Raising the temperature

As ESG disputes against financial institutions heat up, businesses must improve their governance, risk management processes, policies and disclosures. **Anthea Bowater** and **Simon Orton** explain

ESG is an increasingly important area for financial institutions, covering a wide range of issues from climate change and environmental impact to diversity, anti-money laundering and responsible data management. Over the course of the pandemic many firms' resolve to focus on responsible business decisions and sustainable growth has strengthened. But alongside increased focus – and increased attention from financial regulators and investors, as well as disclosure obligations – comes increased risk of disputes.

Understanding the risk

Why does the increased focus on ESG lead to an increased litigation risk for financial services firms?

The increased focus on ESG is being driven by a variety of factors, including changing social and investor expectations and pressure from financial regulators. Although specific drivers vary between jurisdictions, a key theme across the UK, Europe and Asia is increased prudential and disclosure obligations for understanding, reporting on and managing ESG matters, both at a firm-wide and investor level. While the regulatory regime in the US is at the moment limited, the Biden administration has already indicated it will make changes which will likely mean closer alignment with the approach taken by the financial regulators in the UK, Europe and Asia.

Out of all the ESG risks, climate change risk has received the most attention from financial regulators, investors and activists so far as it is recognised as a potentially material financial risk. Given that the financial sector is in the unique position of being able to influence the rest of the economy by directing investment flows, activists and regulators alike see the sector as a key driver in achieving change. The pressures to achieve change, allied with the inherent uncertainties given the pace of change, create the risk of litigation.

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What are the hallmarks of ESG disputes?

Some ESG disputes are traditional in that they will be brought by shareholders or other stakeholders seeking compensation for loss. However, cases are also being brought by strategic claimants, including individuals, NGOs and other groups focused on environmental and human rights issues, and these claimants can be more interested in achieving a change in a corporate's practices than in damages. They may ask the court to make declarations that a law or duty has been breached instead, and their ideal outcome might be a settlement which includes voluntary commitments from the financial institution that a court would not necessarily be able to order.

The recent Australian case *McVeigh v REST* is a good example of strategic claimants in action. In that case the claimant, Mr McVeigh, sued the trustees of his superannuation fund for failing to provide him with information about the fund's approach to climate change, and for breaching their fiduciary investment duties by failing to take account of climate change. The case settled just before the trial last year. As part of the settlement, REST publicly acknowledged the risks of climate change to its business and agreed to incorporate management and disclosure of climate change into its business. It also agreed to work with its investee companies to encourage them to do the same, and to work with industry associations generally to promote the goals of the Paris Agreement, which arguably went further than the Court could have done.

It is also worth noting that, in some jurisdictions, claimants are using the complaints process available under the OECD Guidelines to bring ESG-related claims. Although the complaints process is not a legal process and is therefore not binding, it does tend to generate publicity and, in many cases, has resulted in settlements in which the financial institution has agreed to change its approach.

Key risk areas for financial institutions

Risks around a firm's climate risks, goals and impact – Many of the climate cases against financial institutions in recent years have focused on obtaining disclosure from firms about the climate-related risks that they are exposed to and how they manage those risks. As the regulatory environment, particularly in the UK and EU, becomes more prescriptive about disclosing climate-risks, the emphasis is likely to shift towards the detail and quality of those disclosures. Firms should also be alive to the level of scrutiny that their climate disclosures about risk and impact will be subject to, as well as any commitments they make (such as net zero commitments), as a divergence between their public statements and their practices could potentially expose them to the risk of litigation.

The way that sustainable products and investments are labelled or marketed – Greenwashing – i.e. wrongly labelling products as 'sustainable' or 'green' – is a key risk. This is a difficult area (and more challenging than it sounds) as there is a lack of consistent standards. ▶

Information on the sustainability of companies in which 'green' funds may be investing is also not consistent or readily comparable, and the market's view of what is 'green' and 'sustainable' will evolve over time. Strong product governance is critical and a defensible approach needs to be taken (and kept under review) so that sustainability credentials can be clearly justified.

Investment banking advice – Where firms provide advisory services to companies exposed to ESG risks, they may be exposed to potential liability related to that advice, for example in the context of providing advice on valuation and strategy for a sale or merger, as well as reputational risk (e.g. if a firm's mandates are inconsistent with their public statements). In addition, particularly in an area where standards and market expectations are evolving, a listed issuer's risk disclosures, including regarding ESG issues, could expose that issuer to potential claims by shareholders that such disclosures were false or misleading, and in some circumstances an issuer might look to its advisors to share any responsibility.

Decisions made by asset managers – Expectations of investors and regulators about stewardship are increasing, as well as questions about whether, and if so how, ESG issues are considered in investment decisions. Careful consideration should be given around disclosures to investors as to how ESG matters and risks are taken into account in investment processes. It remains to be seen to what extent investment decisions might be subject to criticism if they are not entirely consistent with specific disclosures and/or are out of step with the wider investment community.

Risks around diversity – Diversity is prominent on the ESG agenda, with California (both in respect of legislation and a cluster of shareholder derivative lawsuits) at the forefront of recent developments. Outside the US and in the absence of legislation or regulation, misleading disclosures about diversity policies could be a catalyst for litigation.

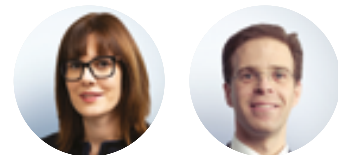
Practical points for minimising litigation risk

Various steps can be taken to mitigate these risks.

Regulators want to see financial institutions treating ESG risks seriously and working to develop their understanding and capabilities in this area

1. **Having strong governance and risk management processes** so that ESG-related issues and risks are understood at all levels of the firm, as this underpins almost all of the ways in which risk can be mitigated. It is also a key focus for the regulators, particularly in the UK and EU, and increasingly in Asia, and they want to see financial institutions treating ESG risks seriously and working to develop their understanding and capabilities in this area.
2. **Ensuring public statements on ESG-related matters are appropriate.** Any disclosures that financial institutions make will be scrutinised carefully, both from the perspective of those who will say that they are not doing enough and from the perspective of those who want to hold them to account. So, despite the pressure to be ambitious, financial institutions do need to find a balance and be comfortable that what is said reflects what is achievable in practice.
3. **Carefully managing potential reputational risk around clients involved in controversial sectors.** This means anticipating the ways in which investors and claimants might criticise an institution's overall strategy on the projects it supports or on the composition of its client base. It also means analysing the dynamics of any complaint or claim carefully – understanding what the claimants want to achieve and the right outcome for the bank from a reputational perspective.
4. **Testing policies and disclosures against changes in social expectations.** It is important to consider policies and disclosures regularly to ensure they are in line with wider expectations. This is an area where it might be worthwhile monitoring shareholder and NGO publications.
5. **Ensuring any claims to ESG-related products and services are accurate.** It is important to be very clear about why a product is labelled 'green' or 'sustainable'. That needs to be communicated very clearly to clients and kept under review, as the market's perception of what falls into those categories will develop over time. Again, this ties back into having a clear policy that enables the firm to be consistent, and benchmarking externally where possible.

Overall, we can expect to see significant developments in the way that ESG risks are considered and addressed this year – last year there was a real step change in thinking on ESG, and this year is likely to be the same.



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