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# ESG Metrics in Compensation Plans and Executive Employment Agreements

See how some of America's largest companies are implementing sustainability metrics into their comp strategies.

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For more than a decade, boards, investors, proxy advisors, public companies, trade associations, thought leaders and regulators have focused on the importance of ESG factors on the strategies, operations and responsibilities of public companies. The impetus for this focus comes from a concern on the part of companies and their boards that shareholder financial returns are not the only goal of a corporate strategy. In fact, there is evidence that companies with positive ESG records also demonstrate solid financial performance.

In reviewing and revising corporate strategies, boards are considering and integrating ESG matters, particularly the E and the S. Along these lines, boards and compensation committees have begun to include ESG metrics in compensation decisions, compensation plans and some executive employment agreements (collectively, compensation plan or plans). As a result, some portion of executive compensation at many companies is beginning to be measured by the individual or corporate achievement of ESG metrics.

These trends and demands raise a question about the information a board or compensation committee should have at its disposal as it considers

## EXAMPLES OF ESG METRICS

Listed below are examples of ESG metrics that companies have used in making compensation decisions and are now incorporating into compensation plans:

*Environmental* (issues relating to the quality of the natural environment)
- Climate risk
- Climate change
- Carbon/emissions
- Energy management/efficiency/sustainability
- Water consumption/management
- Recycling/green investments/products

*Social* (issues relating to the rights, well-being and interests of people and communities)
- Employees/labor practices
  - Health and safety
  - Turnover
  - Diversity and inclusion
  - Development/satisfaction/engagement/talent management
- Customers
  - Product safety
  - Product quality
- Supply Chain
  - Labor standards/rights
  - Human rights
  - Impact on local communities

*Governance* (issues relating to the governance of companies and other investee entities)
- Regulatory
- Risk management
- Bribery and corruption
- Conflicts of interest
- Digital data security
- Compliance

whether to add ESG metrics to its compensation plans. In addition, boards and compensation committees will have to determine how to use such metrics and how to weigh and measure them.

### BACKGROUND AND HISTORY

Investors have expressed their views through shareholder proposals, both in favor of and recently against ESG factors. With the focus on ESG by investors and proxy advisors, ESG has found its way into boardrooms and discussions on strategy and operations around climate, diversity and disclosure of the company's efforts in these areas. Boards have also looked at ways to incentivize employees to reach the ESG goals outlined in the company's strategy and to design compensation plans that reflect the company's priorities. Although there have been companies over the years that, because of the nature of their business, have included health, environmental and safety metrics in their executive compensation (e.g., energy/refining companies), the attention to ESG has led to the more recent focus on these metrics in executive compensation programs more generally.

A quarter of U.S. public companies included some form of ESG metric as part of their executive incentives in 2021, notes Glass Lewis, a proxy advisory firm. According to a March 2022 report published by PwC, 57% of S&P 500 companies and almost 10% of Russell 3000 companies reflected ESG metrics in their compensation plans. This represents a significant increase over recent years.

### ISSUES AND CHALLENGES

Boards that are exploring the addition of ESG metrics to a compensation plan should consider taking the following steps before making their final decision:

**Examine the company's strategy and determine how ESG fits into and promotes that strategy, including how ESG relates to performance goals currently used in compensation plans.** The strategy will also reflect the company's commitment, or lack thereof, to ESG. A company's strategy depends largely on both its industry and its goals and indicates what is important for the company and its values. In addition, the strategy should reflect the regulatory environment in which the company operates and the compliance requirements associated with its business.

**Consider a formal materiality assessment in order to determine the ESG issues most relevant to the company and its stakeholders.** As part of the materiality assessment, the board should seek to understand the views of investors and proxy advisors as well as the kinds of information they perceive as useful.

**Carefully review the company's disclosures in its periodic SEC reports and other public disclosures that contain information about the company's strategy, goals, policies and values.** Care should be given to evaluating the consistency of disclosures with corporate strategy and values and determining whether changes in the disclosures may be advisable.

**Determine whether the company's peers have incorporated ESG metrics in their compensation plans and identify those metrics.** It may be useful to engage a compensation advisor to assist or advise the board or compensation committee in designing compensation plans with ESG metrics.

**Establish metrics that would be best for the company and are designed to support and measure the achievement of ESG goals.** Consideration should be given to incentivizing executives to achieve ESG goals. This task could be handled by the board or the compensation committee with the assistance of management. Boards must also consider the associated challenges and how the metrics align and support the company's strategy and values. There may be different goals and weights ascribed to the E, S and G components.

**Determine what portion of executive compensation will affect achievement of ESG goals (e.g., annual incentive plan or long-term incentive plan).** This task could be handled by the board or the compensation committee.

As the board or compensation committee establishes ESG metrics, careful consideration should be given to:

- What type of metric to use. Should it be a measure linked to a stand-alone weighted metric, a modifier used to adjust the overall payout amount? Should it be used as part of a broader scorecard or as a hurdle?
- How to measure the metrics. Should measurements be quantitative or qualitative? Objective or subjective? And should there be consequences for not achieving the metrics?
- The balance of an ESG metric with other metrics being used (e.g. financial, strategic, operational or shareholder return).
- How to evaluate whether or not the metrics have been achieved.
- Whether the metrics apply to individuals, business units or both.

As the board considers adding ESG metrics to a compensation plan, it should:

- Determine whether any committee charters or governance documents would need to be amended in order to implement or add ESG metrics, and whether such amended charter or other governance documents would need to be publicly filed.
- Review whether there are regulatory and/or disclosure requirements with which to comply.
- Determine whether to make clear disclosure stating why the metrics are being included and the objectives to be achieved by adding such metrics.
- Determine whether the metrics take into consideration the ESG policies or values of third parties, such as suppliers or customers.

Once the board or compensation committee establishes ESG metrics, those and any other metrics should continue to be reviewed as corporate strategies and goals evolve.

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As the ESG movement continues to evolve and more companies consider evaluating the performance of executives by accessing achievement of ESG metrics, companies must carefully consider an array of challenges in developing these metrics. It is important that the metrics are consistent with the company's strategy, goals and values. ■

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# HOW COMPANIES INCORPORATE ESG METRICS IN COMPENSATION PLANS

The following companies have implemented ESG metrics and made disclosures in their 2022 proxy statements.

**ANNUAL INCENTIVE PLANS**

- **The Chemours Company.** The Chemours Company modified its short-term annual incentive plan (AIP) for 2021 "to ensure that management's incentives were aligned with emerging important business metrics." The company shifted the metric mix with the addition of ESG metrics. The ESG metrics are weighted 15% — introducing gender diversity was assigned a 9% weight and environmental projects was assigned a 6% weight. With regard to the 2021 AIP result, the company stated that it "achieved the maximum performance on the environmental projects, but failed to meet the threshold for increasing the percentage of women in the company."

- **The Walt Disney Company.** Disney's compensation committee developed "Other Performance Factors" for the fiscal 2021 annual bonus in December 2020. For fiscal 2021, these other factors were part of the company's strategic objectives and emphasized the importance of one of the company's priority ESG issues: diversity and inclusion. It was assigned the highest weighting among the other performance factors. This ESG metric, together with the Other Performance Factors, was a 30% multiplier of the targeted amount.

- **Dow.** Dow's annual cash incentive program is designed to reward employees for achieving Dow's most critical financial and operational goals. The proxy statement said, "Based on feedback from investors, benchmarking, management's recommendation and input from the independent compensation consultant, the committee determined that operating EBIT, free cash flow and ESG metrics were aligned with the company's stated goals to its stakeholders, including employees and stockholders." For the 2021 performance award, the ESG metric (customer experience, sustainability, inclusion) was 20%. With regard to its 2022-2024 performance share program design, "based on feedback from investors, benchmarking, management's recommendation and input from the independent compensation consultant, the committee determined that including ESG metrics in the 2022-2024 performance share program to drive performance on sustainability targets and carbon and climate goals was aligned with the company's stated goals to its stakeholders, including employees and stockholders. The 2022 program design includes enhancements that align with Dow's stated goal to achieve carbon neutrality by 2050 through increasing its positive impact on customers, business and society, while also supporting Dow's commitment to reduce its net annual GHG emissions by an additional 15% by 2030. The ESG metric is focused on Scope 1, 2 and 3 GHG emission reduction efforts, including a cumulative GHG emission reduction target, as measured against the 2020 baseline previously announced by the company. The ESG metric represents 20% of the 2022 program design."

- **Intel Corporation.** Intel notes that it has a long history of incorporating ESG metrics into its annual cash bonus plan. The annual cash bonus plan for 2021 was made up of three equally weighted performance metrics: revenue, net income and "One Intel" operational goals. Intel also incorporated additional environmental goals as part of the ESG metrics that could increase payouts if achieved. The achievement of preestablished ESG goals could affect the One Intel score by up to 20 percentage points, potentially increasing total payout under the annual cash bonus plan by up to 7%. Intel has integrated corporate responsibility and sustainability leadership into its compensation program in addition to its business operations throughout the company. Two ESG metrics included goals related to 2030 inclusion goals for gender and underrepresented minority diversity and environmental goals related to energy conservation and net positive water use. "Following extensive stockholder engagement, Intel's compensation committee approved several changes to its 2022 compensation programs to align to its new go-forward strategy, strengthen its pay-for-performance linkage, provide better alignment with technology peer industry practices and continue its leadership in ESG issues." In the annual cash bonus plan, there are four equally weighed metrics for the listed officers (other than the CEO). The company's One Intel operational goals were established to reflect the most critical business priorities, and One Intel operational goals continue to include ESG metrics encompassing 2030 RISE environmental and diversity and inclusion goals.

- **Raytheon Technologies Corporation.** In response to investor feedback over the past few years, Raytheon incorporated a corporate responsibility scorecard (CRS) into its executive annual incentive plan for 2021 to drive management focus and ensure accountability on the company's long-term DEI, environmental sustainability and safety objectives. In line with the company's continued emphasis on ESG, the company incorporated nonfinancial performance objectives into the executive annual incentive plan starting in 2021. The CRS consists of two categories — people & culture and sustainability & safety — each weighted at 10%. The financial metrics — earnings and free cash flow — are weighted at 40%. With regard to the weighting of the objectives with the CSR, the proxy statement stated that, since it is believed that the relative importance of the objectives within the CRS will evolve over time, specific weightings were not assigned to these objectives to maintain flexibility.

- **Valero.** Valero has historically included quantitative environmental and safety performance measures in its annual bonus program. Valero's annual bonus plan has three components — financial, operational and strategic. The operational metrics have a 40% weight and include health, safety and environment; mechanical availability and refining cash operating expense management. In 2021, Valero introduced an "energy transition" measure as a modifier within the performance shares program, which links executive compensation with their global refinery Scope 1 and 2 GHG emissions reduction/offset target for 2025 and growth capital deployed for low-carbon projects and initiatives.

- **Walker & Dunlop Inc.** Beginning in 2021, the company embarked on a new five-year plan, "The Drive to '25." The Drive to '25 includes ambitious five-year operational, financial and ESG targets to be achieved by the end of 2025. The ESG targets include increasing diverse leadership, reducing of emissions, donating of 1% of annual income from operations and establishing a cumulative $60B of affordable housing debt financing volume from 2021-2025. With regard to its executive compensation program, the compensation committee conducted a review, and one of the enhancements made to the 2021 annual incentive program was the inclusion of DEI goals (weighted 10%) that include five objective performance factors.

**LONG-TERM INCENTIVE PLANS**

- **Uber Technologies Inc.** In 2019, Uber expanded use of performance restricted stock units (PRSUs) to establish a broader, performance-based long-term incentive program and incorporated DEI goals to align with new cultural norms. In 2020, the company added safety goals to the PRSUs. Uber continued its focus on DEI and safety in 2021. Each executive officer's 2021 PRSU awards were based on the achievement of ESG goals weighted 20% — DEI (10%) and safety goals (10%) — and each executive officer had individual DEI goals under their annual cash bonus plan. Among the priorities for 2022 were achievement of ESG goals, including DEI, climate change, safety, and driver and courier well-being (see also Dow and Valero).

**ANNUAL INCENTIVE PLAN AND EMPLOYMENT AGREEMENTS**

- **Six Flags Entertainment Corporation.** The 2021 incentive plan included a safety metric weighted at 12.5%. It was noted that the company did not achieve thresholds for the safety metric or another metric (guest satisfaction), which were adversely impacted by the pandemic and tight labor market. In the employment agreement of the new CEO in 2021, he was granted a performance stock unit award. The performance goals included ESG achievement metrics. The award provides for payout of additional shares (up to an aggregate maximum) upon achievement of three ESG goals to incentivize sustainable long-term growth. "The Sustainalytics payout opportunity goal will be based on the company's Sustainalytics ESG risk rating compared to its peer group. The Sustainalytics ESG risk rating measures a company's exposure to industry-specific material ESG risks and how well a company is managing those risks. The company is assigned an ESG risk rating in eight separate categories based on its ESG risk exposure compared to its ESG risk management."

- **Activision Blizzard Inc.** The company added an ESG component to its annual incentive program design, which may include diversity, inclusion, promotion and hiring of veterans, and sustainability as part of executive strategic objectives beginning in 2021. Regarding individual strategic objectives (weighted at 20%), the exact objectives for 2021 varied by executive officer, reflecting areas of importance and influence by role. With regard to the CEO's 2021 employment agreement amendment, it increased the percentage of his target bonus opportunity for 2021 and 2022 that will be based on financial metrics — from 60% to 80% — and provides that the remaining 20% will be based on objective and measurable strategic ESG initiatives. Notwithstanding the terms of the employment agreement, in October 2021, the CEO asked not to receive any bonus until the company has made appropriate progress toward the achievement of its transformational goals.


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