CORPORATE GROUP LIABILITY AND ESG - A GOOD TIME TO REVIEW

Governance, Sustainability & Society – Part of the Horizon Scanning series

For corporate groups, addressing Environment, Social and Governance factors (ESG) successfully will require a co-ordinated effort across the whole of the group. New legislation and case law including Okpabi[1], Vedanta[2] and Maran[3], *as well as a general hardening of expectations when it comes to ESG, means now is a good time to review relevant policies and practices.*

This will help with exploiting relevant opportunities, meeting expectations of investors and other stakeholders, and managing risks - both legal and non-legal - at parent as well as subsidiary level. It also means making positive changes, and having a compelling narrative to tell that is consistent with corporate purpose.

A good time to review group-wide policies

The growing interest in ESG, the increase in climate-related claims and actions against corporates generally, and *Vedanta, Okpabi* and *Marana* in particular, mean now is an opportune time for corporate groups to review their policies, procedures and other corporate governance arrangements.

Parent companies are likely to want subsidiaries to help with each of the E, S and G:

- from an **environmental perspective**, this could mean wanting the subsidiary to help meet group targets for reducing carbon emissions (in light of the IPCC's recent report on the state of the climate and in advance of COP26) as well as reducing resource usage, embracing a circular economy business model, and improving energy efficiency. It would also mean identifying, assessing and managing risks to the group's business, and looking for how to exploit the commercial opportunities presented by climate change;

- from a **social viewpoint**, it might mean working with local communities to address their concerns, engaging with employees and workers, and looking to ensure fair pay and decent working conditions in order to improve productivity, motivation, job retention, and company reputation;

- in terms of **governance**, this means looking at policies and procedures in relation to anti-bribery and corruption (ABC), money-laundering (AML), sanctions compliance, ethics and supply chain due diligence.

In many cases, groups will have existing group-wide policies and procedures covering each of these matters on which they can build, whilst in others new policies and procedures may be needed.

The considerations for each group will be dependent on its particular circumstances, including the nature of its operations, the ESG risks associated with those operations and the

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[1] Royal Dutch Shell plc and another v Okpabi and others [2021] UKSC 3

[2] Vedanta Resources PLC and another v Lungowe and others [2019] UKSC 20

[3] Hamida Begum v Maran (UK) Limited [2021] EWCA Civ 326

countries in which it operates and may cause harm to third parties (the laws of which may well govern tortious claims brought against the parent company in England and Wales). In some cases, the advantages of having group-wide policies and procedures and other arrangements that exert control over subsidiaries may outweigh the disadvantages.

ESG risks for corporate groups

Engaging with ESG issues of course also means managing risks effectively. Pressure groups, NGOs, investors, individuals and regulators are increasingly keen to hold corporate groups to account on their ESG record. Increasing ESG-related disclosure requirements provide additional transparency but also evidence to found potential claims. The impact of this trend can be seen in the greater prevalence of ESG-related litigation across the world and the risks of disputes related to the energy transition. It means that parents will want, and need, to pay the right level of attention to the actions or inaction of their subsidiaries.

Legal liability could come in a number of forms depending of the relevant governing law, including:

- **claims for damages** relating to misleading statements or dishonest omissions by listed companies in financial statements, circulars or other announcements, brought under section 90A / Schedule 10A of the Financial Services and Markets Act 2000 (FSMA), or for misleading statements or omissions in a prospectus under section 90 of FSMA;
- **claims relating to alleged failures to address ESG issues adequately**, framed as claims for (i) breaches of directors' duties and brought via a derivative action; (ii) damages in tort (including nuisance) brought by individuals affected by the group's activities (as per the claims in *Vedanta* and *Okpabi* amongst others); and (iii) damages based on a theory of tort done to the climate, planet, the environment or a particular community as a whole (which might gain more traction in some US courts than they are likely to get in English courts);
- **criminal penalties and regulatory action** for breaching laws and regulations relating to, for example, the environment, public health, health and safety of employees, bribery and corruption, supply chain due diligence, misleading statements, climate disclosures and product labelling.

Relevance of *Vedanta*, *Okpabi and Maran*

The judgments are of relevance to UK-incorporated holding companies in multinational groups because they:

- illustrate that a parent company which exerts, or purports to exert, significant control over the operations of a subsidiary may incur a duty of care to third parties who are affected by the operations of the subsidiary;
- show that the courts are reluctant to strike out at a preliminary stage claims that could re-draw the boundaries of liability in tort and that depend on a careful analysis of all the documentary and other evidence. If a parent company cannot get such claims struck out, it may feel obliged to settle rather than face the reputational and financial risks of a full trial; and
- indicate that including provisions in contracts obliging counterparties to comply with the relevant laws, industry standards and ESG policies may not be enough to protect a corporate from a claim in tort, even when those links are at arm's length;

However, they do not include any bright-line or exhaustive guidance on when and where a parent will be under a duty of care to those impacted by their subsidiaries and suppliers.

ESG factors also pose substantial reputational risks. A perceived failure to address the issues properly could lead to allegations that, for example, the company is putting profit before people and planet; trying to "hide" harmful activities or poor behaviours in faraway locations; implicitly supporting child labour or forced labour; contributing to deforestation, pollution, climate change and other forms of environmental damage; perpetuating or supporting corrupt governments and their associates; ignoring or riding roughshod over human rights; or presenting a misleading picture of the group's ESG credentials and its efforts to address ESG issues. As a result, a company could find it more difficult to attract and retain investment, finance, employees and customers.

Recent cases like *Vedanta* and *Okpabi* (though only preliminary hearings) have highlighted the risk that a parent company may find itself liable for the (in)actions of its subsidiaries. Specifically, where it takes active steps to implement group-wide-policies and procedures or otherwise exerts a high level of control over the activities of its subsidiaries and fails to exercise an appropriate level of care when doing so, it might face liability established in tort, or under a tort-like claim, depending in the relevant governing law.

Why pushing subsidiaries away is unlikely to be effective (or desirable)

There are various reasons why it is often not feasible for a parent to successfully immunise itself against the risk of being liable to employees, members of local communities and other third parties who are adversely affected by the activities of a subsidiary. These include:

- **commercial and reputational risks** because customers, the local community and people generally tend to see a group as a single business entity controlled ultimately by the board of the parent. They are likely to hold the group as a whole, and especially the parent and its directors, "responsible" for any poor behaviour in one part of the group irrespective of the legal and governance structures in place. By the same token, a group may feel that it has to stand behind its subsidiaries, even if they take decisions that depart from the group's stated policies and procedures;

- the need to have in place suitable **systems and controls**, as required by the disclosure rules applicable to listed parent companies, or for audit and risk management purposes, or as part of good corporate governance even where not required by law. Business are likely to fall foul of these if they allow a subsidiary to be outside of their systems of control;

- **difficulty in identifying all the risks and knowing how to protect against them** as it is difficult to know what parent companies should do, and should avoid doing, in order to reduce the risk of liability completely. This is in part due to the range of situations that might arise, but also because case law like *Vedanta* and *Okpabi* does not give an exhaustive list;

- the fact that **keeping potentially incriminating information away from the parent is risky**, given that a parent company or its management could be treated as having been aware of problems with its subsidiary in the context of a claim if they should have known of them.

This is over and above the positives associated with group-wide policies and procedures that are designed to enable the parent company and its management to exert control over their subsidiaries' actions. For example, ensuring that strategy, business plans and budgets set by the parent are followed; enabling monitoring of financial and business performance; ensuring proper risk assessment and management; compliance with relevant legislation and governance codes; protecting the group's reputation; reducing tax; and attracting and retaining long-term investors, especially those concerned with ESG issues.

General principles to apply

Corporate groups should continue to have in place policies and procedures that apply across the whole group, and consider other arrangements that enable the parent company and its management to exert an appropriate level of control over the activities of all subsidiaries. However, these should be reviewed against the backdrop of *Vedanta*, *Okpabi* and *Maran*, and the sustainability/ESG agenda, to identify areas where risk could be reduced.

In practice this means parent companies:

- should review group-wide policies to ensure they do not contain any errors; reflect best practice for the sector; are consistent with other group policies; and are consistent with public statements made by the parent company;

- should expect boards of subsidiaries to be able to actually direct and manage their affairs even if the parent should expect to set strategy and take decisions that affect the group as a whole;

- might consider differentiating between group-wide risks, which the parent company is better placed to identify and manage (a top-down approach), and local / subsidiary-specific risks, which the subsidiary is likely to be better placed to identify and manage (a bottom-up approach). In some areas, both may be needed. Where there are risks that are particular to a subsidiary, or that have characteristics that are particular to a subsidiary, local management should be involved in designing and implementing policies and business practices to manage those risks;

- should be cautious of advising a subsidiary on risk matters where the subsidiary is better placed. Obtaining external advice from third-party risk consultants is one way to mitigate potential parent company liability;

- will want to come to their own balance of control vs autonomy depending on the specific circumstances of their and their subsidiaries' businesses and the countries and industries in which they operate.

Specific polices to review

ESG is wide ranging by nature, and will impact a range of parent company policies. Some key areas parent companies may want to review in light of potential litigation and other risks are:

- **Supply chains**. Parent companies will want to ensure that ESG factors are taken into account when assessing the suitability of suppliers both initially and on an ongoing basis. Parents may also want to set procurement standards to send clearer messaging to suppliers that can encourage them to invest in long-term sustainability and worker rights initiatives;

- **Human rights.** The parent should consider:

    - defining "human rights" by reference to an internationally accepted standard and commit to follow the Universal Declaration of Human Rights, the International Covenant on Civil and Political Rights, the International Covenant on Economic, Social and Cultural Rights, and the core International Labour Organization (ILO) standards, as recommend by the Workforce Disclosure Initiative;

    - identifying, at a high level, the salient human rights risk areas the group as a whole and/or a particular subsidiary may face, such as modern slavery and child labour; paying staff less than a living wage; discrimination and preventing staff joining a union;

    - identifying how the group should assess suppliers against human rights commitments, both at the procurement stage and on an ongoing basis;

    - identifying stakeholder groups that may be particularly impacted by the activities of the group or a particular subsidiary, and their value chains;

- **Employment.** There is a high risk of civil claims and reputational damage, with global media meaning an issue “over there” can quickly become a problem “right here”. Parent companies could also consider requiring employment practices and terms above and beyond local expectations.

Enforcement and accountability

Policies are all very well but consideration should also be given to appropriate dissemination, review and enforcement mechanisms. This might include checking policies are being followed on a regular basis, ingraining ESG factors into decision making and other processes like procurement, and ensuring polices are clearly written, well communicated and understood.

Conclusion

Now is a good time for parent companies to review group-wide policies, including key policies relating to supply chains, human rights and employment, and to consider the general principles that apply to corporate group liability. In doing so, parents can still take steps to minimise potential legal risk whilst promoting positive business outcomes.

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