Environmental, Social and Governance (ESG) considerations for Directors and Officers

January 2023

Update #2

Overview

This update follows the Zurich ESG whitepaper published in July 2022, providing further updates on ESG related regulations and litigation which may impact Directors' and Officers' liability risk.

All previous updates can be found here.

Contents

Regulation and Legislation

FCA proposes new rules to tackle greenwashing (UK)

In October 2022, the FCA issued a press release proposing a package of new measures to clamp down on greenwashing with restrictions on how terms such as 'ESG', 'green' or 'sustainable' can be used, including in invesment product sustainability labels.

The FCA is proposing to introduce:

- Sustainable investment product labels that will give consumers the confidence to choose the right products for them. There will be three categories – including one for products improving their sustainability over time – underpinned by objective criteria.

- Restrictions on how certain sustainability-related terms – such as 'ESG', 'green' or 'sustainable' – can be used in product names and marketing for products which don't qualify for the sustainable investment labels. It is also proposing a more general anti-greenwashing rule covering all regulated firms. This will help avoid misleading marketing of products.

- Consumer-facing disclosures to help consumers understand the key sustainability-related features of an investment product – this includes disclosing investments that a consumer may not expect to be held in the product.

- More detailed disclosures, suitable for institutional investors or retail investors that want to know more.

- Requirements for distributors of products, such as investment platforms, to ensure that the labels and consumer-facing disclosures are accessible and clear to consumers.

German Supply chain Due Diligence Act

German Supply Chain Act is due to come into force on January 1, 2023. The Act will impose due diligience obligations on companies to respect human rights and protect the environment. The act applies to companies that:

1. have their head office, principal place of business, administrative headquarters, or registered office in Germany and;

2. generally employ at least 3,000 employees (from Jan 2024, law applies to companies with 1,000 or more employees)

The definition of supply chain covers:

1. the actions of a company in its own business area
2. the actions of a direct supplier
3. the actions of an indirect supplier

The act covers various aspects including: human rights, duties of care, risk management, duty of documentation & reporting, and sanctions.

Corporate Sustainability Reporting Directive (EU)

The European Commission has given the Corporate Sustainability Reporting Directive (CSRD) final approval and more companies operating in the EU will now have to publish detailed information on sustainability issues from 2024, including:

- Description of the company's business model, strategy and sustainability risks and opportunities. Under the CSRD, in-scope companies must set clear ESG targets and annually publish their progress on these targets, as well as their transition plans. As a result, the focus on sustainability becomes mandatory, and must be embedded in the company's long-term vision and strategy, and must also be applied to its policies.

- Implementation plans in relation to the transition to a sustainable economy, measures taken to limit global warming in line with the Paris Agreement and to achieve climate neutrality by 2050, and exposure to coal, oil and gas-related activities.

- Sustainability matters that affect the company and the impact of the company on sustainability matters ("double materiality" perspective).

- Greenhouse gas emission targets.

- Policies in relation to sustainability (including incentive schemes linked to sustainability matters).

- Due diligence processes implemented and the actual and potential adverse impacts of the company's operations and value chain.

The CSRD replaces the current Non-Financial Reporting Directive (NFRD) and will be phased in over four stages in the following timeline:

- Companies already subject to NFRD will first report under CSRD in 2025 for FY2024

- Large EU companies that aren't subject to NFRD will report under CSRD in 2026 for FY2025

- Listed SMEs and captive insurance companies will report under CSRD in 2027 for FY2026

- Non-EU firms with net turnover above €150m in the EU and at least one subsidiary or branch in the block will begin reporting under the CSRD in 2029 for FY2028

EU Deforestation rules

In September 2022, plenary adopted its position on the Commission proposal for a regulation on deforestation-free products. The new law would make it obligatory for companies to verify that goods sold in the EU have not been produced on deforested or degraded land anywhere in the world, guaranteeing consumers that the products they buy do not contribute the the destruction of forests and hence reduce the EU's contribution to climate change and biodiversity loss. Members of the European Parliament also want companies to verify that goods are produced in accordance with human rights provisions in international law and repects the rights of indigenous people. Companies placing products in the EU market would be obliged to exercise due diligence to evaluate risks in their supply chain and can use, for example, satellite monitoring tools, field audits or isotope testing to check where products come from. The Commission's proposal covers cattle, cocoa, coffee, palm-oil, soya and wood, including products that contain, have been fed with or have been made using these commodities (e.g. leather, chocolate and furniture). Parliament wants to also include pigmeat, sheep and goats, poultry, maize and rubber, as well as charcoal and printed paper products.

Senate Republicans warn US law firms over ESG advice

In November 2022, 5 US senators sent letters to 51 large US and global law firms saying they plan to use their congressional oversight powers to "scrutinize the institutionalized antitrust violations being committed in the name of ESG," citing a collusive effort to "restrict the supply of coal, oil, and gas, which is driving up energy costs across the globe and empowering America's adversaries abroad." As companies face pressure from regulators, investors, customers and employees, to demonstrate their ESG credentials, they may increasingly find themselves caught in the crossfire as participants in the political process seek to push back against ESG commitments and liberal stances on issues such as abortion rights, gun control, climate change, and diversity.

Enforcement

The SEC launched the Climate and ESG Task Force within the Division of Enforcement to develop initiatives to proactively identify ESG-related misconduct consistent with increased investor reliance on climate and ESG-related disclosure and investment. With increasing regulatory focus being put in ESG-related issues and statements, it is essential that companies not only develop their ESG policies and procedures but ensure that they adhere to them.

Goldman Sachs

In November 2022, the SEC charged asset management firm Goldman Sachs Asset Management, L.P. (GSAM) for policies and procedures failures involving two mutual funds and one managed account strategy marketed as ESG investments. The SEC's order finds that, from April 2017 until February 2020, GSAM had several policies and procedures failures involving the ESG research its investment teams used to select and monitor securities. The SEC alleges that the company failed to have any written policies and procedures for ESG research in one product, and once policies and procedures were established, it failed to follow them consistently. For example, under the procedures, personnel were to complete a questionnaire for each company that was to be included in the product's investment portfolio; however, the agency alleged, in many instances, personnel completed the questionnaire after the securities were already selected for inclusion. Goldman Sachs agreed to the entry of a cease-and-desist order without admitting or denying the allegations, and agreed to pay a $4 million penalty.

Compass minerals

In September 2022, the SEC annouced the settlement of charges against Compass Minerals International Inc for misleading investors about about a technology upgrade that the company claimed would reduce costs at its most significant mine, but in reality, had increased costs, and for failing to properly assess whether to disclose the financial risks created by the company's excessive discharge of mercury in Brazil. Compass is ordered to pay $12 million to settle the charges. The order found that Compass's deficient disclosure controls resulted in the company failing to assess the financial risks of mercury contamination by one of it former facilities in Brazil and the facility's cover-up of the misconduct by submitting inaccurate test reports to Brazilian environmenal authorities.

Securities lawsuits

Starbucks

In August 2022, the National Center for Public Policy, a conservative non-profit think tank, filed a complaint against Starbuck directors and officers objecting to Starbucks' diversity and inclusion policies including the aim for Black people, indigenous people and other people of colour to hold at least 30% of US corporate jobs by 2025, tying executive pay to its diversity policies and increasing its annual spending with diverse suppliers and vendors by 2030. The complaint alleges that these policies require the company to make race-based decisions that benefit minoroties and violate federal and state civil rights laws. This example again shows the political environment companies must navigate when publishing their ESG agendas.

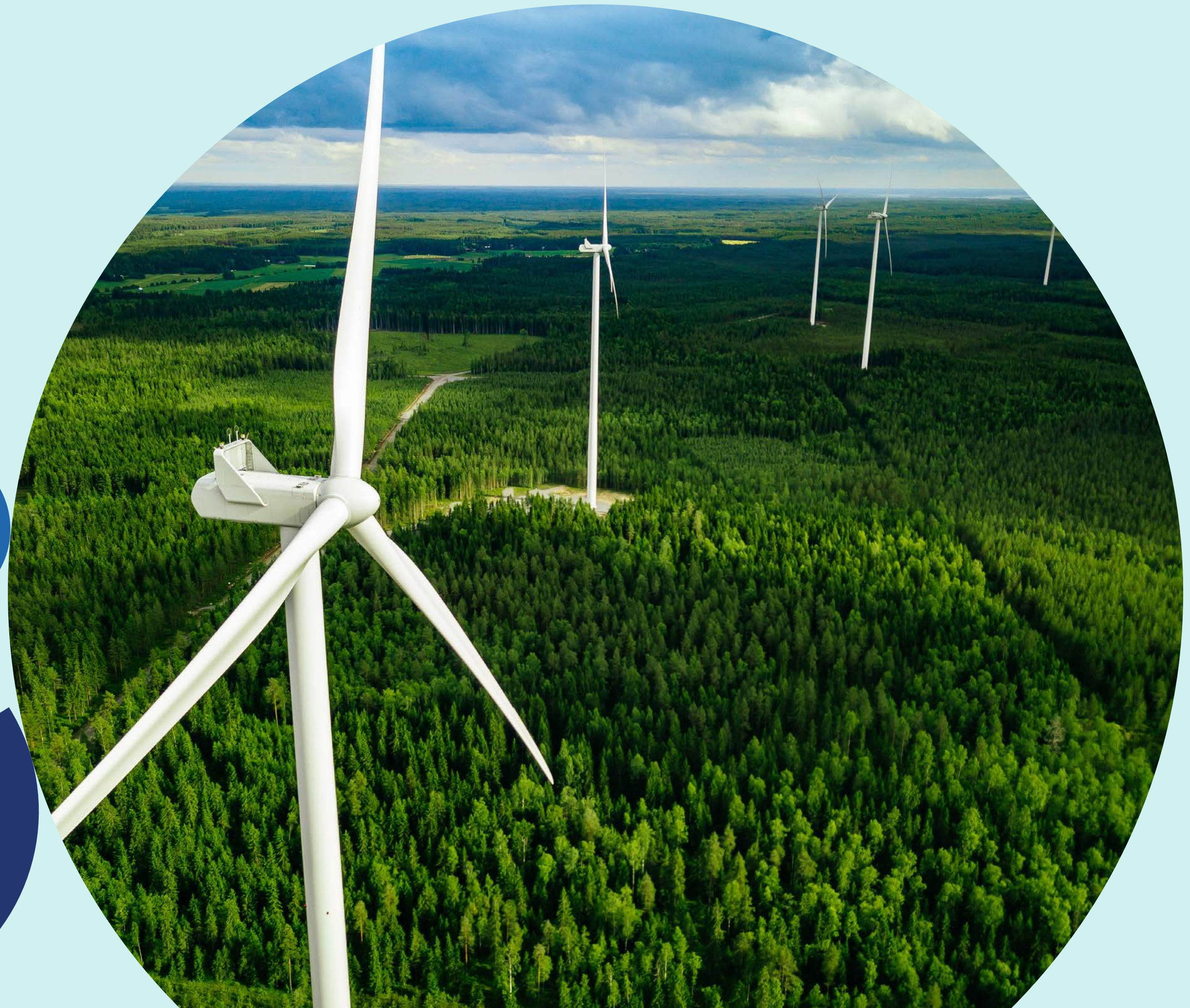
Enviva:

In November 2022, a securities class action was filed against wood products company Enviva. The class action states that "Enviva touts itself as a "growth-oriented" environmental, social, and governance ("ESG") company with a "platform to generate stable and growing cash flows.", however alleges that the company and its directors and officers made false/ misleading statements and/or failed to disclose that Enviva had misrepresented the environmental sustainability of its wood pellet production and procurement. This class action comes off the back of a short seller report stating that the company "is flagrantly greenwashing its wood procurement" which it characterised as being unsustainable and that the Enviva in fact drives demand for deforestation and incentivises "the destruction of American forests."

Companies must be wary of overstating their green credentials as any appearance of greenwashing could be an avenue through which securities class actions could be brought with allegations of companies and/or their directors and officers misrepresenting their environmental sustainability.

ESG Disclosure Best practice

With rising investor pressure for companies to provide ESG-related disclosures, there has also been an increase in accompanying shareholder litigation in ESG issues.



The following best practices, outlined by Kuratek, Hall and Huber (2020), can be followed by companies looking to continue ESG disclosure whilst limiting litigation risk:

- **Best Practice 1 :** Draft ESG disclaimers in a way that explicitly covers ESG data to reduce the risk of litigation. State that ESG data is non-GAAP (ESG data is usually non-GAAP and non-audited), and have consistent disclaimers across SEC filings and all company documents that reference ESG data.

- **Best Practice 2:** Companies should ensure statements in ESG reports are supported by fact or data and should limit overly aspirational statements. Representations made in ESG Reports may become actionable, so companies should disclose only what is accurate and relevant to the company. As per The US Chamber of Commerce in their ESG Reporting Best Practices: do not include ESG metrics into SEC filings; only disclose what is useful to the intended audience and ensure that ESG reports are subject to a "rigorous internal review process to ensure accuracy and completeness."

- **Best Practice 3:** Companies should try to understand key ESG rating and reporting methodologies and how they match their company profile. By understanding the current ESG market raters and methodologies, companies will be able to better align their ESG disclosures with them. The U.S. Chamber of Commerce suggests that companies should "engage with their peers and investors to shape ESG disclosure frameworks and standards that are fit for their purpose."

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