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

December 2023
Update #4

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.

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Companies are under increasing pressure to report sustainability-related information about their businesses. These demands come from multiple directions: institutional investors seeking disclosure on certain sustainability-related topics, shareholders making sustainability-related proposals at record numbers, and regulators proposing and adopting new rules requiring companies to disclose sustainability-related information, such as the SEC's proposed rules regarding climate disclosure, California's Climate Accountability Package (discussed below), the European Union's Corporate Sustainability Reporting Directive ("CSRD"), and the International Sustainability Standards Board's ("ISSB") Sustainability Disclosure Standards (which the UK government has signaled that it will adopt as part of its sustainability reporting requirements).

California GHG Disclosure Laws
As public companies await the SEC's final climate disclosure rules, expected to be released in Q4 2023, California has been working on its own set of climate-disclosure laws. In October 2023, California's Governor signed both The Climate Corporate Data Accountability Act (SB 253) and The Climate-Related Financial Risk Act (SB 261) into law.

The Climate Corporate Data Accountability Act (SB 253)
The Climate Corporate Data Accountability Act would require entities engaged in business in California with total annual revenues greater than $1 billion to make public disclosures of their GHG emissions, including Scope 1, Scope 2 (starting in 2026), and Scope 3 (starting in 2027) emissions. Unlike the SEC's proposed climate-related disclosure rules, California has no carve-outs for Scope 3 emissions, and entities would be required to report their Scope 3 emissions even if not material and the entity has not disclosed any GHG emission targets or goals. The legislation would also require reporting entities to independently verify their Scope 1, Scope 2, and Scope 3 emissions through a third-party auditor.

The Climate-Related Financial Risk Act (SB 261)
Starting in 2026, The Climate-Related Financial Risk Act would require covered entities with total annual revenues greater than $500 million to prepare annual reports disclosing the entity's climate-related financial risk by following the recommendations of the Task Force on Climate-Related Financial Disclosures ("TCFD"). Companies would be required to submit such reports to the California State Air Resources Board, make the reports publicly available on their websites, and issue a statement to the California Secretary of State affirming that the report discloses climate-related financial risks in accordance with the requirements of the legislation. The legislation would also require entities to disclose the measures they adopt to reduce and adapt to the climate-related financial risks they identify.

Companies should take note that, while the SEC's proposed climate-related disclosure rules, if finalized, would only apply to public registrants, California's proposed legislation would encompass any private company with the requisite total annual revenues doing business in California. Furthermore, companies with total annual revenues between $500 million and $1 billion would still be subject to the Climate-Related Financial Risk Act, even if not required to comply with the Climate Corporate Data Accountability Act.

These new laws demonstrate the overlapping and inconsistent approaches to climate disclosures required from corporations by a growing number of jurisdictions. In addition to the forthcoming SEC rule on climate-related disclosures, the European Union has also taken drastic steps in the last year with passage of the Corporate Sustainability Reporting Directive ("CSRD"), and now, with California's new laws, it will be difficult for larger companies to avoid being subject to some, if not all, of these rules.

It is very likely that the California laws will face legal challenges, including to the state's authority to force companies to report their GHG emissions, especially for those companies with relatively minimal footprints in the state. Regardless of the timing of or outcome of any litigation, however, businesses with a link to California should proactively prepare for these impending laws. Large companies should initiate an action plan for climate disclosure now, because gathering emissions data and climate risk information for fiscal year 2025 would currently be subject to disclosure in 2026.

Regulation and Legislation

European Sustainability Reporting Standards (ESRS)
In January 2023, the European Union adopted the Corporate Sustainability Reporting Directive (CSRD), which requires EU and non-EU companies with activities in the EU to file annual sustainability reports alongside their financial statements. These reports must be prepared in accordance with European Sustainability Reporting Standards (ESRS).

The ESRS set out detailed reporting requirements for EU companies in scope of the CSRD, including EU subsidiaries of non-EU companies. The ESRS cover:

- General reporting principles.
- A list of mandatory disclosure requirements for EU companies related to the identification and governance of sustainability matters.
- The 10 ESG topics where disclosure is required, subject to a materiality assessment (divided into Environmental, Social and Governance)

Together, the CSRD and ESRS require companies to:

- Perform materiality assessments on each sustainability topic applying the double materiality principle to work out which information should be reported. In line with double materiality, companies must report if sustainability information is material from either a financial or an impact perspective, taking account of people and the environment.
- Report on the material impacts, risks and opportunities identified in the company's own operations, those of its group and those of its upstream and downstream value chain.
- Provide metrics and targets for material sustainability topics and connect these to their financial reports.
- Have their sustainability disclosures audited by an independent third-party auditor before they are filed with the relevant authority.

As part of the European Commission's release of its 2024 Commission Work Programme, the Commission proposed a two-year delay of the date of adoption of the sector-specific ESRS. The first set of sector-agnostic ESRS rules, which were adopted in July of this year, will still apply in 2024. But the second set of rules outlining sustainability information relating to the industries in which companies operate have been put back to 2026.

The FCA and PRA propose measures to boost diversity and inclusion in financial services

The UK's financial regulators have proposed new rules on diversity and inclusion (D&I) to tackle bullying and sexual harassment that pose risks to work cultures in the sector. Among the changes, regulators will consider a history of bullying or harassment as part of their fit and proper assessment of senior management functions. The FCA said the new regulatory framework on D&I in financial services, establishing minimum standards, will be largely weighted to the UK's biggest firms. They will be asked to implement the plans and report on delivery. In particular, the FCA is proposing firms should develop a D&I strategy to set out how they will meet key objectives, collect, report and disclose data, and set targets to address areas of under-representation.

The PRA wants D&I strategy and targets to be a board-level responsibility. It said accountability for D&I should be allocated to a senior manager to improve culture. D&I should be considered as a risk by internal controls functions, the PRA said, adding that patterns of bullying, discrimination and harassment will be considered as part of fit and proper assessments of individuals. The regulators have opened two separate consultations with plans to publish final rules and policies in 2024, with any changes likely to follow after a further 12 months.

EU to ban greenwashing and improve consumer information on product durability

In September 2023, the EU Parliament and Council reached a provisional agreement on new rules to ban misleading advertisements and provide consumers with better product information.

- Generic environmental claims (e.g., "environmentally friendly", "natural", "climate neutral" or "eco") without proof of recognized excellent environmental performance relevant to the claim and other misleading marketing will be banned. Also, claims based on emissions offsetting schemes that a product has neutral, reduced or positive impact on the environment;"
- Ban will also apply to commercial communications about goods that contain a design feature introduced to limit product durability
- Only sustainability labels based on approved certification schemes or established by public authorities will be allowed
- Guarantee information to be more visible and a new guarantee extension label to be introduced

Regulation and Legislation

Looking ahead to 2024

The above developments are evidence that stricter EU, US, and global ESG-related regulations are being introduced as investors and key stakeholders are looking for companies to report on their performance across non-financial areas. Increased ESG reporting can provide benefits such as increased transparency regarding a company's ESG performance and may help companies better identify and manage their ESG-related risks. However, with evolving reporting requirements, the process can be complex and will need firms to have a variety of skills within the organisation and the ability to collect, analyse and report on qualitative and quantitative data.

As per a report by KPMG, only a quarter of companies feel confident that they can meet future ESG reporting requirements across the US, EU and other international jurisdictions. Looking ahead to just the coming year with the EU's Corporate Sustainability Reporting Directive (CSRD), starting from 2024, almost 50,000 companies are subject to mandatory sustainability reporting, including non-EU companies which have subsidiaries operating within the EU or are listed on EU regulated markets. The CSRD will require a new level of disclosure, with ESG reporting now a board-level priority. Companies need to disclose their policies and targets across a wide range of areas, including emissions reduction targets and resource conservation plans.

As per KPMG, it is vital for companies to consider the following steps:

- Establish a board-led governance structure
- Set up a due diligence process across complete value chains
- Integrate ESG into corporate risk management systems
- Prepare for assurance
- Consider short, medium, and long-term time horizons

Enforcement

DWS charged for misstatements regarding ESG investments

In September 2023, DWS Investment Management Americas Inc., a subsidiary of Deutsche Bank, was charged with two enforcement actions, one for failure to develop a mutual fund anti-money laundering program and the other for misstatements regarding its ESG investment process. DWS agreed to pay $25 million in penalties to settle the charges.

Pursuant to the SEC's order, DWS made materially misleading statements about its controls for incorporating ESG factors into research and investment recommendations for ESG products. The SEC found that, while DWS marketed itself as a leader in ESG and claimed to adhere to specific policies for integrating ESG considerations into its investments, from August 2018 through 2021, it failed to implement certain provisions of its ESG integration policy adequately despite leading clients and investors to believe that it would.

The SEC also determined that DWS failed to adopt and implement policies and procedures reasonably designed to ensure that its public statements about ESG integrated products were accurate. As per the SEC's 2023 Examination Priorities, ESG investing is a notable and significant focus area, and the division would "continue its focus on ESG-related advisory services and fund offerings, including whether funds are operating in the manner set forth in their disclosures."

Securities lawsuits

ESG Backlash

In June 2023, Delaware judge Lori Will ruled that The Walt Disney Co board did not act negligently when, facing pressure from employees and creative partners, it criticized a sexual identity bill signed by Florida Governor Ron DeSantis. The judge concluded that "this suit concerns such a business decision by the Disney board—a decision that cannot provide a credible basis to suspect potential mismanagement irrespective of its outcome. There is no indication that the directors suffered from disabling conflicts. Nor is there any evidence that the directors were grossly negligent or acted in bad faith. Rather, the board held a special meeting to discuss Disney's approach to the legislation and the employees' negative response. Disney's public rebuke of HB 1557 followed."

Vice Chancellor Will said that "Given the diversity of viewpoints held by directors, management, stockholders, and other stakeholders, corporate speech on external policy matters brings both risks and opportunities" and that the board is "empowered to weigh these competing considerations and decide whether it is in the corporation's best interest to act (or not act)." The judge also said that "it is not for this court to question rational judgments about how promoting non-stockholder interests – be it through making a charitable contribution, paying employees higher salaries and benefits, or more general norms like promoting a particular corporate culture – ultimately promote shareholder value."

In August 2023, conservative legal organization America First Legal filed a securities suit in Florida on behalf of an investor against the retailer Target and its CEO and board of directors, saying the company misrepresented the adequacy of its risk monitoring when customer backlash over LGBTQ-themed merchandise. The investor claimed Target's board misstated its oversight of "social and political risks" to the company and that the ESG and DEI policies and the company's disclosure did not account for "the risk of backlash in the oversight and political risks to their ESG and DEI mandates." This is another example of litigation in which conservative legal groups and Republican legislators are challenging corporations that have enacted policies on environmental and social issues.

These cases show that ESG remains a politically polarized issue and companies may be hit with lawsuits alleging their policies are too progressive or not going far enough. In this environment, companies need to be able to demonstrate that they consider the sometimes competing views of their various stakeholders before they take any actions on ESG issues.

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