Nominating and Governance Committee Chair and Risk Oversight Advisory Councils

Long-Term Value Versus Short-Term Gains: The Board's Role in ESG (Part I)

According to The Collegiality Conundrum: Finding Balance in the Boardroom, PwC's 2019 Annual Corporate Directors Survey, "More than half of directors (56%) say investors devote too much attention to environmental/sustainability issues, even though only 50% think their board has a strong understanding of the ESG issues impacting their company."[1] At the same time, for the first half of 2019, ESG-related contested shareholder votes affected numerous companies.[2] And while the Business Roundtable Statement on the Purpose of a Corporation released in August of 2019[3] endorsed a broader set of stakeholders, some of which are focused on issues under the ESG umbrella, activist Paul Singer, principal of Elliott Management, told *The Economist* that the current debate over corporate purpose "risks obscuring the fact that earning a rate of return for pension plans, retirement accounts, universities, hospitals, and charitable endowments and so on is itself a social good. . . ."[4]

Against this backdrop, NACD, Heidrick & Struggles, PwC, and Sidley Austin convened NACD's Nominating and Governance Committee Chair and Risk Oversight Advisory Councils in New York to discuss both ESG and shareholder activism. The discussion was held using a modified version of the Chatham House Rule, under which participants' quotes (italicized below) are not attributed to those individuals or their organizations, with the exception of those whose direct quotes were approved prior to publication.

Part I of the conversation, focused on ESG oversight, is distilled below.

"These advisory councils bring together directors from some of this country's most important and diverse companies. Convening a group like this for these important discussions is something that only NACD can do."

Ted Dysart
Heidrick & Struggles

PART I
Environmental, Social, and Governance (ESG) Oversight

On the subject of ESG and long-term value creation, Alaska Airlines' lead independent director, governance and nominating chair, and vice president of external relations led a discussion on ESG oversight that yielded a number of key insights for boards.

1 PwC, *The Collegiality Conundrum: Finding Balance in the Boardroom* (New York, NY: PwC, 2019), p. 4.

2 Lazard's Shareholder Advisory Group, *Review of Shareholder Activism–H1 2019*, July 2019, p. 17.

3 The Business Roundtable, *Statement on the Purpose of a Corporation*, August 2019.

4 "Big business is beginning to accept broader social responsibilities," *The Economist*, Print Edition Briefing, August 22, 2019.

1. Stakeholders, including shareholders, should benefit through long-term value creation, though not all investors agree that they will.

According to Alaska Airlines' lead director Patricia Bedient, "Alaska Airlines has always had a very strong point of view on ESG." Governance and nominating committee chair Phyllis Campbell agreed: "The primacy debate has never been a debate at Alaska Airlines because we've always been about shareholder value, and have always focused on happy customers and community. At Alaska, our thesis is that highly engaged employees are the secret to satisfied customers, which leads to happy shareholders."

However, as was pointed out by various delegates in the room, an increase in interest in ESG from some shareholders does not mean that all shareholders share the same view. The short-term perspective of some shareholders, in particular certain activist shareholders, continues to stand in opposition to the long-term value creation mind-set promulgated by the Business Roundtable letter.

2. Leveraging its oversight role, the board can lead the way.

Though Alaska Airlines has long had a focus on ESG, the recent creation of an ESG dashboard at the direction of the board further catalyzed the organization and now gives the board regular insight into the varied aspects of ESG. Diana Birkett Rakow, vice president of external relations, said, "The board has helped us look down the road and see the macro view." Of course, it is helpful for the board to have alignment at the top of the management team. "Speaking from my side of the board, the CEO is 100 percent supportive," added Campbell.

3. Spring ESG from strategy to maximize impact and avoid topic fatigue.

The lack of standardization in ESG reporting (especially for *E* and *S*) that can force companies to pull together a myriad of varying information for shareholders could be contributing to ESG fatigue among companies, according to one delegate. And while the Sustainability Accounting Standards Board (SASB) may be leading the way in creating standardization, variability still exists, and not all measures—even industry-specific ones—work for every company.

If framed properly for the board, however, ESG should resonate for directors. "Don't do a dashboard for dashboard's sake. Our board emphasizes that this has to be driven by the strategy of the company," said Bedient. Further, Campbell noted that to avoid ESG fatigue, directors should be thinking about ESG's link to long-term value and about ESG oversight as another form of risk mitigation.

4. Involve the whole board.

Because ESG metrics tie to the company's strategy, the whole board should be involved, according to various delegates. At Alaska Airlines, while the whole board attends to the oversight of ESG as a part of the company's strategy, the board delegated the development and oversight of the dashboard to the company's governance and nominating committee; however, depending on the metric, other committees of the board, such as the compensation committee and the talent oversight committee, oversee the parts of the dashboard relevant to their areas of focus.

5. With ESG metrics, the board has to start somewhere.

Rakow stressed the importance of just getting started with a dashboard. "The dashboard forces the conversation in a productive way, but we're not where we need to be in managing the items reflected on it with rigor at every level of the organization. . . . You could argue we should have gone slower to get there, or faster, but with the board's encouragement we decided there was value in starting somewhere."

Added Campbell, "One lesson learned is that we should encourage boards to get out there and go ahead and take a cut at this." A good deal of committee work, management work, and structural support needs to happen prior to the dashboard's launch. "It's hard and can be messy, but it's worth creating the pressure," Campbell said. Once created, year-over-year data can show the company's ESG trajectory over time.

6. Don't necessarily limit your metrics to ESG standards.

As noted above, SASB is leading the way on the establishment of metrics, including by industry, which allows for company-to-company comparison. However, not all SASB metrics will work for every company. "We put metrics in *S* that were unique to our company strategy," said Campbell. "Labor is a bit different for us. SASB metrics for the airline industry look at the percentage of active workforce, [and the] number of strikes and walkouts you've had," Rakow added. For an airline at the top of the industry for labor and workforce, other measures proved more useful to achieving the company's goal of topping the Forbes list of best employers. "Under *S*, we have culture, people, and community and safety goals," said Campbell, "including employee-engagement metrics." The dashboard also continues to evolve to include the most appropriate and most powerful metrics to support the company's strategy.

Not all SASB metrics will work for every company. "We put metrics in S that were unique to our company strategy."

Phyllis Campbell
Alaska Air Group

7. Look to Europe for trends.

More than one delegate noted that looking to Europe for ESG trends can enable companies to get ahead of the curve. For Alaska Airlines, the "flight shaming"[5] that is taking place in Europe is a trend the company is monitoring. ESG efforts related to issues like emissions may take on increased importance should this trend appear in the United States. In any case, younger generations think about *E* and *S* elements when making purchasing/employment decisions, so greater visibility into environmental impact is important to the airline regardless.

8. If possible, turn ESG into a business opportunity.

A delegate from another company represented at the meeting has also looked to macro trends from Europe, looking at regulations and trends that may come to this country to develop products and create a whole business around the circular economy.[6] The delegate noted that boards should ask, *"How do we capitalize on this and make it a benefit to our shareholders?"* By contrast, companies that fail to consider ESG may not survive. *"We had a competitor who didn't pay attention to [ESG], and is no longer in business,"* shared one delegate.

9. Transparency is a journey. So is quantifiability.

The executive team at Alaska Airlines has tapped a single individual to be the director of sustainability, but elevated that person to report to senior management. The move gave ESG more visibility within the company, and with only one person with the role, ESG by necessity becomes a part of everyone's job.

While the airline intends to release its full dashboard over time, at present the company maintains a website dedicated to sustainability, and, as noted below, continues to dialogue with shareholders about ESG efforts. One delegate noted that transparency can become a struggle with company lawyers about what to disclose and what to keep private.

Another delegate noted that if ESG is to be tied to a company's strategy, then the company has to have some way to measure its impact. For Alaska Airlines, some measures are easy to quantify, such as fuel use, which has both a bottom line and an environmental cost. Other measures are not as easy to quantify or tie directly to impact.

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[5] See Megan Cerullo's blog post, "'Flight shame' could hurt airlines as travelers shun air travel," *CBSNews Moneywatch* (blog), October 3, 2019.

[6] See the "Circular Economy" entry in Wikipedia.

According to Paula Loop, leader of PwC's Governance Insights Center, questions about the next level of ESG metrics are starting to arise. For example: "How do you bake metrics people will be using into compensation plans? Are they comparable year to year? Do we need to test these metrics to make sure they're accurate?" The role of auditors, both external and internal, will need to be considered. According to one delegate, *"I would not let our sustainability report be released until internal audit audited every single number in the report."*

10. Invite shareholders to ask questions. They will.

Bedient and Campbell have invited shareholders to ask them questions, and many have done so, with a growing number focusing on ESG. "They were saying, 'Where would we find that information?'" Bedient related. "They are looking for more structure," she continued. "We sent 20 or so letters to investors every proxy season to invite conversations," added Campbell, who believes that shareholders' desire to talk to directors is only going to increase. Most questions this year were about ESG-related metrics.

Regarding advice to other directors who might be on the fence about ESG efforts, Bedient suggests the following: "Think through sitting in front of a shareholder that is asking a question about ESG. 'Huh, that's a good question,' is not a good answer. Think about how you would respond."

Part II of the discussion on shareholder activism can be found here.

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Long-Term Value Versus Short-Term Gains: Best Practices in Shareholder Activism (Part II)

According to *The Collegiality Conundrum: Finding Balance in the Boardroom*, PwC's 2019 Annual Corporate Directors Survey, "More than half of directors (56%) say investors devote too much attention to environmental/sustainability issues, even though only 50% think their board has a strong understanding of the ESG issues impacting their company."[1] At the same time, for the first half of 2019, ESG-related contested shareholder votes affected numerous companies.[2] And while the Business Roundtable Statement on the Purpose of a Corporation released in August of 2019[3] endorsed a broader set of stakeholders, some of which are focused on issues under the ESG umbrella, activist Paul Singer, principal of Elliott Management, told *The Economist* that the current debate over corporate purpose "risks obscuring the fact that earning a rate of return for pension plans, retirement accounts, universities, hospitals, and charitable endowments and so on is itself a social good. . . ."[4]

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As board agendas continue to evolve to meet the demands of stakeholders, the development of an ESG dashboard may be a viable vehicle for catalyzing change and creating long-term value for stakeholders, including shareholders. At the same time, boards must be ready for the likely scenario of an activist among the company's stockholders that may be looking for short-term shareholder returns. Balancing the long- and short-term views can no doubt be a challenge, even for the highest-performing boards.

Part II of the conversation, focused on defense against shareholder activism, is distilled below.

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[1] PwC, *The Collegiality Conundrum: Finding Balance in the Boardroom* (New York, NY: PwC, 2019), p. 4.

[2] Lazard's Shareholder Advisory Group, *Review of Shareholder Activism–H1 2019*, July 2019, p. 17.

[3] The Business Roundtable, *Statement on the Purpose of a Corporation*, August 2019.

[4] "*Big business is beginning to accept broader social responsibilities*," *The Economist*, Print Edition Briefing, August 22, 2019.

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PART II

Best Practices in Shareholder Activism

Led by expert attorneys from Sidley Austin, the group delved into the **anatomy of a proxy fight**. Several delegates in the room had been through an activism fight as a board member of a target company, and while many delegates had been asked by an activist to join a slate, only one delegate had done so.

A number of important considerations for directors came to light during the proxy fight discussion.

1. Get ready during peacetime.

According to Sidley Austin's proxy fight defense attorney Kai Liekefett, in addition to having outside proxy fight counsel review company bylaws and ensuring that the company's D&O policies are adequate, boards should take time to look at the company's governance like an activist would. Also, a rapid response team should be assembled, and a communications plan developed. A stock-watch service should monitor trading in the company stock so the company will know when an activist builds a stake, though the stake building may actually be a lagging indicator. The importance of investor relations, including investor screening and surveys, should not be underestimated; talk to these investors before an activist does.

2. Watch for early warning signs.

An advance warning can give the company value-preparation time. Unfortunately, SEC filings such as Schedules 13D and 13G, and Form 13F, and filings with the FTC and DOJ under the Hart-Scott-Rodino Act, rarely provide early warnings due to the numerous loopholes in these reporting regimes. However, a company can use tactics such as watching for hits to the investor-relations section of its website by activists and their lawyers to read the tea leaves early, for example.

3. Have a plan for notifying the board, and be cautious of communication methods.

Protocols should be in place for when and how the board is informed about an activist approach, according to Sidley Austin attorney Holly Gregory. One delegate mentioned that his board receives an email from the CEO/chair if the company has been contacted by an activist. Another delegate shared that the board portal is used. An emergency meeting of the board might be called if the activist is well known.

Liekefett urges caution about the use of email in a proxy fight for any substantive communication. "Using private email is the biggest cybersecurity risk in activism," he said.

4. Consider a special committee.

An important question is how the board should organize itself in an emerging activist situation. In the earlier stages, the whole board may be involved; however, in the later stages of a fight, the board may have no choice other than to delegate responsibility to two or three board members, either as an informal or formal special committee of the board. A handful of delegates in the room had seen such a committee put to use.

5. Choose the right spokesperson(s) from the board.

The chair, lead independent director, and the chair of the committee whose work is under attack are the likely participants in a meeting with the activist. Be aware of the fact that activists are good at "sniffing out weaknesses, differences between the board and management, and body language," according to Liekefett. So, choose carefully those to participate in such a meeting. In terms of personality, select those who are not likely to become emotional if attacked. Also, one delegate pointed out that when he met with an activist, he was coached to listen most of the time. Specifically, Liekefett advises use of the "80/20 rule": talk 20 percent of the time and listen for 80 percent.

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Kai Liekefett
Sidley Austin

6. Remember every constituency counts.

One delegate shared a belief that board members should focus on having relationships directly with institutional shareholders. Such relationships may prove helpful. According to Liekefett, "Years ago none of the institutional investors would go on record saying they agree with the board and management, or take a public stance in favor of management." Now, having an institutional investor's public support is an important arrow in the company's quiver. Think also about the importance of the broader ecosystem, namely rating agencies, business associates, regulators, analysts, employees, and the media.

7. Look for the hallmarks of speed and increasing hostility.

Speed is one of tools in an activist's toolbox, especially if a company is caught unprepared. Also, as the activist's playbook lays out the process from stake building, engagement, and the proxy contest to litigation and a takeover bid, the level of hostility increases accordingly. If the company is prepared, and responds quickly and as if nothing is surprising, then other activists will pause before following the original activist into the fight, according to Liekefett.

8. Be aware of tactical options.

As a proxy fight progresses, a myriad of options ensues, including an SEC poison pen letter, a roadshow to meet with the company's large institutional investors, and settlement negotiations. The critical element is to have your team of experts—an investment bank, special proxy fight counsel (in addition to or in lieu of regular outside counsel), a public relations firm, and a proxy solicitor—identified before a proxy fight begins so that the company is prepared to deploy all potential tactics.

9. Realize that many fights never get to a vote.

Fewer than half of all proxy fights ultimately make it to a vote, and those that do make it to a vote often net out in favor of the incumbent. If a company decides to settle, agreements must be filed with the SEC and would include provisions for board representation, including committees; a voting agreement; withdrawal of the proxy contest; a standstill obligation; a non-disparagement covenant; mutual releases; a covenant not to sue; and a provision related to reimbursement of expenses.

10. Keep fiduciary duties in mind.

Since a board is under siege during a proxy fight, the directors' fiduciary duties are very much a focus. Activists are often pushing for a transaction; if a board member decides hastily, in the face of activist pressure, to sell the company, for example, that director could be held responsible for failing to exercise his or her duties. In a proxy fight against PLX Technology over whether or not the company should be sold, the activists won the proxy fight and joined the board, but in the minority. Incumbent board members gave in and put up the company for sale, which, as is so often the case, led to shareholder suits. The court found that the incumbent directors breached their fiduciary duty because they put their own interests (namely avoiding another proxy contest) above the best interests of the company.

Part I of the discussion on ESG oversight can be found here.

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