STRIVE
ASSET MANAGEMENT

Hostile Takeover: Europe and California Impose ESG on Corporate America

Executive Summary

- Regulation of corporate America has historically been the province of the federal government and the state where the company has chosen to incorporate, most commonly Delaware.
- That's changing. Foreign and state-level governments are increasingly using their own laws to impose ESG mandates on American companies—mandates that apply to the company's worldwide operations, far outside these regulators' borders.
- The European Union has proposed regulations that would require U.S. companies to identify and address human rights and environmental violations in their entire value chains.
- California has similarly proposed legislation that would require U.S. companies that do business within its borders to disclose their worldwide emissions, including third-party emissions from customers and suppliers up and down their supply chains.
- Investors, corporate leaders, and all Americans concerned about the future of the U.S. economy should carefully monitor these developments and oppose them where appropriate.

Background

Historically, regulation of U.S. corporations was left to the states, rather than the federal government. A corporation was usually governed by the laws of the state in which it chose to incorporate, even if it did business elsewhere. This principle is called the "internal affairs" doctrine, and states that the internal affairs of corporations—such as the fiduciary duties of their directors, the types of disclosures that companies are required to make, and whether they must operate purely to increase financial value for their shareholders or are allowed to pursue social goals—are all determined solely by the corporate laws of the state in which they are incorporated.[1] The doctrine makes a lot of sense, as it prevents national companies from having to comply with the conflicting laws of 50 different states—an arduous and often impossible task.

Over the past century, the federal government has also stepped in to regulate corporate America. The Securities and Exchange Commission was established in 1934, in the aftermath of the Wall Street Crash of 1929. Over time, the agency has gained significant authority to regulate publicly traded companies,[2] including requiring companies to issue certain disclosures and making it a federal crime to mislead investors.

States and foreign governments have always had the ability to regulate *some* aspects of corporate behavior—safety requirements for products imported into the territory, what the minimum wage for local workers must be, whether the company needed to pay state or foreign taxes on products sold locally, and so on. But generally, states and foreign governments have not attempted to regulate how companies operate outside of the governments' own borders.

In the wake of the stakeholder capitalism movement, that appears to be changing.

At first, states and countries made ESG-related laws that applied only to companies incorporated within their borders. Many governments, for example, have environmental regulations that govern waste discharge and pollution from corporate activities that take place within their jurisdiction. More recently, states have been venturing into corporate diversity regulations as well. Washington, for example, enacted a law that requires publicly-traded companies to have a gender-diverse board or explain to shareholders why they do not.[3] But the law expressly only applies to companies incorporated in Washington. New York, Illinois, Colorado, and

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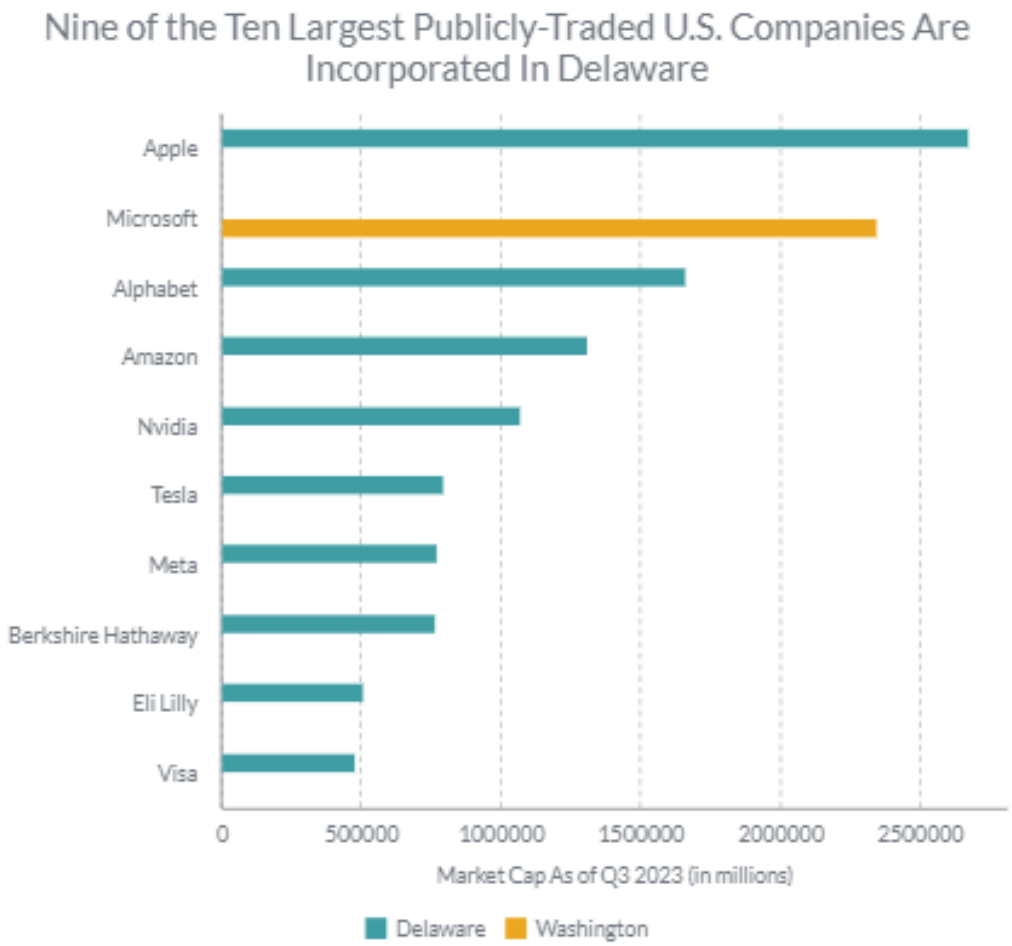
[1] *See, e.g.*, *In re Sagent Tech., Inc., Derivative Litig.*, 278 F. Supp. 2d 1079, 1086 (N.D. Cal. 2003).
[2] https://www.sec.gov/news/speech/2010/spch120110klc.htm.
[3] https://app.leg.wa.gov/rcw/default.aspx..

Maryland require similar diversity-related disclosures for companies incorporated within their borders.[4]

Delaware has taken a different tack. Delaware, long considered a business-friendly jurisdiction, is by far the most popular place to incorporate: over two-thirds of the Fortune 500 is incorporated there, as well as over 80% of start-ups that have gone public in recent years.[5]



Source: Strive; data source: https://en.wikipedia.org/wiki/List_of_public_corporations_by_market_capitalization and company SEC filings.

Unlike some other states, Delaware does not require—or even permit—for-profit companies to pursue ESG initiatives; nor does it mandate diversity or climate-related disclosures.[6]

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[4] https://corpgov.law.harvard.edu/2020/05/12/states-are-leading-the-charge-to-corporate-boards-diversify/
[5] https://www.dwt.com/blogs/startup-law-blog/2020/07/why-do-so-many-startups-form-corporations-delaware.
[6] https://www.shareholderforum.com/access/Library/20150320_Strine.pdf

The Securities and Exchange Commission has similarly refrained from forcing corporate America to adopt ESG initiatives, at least so far. Despite a flurry of proposed regulatory activity following the Biden Administration's push for environmental and social regulations, these proposals have largely stalled amid fierce public opposition. In March 2022, for example, the SEC proposed a 500+ page rule that would require American companies to measure and disclose greenhouse gas emissions up and down their supply chain, imposing mammoth costs on corporate America and small businesses alike.[7] The rule has faced significant criticism, as well as threats of legal action as critics note that the measure may go beyond the SEC's power.[8]

Perhaps believing that Delaware and the SEC are not doing enough to push climate- and diversity-related goals on corporate America, other regulators have stepped in—despite the fact that these companies are incorporated elsewhere and not generally subject to outside regulations on these issues. In particular, both the European Union and California have recently moved forward with far-reaching

legislation that would require nearly all large American companies to comply with ESG mandates and disclosures, even with respect to their operations outside of those governments' borders.

Europe's Attempt to Recolonize Corporate America

The EU is in the midst of passing new trade regulations to impose ESG requirements on U.S. companies. The pair of regulations is called the Corporate Sustainability Reporting Directive (CSRD) and the Corporate Sustainability Due Diligence Directive (CSDDD). Together, these regulations will impose significant new ESG burdens on American companies.

Under these regulations, American companies that sell goods and services in Europe will be required to comply with ESG disclosures on a range of issues.[9] Companies must disclose ESG targets and annual progress and implementation plans to limit global warming to achieve climate neutrality by 2050, in line with the Paris Agreement goals.[10]

[7] https://www.sec.gov/news/press-release/2022-46
[8] https://www.wsj.com/articles/sec-considers-easing-climate-disclosure-rules-after-investor-pushback-11675416111
[9] https://www.forbes.com/sites/stevebanker/2023/08/16/trade-rules-are-increasingly-esg-rules/
[10] https://corpgov.law.harvard.edu/2023/09/17/the-eu-corporate-sustainability-reporting-directive-what-non-eu-companies-should-know/

Source: Strive; data source: EFRAG draft disclosures standards; https://www.wsj.com/articles/at-least-10-000-foreign-companies-to-be-hit-by-eu-sustainability-rules-307a1406

Notably, the directives require companies to disclose not only their own environmental and social impacts, but those of vendors and customers within their supply chains. In particular:[11]

- Under the "environmental" prong, companies must report not only carbon emissions, but their and their suppliers' and suppliers' suppliers' impacts on water availability, wildlife biodiversity, deforestation and more.

- Under the "social" prong, companies must report how they treat their workforce, anti-discrimination and anti-child labor measures, and how they impact the communities in which they operate. It also requires similar reporting for every supplier (and suppliers' supplier, through the entire value chain), including whether, for example, the workers for an upstream supplier have access to adequate housing.

- Under the "governance" prong, companies must disclose board diversity and similar social metrics with no connection to shareholder value.[12]

Critics have described the regulations as calling for a "tsunami of detail" where "the only big winners are the consultants."[13]

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[11] ttps://www.forbes.com/sites/stevebanker/2023/08/16/trade-rules-are-increasingly-esg-rules/
[12] https://www.strive.com/documents/FG/strive/news/627521_Race_Gender_and_Corporate_Performance.pdf
[13] https://www.irmagazine.com/reporting/tsunami-detail-required-europes-new-common-reporting-framework

The disclosures must be audited.[14] The Wall Street Journal estimated that the "related yearly auditing costs for 'limited assurance' can range from . . . $130,000 to $260,000 per year for every $10 million in revenue."[15] Note that this estimate is for auditing alone, and does not include costs related to compiling and drafting the disclosures, or the accompanying legal review. Nor does this figure include the valuable time and attention C-suite executives must devote to these new compliance requirements, rather than business concerns. The European Commission itself has assessed the likely impact on EU businesses will be between $3.6 and $8.8 billion over the first ten years.[16]

The new regulations expressly apply to non-EU businesses. While the rules and their exemptions are complex, generally speaking, the new rules apply to U.S. businesses listed on EU exchanges, as well as U.S. businesses that have at least $150 million in net sales annually in the EU and have an EU subsidiary.[17] The Wall Street Journal estimates the regulations will apply to 10,000 non-EU companies.[18]

In response, U.S. companies and industry groups have warned regulators about the massive costs and near impossible undertaking of forcing companies to monitor and disclose non-financially material actions of third parties up and down their supply chains. The regulations have also faced opposition by EU lawmakers on the center-right, who have called to revise the restrictions in light of the "high administrative burden" they will place on companies, making the EU less competitive for businesses.[19] Commentators note, however, that it will be difficult for these lawmakers to muster a majority in the EU parliament.

American businesses are further concerned that the EU regulations will lead to more securities litigation in the United States.[20] That's because under U.S. law, a company can be held liable for any false or misleading statements made anywhere in the world, even if those statements were made as part of a disclosure regime mandated by a different country.

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[14] https://www.futrproof.io/insights/new-eu-reporting-rules-to-impact-us-companies-sustainability-disclosures
[15] https://www.wsj.com/articles/at-least-10-000-foreign-companies-to-be-hit-by-eu-sustainability-rules-307a1406
[16] https://www.futrproof.io/insights/new-eu-reporting-rules-to-impact-us-companies-sustainability-disclosures
[17] https://www.eyeonesg.com/2022/05/human-rights-and-the-environment-what-non-eu-based-companies-need-to-know-regarding-the-eu-draft-corporate-sustainability-due-diligence-directive/;
https://corpgov.law.harvard.edu/2023/09/17/the-eu-corporate-sustainability-reporting-directive-what-non-eu-companies-should-know/
[18] https://www.wsj.com/articles/at-least-10-000-foreign-companies-to-be-hit-by-eu-sustainability-rules-307a1406
[19] https://www.reuters.com/sustainability/eu-lawmakers-push-weaken-corporate-sustainability-disclosure-2023-10-13/
[20] https://corpgov.law.harvard.edu/2023/09/23/the-eus-new-esg-disclosure-rules-could-spark-securities-litigation-in-the-us/

Treasury Secretary Janet Yellen has similarly spoken out on the proposals, explaining the rules carry the "potential for unintended negative consequences for U.S. firms."[21] She added that the U.S. is "concerned it has extraterritorial scope" and "could affect the global activities of U.S. firms where there is no clear nexus to the EU." She explained that the U.S. is discussing these issues with the EU, but, to date, the EU has not made significant changes to the regulations.

The Californication of Corporate America

Like the EU, California has similarly been working to impose climate mandates on American businesses, including on operations that occur outside of its borders.

On October 7, 2023, Governor Newsom signed two laws requiring companies that do business in California to make extensive climate-related disclosures.[22] The first, entitled the Climate Data Accountability Act or Senate Bill 253, requires companies to disclose greenhouse gas emissions. The second, entitled Climate-related Financial Risk Act or Senate Bill 261, will require companies to file annual climate-related risk reports in accordance with the Task Force for Climate-related Financial Disclosures ("TCFD").

The bills go beyond the climate-related disclosures the SEC has been mulling for the past year. The emissions rule, for instance, requires any business with more than $1 billion in revenue to report not only its own emissions, but those of its suppliers, vendors, and customers throughout its value chain. As a result of these so-called "Scope 3" disclosure requirements, the laws will likely affect not only large companies, but any company that sells good or services to larger companies, since these companies will have to provide estimates of their own emissions for their larger counterparts to report.

The California Chamber of Commerce fiercely opposed the effort, calling it "an onerous emissions tracking and paperwork requirement that will increase costs on California businesses" of all sizes.[23] One of the bill's sponsors estimated the new law would cost businesses around $300,000 annually,[24] but there are reasons to suspect that number may be low. The SEC, for example, estimated its own, narrower regulation would cost companies over $500,000[25]—a figure criticized by the SEC's

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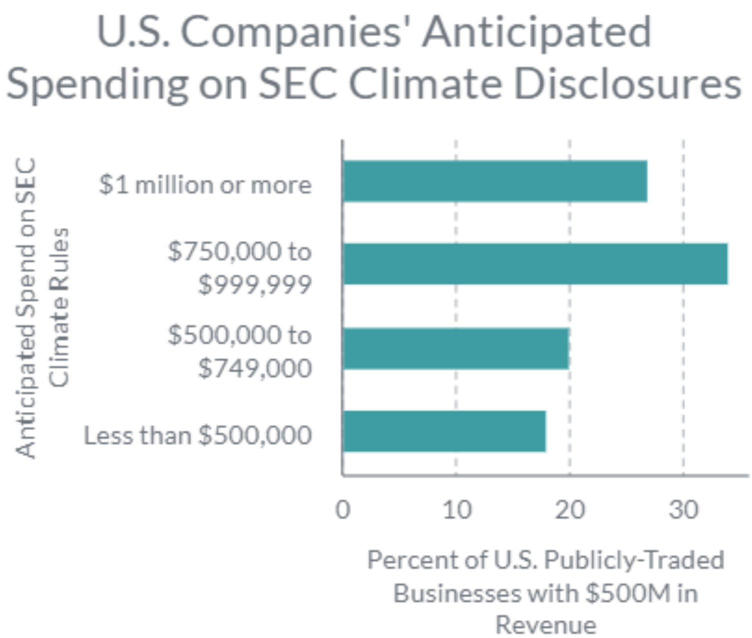
[21] https://subscriber.politicopro.com/article/2023/06/yellen-warns-about-eu-climate-rule-00101712#:~:text=A%20European%20Union%20proposal%20that,Secretary%20Janet%20Yellen%20said%20Tuesday.
[22] https://fortune.com/2023/10/10/climate-change-greenhouse-gas-emissions-california-gavin-newsom-disclosure/
[23] https://timesofsandiego.com/politics/2023/09/12/california-senate-passes-corporate-climate-disclosure-bill-governor-must-decide-by-oct-14/
[24] https://www.nbcnews.com/science/environment/california-bill-force-large-companies-disclose-greenhouse-gas-emission-rcna105119
[25] https://www.wsj.com/articles/secs-climate-disclosure-rule-isnt-here-but-it-may-as-well-be-many-businesses-say-854789bd

former chief economist, who explained it omitted many costs, including the cost of climate disclosure related litigation that will almost certainly follow.[26] Most business leaders agree, as a majority of executives said they would likely have to spend at least $750,000 to comply with the new SEC rule in the first year:



Source: Strive; data source: Workiva Inc. and Pwc, *see also* https://www.wsj.com/articles/secs-climate-disclosure-rule-isnt-here-but-it-may-as-well-be-many-businesses-say-854789bd

As noted above, California's rules are expected to be even more expensive.

Even Governor Newsom expressed concern, issuing a press release stating that he believed implementation was "infeasible" and that he was "concerned about the overall financial impact" on businesses.[27] These concerns are amplified given that the costs of complying with California's laws will be on top of the costs of complying with the different disclosures regimes enacted by the European Union, the Securities and Exchange Commission, the United Kingdom and other locales.[28] He nonetheless signed the bills into law, asking only that regulators "monitor" their impact going forward.

Although no lawsuits have yet been filed, the bills are expected to face legal challenges by covered companies and/or nonprofit organizations on state and federal constitutional grounds.[29]

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[26] https://www.reuters.com/sustainability/companies-fear-lawsuits-californias-climate-disclosure-rules-2023-10-12/
[27] https://www.gov.ca.gov/wp-content/uploads/2023/10/SB-253-Signing.pdf
[28] https://corpgov.law.harvard.edu/2023/01/30/eu-finalizes-esg-reporting-rules-with-international-impacts/
[29] https://www.stblaw.com/docs/default-source/publications/esg_ca-bill.pdf

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Conclusion

As ESG-related debates—about climate change, and social issues, and the economy, and costs, and tradeoffs, and keeping American businesses competitive on the global stage—continue among officials elected by the American public, unaccountable bureaucrats in other jurisdictions are seeking to take matters into their own hands. These foreign and local regulators do not represent the American people, and yet seek to impose their will on corporate America in its entirety. The implications are likely to be costly for American businesses, investors and the public as a whole.

American businesses facing such regulations should continue to monitor the situation, including any legal developments or challenges to such regulations that may delay or obviate the need for costly and risk-creating compliance. Financially-minded investors should similarly educate themselves on the situation, and, where appropriate, debunk the myth that these regulations are simply asking for disclosures that investors themselves care about. And Americans dissatisfied with being governed by leaders in faraway places should push back on these practices as well, through public comment and discussions with their elected representatives.

Strive will do the same. We believe that corporations should focus on creating long-term financial value for shareholders alone, and that forcing corporations to redirect their time, money and resources to pursuing social and political goals will only harm those companies, their investors, the economy, and the American people in the long run. Accordingly, we are paying close attention to how these extraterritorial efforts to regulate American businesses develop and what financially-minded investors can do to fight back.