THE GLOBAL LEGAL POST

The Sustainability-Savvy Board: Leading the Just Transition

Julia Hayhoe and Iris Mol discuss the challenges dominating the agenda of business leaders most advanced in their ESG thinking

Environmental, social and governance issues are now recognised as a strategic priority by business, investors, society and political leaders alike. What can we learn from boards, which are already wise to the challenges and opportunities, that the quest for a sustainable future present?

While sustainability and ESG issues are rising up the corporate, political and public agenda, progress towards a more sustainable future remains slow.

Ahead of the crucial COP26 climate conference in Scotland this November, a successful outcome to the talks remains very much in the balance. Business is facing criticism for dragging its feet on turning commitments into material and measurable action. There are doubts whether the world's richest nations will meet their pledge to finance a "just transition" to a more sustainable way of life.

While many boards are sincere in their desire to operate in a more sustainable way, they face significant challenges. It calls on boards to understand the dynamic demands, opportunities and risks presented by a broad range of stakeholders. Then to make tough choices about the mindsets, behaviours and tools they need to adopt and embed within the business.

Some business leaders are clearly ahead in their thinking and are wise to the challenges, and, importantly, the opportunities, that lie ahead.

So what can businesses, and the professional firms that advise them, learn from what sustainability-savvy boards are focussing on?

Drawing on our work with boards, independent advisory roles to NGOs such as The World Economic Forum and on the latest academic research, we have distilled the Top 5 challenges far-sighted boards are grappling with.

Fundamental paradigm shifts

Before we tackle these challenges, we first need to understand two paradigm shifts in board thinking that are influencing these business leaders - Stakeholder Capitalism, The Just Transition.

Stakeholder Capitalism

Much has been written about the shift in boardroom thinking from one focused on the primacy of creating shorter term profits for shareholders (Shareholder Primacy) to where long-term value is created for and with its material stakeholders (Stakeholder Capitalism).

It is also an oversimplification to set these two approaches as binary choices. Indeed, it is a false dichotomy. For a business to create shareholder wealth, it must understand, and adapt to, the changing expectations and needs of its material stakeholders.

> *"Sustainability-savvy boards recognise they are part of the solution and have a key role to play in ensuring the substantial benefits of a green transition*

This debate has stimulated progressive boards to reflect deeply on what is the fundamental purpose of their business in today's much-changed world. In particular, to deliberate on the time horizons over which a board seeks to create and protect value; how it assesses value in financial, environmental, social, and ethical terms, and with and for whom it achieves this value - its material stakeholders.

Professor Colin Mayer articulates this version of business purpose well, when he writes: "The purpose of business is to solve the problems of people and planet profitably, and not profit from causing problems."

A recent study also shows that authentic corporate purpose, experienced through the brand and lived through the strategy, creates both shareholder and broader stakeholder value. The key, as we see later, is how purpose is operationalised within the business and embedded into management decision-making. https://fortuna-advisors.com/wp-content/uploads/2021/08/A-Deeper-Look-at-the-Return-on-Purpose-JACF.pdf

The Just Transition

The pandemic, social and racial justice movements have thrown a dramatic spotlight on pre-existing inequalities in healthcare, education, technology and jobs, the majority disproportionately impacting minority groups.

At the same time, we are witnessing the impact of Climate Change first-hand through more frequent and more devastating wildfires and floods across the world.

Sustainability-savvy boards recognise they are part of the solution, and have a key role to play in ensuring the substantial benefits of a green transition and economic recovery are shared widely, particularly for those who stand to lose out economically – be they minorities, communities, industries, countries.

This brings to the fore, what does sustainable growth mean for business today?

Sustainable growth draws upon both Stakeholder Capitalism and the Just Transition. So for business today it means creating and sustaining value that is ethical and responsible to, and for, its current and future material stakeholders. It has three main pillars of likely most material opportunity and risk to evaulate: Enviromental, Social, Governance issues.

Regardless of this incredible challenge, progressive boards are not thinking solely in terms of sustainability risks. They realise opting for the bare minimum means missing out on structural shifts in markets, loss of customers and talent and ultimately the trust on which their license to operate is based.

Sustainability is now equally about on the opportunities it presents, seen as a pre-requisite to achieving more resilient business performance and offering a company real competitive advantage in its marketplaces.

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So, with these significant changes in mindset, what are the five issues dominating the agenda of the boards that are most advanced in their thinking?

1. Embedding Sustainability into Purpose, Strategy and Culture

As a starting point, sustainability-savvy boards are reflecting upon, and in many cases re-evaluating, their core purpose and holding it as their guiding star in making strategic choices and investments.

To inform and shape their purpose, they are asking fundamental questions, including:

- "Why do we exist as a business?"
- "What needs do we meet?"
- "Whom do we serve?"

By asking these bare bones questions, boards can ensure that sustainability is embedded into the enterprise-wide strategy-setting process and corporate governance. It helps inform and identify which investments are likely not sustainable in a Net Zero economy. Crucially it means they boards avoid the old practice of shunting sustainability into a separate strategic initiative box or vested just in an arms-length CSR Committee.

But how to do this?

Enacting Purpose in the Modern Corporation has devised a useful framework for boards on how to enact purpose into action, utilising a SCORE framework. You can find more information here: http://www.enactingpurpose.org/assets/enacting-purpose-initiative---eu-report-august-2020.pdf

A great practical example of enacting purpose is Ørsted, the Danish energy group, which has restated its purpose as: 'to create a world that runs entirely on green energy'. By embedding sustainability in its purpose, strategy and culture, the company has undertaken a massive transformation from a fossil-fuel-based energy company, to a green energy company.

Boards are the ultimate guardians of companies. Those that fail to effectively embed sustainability into purpose, strategy and culture face the risk of being unable to convert good words into material action. And being accused of green or social washing, in the process damaging brand, revenues and the trust put in them by key stakeholders.

2. Developing effective Stakeholder Governance

Effective Boards have always taken a critical look at whether their board composition, succession, competency and compensation are up to the task of delivering on strategy. Compensation is now in particular under the acute stakeholder spotlight.

Sustainability-savvy boards are taking a step back ahead of these considerations, to check they are starting with the right landscape, considering afresh first:

- "Who are our material stakeholders?
- "How are they becoming more segmented in different groups and generations?
- "How effectively are we listening and engaging with each segment to understand, create and protect long-term value?"

This fundamentally different approach to decision-making in the boardroom – connecting value creation and stakeholder outcomes – lies at the heart of stakeholder governance, as articulated in The World Economic Forum board report co-authored by Julia Hayhoe and Beatriz Araujou, Baker McKenzie partner and WEF Fellow.

https://www.weforum.org/whitepapers/d5081d5a-0760-4cae-8ce9-46252ab4ddee

Boards have always focused on shareholders, investors, customers, employees as material stakeholders. Increasingly other stakeholders are having a material impact on business, such as regulators, suppliers, communities, and, ultimately, the Planet itself.

In addition, minority stakeholders are often not heard, making business blind to newly evolving market trends, demands and risks.

So, the board's task is to identify its own unique set of material stakeholders, in all its diversity. A 'materiality assessment' is often used to do this, as a method to understand the most material ESG issues to stakeholders.

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> *Climate and human rights litigation are also increasingly being used to advance environmental and human rights protection through the legal system*

But doesn't this cause boards to lose focus, or become captive to special interests?

Martin Lipton, of Wachtell, Lipton, Rosen & Katz, a longstanding leading proponent of stakeholder governance, calls upon Directors to exercise their 'business judgment' for the corporate entity that they represent. That means balancing the rights of and the company's obligations to all material stakeholders. You can read more about this approach here:

https://corpgov.law.harvard.edu/2020/09/17/the-friedman-essay-and-the-true-purpose-of-the-business-corporation/

Measurement and Materiality are fundamental to ESG transparency and accountability. The origins of sustainability reporting on material ESG issues stem from the work of Global Reporting Initiative (GRI) over 20 years ago. Whilst there are harmonisation initiatives underway, today there are still no common standards in ESG reporting.

That is not getting in the way of forward-looking directors. Rather than getting stuck waiting for ESG metrics to be harmonised, sustainability-savvy boards are adopting science-based targets to bake in action, transparency and accountability for today and to guard against complacency in the short term.

They also know that what counts as material risk and opportunity is not fixed. Instead they focus on Dynamic Materiality, recognising that what is material for an industry and an individual business is changing rapidly, due to new regulations, technologies, knowledge and social expectations.

3. Funding the Transition

Governments globally are introducing sustainable finance regulations with the clear purpose of stimulating and directing investment towards activities benefiting the environment. At the same time, public and private investors are piling unprecedented levels of cash into sustainable funds and financing.

As sources of capital shift, so does the quantum of capital required to achieve sustainable business transition. The cost of the UK Government's 2050 Net Zero commitment is estimated to range from £70 billion to £1.4 trillion. In the US the Senate has just approved a sweeping new bill to inject around $1 trillion over five years into America's infrastructure. For some programmes, at least 10 percent must be spent through small businesses, owned by socially and economically disadvantaged individuals.

Boards have whole new sources of sustainable capital to consider from Government subsidies, project finance and sustainable finance. Private Equity sponsors too, are bringing in new investment practices, which favour prospective portfolio companies poised for success in embracing new consumer preferences, new regulatory regimes and with their own responsible business house in order. Sustainability now stands as a key priority for Chief Financial and Investment Officers.

Meanwhile, Investor Activism is rising dramatically, requiring boards to think proactively and analytically about their investor stewardship to ensure they attract and retain their preferred investor base.

4. Re-evaluating the Value Chain

Sustainability-savvy boards recognise that a great source of value, and often the greatest source of risk, sits outside their immediate corporate boundaries within their wider supply and value chain. They recognise too that their own business will sit in someone else's supply chain. So, there is a key question boards need to consider: To what extent are we a source of value creation, or risk mitigation, to our clients or customers, communities, natural environment?

The risks for business in not measuring its impact across its suplychain, mean it leaves itself open to claims of green or social washing from a range of stakeholders whose voices are magnified by social media.

However, it can be a struggle to locate the most material sources of value or risk in complex supply chains. For that reason, business partnering has become critical in this endeavour.

Within the legal sector, The Chancery Lane Project (TCLP) is a stellar example of a focused and collaborative partnering effort. Lawyers from around the world are working together through the TCLP to develop new contracts and model laws that deliver climate solutions for business across the supplychain. A move that is embedding practical material change at a far faster pace than can be achieved through regulation.

5. Digitising the Transition

Closely linked to re-evaluating supply chains, forward-thinking boards recognise how big data, when twinned with blockchain technologies and artificial intelligence (AI), creates a tremendous ability to unravel the value and risks in every part of the value chain.

Take coffee as an example. It is the world's most popular drink, yet the supply chain bringing this staple from crop to cup is full of adverse social and economic impacts that mostly impinge on local growers. Using blockchain technology in the supply chain can help businesses ensure that growers are not only given fair payment for their crops but are also using sustainable farming practices. It also enables consumers to see where their coffee comes from and make more informed purchasing decisions.

AI is also being used to identify and assess the sentiment of stakeholders, to alert the board to new opportunities and issues among consumers, investors, activists and regulators.

Of course, AI does contain significant risks for perpetuating inherent, systemic bias within algorithms and data sets, along with ownership and security issues. Advanced boards know they need to challenge themselves and hold to account operational managers to build diversity, equity and inclusion into AI design.

A shift in leadership mindsets and behaviours

As we have seen, sustainability and ESG presents great opportunities for new sources of value creation, and attendant risks and responsibilities.

Sustainability-savvy boards recognise that this requires a mindset shift in thinking about who are the company's material stakeholders and how to create, maintain and protect value for the longer term.

It also requires translating these mindsets into action. We offer here our guide on how to do this, through the lens of the top five issues being tackled by leaders who were early to understand the issues and opportunities, and quick to act. For professional advisors to boards, our aim is to reveal the areas where boards are likely to most value professional advice, in their quest to transition to more sustainable, resilient businesses.

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