Climate change and the corporate board: Too hot not to handle?

It is an issue that boards must deal with because many investors demand its consideration. Better yet, a board should consider climate change because it is the best interest of long-term shareholder value. By Charles M. Elson and Nicholas J. Goossen

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The board's responsibility for considering climate change and its associated issues as it evaluates corporate performance and strategy has become increasingly more important to a significant number of investors and advocates. For this reason, among others, the pressure to adopt effective board oversight and practices relating to these issues has become the proverbial elephant in the boardroom.

Most directors are aware of climate change as an issue, but many seem reluctant to discuss it on a periodic basis. Climate change and attendant sustainability practices, because of their perceived political edge, have to date been overlooked by many corporate directors. However, both political and potential regulatory pressure, combined with significant investor concern, is making these issues not only relevant but important topics that should be considered in the boardroom. What should be the appropriate response by a well-governed and diligent board? There are several factors to consider.

Although most traditionally considered the issue of climate change as social or political in nature, the argument made by climate change advocates has shifted to discussing its economic and risk-based implications. They have correctly argued that it may have serious implications for a number of industries. Therefore, this has become a legitimate business concern. Additionally, and perhaps more importantly, the government through its regulatory structure may compel corporate consideration of this issue. Of course, the broader question involves how far should boards go in examining the problem with its associated risks and how should they appropriately respond to it.


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A specific skill set?

Some have suggested that the best way to approach effective oversight of the issue is to appoint a director to the board with environmental expertise. Of course, the notion of such a director with only this skill may be troubling to overall board function and broad-based management monitoring. Such a specific skill set may also be

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Panel on climate risk: It's real, it's material, it's a board issue

A matter of morality? No. A matter of corporate risk and performance? Yes.

Ed Note: *"The Climate-Competent Board" was the theme tackled by a panel of investors and other involved executives in corporate governance and environmental oversight that Charles Elson brought together in October 2016 under the auspices of the John L. Weinberg Center for Corporate Governance at the University of Delaware. The program, sponsored by the Weinberg Center and the KPMG Board Leadership Center, addressed such questions as: What does "climate competency" mean? What should the role of the full board and/or specific board committees be with regard to the oversight of climate risk issues? Should boards add a director with specialized climate-competency skills? And there were many other sensitive and timely matters up for examination. (The program coincidentally took place shortly after the EU ratified the Paris Climate Accord, an ambitious effort by the major trading nations to combat climate change.) From this robust panel discussion, a keen comment by each of the participants follows.*

The KPMG Board Leadership Center recently surveyed corporate directors on the top issues that they would rather spend less time on. Sustainability and climate change was one of those issues that ranks low on the board agenda. What that shows is a deep disconnect between what the board thinks are its priorities and what shareholders think are the board's priorities. This is a surmountable challenge. We have to frame the issue correctly. If climate risk is framed simply as a morality issue, it can be easily dismissed. If it is framed as an issue of risk and business management, you have a much better shot at moving it up the board agenda.

— ***Stephen L. Brown**, Senior Advisor, KPMG Board Leadership Center*

At BlackRock, internally, we talk a lot about the importance of our employees being students of the market. Similarly, we expect directors to be perpetual students of the companies whose boards they're serving on, of the industries they're involved in, and of the macroeconomic and geopolitical environment that influences companies and the way that they can operate. We are wary of using the term "climate change" in our dialogue with companies, as some of those we engage with see it as politically charged. Instead, we ask about the ways in which boards support and oversee management in setting and implementing strategy and anticipating future risks and opportunities, of which climate is one of many. Through this lens of operational excellence, we aim to link factors such as product innovation and plans for adapting to a low carbon economy to how well positioned a company is to deliver its strategy and long-term financial returns.

— ***Michelle Edkins**, Managing Director and Global Head Of Investment Stewardship, BlackRock*

Climate change is an increasingly important issue to the largest investors on the planet because of the significant portfolio risks that they see. In The 50/50 Project's Key Climate Vote Survey of 2016 of large asset managers, we noted the trend is significantly toward voting for what used to be ESG [environmental, social and governance] proposals but are now seen as portfolio risk management proposals. The most important thing the board can do is understand that climate change should be elevated to a board-level responsibility. Investors are trying to determine among themselves how to act cohesively in corporate engagements to ensure that boards become more climate competent.

— ***Richard Ferlauto**, Senior Advisor and Member of the Governing Board, 50/50 Climate Project*

At the New York City Pension Funds we are doing a carbon footprint of our portfolio. Every company has some exposure to climate risk. Companies will need to change their business plan if they're going to succeed over the long term. We look to the board to focus management on long-term investment. Management isn't going to be rewarded for making an investment today that may not pay off for five or 10 years but may, fundamentally, save the company 20 or 30 years down the road. That's why we want to make sure the board is looking at strategy, at capital allocation, at the long term. And that's what is driving us to submit proxy access proposals. We want to make sure we have independent boards protecting our interests.

— ***Michael Garland**, Assistant Comptroller for Corporate Governance and Responsible Investment, Office of the New York City Comptroller*

Once the Paris Accord was signed, we felt that the risk had become clear and present for companies. It was no longer theoretical. We wanted to make sure that companies were prepared to face any regulatory changes that were going to impact them. We came up with a simple paper for directors that stated, very clearly, that boards should regard climate change as they would any significant risk to their business and ensure that a company's assets and its long-term business strategy are resilient to the impacts of climate change. And we laid out our expectations. We said in that paper that we want directors to be conversant on climate risk if it's material to their business and be prepared to discuss it with investors.

— ***Rakhi Kumar**, Head of Corporate Governance, State Street Global Advisors*

I will offer a director's perspective. I was elected to the board of Kering, a leading luxury group. It owns Gucci, Balenciaga, Alexander McQueen, Puma, and other global luxury brands, with suppliers in 120 countries. What I found compelling was its commitment to social environmental impact. It was the first company to publish an environmental P&L (EP&L). Kering's EP&L is an open source tool that makes the "invisible" impacts of business "visible," quantifiable and comparable. The luxury industry's environmental impact is very different from the energy sector, which has been the primary focus of many investors. So one might ask why would a luxury company do that? The answer is leadership. The CEO feels that environmental and social responsibility is important to its customers and employees, to engage and retain talent — employees want to be part of a company whose values they share. That EP&L is available online. I recommend you look at it. It was created as an open platform so that other companies could share information and learn from it.

— ***Sophie L'Helias**, President, Leaderxxchange; Co-Founder, International Corporate Governance Network (ICGN); Director, Kering*

Investors do care deeply about ESG issues and, to be fair, many corporations are ahead of the investment community. The IRRC Institute did a report three years ago that revealed that 55% of the S&P 500 had specific sustainability oversight at the board level. My vision is that 10 years from now this discussion will seem quaint. The reason for that: technology. You are going to see smart companies get ahead on environmental issues by using technology in a lot of different ways. You could envision a greenhouse gas report being a real-time video shot from a drone over a utility plant, with augmented reality providing the date and

University of Delaware/Kathy Atkinson

The Climate-Competent Board discussants who convened at the Weinberg Center for Corporate Governance in October 2016: (front row, left to right) Charles Elson, Veena Ramani, Rakhi Kumar, Michelle Edkins, Ann Mule of the Weinberg Center, and KPMG's Susan Angele and Dennis Whalen; (back row, left to right) Stephen Brown, Michael Garland, Sophie L'Helias, Jon Lukomnik, Richard Ferlauto, Paul Rowsey, Patrick McGurn, Joseph Slights, and Travis Norton.

the baseline, for example, rather than thinking about it as a written report the way we do now. Clearly you will need a competent board, whether you want to call it climate competent, technology competent, social media competent (seeing as tweets on environmental disaster can be around the world in 30 seconds) — it will need to be a competent board to deal with these issues.

— ***Jon Lukomnik***, *Executive Director, IRRC Institute*

Heading into the 2017 season, ISS' radar screen is tracking more shareholder proposals on climate risks than any other topic, including proxy access. In fact, 2017's climate risk proposal tally could eclipse 2016's record-setting proxy access campaign. Climate change is a slow-moving risk. The debate will play out over time, so the resolutions are not going to be a passing fancy. Climate risk touches on every major area of board activity: disclosure, engagement, compensation and risk management. Risk oversight really boils down to competency — not just on climate risk but on various issues. Do you have the best "athletes" in place to face the current and future challenges that boards will be facing? Sometimes boards don't even know what they don't know, simply because there is not enough expertise in the boardroom itself to digest and understand whether they are getting straight information from senior management.

— ***Patrick McGurn***, *Special Counsel and Head of Strategic Research and Analysis, Institutional Shareholder Services (ISS)*

To be sure, climate risk is material for some companies. But one question we should be asking is: Should every company be required to make some sort of ESG disclosure? We have to keep in mind what makes our capital market so special and what it is about our system of corporate governance that has worked for so long. In this push to increase climate-related disclosure, are we going to redefine — re-imagine, really — the concept of materiality? What would a disclosure system look like that is subject to revision based on what kind of information investors are asking for? We're at a crossroads right now with the ESG movement, so I pose these questions to keep the climate-risk issue in perspective.

— ***Travis Norton***, *Former Executive Director, U.S. Chamber Center For Capital Markets Competitiveness*

Ceres works with large companies and large investors to help them figure out what environmental and social risks, such as climate change, mean in terms of their business model, business strategy, and their thinking and decision making. What we have found — and it won't be a surprise to anyone on this panel — is that there is no single answer, no one approach. A climate-competent board is one that considers a range of systems and metrics and approaches to integrating sustainability into their oversight responsibilities and decision making. And it all starts with materiality. Boards have an important role to play in driving the assessment of whether and how environmental and social issues, like climate change, are material in terms of corporate value and corporate performance.

— ***Veena Ramani***, *Program Director, Capital Market Systems, Ceres*

We touch climate change in just about all the boards I am on, which include businesses in offshore drilling, real estate, renewable energy, and an adventure outdoor lifestyle company. Our businesses tend to be focused on long-lived capital assets, so thinking about long-term risk is important to us. Let me make this observation: I have been on public company boards for over 25 years, and what I have seen is an incredible evolution, not only in board function and composition but also in competence of board oversight. Climate risk is a very significant risk, especially for companies with capital-intensive, long-lived assets. It always ranks as a Top 10 risk to the enterprise and is discussed vigorously at the board level — about what we can do to mitigate climate risk. If you are not addressing climate risk as a company, you are not going to be able to attract a younger generation of talent, and on the product side, you are going to have more trouble attracting customers.

— ***Paul E. Rowsey III***, *President and CEO, Compatriot Capital; Chairman of the Board, Ensco PLC; Lead Director, KDC Holdings LLC, JBL Partners LLC, Village Green Consolidated, E2m Partners LLC; Director, Powdr Corp.*

In Delaware the bar is high, as it should be, for directors to be held personally liable when an entity finds itself at the wrong end of a crisis — in our case here, the climate change scenario. I am speaking here as an individual, not on behalf of the Court of Chancery or any of my judicial colleagues. Judicial solutions to problems are highly imperfect. Climate competency is going to have to be more organically driven. It's going to have to be driven internally, and by internally I mean by the owners of the enterprise and by boards who want to do the right thing. I don't think it is fair, reasonable or realistic to expect that the courts will police this.

— ***The Honorable Joseph R. Slights III***, *Vice Chancellor, Delaware Court Of Chancery*

IF A SIGNIFICANT NUMBER OF A CORPORATION'S OWNERS BELIEVE THAT CLIMATE CHANGE IS AN ISSUE OF IMPORTANCE, THEN BOARDS MUST APPROPRIATELY AND EFFECTIVELY REACT.

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unnecessary, though obviously not unwelcome, to achieve effective board oversight in this sensitive area, depending on the industry involved. Effective directors come to the table with a multiplicity of monitoring skills and subject matter expertise. However, in some industries, particularly those involving carbon intensive activities, there would be a great benefit accruing from a director who has significant expertise in the environmental area, among other skills.

Others have suggested separate board committees focused on climate change and other environmental and sustainability issues. This may be appropriate for carbon intensive industries as the risks and opportunities associated with climate change and other environmental and sustainability issues can have a material impact on those companies. However, in non-carbon intensive industries a separate board committee may not be appropriate. So, how should a board respond?

Frankly, it is better that the whole board consider and become better educated in the area, even if a committee is involved. It may even become a valuable business practice as a growing number of the population regards 'green' practices as important points in considering when to become a consumer of goods and services. Yet, it is the board's responsibility to oversee these issues and help mitigate the risks imposed by climate change on the corporation.

An open dialogue

As time progresses, if we expect the effects of climate change to increase in intensity, the board should maintain an open dialogue addressing these ever-changing risks, whether or not the directors personally believe in climate change. Investors, especially some of the large investment funds, such as State Street Global Advisors, have expressed significant concern about the impact of climate change on the value of a company's assets and its long-term business strategy. (See accompanying sidebar for a range of investor, legal, and environmental advocate views.)

The biggest threat to effective board oversight and response to the climate issue comes not from within the boardroom itself but, interestingly enough, potentially from the government. With increasing popular pressure on boards to examine environmental issues, there are calls for regulators to achieve such a result. In any effort to force companies to consider the issue through regulation, the government may achieve the opposite result. Where boards are required to respond to various problems such as effective compliance with regulation through government fiat, there is the danger that the response by the board will act simply to avoid potential liability for the directors themselves, rather than furthering the best interests of the corporation. Such responses, as we have seen in the general compliance area, may be wooden, artificial and ultimately ineffective. A board should consider climate change not because an investor or the government demands it, but because it is the best interest of long-term shareholder value. Of course, under the Delaware *Caremark* rule, failure by the board to respond to this issue may have unwelcome liability implications for the board.

Finally, while boards are expected to consider the effect on long-term value by their actions, which generally means 10 to 20 years or so, how can the effectiveness of their actions to help mitigate the risks of climate change and its concomitant issues ever be appropriately measured? Climate change takes place over decades, while the long-term corporate horizon is measured in a much less extended time period. Corporate concerns, such as executive performance, are examined over a three- to five-year time period. How can shareholders ever rationally judge the effectiveness of board action in the climate change area where the results may not even become known in the investors' own lifetime? Still, simply because the issue's intensity and projected impact on the operation of a business may not be fully realized until sometime in the future, this does not excuse the board from neglecting it. Regardless of time horizon, it cannot at this point be ignored.

Needing a measured response

Ultimately, regardless of how one views the effect of climate change, it is an issue that boards must deal with. Many investors, and potentially the government, demand its consideration. If a significant number of a corporation's owners believe that it is of importance then boards must appropriately and effectively react.

How exactly a board should respond is obviously in the purview of the directors' discretion. But to ignore it is inappropriate and foolhardy for a variety of reasons. The key is a considered and measured response. It has become part of the path of long-term corporate success and must be dealt with by the well-governed board in an appropriate and responsive manner. ■

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