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

Overview

Event-driven litigation relating to ESG risks is rising with D&O exposures such as failure to act, inadequate procedures, or the potential for “greenwashing” or exaggerating ESG credentials raising concerns from investors and customers.

Directors and officers could face litigation over their failure to carry out fiduciary duties related to climate change, such as to consider the risks and opportunities, or implement risk controls. Disclosure requirements are also increasing and therefore companies must ensure correct reporting guidelines are being followed or firms risk increased regulatory exposure for failing to comply. Climate change litigation is rising with the number of cases doubling since 2015, the year the Paris Agreement was signed, according to the LSE’s Grantham Research Institute. Lawsuits have broadened from pollution events to include the failure of companies to adapt to climate change and transition to a low carbon economy, as well as relating to issues such as board diversity and human rights. Companies must also consider the ESG policies and practices of their supply chain to ensure their reputations and sustainability efforts are not compromised by the business activities of related parties.

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Introduction

Increased scrutiny from investors on companies' Environmental, Social, and Governance (ESG) credentials, such as board diversity and environmental impacts, presents greater potential Directors' and Officers' (D&O) liability exposure. Investors, employees and consumers increasingly expect companies to be actively addressing ESG considerations in their structures and operations. Those failing to address these issues may open themselves up to ESG-related litigation.

This pressure to act is coming from various stakeholders:

- **Customers** are filing class-action suits against companies they allege have made false claims about the sustainability of their products.
- **Employees** are choosing where to work based on how socially responsible prospective employers are.
- **Regulators** are seeking more detailed disclosures on the sustainability of firms, including climate-related matters and diversity & inclusion.
- **Investors** are targeting boards of directors in litigation, alleging breaches of their duty to address ESG-related threats to their organisation.

All of these threats can lead to tremendous costs for businesses and individual directors and officers.

ESG considerations for Directors and Officers

a) Climate change
Much of the litigation seen to date has been related to companies and boards failing to adequately disclose the material risks climate change presents to their organisation. Boards of directors have a vital duty to ensure corporate responsibility, which includes appropriate reporting and due diligence. Some examples include:

- Companies being sued for their direct contribution towards climate change. This is usually targeted towards companies in the energy sector but is increasingly seen as a threat to other sectors.
- Claims relating to corporates failing to disclose or misrepresenting their contribution to climate change. This exposure is concentrated in the financial and energy related sectors however other industries can also be exposed.
- Claims relating to failure to mitigate or prepare for risks associated to climate change. Failure to adapt to physical and transition risk to protect corporate value and return can lead to shareholder or derivative class action lawsuits.

In March 2022, environmental law charity ClientEarth said they were preparing legal action against the directors of Shell, in which it holds shares, over its climate transition plan. The lawsuit is seeking to hold the directors of the company personally liable for failing to prepare for the global transition to a low carbon economy. ClientEarth argue Shell's current commitments are not consistent with the Paris Agreement's aim to limit global temperature increase to 1.5C above pre-industrial levels and are alleging breach of the directors' duties under the UK Companies Act, which requires them to act in a way that promotes the company's success. This is believed to be the first example of a case that seeks to hold directors accountable for the alleged failure to prepare for the physical and transition risks associated with climate change.

Examples of climate change disclosure regulations

UK

On 29th Oct. 2021, the UK confirmed it will make it mandatory for large companies to disclose information in alignment with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD), becoming the first G20 nation to enshrine it into law. From 6 April 2022, over 1,300 of the largest UK-registered companies and financial institutions will have to disclose climate-related financial information on a mandatory basis – in line with recommendations from the TCFD. This will include many of the UK's largest traded companies, banks and insurers, as well as private companies with over 500 employees and £500 million in turnover.

EU

EU rules on non-financial reporting (NFRD) currently apply to large public-interest companies with more than 500 employees. This covers approximately 11,700 large companies/groups across the EU including: listed companies, banks, insurance companies, and other companies designated by national authorities as public-interest entities. Under Directive 2014/95/EU, large companies must publish information related to: environmental matters, social matters & treatment of employees, respect for human rights, anti-corruption & bribery, and diversity on company boards (age, gender, educational and professional background). On 21st Apr. 2021, the Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which would amend the existing reporting requirements of the NFRD. The proposal extends the scope to all large companies and all companies listed on regulated markets (except listed micro enterprises), requires the audit of reported information, introduces more detailed reporting requirements and a requirement to report according to mandatory EU sustainability reporting standards.

US

On 21st March 2022, the Securities and Exchange Commission (SEC) unveiled a proposal requiring US-listed companies to disclose their climate-related risk and greenhouse gas emissions, largely based on the TCFD and Greenhouse Gas Protocol disclosure frameworks. The proposal asks companies to disclose their own direct and indirect greenhouse gas emissions (Scope 1 and 2 emissions), as well as those generated by suppliers and partners (Scope 3 emissions) if material. Companies will have to disclose the "actual or likely material impacts" climate-related risks will have on the company's business, strategy and outlook, which could include physical risks, such as droughts, flooding and sea level rise, as well as new regulations such as a carbon tax. This proposal could become effective in December 2022 and would be gradually phased in.

Increased disclosure regulations drives consistency and transparency in reporting, however may lead to shareholder class actions or derivative actions. Adverse findings in an SEC settlement or litigation are generally binding in private litigation. When cooperating with the SEC, it's possible that some materials shown to the SEC could be produced in civil litigation.

b) Environmental disasters

Following events which impact ecologically-sensitive areas (e.g. oil spills and pollution events), boards and directors are increasingly being asked about whether there were adequate risk management processes in place to prevent these incidents and how aware they were of the possibility of them happening. Environmental disasters can lead to event-driven litigation for directors and officers and therefore it is vital that robust risk management processes are in place to prevent and respond to these incidents. The Environment Agency continues to target those at the top of the management chain for compliance failures, resulting in more investigations being opened against directors.

Environmental risk such as biodiversity degradation can also cause litigation exposure for directors and officers, if companies are seen to be negatively impacting nature through their operations.

c) Greenwashing

Greenwashing is the practice of making an unsubstantiated or misleading claim about the environmental or social status of a business or the environmental or social benefits of a product, service, technology or company practice.

Incidents of companies providing misleading information to present a more responsible public image have been subject to litigation in the US and regulators are increasingly looking at this issue. The Financial Conduct Authority has developed a set of principles to tackle concerns over false claims and the Competition and Markets Authority (CMA) has published the Green Claims Code, where it is clear that firms making green claims "must not omit or hide important information" and "must consider the full life cycle of the product". The UK government has also formally launched a new taskforce to tackle greenwashing and develop measures to support UK companies in their plans to transition to net-zero carbon emissions. Large companies and certain financial sector firms will be required to publish a transition plan from 2023. In the US, the Federal Trade Commission's (FTC) Green Guides set out federal guidance on environmental marketing, outlining which types of marketing claims the FTC might find to be deceptive or constitute "greenwashing." For example, making broad and unqualified general environmental benefit claims such as "green" or "eco-friendly".

d) Board diversity

Scrutiny on board diversity has also increased in the past few years, particularly since the Black Lives Matter (BLM) movement captured global attention in 2020. Consumers and investors now expect companies to have greater gender and racial diversity at both a board and management level.

In 2021, the Nasdaq introduced new rules around diversity listing standards, mandating Nasdaq-listed companies to have, or explain why they do not have, at least two diverse directors, including one who self-identifies as female and one who self-identifies as either an under-represented minority or LGBTQ+. In September 2020, it was made a legal requirement that publicly held companies headquartered in California must include board members of underrepresented communities, however, this was later struck down in April 2022 as it was found that the law violated the state's constitution. In the UK, the FCA is introducing board diversity targets on a 'comply or explain' basis for listed companies, with additional gender and ethnicity disclosures also being required. The targets proposed by the FCA suggest at least 40% of the board should be female, including one in a senior board position, and for one board member to be from an ethnic minority background. These regulations and disclosure requirements are subject to legal challenge, however they do highlight the increased regulatory focus on board diversity.

Board diversity issues have also been the subject of litigation. Directors of companies are increasingly being sued through shareholder derivative lawsuits in which the shareholder plaintiffs allege that board members have breached their fiduciary duties by failing to elect or appoint diverse board members. These lawsuits typically allege that the companies have misrepresented their commitment to diversity and inclusion. These lawsuits have so far fared poorly at motion to dismiss stage, however the number of cases relating to the issue of board diversity shows that public attention and pressure is mounting.

e) Supply chain and human rights

As companies continue to develop and execute their ESG strategy, it is important that they consider their entire supply chain. Companies can be exposed to supplier bad practice, such as depletion of natural resources or human rights abuses, which can negatively impact their own ESG credentials.

This is also an area where lawmakers are focusing their attention. In New York, for example, The Fashion Sustainability and Social Accountability Act has been proposed, which would require fashion retailers and manufacturers conducting business in New York, with annual revenue of $100m or more, to map 50% of their supply chains by volume across all tiers of production as well as disclose impacts such as greenhouse gas emissions, water footprint and chemical use. In February 2022, the European Commission adopted a proposal for a Directive to require companies to identify and prevent, end or mitigate adverse impacts of their activities on human rights, such as child labour and exploitation of workers.

Businesses should respect human rights and quickly move to address adverse human rights impacts with which they are involved. The responsibility to respect human rights requires businesses to avoid causing or contributing to adverse human rights impacts through their own activities, as well as preventing or mitigating adverse human rights impacts that are directly linked to their operations, products or services. This responsibility also extends to a company's business relationships. Corporations must manage these social risks through detecting, assessing and mitigating human rights and child labour risks which can be inherent in specific business transactions. As companies are taking more visible positions on how their business impacts communities and society, it is possible that litigation against the company, as well as its directors and officers, could follow if it is seen that the business's or their suppliers' practices do not align to these representations.

f) Russia Ukraine Conflict

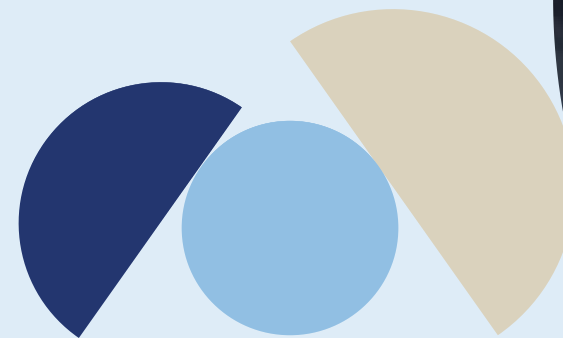
Russia's invasion of Ukraine has put greater pressure on the ESG approaches of companies and investors. As of April 2022, over 750 companies, including multinationals such as Nestlé, L'Oreal and Intel, have withdrawn or scaled back operations in Russia. The invasion has put more focus on human rights violations of investors and companies. Public tolerance for investing in a country where such violations are known to exist can lead to reputational risk. From a governance point of view, firms must ensure they are monitoring sanctions and compliance requirements of the countries in which they operate. This conflict has highlighted the need for firms to understand and manage their exposure in terms of operations, suppliers and customers in Russia, Ukraine and Belarus to effectively manage their risks in those territories. A poll carried out by the Institute of Directors found that 9 in 10 business leaders expect the Ukraine war to damage their companies through higher energy and commodity prices, impact on confidence/UK economic growth and its impact on global financial markets.

ESG issues insurers are concerned about:

- Carbon emissions/pollution/chemicals
- Emissions targets and disclosures
- Environmental groups (interaction and pressure from)
- Impacts to environment/biodiversity
- Plastics
- Child labour/Human slavery/Human rights abuses
- Health and Safety, e.g. conditions in factories/plants
- Unions
- Board and management diversity and inclusion
- Impacts on local communities
- Bribery and Corruption
- Whistleblowing
- Internal audits/committees
- Government contracts/relationships
- Sanctioned territories
- Supply chain
- Sources of materials
- Cannabis/illicit substances

Things to consider:

- Have you set sustainability targets and goals? How is management/the board overseeing progress towards achieving these goals?
- What reporting framework are you using? (e.g. SASB, GRI, TCFD, etc.). How is your ESG reporting satisfying the needs of the investment community and other stakeholders. How often are you disclosing?
- What accountabilities have you set for ESG-related performance?
- Does the company have a Chief Sustainability Officer? A Diversity and Inclusion Officer?
- Does the company have a Diversity and Inclusion Policy?
- Does the company have a Human Rights Policy?
- Have you considered what your ESG risks are? What are they and how are you managing them?
- Are you assessing the ESG credentials of your suppliers?
- What have you done to ensure that your ESG-related disclosures are reliable? Does an independent auditor have a role in your ESG reporting?
- What is the board's oversight of climate risks?

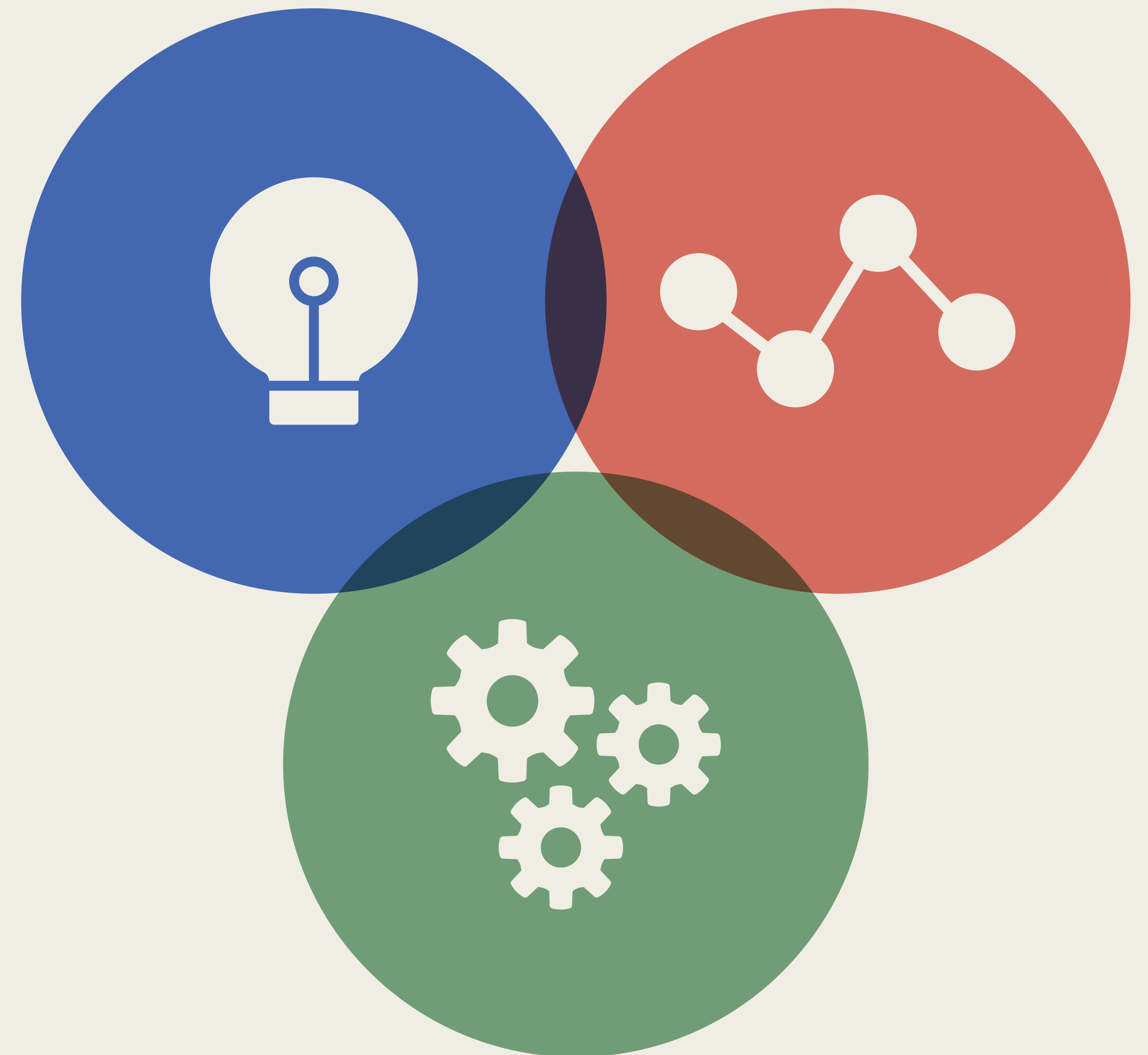


Zurich's Sustainability Position

Zurich strives to be a leader in helping the world better manage climate risk and improve resilience against it. In June 2019, we became the first insurance company to sign the Business Ambition 1.5 ˚ C Pledge and as part of this, we updated our position on some of the most carbon-intensive fossil fuels. As a founding member of the Net Zero Insurance Alliance (NZIA), we also commit to transition our underwriting portfolios to net-zero greenhouse gas (GHG) emissions by 2050. Zurich supports all sectors of the economy through our insurance and investment activities. We work with our customers, brokers and other distribution partners to ensure responsible and sustainable business practices and to protect reputations, while promoting best practices in managing environmental, social and governance risks. For example, Zurich Climate Change Resilience Services has been helping risk managers understand their first party and pollution exposures, and it is increasingly working with customers on assessing and managing their climate change risks more broadly.

Our aim is to promote international best practice standards that help ensure that potentially adverse social, environmental and economic impacts are adequately managed.

Find out more about how we integrate ESG into Zurich's business: https://www.zurich.com/en/sustainability/our-customers/esg-integration-in-insurance



Why we do it

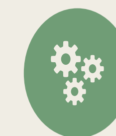
Society is **transforming**, No single actor can **solve** complex societal issues like globalisation, digitalisation or climate change alone. To help manage the **risks** and benefit from the **opportunities** they present, we must take bold **actions**.

What matters most

1. Changing climate
Actively tackling climate change as a risk and opportunity

2. Confidence in a digital society
Making people and organisations more resilient by enabling and inspiring confidence in a digital society

3. Work sustainability
Supporting our employees and customers navigating the impact of the changing nature of work



How we will do it

1. Sharpen our focus on innovative **sustainable solutions**, investments and operations
2. Develop clear **positions** on sustainability issues and stand up for what is right
3. Manage our own **exposure** to sustainability risks

Conclusion

With the focus on ESG issues increasing and questions being raised by investors and customers on the practices of companies, it is clear that directors and officers must keep up to date with evolving regulations, disclosure requirements, and sustainability concerns.

ESG issues present board level concerns:

- ESG issues should be a regular part of the board's agenda, reflecting the specific circumstances of each company.
- Boards should expedite efforts to assess their company's current ESG position. For example, they may want to consider their existing climate change related disclosures and consider ways in which they could improve existing practices to better position the company for future success as ESG issues continue to develop.
- Boards should put mechanisms in place to monitor ESG issues as they evolve, with an emphasis on assessing how the changes affect the company. For example, keeping up to date with regulatory and disclosure requirements relating to board diversity.

Directors and officers must ensure claims of their companies' environmental and social credentials are not misleading and remain accurate in order to avoid allegations of greenwashing. Firms must also monitor the ESG credentials of their suppliers and the countries in which they operate to mitigate the risk of reputational harm. ESG is in the spotlight and it is clear that stakeholders expect companies and their directors and officers to participate in the transition of the global economy to a more sustainable future.

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