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Editor-in-Chief
BROC ROMANEK
broc.romanek@gmail.com

EDITORIAL OFFICE
28 Liberty Street,
New York, NY 10005
212-771-0600

Wolters Kluwer
Richard Rubin, Publisher
Jayne Lease, Managing Editor

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ESG Incentives: Intended to Improve Corporate and Societal Environmental and Social Outcomes

By Ira Kay, Mike Kesner, and Joadi Oglesby

Early indications are that the inclusion of environmental, social, and governance (ESG) metrics in corporate incentive plans—primarily annual incentives currently—is becoming common, with 69 percent of S&P 500 companies (207 of 301) reporting the inclusion of such metrics in their 2022 proxies.[1] If this level of inclusion holds for all of 2022, it would represent a significant increase from 2021 when 52 percent of the S&P 500 reported ESG metrics. It is apparent that large corporations and their executives have undertaken a good faith effort in using incentives to address ESG issues at the company level, with possible beneficial societal implications.

This unprecedented movement in incentive metric usage—much faster even than the relative total shareholder return (TSR) transition—is caused by many factors: from boards'/executives' desire to help improve the social footprint of their companies and society to responding to shareholder pressures. This shift is viewed by most audiences as a positive response from the corporate sector, but it has its critics and challenges: measuring real impact; interpreting limited data; navigating the lack of uniform measurement standards; choosing metrics; setting goals; and balancing shareholder, societal, and employee priorities, among others.

Ira Kay *is a managing partner,* **Mike Kesner** *is a partner, and* **Joadi Oglesby** *is a consultant of Pay Governance.*

Most, but not all, companies that have added ESG metrics to an incentive plan have included them in a holistic/qualitative scorecard that may include a combination of quantifiable and qualitative goals. There are many valid reasons for this including measurement difficulty, litigation risk, and motivational challenges. There are several companies that have purely quantitative goals, and there is governmental, institutional, proxy advisor, and media pressure to adopt this approach.

Bebchuk/Tallarita (BT),[2] major critics of the ESG/stakeholder movement, have challenged the suitability and utility of incorporating these metrics/goals into corporate incentive plans. BT raised several valid criticisms/questions of the ESG/stakeholder incentive movement,[3] including the narrowness of the metrics, the limited use of quantitative metrics, and the possibility that executives are implementing these metrics to improve their incentive payouts at the expense of shareholders. Their view is that ESG metrics will likely *not* improve the desired corporate and societal goals and might distract the executives from focusing on shareholder value.

Tom Gosling, another expert in this field, agrees with the BT view: "One of my big fears about this sort of stampede towards including ESG targets in executive pay is that it's likely just to lead to more pay and not more ESG."[4]

However, despite these criticisms, the ESG incentive metrics movement has significant, and arguably irreversible, momentum to address the private and public issues due to substantial pressure on large corporations to move rapidly into ESG/stakeholder incentive commitments. Therefore, it is essential that this movement be based on financial and economic validity and facts.

Pay Governance Research

One important criticism from BT remains empirically unresolved: "it is difficult if not impossible for outside observers to assess whether this use provides valuable incentives or rather merely lines CEO's pockets with performance-insensitive pay." They worry that these incentives will motivate executives to increase their pay without benefiting other stakeholders and "indeed might dilute executives' incentives to deliver value to shareholders." Pay Governance has conducted unique research to try to address this issue. We find the usage of ESG metrics, thus far, does not appear to have significantly diluted other incentives or distracted executives from creating shareholder as well as stakeholder value.

Here are the hypotheses we thought should be tested:

1. Is the ESG payout multiplier in incentive plans higher than the payout multiplier for financial metrics?
    a. If there is validity to the criticism that ESG metrics are a distraction and being added to increase executive pay, there would be some indication that ESG metrics are in fact diluting attention from creating shareholder value relative to other stakeholders.
    b. It is too early in the ESG incentive movement to test whether they have a positive impact on TSR or other performance metrics.
    c. However, we can test whether the ESG incentive payouts are higher than the payouts for financial metrics.
2. What conclusions can be drawn from companies that use a weighted ESG factor versus a modifier?
    a. We note that 77 percent of companies with an explicit ESG metric use a "weighted" structure versus 24 percent of companies with an unweighted modifier (the total adds to 101 percent, as one company uses a weighted metric and modifier).
    b. See below for additional information regarding weighted metrics and modifiers.
3. Are there any indications that Compensation Committees may be hesitant to provide payouts above or below target based upon the achievement of ESG metrics if such metrics are measured based on a combination of quantitative and qualitative goals and/or when financial and operational goals are not attained?

We utilized the following methodology to test for the answers:

1. Scanned 100 S&P 500 companies' proxies using ESGAUGE to identify companies with ESG metrics that provided clear disclosure of *both* the financial and ESG metrics included in their annual incentive plan, even if the ESG metrics were part of a holistic scorecard of other strategic metrics.
2. Segregated the data into two different groups based on the method used to include ESG in the incentive plan: either a weighted ESG factor, which reduces the weight of the financial metrics, or a modifier that is used to increase or decrease the financial payout.
3. Collected the 2021 payouts for:
    a. Financial/operational metrics
    b. ESG metrics
    c. Overall payout after incorporating the ESG impact

We found 62 large companies that met these criteria.

Exhibit 1

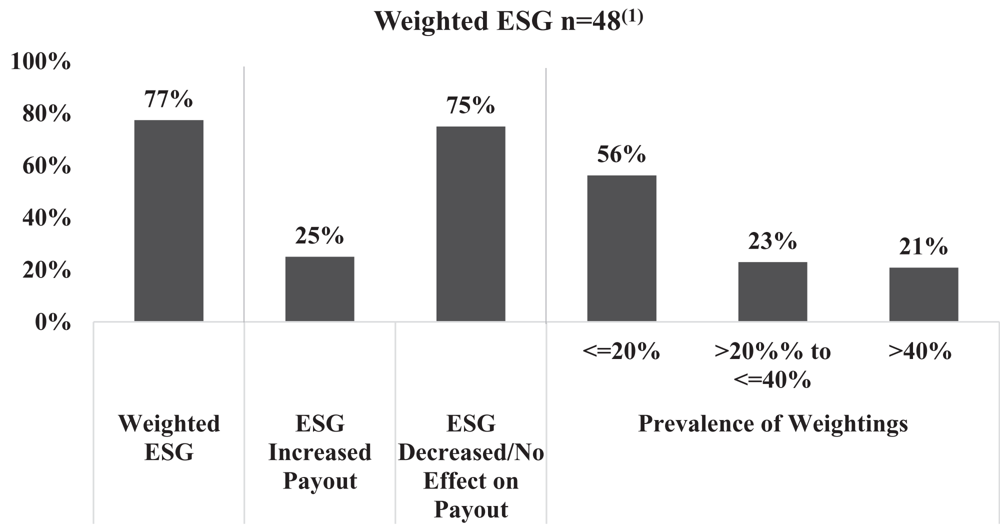
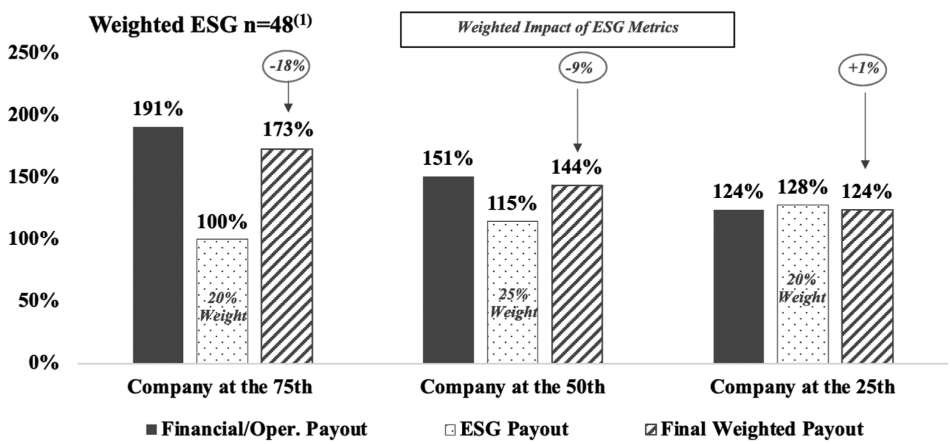


Exhibit 2



Pay Governance Findings

Here are our key findings:

1. ESG reduced the overall payout at 75 percent of the companies using a weighted metric, (*see* Exhibit 1) with the median reduction equal to 9 percent. (*See* Exhibit 2.)
2. Most ESG-weighted metric companies (56 percent) used a 20 percent weighting or less. (*See* Exhibit 2.)
   a. In some cases, the company used a scorecard approach and did not provide sufficient detail to determine the portion of the weighted metric attributable to ESG; in those cases, we included the entire weighting.
   b. Many of the companies with a >20 percent weighting included ESG and other strategic metrics.
3. Of the companies that incorporated ESG metrics as part of a modifier, 33 percent increased payouts and the remaining 67 percent had no effect or reduced payouts. (*See* Exhibit 3.)
4. The average impact on payouts for companies using a modifier on the financial performance metrics ranged from +35 percent to -14 percent and averaged +2 percent. (*See* Exhibit 4.)

Exhibit 3

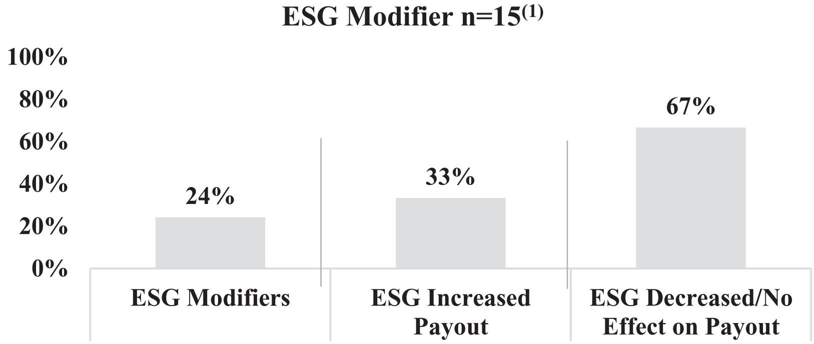
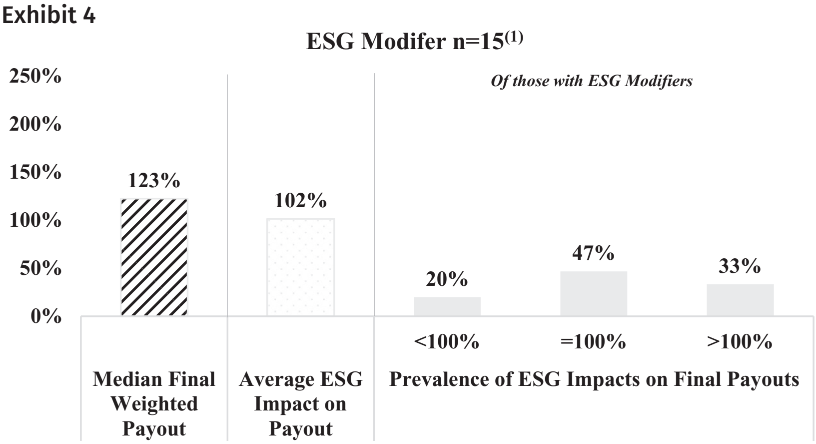


Exhibit 4



5. These findings indicate that the compensation committee members are acting conservatively in setting and scoring ESG goals, thus the narrow band around target for most companies.

We ranked the 48 companies from largest (negative) impact to smallest (positive).

Conclusion

The ESG movement has made substantial progress in encouraging US companies to incorporate ESG metrics into their incentive plans. It is early in this process, and we need to wait for information about the impact of these corporate programs on companies' long-term performance and sustainability as well as the effect on societal problems. However, it does appear that the ESG incentive criticism, that executives are using these metrics inappropriately to increase their compensation, is not empirically supported.

Notes

1. Data provided by ESGAUGE.
2. Lucian A. Bebchuk and Roberto Tallarita, "The Perils and Questionable Promise of ESG-Based Compensation," *Journal of Corporation Law*, March 4, 2022, available at *https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4048003*.
3. Ira Kay, "The Perils and Promise of ESG-Based Compensation: A Response to Bebchuk and Tallarita," *Harvard Law School Forum on Corporate Governance*, April 27, 2022, available at *https://corpgov.law.harvard.edu/2022/04/27/the-perils-and-promise-of-esg-based-compensation-a-response-to-bebchuk-and-tallarita/*.
4. CJ Clouse, "Does Linking ESG Performance to Executive Pay Actually Make a Difference?," *GreenBiz*, February 2, 2022, available at *https://www.greenbiz.com/article/does-linking-esg-performance-executive-pay-actually-make-difference*.

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