As a director, should you be concerned about environmental, social and governance (ESG) issues?

What if any impact does ESG have on business value?

What can happen if ESG is ignored? Can a director be held responsible for not considering non-financial information?

Fiduciary duty and ESG

When serving as the director of a company, certain legal obligations are created and attached as a result of the nature of the relationship with the company. This includes the existence of a fiduciary duty to the company. “A fiduciary is someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence.” This means that, as agents of the company and stewards of its affairs, directors must make business decisions after taking all available information into account, and
then act in a judicious manner that promotes the company’s best interests. Increasingly this entails considering non-financial information.

Non-financial information means environmental, social and governance information (ESG), aka sustainability. Failure to consider ESG as part of the decision-making process and business management practices exposes the company to several risks – risks arising from the non-management of ESG issues within business operations, lost opportunity to derive greater business value by managing ESG, and legal risk for the director for failure to meet fiduciary duty. Below are a few real-life case studies that illustrate how companies and directors can be impacted.

**Case Study #1 – Risk of unmanaged ESG**

Nike is an example of what can go wrong when non-financial (social) considerations do not form part of the business decision equation. Nike created a pioneer business model, outsourcing all of its production to a network of suppliers in other parts of the world where labour costs were extremely low, enabling exceptional growth. However, the factories had unhealthy working conditions, forced overtime, paid less than minimum wage, used child labour and the Nike brand came to be criticized for selling goods produced in sweatshops. For example, workers in the Vietnamese Nike plants were being exposed to carcinogens at 177 times above safety levels and were being paid just $10 for a 65-hour work week. By contrast, Nike heavily invested in celebrity advertising to promote its products, which in 1998 amounted to US$1.13 billion when it paid Tiger Woods $28 million and Michael Jordan $45 million. Around the same time, these sweatshop practices began to negatively impact Nike, who became dogged by protests, allegations and charges about abuse of workers, and child labour practices. Nike denied responsibility by claiming that it had no say over the actions of its suppliers but ultimately had to succumb to the pressure and begin to address the concerns in its supply chain and business operations. Though its business strategy helped Nike soar financially, its (indirect) labour practices brought Nike serious reputation damage, impacting revenues and forcing redundancies.

Since then, Nike has turned its brand around by managing sustainability issues and has regained public trust – in 2015 Nike was identified by the Reputation Institute as the second most-trusted company by millennials in the US.

Nike is a classic example of the triple bottom line concept – measuring the financial, social and environmental performance of a company to take into account the full cost of doing business, i.e. financial value can be quickly offset by not pricing-in social (or environmental) considerations.

**Case Study #2 – Lost business opportunity**

Unilever launched its sustainable living plan in 2010. It aimed to create positive social impact while decoupling growth from negative environmental impact, through product redesigns, more efficient resource management in its operations, and rethinking its sourcing practices for materials used in production. One product example is the Pureit in-home purifier which delivers safe, affordable drinking water that can reduce the incidence of diarrhoeal disease by up to 50%. This product can help improve the quality of life of 1 billion people worldwide who are without access to clean water, and can help reduce disease in the developing world where 80% of diseases are water-borne. The Pureit in-home water filter delivers Unilever financial profits, whilst addressing environmental and social issue (i.e. positive net value), and brings its customers a sustainable living solution. This sustainability-focused approach brought positive results for Unilever’s bottom line in 2017: its sustainable brands grew 46% faster than the rest.

---

of the business and delivered 70% of its turnover growth.\(^2\)

**Case Study #3 – Risk of director liability**

VW’s emissions scandal is a recent example of poor sustainability governance practices. The scandal arose when executives attempted to derive financial gain at the expense of environmental considerations by installing software on diesel cars sold in the USA to lower the figures in emissions tests. Falling share prices, class action lawsuits, regulatory fines, recalls, criminal charges and the resignations of its Chairman and CEO are some of the consequences of this business decision. As well, its supervisory board is being investigated and may face liability. VW set aside US$6.7 billion in 3Q2015 for repair costs on some 11 million vehicles worldwide and is expected to pay some US$4.3 billion in criminal and civil penalties in the US. The total estimated cost of this environmental deception in the US is US$20 billion. It is one of the costliest corporate scandals in history.

The above case studies demonstrate that directors should consider non-financial information in order to discharge their duty to the company as part of the governance and decision-making process. Importantly, since boards delegate the day to day management of business operations to a management team, this in turn will require directors to insist that management implements processes to adequately and systematically manage ESG issues as part of business operations. However, although 80% of CEOs surveyed believe that it is important to measure and try to reduce their environmental footprint, only 26% are actually addressing the risk of climate change as a priority. This suggests that there is a large gap between intention and action. This gap exposes directors to potential liability.

The non-management of ESG can also bring other longer-term consequences to the company’s value. Climate change is expected to increase the number of stranded assets (assets that need to be written off because of unforeseen circumstances). For example, if sea levels rise in accordance with climate change models, seaside properties will be under water (no pun intended) and loans will be unrecoverable. For example, the transition to a low carbon economy will negatively impact oil and gas physical assets. In addition, the company is missing out on broader business value opportunities such as cost savings through energy efficiencies, new market and investment opportunities, lower cost

\(^2\) The UN Sustainable Development goals outline 17 areas which are estimated to open up approx. US$12 tn in market opportunities in four economic systems: food and agriculture, cities, energy and materials, and health and well-being, and represent around 60% of the real economy. Source: Better Business Better World Report by the Business & Sustainable Development Commission, 2017.


\(^4\) PWC 17th Annual Global CEO Survey 2013.
of capital, business competitiveness, and so on.

The ability of a director to adequately oversee the management of ESG pre-supposes a comprehensive understanding of the complex and interconnected nature of ESG topics, of how ESG can impact the company, and how the management of ESG can support the company’s business value proposition. For any director, the first call to action is to develop his or her expertise in sustainability. This might include inviting external experts to train the board, and/or attending sustainability leadership programmes at a well-known University specialising in the business management of sustainability, or through director qualification programmes such as the Hawkamah Institute’s. Armed with knowledge, the director is then positioned to connect sustainability with corporate purpose and strategy, gauge whether management is effectively and comprehensively managing business operations, and deliver long-term value to shareholders.

There is a groundswell global movement compelling companies to integrate ESG. This includes compulsory disclosures such as the European Union Directive on disclosure of non-financial and diversity information (the ‘Non-Financial Reporting Directive’) and new carbon emissions reporting requirements in the UK. New disclosure frameworks include the Task Force on Climate-related Financial Disclosure (TCFD), driven by investor pressure to price climate change risk into investment decisions. As well, institutional investors are under pressure to integrate ESG into their investment decisions - currently some 42% of institutional investors are required to disclose their approach to ESG investing and the EU is expected to report on its decision whether to make TCFD mandatory in Dec 2018.

The EU is also looking to amend the prudent person rule to require that ESG factors be taken into account in investment decisions. Japan’s Government Pension Investment Fund, the world’s largest pension fund, already requires this of its external asset managers, as does Australia. This international trend is noteworthy, especially if your company anticipates raising funds abroad, has foreign investors or plans to expand into other markets where regulations and disclosure frameworks are mandatory.

To conclude, business as usual is rapidly changing as ESG integration rapidly becomes the new norm. It is important for directors to understand sustainability risks (and opportunities) and consider such non-financial information when making business decisions. Not only does this make good business sense but it also plays an important role in discharging a director’s fiduciary duty to the company.

---

6 The prudent person rule is a legal standard that requires a fiduciary entrusted with funds to invest them in investments that a reasonably prudent person who expects to receive a good return of income while preserving the capital would invest.