Reducing ESG Litigation Risk Through Integrated Thinking

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The need for corporate purpose and the question of "why" companies do what they do is becoming ever more important. For a corporation articulating an inspiring purpose to all the stakeholders and especially to the employees is just a first step. Next comes the challenge of how to walk the talk? In a transparent environment with an ability to voice out one's observations and concerns, our employees could be our best auditors and our first line of defense. However, in reality global headlines seem to be dominated by challenges. Every day, we read of corporations facing increasing risk of litigation related to ESG and associated reputational risks.

These days, a lot of ESG litigation is climate-focused or presents itself in cases of EHS (environment, health and safety). Examples which come to mind include the investor class action suit against Brazilian mining company Vale following a deadly mining accident or the suit against Massey Energy claiming that the company had committed securities fraud by misleading the market about its safety and compliance record.

It is not just malfeasance; we are also seeing an increasing number of cases being brought over other social and governance issues — such as modern slavery in the supply chain or corporate reporting failures.[1] One such lawsuit, a child labor case brought against Nestlé and Cargill, was recently heard by the US Supreme Court and it would not be surprising if more such cases follow.

In the past, we frequently included the financial risks, such as stranded assets or the threat from divestment campaigns, in our discussions, in this article we wish to focus on another type of risk companies carry for ESG failures: namely litigation in court.

We had previously argued that integration of ESG into investment decisions is a concept that should be adopted by all asset managers when they are constructing their portfolios. We can no longer afford having ESG as an optional theme in money management industry. Now we will elaborate on litigation risk as an additional compelling reason for why ESG needs to be an integral part of an asset manager's due diligence.

As more regulators and investors start requiring companies to disclose ESG data, we will see the number of litigation cases increase. According to a report from law firm Latham and Watkins called "ESG Litigation Map", it is important to "Treat public disclosures in relation to ESG matters as seriously as those deployed in respect of financial disclosures and adopt similar processes." In the US, John Coates, the newly appointed acting director of corporation finance at SEC, spoke at a recent investor event and made it clear that ESG denialism is not on the agency's agenda. He also pointed out that lack of mandatory disclosure requirements in the United States does not rule out reputational risks. "With a growing number of institutional investors demanding ESG information from companies, these disclosures are becoming mandatory by default" he said. Further elaborating he stated that "When companies volunteer this

[1] https://www.lw.com/thoughtLeadership/ESG-litigation-roadmap

information, they are legally obliged to tell the truth, which gives regulators an opening to get involved. And I worry sometimes that the people involved in the production and consumption of those documents don't remember that."

These comments by the head of a key regulatory agency telegraph that if a company takes a very rule-based approach to organize its corporate affairs, it may no longer be sufficient. Even if your actions are legal it can still be unethical. It is no longer enough to abide by the written rules, we need to understand and act according to the spirit of the reasons for the regulations as well. Regulation covers only so much and not all the possibilities. Corporations have to be careful about how they approach corporate life because rules are constantly evolving. Also, when society finds something unacceptable and unethical, it is only a matter of time that regulations will catch up. An internal issue of an organization with its employee relations or supply chain may no longer easily go away and can easily snowball with governments and regulators getting involved.

So, what could companies do to protect themselves, explicitly against risks related to social issues and supply chains?

- One of the lessons from Sustainability Governance Scorecard©[2] by Argüden Governance Academy is that the first thing they should do is adopt a stakeholder-centric view and assume responsibility for your ecosystem. License to operate in today's world requires responsible leadership – companies who actively manage sustainability benefit both the company and the society. Reaching sustainable development goals requires setting-up a multi-layer multi-year process and requires cooperation from stakeholders. When crafting their sustainability approach, companies must move to a more stakeholder-centric model and widen their view to encompass their ecosystem and long-term impact.
- Second, it is essential that firms bring these discussions in detail to the board level and a proper oversight system is being conducted both through internal systems as well as through third party oversight. Corporations need to enhance board leadership for sustainability and the boards should understand their responsibility over the ESG efforts of their companies. This is possible through setting the right governance mechanisms, ensuring the board has the composition and skills to lead sustainability and tying executive compensation to sustainability metrics to incentivize management towards sustainable value creation in the long run.
- An additional advice for corporations is to use integrated thinking with a stakeholder encompassing approach. Organizations need to make their top-down and end-to-end value chain approach an integral part of their overall risk management. They need to set values and beliefs and then make sure that these are pushed through the organization and then review every component of the operation to make sure that it is defensible.
- Finally, it is also important that companies take additional precaution to safeguard that the ESG data they report is accurate. Organizations need to describe and provide transparency to their stakeholders on what they have achieved and how they engaged various stakeholders in this process.

For example, let's take organizations operating in the consumer sector. Auditors and third- party certifiers can play a particularly significant role for them as key stakeholders because of the independent certification they provide for their products. Similarly, brand owners such as Whole Foods certifies an important number of its products through third parties and therefore clarifies the ethical trading and the origins of some of its products to protect their own brands.

Usually, this type of vetting will reduce reputational and litigation risks, however it may increase operational expenses and raise prices of products. In that case, organizations may need to co-opt governments and regulatory agencies as their stakeholders. Governments often help businesses by leveling the playing field and they have the capacity to make things amongst corporations in the same sector more equal. In practical terms, regulation can play a role in setting new rules empowered by consumer demand and new norms which are being set by ethically correct

[2] A research of 212 Global Sustainability Leaders with respect to how they conduct governance of their sustainability efforts (https://sgscorecard.argudenacademy.org)

organizations. Through regulation and societal influence, over time these type of product certifications may become the new standards for the industry rather than an exception.

Consumers and the public are among organization's key stakeholders and they do understand that ESG trends here to stay. Therefore, this recognition of evolving environment is crucial whenever an organization is considering or reevaluating its brand. "Even if you sell the best product in the world, if your ESG practices are not up to par or best in class, then you can't inspire a lot of trust" says Kashyap Kompella, CFA, CEO of the AI industry analyst firm RPA2AI Research. "A good example is the difference in perception between some Chinese brands and European brands. Even though many furniture sellers may have similar product quality, it is difficult to beat IKEA's aspirational brand because of their strong focus on sustainability".

Finally, engaging another stakeholder group, the non-profits, can be rewarding as well. Non-profits by definition have an advantage that they don't have to worry about delivering short term financial metrics and with their local presence and expertise, they can play a role in bringing various institutions together and help shape regulations.

Another reason why it is increasingly becoming important to pay attention to NGOs, activists and similar organizations, especially for large multinationals is because large organizations are becoming NGOs' primary target in their investigations for ESG-related claims.

In conclusion:

Litigation risks are for real. Even if companies end up prevailing in these lawsuits, simply being caught up in court can hurt their reputation — and can become costly. Therefore, the key thing is to reduce the risk of any potential litigation in the first place. From a capital allocators point of view, they need to be aware of the legal issues and their impact when funding projects, investing in companies or while reviewing stocks in their portfolios.

In short, sustainability is not only a 'nice thing to do', but also a great 'risk management tool' and even a 'value creation opportunity'.