company's mission-critical functions and the court allowed the plaintiff's *Caremark* claims to proceed (212 A.3d 805, 809 (Del. 2019)). In *In re Clovis Oncology, Inc. Derivative Litigation*, the Delaware Chancery Court found that a board had implemented an oversight system but that the plaintiffs had sufficiently shown that the board ignored multiple instances of regulatory noncompliance and failed to adequately monitor the oversight system (2019 WL 4850188, at *13-15 (Del. Ch. Oct. 1, 2019)). If there is an oversight system and monitoring in place, and the board exercises at least "*some* oversight," courts are unlikely to allow a plaintiff to move forward with a *Caremark* claim on the argument that the board should have implemented a better oversight system (*In re Gen. Motors Co. Derivative Litig.*, 2015 WL 3958724, at *14-15 (Del. Ch. June 26, 2015)).

While recent *Caremark* cases have focused on board oversight and monitoring of regulatory risks, Delaware courts have been less likely to find *Caremark* liability in connection with monitoring business risks (see *In re Clovis*, 2019 WL 4850188, at *12 (distinguishing the board's oversight of the company's management of business risks from the board's oversight of the company's regulatory compliance); *In re Facebook, Inc. Section 220 Litig.*, 2019 WL 2320842, at *14 n.150 (Del. Ch. May 31, 2019) (stating that "it is more difficult to plead and prove *Caremark* liability based on a failure to monitor and prevent harm flowing from risks that confront the business in the ordinary course of its operations")). However, Delaware courts have not definitively stated that *Caremark* does not extend a board's duty of loyalty to the duty to monitor business risks. As ESG issues become increasingly subject to legal requirements as a result of federal and state legislative and regulatory efforts, it is possible that directors' exposure to *Caremark* liability in connection with ESG-related decisions could also increase.

As with any board action, the Board must be adequately informed and make decisions based on all material information reasonably available to satisfy its duty of care. In some cases, the decision to divest must be made quickly. If the Board continues to monitor and stay up to date on ESG risks affecting the Company as well as the Company's overall ESG strategy, the Board will be better positioned to respond quickly and on an informed basis when a risk requires action.

Search Delaware Supreme Court Reverses Chancery Court in Marchand v. Barnhill, Finds Reasonable Doubt of Director Independence and Possible Caremark Claim and Clovis: Delaware Chancery Court Allows Caremark Claim to Proceed for Failure to Monitor for more on Delaware court decisions involving *Caremark* claims.

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3. THE GOVERNANCE FRAMEWORK AND BOARD OVERSIGHT

The Board should evaluate on a regular basis whether the Company's governance structure adequately supports evaluation of ESG topics, especially in light of recent developments, including mounting investor focus on ESG and the SEC's rulemaking. Oversight of ESG issues often requires combined efforts from management, various board committees, and the board as a whole. Because ESG issues implicate a company's long-term business strategy, some boards elect to maintain primary oversight of sustainability issues at the full-board level. Although this approach is effective at impressing the importance of ESG issues on all board members, a board may not have sufficient time to fully and frequently examine the complex and rapidly evolving ESG issues related to a company's business. Therefore, many boards delegate primary responsibility for considering ESG issues, including management-proposed ESG strategies, to either existing committees, such as the nominating and governance committee or the audit committee, or a stand-alone committee dedicated to these issues. There is no one-size-fits-all approach to board oversight of ESG topics. However, given the overlapping issues in ESG, particularly when transactions that could impact financial performance are considered, a board should bring together all of the appropriate committees and directors to deliberate on the ultimate decision.

Relatedly, the Company should consider whether it is appropriate to update internal policies, corporate governance guidelines, and committee charters. ESG-related developments (including governance and reporting requirements under the SEC's recent rulemaking) may necessitate updating these documents to reflect and allocate any new responsibilities for the Board and management.

Search Sustainability Committee Charter for a model charter for a stand-alone committee dedicated to ESG issues, with explanatory notes and drafting tips.

Search Nominating and Corporate Governance Committee Charter, Compensation Committee Charter, and Audit Committee Charter for model committee charters that include ESG-related provisions, with explanatory notes and drafting tips.

4. INTERNAL AND EXTERNAL SOURCES OF ESG EXPERTISE

The Board should consider what resources, both internal and external, it can utilize to meet its obligations. ESG issues span a broad range of topics, and the Board should have access to a variety of subject matter and industry experts to obtain any material information it needs. The Board should work with these experts in evaluating the appropriateness and viability of the Company's long-term ESG strategy and in assessing whether it complements the Company's overall business strategy. These experts can also assist the Board in exploring how a particular ESG-driven demand, such as a divestment, would likely impact the long-term strategy of the Company.

The Board should also work with the Company's investor relations team to understand shareholders' concerns and strategize how best to communicate the Board's decisions and processes to investors and other stakeholders. If the Board decides that a divestment demanded by certain Company shareholders is not appropriate, it is especially important to assist the shareholders in understanding the rationale for the decision and to increase buy-in from investors for the Company's long-term strategy. In the absence of investor buy-in, the Company may receive negative publicity and become a target for shareholder activism, and the Board may face increased voting pressure. If the Board decides to pursue a divestment demanded by shareholders, proactive engagement may be helpful because ESG priorities may differ among the Company's investors. It may also be necessary for the Company to use the investor outreach process to assist investors who support a divestment in understanding any practical or legal challenges that require a gradual exit and to manage their expectations for the timeline of the Company's planned actions.

5. DISCLOSURE AND MESSAGING CONSIDERATIONS

In general, the Board should leverage communications resources to craft a core message on its ESG priorities and positions, which must be consistent across all of the Company's disclosures (for example, on the Company's website and social media channels and in its sustainability reports and

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SEC filings). Additionally, it may be necessary for the Company to evaluate on an ongoing basis whether changes should be made to this message in light of recent developments affecting the Company, the industry, or the broader economy. Accuracy and consistency in ESG disclosures is particularly crucial given the creation of the SEC's Climate and ESG Task Force in the Division of Enforcement, which has stated that it will focus on material misstatements or gaps in companies' statements concerning ESG issues, including by bringing enforcement actions for "greenwashing."

More specifically, if the Company decides to pursue an ESG-driven divestment, the Board should work with internal and external public relations teams to ensure that the Company can articulate clear and compelling reasons for the divestment. Generally, divestments and similar transactions that are viewed as proactive steps in furtherance of defined corporate strategies are valued positively by the market. On the other hand, divestments perceived as reactive steps in the absence of defined strategic goals are valued negatively. Further, a highly complex transaction may make a company more vulnerable to a takeover attempt, especially if the transaction encounters unforeseen issues or initially depresses share prices. A clear explanation of the execution risks and challenges when the Company begins its execution may prevent an opportunistic hostile bid from prevailing in these circumstances.

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I look forward to discussing this at your convenience.

F.J.A.

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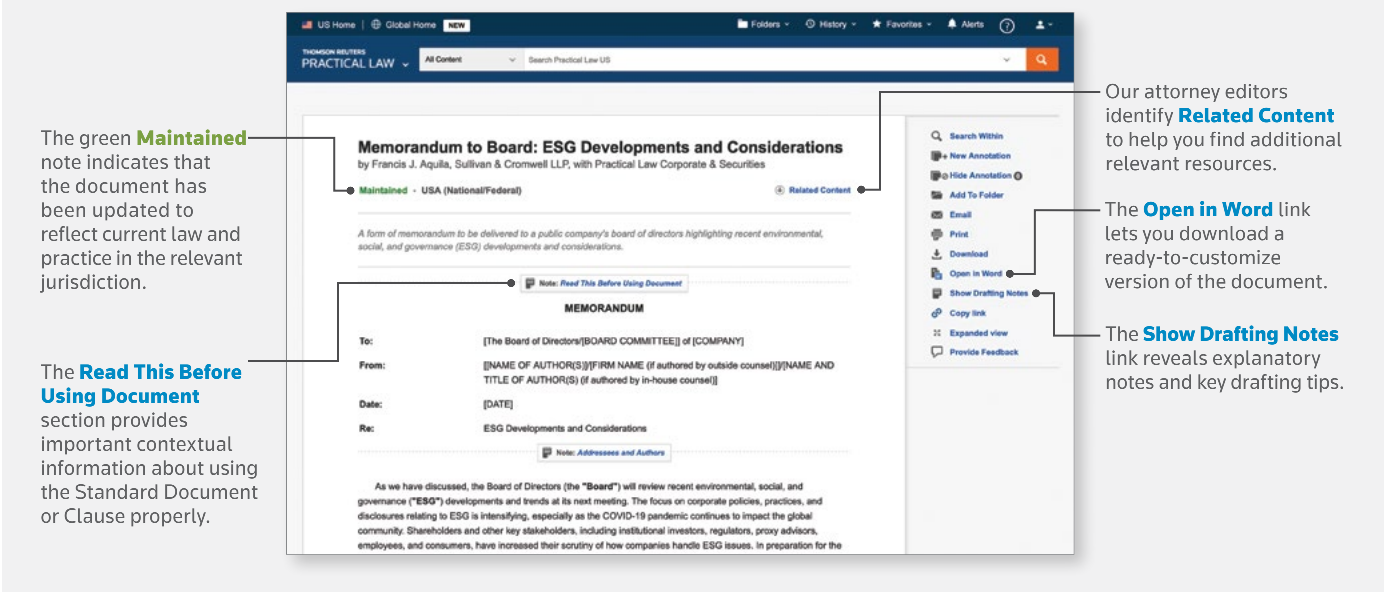

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