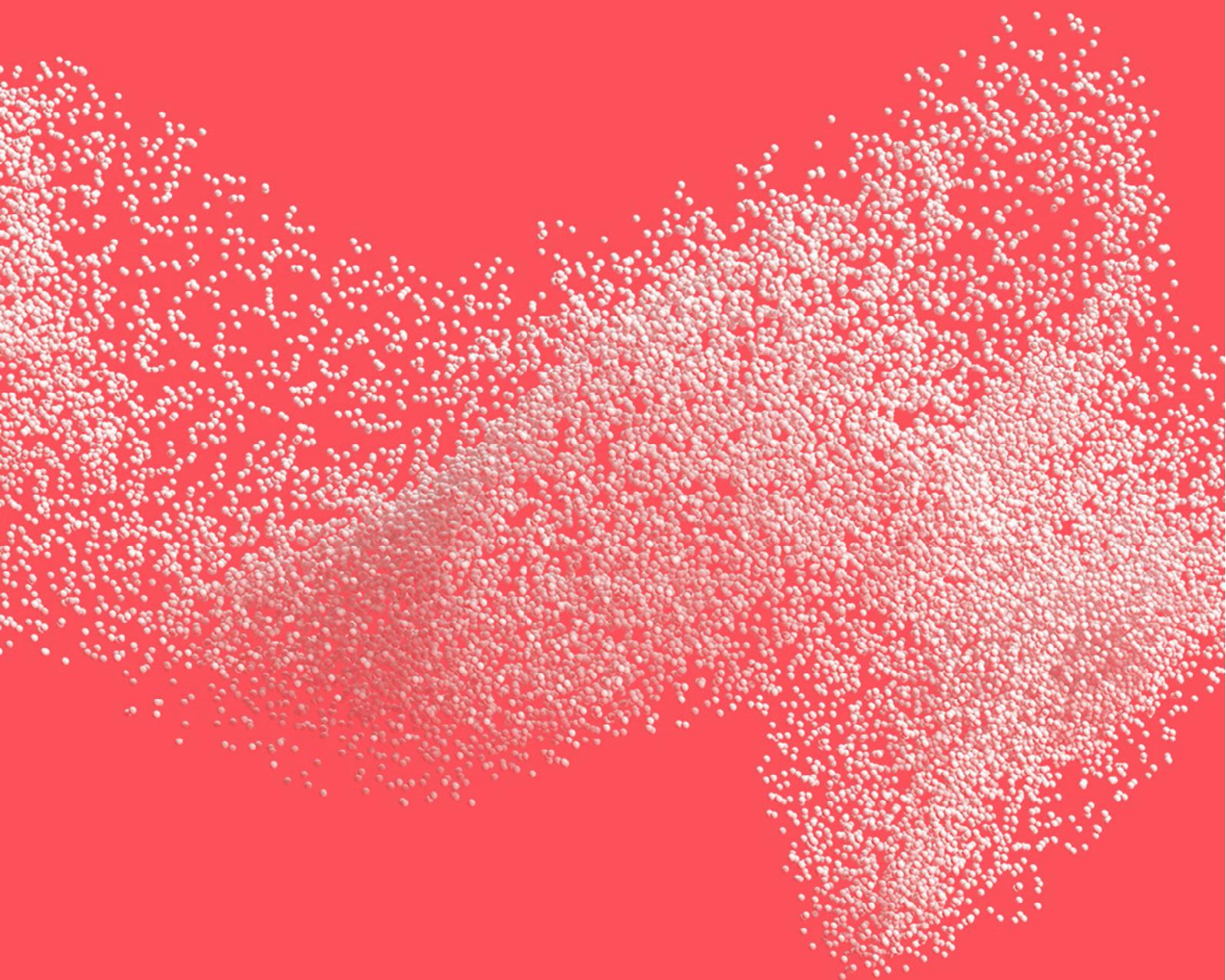


ESG: 10 considerations for UK Directors



WHAT ARE ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) FACTORS?



ENVIRONMENTAL

- climate change
- greenhouse gas emissions
- resource depletion, including water
- waste and pollution
- deforestation



SOCIAL

- working conditions, including slavery and child labour
- local communities, including indigenous communities
- conflict and humanitarian crises
- health and safety
- employee relations and diversity



GOVERNANCE

- executive pay
- bribery and corruption
- board diversity and structure
- fair tax strategy

Source: UN-backed principles for responsible investment (UNPRI)⁽¹⁾

“Global sustainable investments grew by 34% to \$30.7 trillion from 2016 to 2018, and investors who specifically integrate ESG principles into their portfolios now represent about \$17.5 trillion, up 69% from 2016. Taxonomies and definitions differ between analysts and commentators, but the sense of materiality and direction of travel is clear”⁽²⁾

(1) Table from “EU Parliament: Sustainable finance and disclosures: Bringing clarity to investors”

(2) 2018 Global Sustainable Investment Review, Global Sustainable Investment Alliance, March 2019

ESG: 10 considerations for UK Directors

The COVID-19 crisis will strengthen the ESG momentum as society re-prioritises what is most important. “We are never going back to the place we started from”⁽³⁾. We are already seeing a greater focus on the ‘S’ and the ‘G’ (whereas previously the focus was much more on the ‘E’). People are very interested in how companies treat their employees, customers and suppliers during the crisis and following it. In April 2020, Legal & General Investment Management urged companies to treat staff and suppliers well, warning that those who failed to do so would be held to account. And we are seeing governance coming into even greater focus – there is much discussion and consideration of how to govern during the crisis in terms of factors to consider, practicalities of remote decision-making etc.

ESG was already getting an ever-increasing focus due to a mixture of factors, such as changes in society’s expectations, trust in business, the viewpoint of younger people, regulation, performance and more. As a result of this crisis, the link between global risks and those companies with socially acceptable conduct and sustainable businesses is becoming more apparent.

As ESG factors continue to be a focus area for shareholders and other stakeholders, so they are a focus and opportunity for businesses. And this is both ESG relating to the actual business type and the type of investments that are made and also internal ESG – looking at how businesses themselves are operated. Regulation and pressure from stakeholders, along with moral and ethical concerns, are resulting in an ever-increasing need for all companies to embrace ESG factors fully and to communicate how they are addressing them. And this is being fuelled by evidence of ESG financial return and value.

We’ve created a top 10 checklist to help directors focus on ESG requirements. The list is not exhaustive nor is it prioritised - priorities will differ for different companies – and it is general in its application, not looking at specific sectors or business types.

This note is focused on UK directors of companies that are not FCA regulated and therefore not subject to the Senior Managers & Certification Regime. For those firms this note contains matters of broad relevance to them and to the companies in which they invest, finance or advise. It should be read alongside our other client insights such as [as Top 10 things asset managers need to know about the EU ESG initiative](#). See also our [Sustainable Financing and ESG Investment](#) feature.

We are happy to help identify and discuss individual priorities and their solutions. Please do get in touch with any of the authors of this note or your usual Simmons & Simmons contact.

See also [COVID-19: 10 corporate governance points for UK directors](#).

[What does the world look like post COVID? A scenario analysis](#)

⁽³⁾ Professor Linda Gratton, London Business School

Contents

01 P5

How do ESG factors affect your company?

02 P6

Do you need an ESG strategy?

03 P7

How does ESG impact your decision-making?

04 P9

How does climate change affect your long-term sustainable success?

05 P12

Can you show you understand the ESG impact on your shareholders/stakeholders?

06 P14

Is your board diverse enough?

07 P16

What about ESG and your workforce?

08 P18

Does ESG impact how you market your products?

09 P19

How does ESG affect your supply chain?

10 P21

How are ESG factors affecting M&A transactions?

How do ESG factors affect your company?

The ESG factors described on page 2 potentially impact companies in many different ways. These, in turn, could affect the following areas of your financial reporting:

<p>Asset valuation/impairment</p> <ul style="list-style-type: none"> • Property, plant and equipment • Intangible assets • Financial instruments • Other assets 	<p>Business model</p> <ul style="list-style-type: none"> • Processes to generate/maintain value • Resources and stakeholder relationships that support • Generating/maintaining value 	<p>Strategy</p> <ul style="list-style-type: none"> • Purpose and obligations • Objectives linked to principal risks
<p>Risks/risk management</p> <ul style="list-style-type: none"> • Principal risks • Emerging risks • Systemic risks • Internal controls 	<p>Going concern/viability</p> <ul style="list-style-type: none"> • Short, medium and long term • Link to risk management 	<p>Performance</p> <ul style="list-style-type: none"> • Provisions • Contingent liabilities • Key performance indicators

Many businesses will also be concerned with the reputational impact of being viewed as not doing enough to address their ESG risks or lagging behind peers. Reputational damage can then have a knock-on effect on your brand and your ability to attract and retain investors, employees etc. State Street reported that avoiding reputational risk drives pension funds (more than other types of institutional investor) to adopt ESG principles.⁽⁴⁾

Our view

Intangible assets such as intellectual property, customer base and brand now account for over 80% of total corporate value, compared to under 20% 40 years ago.⁽⁵⁾

ESG is clearly more than just about brand protection/enhancement. It seems to us that understanding how ESG factors affect your company is key to getting onto the front foot. In the meantime, ESG analysts are emerging, all seeking data to measure and compare companies according to an array of metrics.

(4) Into the mainstream, ESG at the Tipping Point” State Street Global Advisors – November 2019

(5) FRC publication “Corporate Culture and the Role of the Boards”

Do you need an ESG strategy?

There is increasing pressure on companies to deliver strategies that achieve long-term sustainable success, creating value not only for shareholders, but also for a wide range of other stakeholders. Companies are being guided, and in some cases expected,⁽⁶⁾ to align their purpose, values and culture with that strategy.

...“...a company cannot achieve long-term profits without embracing purpose and considering the needs of a broad range of stakeholders.”⁽⁷⁾

This pressure is coming not only from the wider society but also from investors and asset managers who are becoming increasingly vocal about how they will exercise their voting power on ESG matters. The Investment Association (IA) has warned that responding to climate change, stakeholder engagement and diversity (all ESG factors) are three of the four critical drivers of long-term value that its members will be focusing on in 2020.⁽⁸⁾

Increased regulation that is requiring investors “actively to manage” their holdings in companies and be seen to do so could also result in investors placing companies under greater pressure to explain their purpose and culture. The focus on the ESG agenda provides shareholders with another metric on which to judge boards and voice their concerns, including through voting against resolutions at general meetings. See “[UK Shareholder Activism – a new ESG environment](#)” for more information.

More companies are committing to take into account various ESG factors in their strategies and business activities. For example, 2019 saw more large international companies commit to the United Nations’ Sustainable Development Goals (SDGs) after a call to action by the United Nations. The SDGs are a set of seventeen inter-connected goals with the aim of achieving sustainable development for all countries by 2030. The SDGs relate to poverty, inequality, climate change, environmental degradation, peace and justice. But, in 2019 only 50% of the FTSE 350 (excluding investment entities) clearly outlined their “purpose” for existing beyond the single purpose of generating profit.

Our view

This shift to long-term sustainability and to companies needing to have a ‘positive impact’ means that companies need to engage and communicate their approach to ESG matters more effectively. Companies will be expected to have an ESG strategy that considers and assesses the ESG issues relevant to them and allows them to:

- address the risks and opportunities posed by those issues, including the impact they will have on their business model and strategy; and
- comply with the new ESG disclosure requirements (described below).

(6) For example, UK Corporate Governance Code 2018, Principle 1B

(7) Larry Fink, Letter to CEOs 2020

(8) IA Shareholder Priorities for 2020 – Supporting Long-Term Value in UK listed Companies, January 2020. Fourth critical driver is audit quality

How does ESG impact your decision-making?

“Where judgement is used and we have questions on the decisions reached, issuers who maintain contemporaneous and complete records of decisions and actions regarding the disclosure of inside information will find it easier to reconstruct and justify their approach”

Directors of UK companies are required to promote the success of the company for the benefit of its members as a whole, having regard to the various matters listed in s.172 Companies Act 2006. These include the likely consequences of decisions in the long term, the interests of employees, relationships with customers and suppliers, the impact of the company’s operations on the community and the environment and the company’s business reputation. This duty is not new having come into force well over 10 years ago. But, certain large companies and financial services companies⁽⁹⁾ must now also report annually on how they have had regard to those matters, when performing their duty under s.172 (**section 172(1) statement**).⁽¹⁰⁾

Also, companies (including non-UK ones) that apply the UK Corporate Governance Code 2018 (**Governance Code**)⁽¹¹⁾ are expected to:



In 2020, significant private or unlisted companies⁽¹²⁾ must make a corporate governance statement setting out which corporate governance code they have applied and how they have applied it. These companies could therefore choose to apply the Governance Code or the Wates Corporate Governance Principles or other variations⁽¹³⁾. The Wates Corporate Governance Principles also focus on a company’s purpose and meaningful engagement with the wider stakeholder group and having regard to their views when decision-making.

“Companies that fulfil their purpose and responsibilities to stakeholders reap rewards over the long-term. Companies that ignore them stumble and fail. This dynamic is becoming increasingly apparent as the public holds companies to more exacting standards. And it will continue to accelerate as millennials – today representing 35% of the workforce – express new expectations of the companies they work for, buy from, and invest in.”⁽¹⁴⁾

(9) Large companies – ones that do not qualify as medium sized for a financial year. This includes ones which meet at least two of: (i) turnover more than £36m; (ii) balance sheet more than £18m; and (iii) more than 250 employees

(10) The Companies (Miscellaneous Reporting) Regulations 2018, which apply to financial years beginning on or after 01 January 2019 (Regulations)

(11) Companies with a premium listing in the UK, (whether incorporated in the UK or elsewhere) must apply the 2018 Code for financial years beginning on or after 01 January 2019

(12) A company of significant size is one that has (i) more than 2000 employees worldwide and/or a turnover of greater than £200 million and (ii) a balance sheet greater than £2 billion

(13) Wates Corporate Governance Principles for Large Private Companies

(14) Larry Fink’s 2019 letter to CEOs

See [Structured & Systematic: the new directors' duties 's172\(1\)' statement](#) for more information.

See also [Data: our new best friend](#) and [Data: words alone are not enough](#).

Our view

The new section 172(1) statement will bring more structure to how boards deal with section 172(1) matters. They will identify and engage with stakeholders more extensively and will focus on those disclosure when making strategic decisions.

There is still no need to record in board minutes how each of the s.172(1) matters has been addressed for each decision. But, we do think that board papers and board minutes at least for principal decisions (selectively and advantageously) should refer to stakeholder considerations and other s.172(1) matters that are relevant, especially where there are conflicting priorities among them.

How does climate change affect your long-term sustainable success?

It is not possible to identify one single set of ESG risks that all businesses are facing - they depend on the nature of your business and your investors.

It is, however, hard to escape discussions on climate change and it has arguably moved to the top of the agenda for many.

“Climate Change is the defining issue of our time and we are at a defining moment.”⁽¹⁵⁾

BlackRock has stated that “climate change is invariably the top issue that clients around the world raise”⁽¹⁶⁾ with it at the moment and has said that it will not invest in companies that do not show progression in meeting climate-related risks. Investors are recognising that the risk from climate change is potentially also a risk to their investment return.

But what does this mean for your business?

For oil and gas businesses it is more obvious than for others. BP recently stated that it would be investing more in low carbon businesses and less in oil and gas over time as it seeks to become a net zero company by 2050.⁽¹⁷⁾ Pressure on those industries considered to be the most pollutive is continuing to build and other oil and gas companies likely need to follow suit.

Shareaction recently advised investors to abstain from voting on BP’s remuneration policy and to engage with the company on the need for increased transparency to ensure that executive remuneration reflects and reinforces BP’s recent net zero ambition announced in February 2020. Shareaction also advised voting against Shell’s remuneration policy and engaging with the company on the need to ensure that its remuneration policy reflects and reinforces Shell’s net-zero ambition announced in April 2020.

But all companies are now expected to be considering climate related risks - these range from the impact of extreme weather events on business operations and supply chains to changes in consumer demand.

Investors and regulators are expecting all boards to:

understand the impacts of climate change on their business

have a process in place to identify and assess the risks and changes to their business model and strategy that are needed as a result

The IA is expecting all listed companies to include a discussion (in their annual report) of the impact that climate change will have on their business and how that impact is being managed.

⁽¹⁵⁾ United Nations <https://www.un.org/en/sections/issues-depth/climate-change/>

⁽¹⁶⁾ Larry Fink, Letter to CEOs 2020

⁽¹⁷⁾ BP announcement, 12 February 2020

New energy and carbon reporting regulations⁽¹⁸⁾ require quoted companies, large private companies⁽¹⁹⁾ and limited liability partnerships to disclose emissions, energy consumption and energy efficiency in a separate energy and carbon report. This reporting can be complex for companies, particularly when reporting for the first time. The Financial Reporting Lab (linked to the FRC) has published a study on climate-related corporate reporting which seeks to provide some tips and guidance to companies and investors.⁽²⁰⁾

The UK government and UK regulators are also encouraging companies to disclose their climate change risks and opportunities in their annual reports:

Government	FRC	FCA
<ul style="list-style-type: none"> Government's actions include its expectation that all listed companies and large asset owners will disclose in line with the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFDs) recommendations by 2022. Government will publish an interim report by the end of 2020 which will include progress on implementation of the TCFD recommendations. 	<ul style="list-style-type: none"> FRC has emphasised the responsibility of UK company boards to consider their company's impact on the environment and the likely consequences of business decisions in the long term. These companies should address and, where relevant, report on the effects of climate change. FRC will monitor how companies are fulfilling their responsibilities. 	<ul style="list-style-type: none"> FCA proposals for new climate-related disclosures would require all premium listed companies to make climate-related disclosures consistent with the TCFD's recommendations or explain why not. (FCA may consult on extending this to a wider scope of issuers.) FCA is also seeking feedback on clarifications to existing disclosure obligations relating to climate and sustainability disclosures. FCA is considering how best to enhance climate-related disclosures by regulated firms, including asset managers and life insurers. A Climate Financial Risk Forum (FCA/PRA joint advisory group) is due to publish industry guidance covering climate-related disclosures, risk management, scenario analysis and innovation.
<p>(BEIS Green Finance Strategy, July 2019)</p>	<p>(FRC Statement, 2 July 2019)</p>	<p>(FCA CP 20/3, March 2020)</p>

⁽¹⁸⁾ The Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018, which apply to financial years beginning on or after 01 April 2019

⁽¹⁹⁾ This includes companies and LLPs which meet two of: (i) turnover not more than £36m; (ii) balance sheet not more than £18m; and (iii) less than 250 employees

⁽²⁰⁾ Financial Reporting Lab, "Climate related corporate reporting: where to next", October 2019

“Climate change presents a serious and wide-ranging threat to global economic prospects, society more broadly and our natural environment. The changes we propose will help to provide the transparency the market needs to be able to assess how well companies are adjusting to the risks of climate change. Improved disclosures will support better asset pricing and enable investors to make more informed choices about where to allocate their capital – which will ultimately support the transition to a low carbon economy.”⁽²¹⁾

Our view

Climate-related disclosures are assuming such importance to investors, other stakeholders and society that their impact becomes, we think, an integral and critical part of a company’s ESG strategy. As transparency and non-financial disclosures become ever more specific, ESG analysts will produce increasingly sophisticated data highlighting the strengths and weaknesses of individual company approaches.

Can you show you understand the ESG impact on your shareholders/stakeholders?

Institutional investors and asset managers are also facing greater scrutiny and are expected to have an increasing level of engagement about ESG matters with the companies that they invest in.

SRD II

The Shareholder Rights Directive II (**SRD II**) amended the Shareholder Rights Directive to strengthen shareholder engagement and increase transparency. One of the key changes introduced is that institutional investors and asset managers must develop engagement and voting policies and annually disclose those policies, how they have implemented them and how they have cast their votes. This includes disclosure of how they monitor investee companies on their social and environmental impact.

2020 Code

The UK Stewardship Code 2020 ("**2020 Code**")⁽²²⁾ has also been updated both generally and to reflect the SRD II amendments. Whilst the 2020 Code continues to be voluntary, regulated firms will be required to disclose on their websites whether or not they commit to the 2020 Code.⁽²³⁾

The 2020 Code sets substantially higher expectations for investor stewardship policy and practice. Key changes include:

- defining stewardship as “the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the environment and society”;
- extending its scope to cover asset owners (such as pensions funds and insurance companies) and service providers as well as asset managers;
- reporting annually on stewardship activities and what the outcome was;
- recognising the importance of ESG factors; signatories must take ESG factors into account in all stewardship activities and ensure investment decisions are aligned with clients’ needs;
- requiring signatories to explain how they exercised stewardship across all asset classes (not just listed equity). Other asset classes include fixed income, private equity and infrastructure and investments outside the UK; and
- requiring signatories to explain their organisation’s purpose, investment beliefs, strategy and culture and how their governance, resourcing and staff incentives help with them. This aligns the 2020 Code with the Governance Code.

⁽²²⁾ Applies in respect of reporting years beginning after 01 January 2020

⁽²³⁾ COBS 2.2.3

The IA's recent figures show that investment managers are holding companies to account: 158 FTSE companies were added to the IA's public register in 2019, and a quarter of those were for pay-related resolutions. The IA's register (the world's first of its type) tracks when there is a vote of at least 20% against a resolution at an AGM or general meeting. ⁽²⁴⁾

Our view

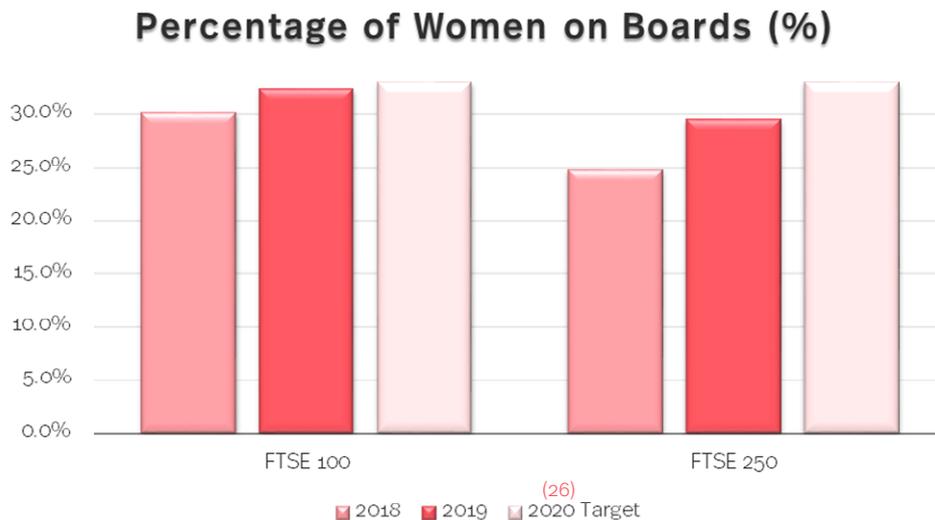
Investors wanting to be among the first signatories to the 2020 Code need to file their first stewardship report, for their financial year beginning on or after 01 January 2020, by 31 March 2021. This means that they will need to have policies and processes in place at the start of that financial year. The effect, we think, is a fundamental change in which investors will increasingly adopt ESG investment considerations as normal, even outside ESG specific funds. This will flow into index-based funds as their managers seek to engage individual companies within an index because multiple companies or sectors within an index are also exposed to climate change and other macro ESG risks.

⁽²⁴⁾ IA announcement, 20 February 2020

Is your board diverse enough?

Diversity on boards will be top of the agenda for listed companies in 2020 as companies are expected to have achieved the Hampton-Alexander targets by the end of this year⁽²⁵⁾.

Whilst all FTSE 100 boards have now met the target of 33% women on the board, not all FTSE 250 companies have done so. And there is still a way to go before female representation at executive director level and in other senior leadership roles hits the targets.



Diversity is also another key area of focus for IA members in 2020⁽²⁷⁾. The IA has said that their Institutional Voting Information Service (IVIS) will:

‘red top’⁽²⁸⁾ any company where:

- women represent 20% or less of the board;
- there is one or less women on the board (unless the one third target is met, that is, it is a board of three directors); or
- women represent 20% or less of the executive committees and their direct reports.

“amber top”⁽²⁹⁾ any FTSE small cap companies where:

- women represent 25% or less of the board;
- there is one or less women on the board (unless the one third target is met); or
- women represent 25% or less of the membership of executive committees and their direct reports.

The IA has also announced⁽³⁰⁾ that it has written to nearly a fifth of FTSE 350 companies asking them to explain how they intend to improve the gender balance in their leadership teams and meet the Hampton-Alexander targets of 33% women on their board and in their senior leadership teams by the end of 2020.

⁽²⁵⁾ Hampton-Alexander Review Report, November 2018

⁽²⁶⁾ Compiled from data in the Fourth Hampton-Alexander Review Report

⁽²⁷⁾ IA Shareholders Priorities for 2020 – Supporting Long-Term Value in UK listed Companies, January 2020

⁽²⁸⁾ A ‘red top’ is IVIS’s strongest level of concern and is used to highlight a breach of best practice or IA guidelines

⁽²⁹⁾ An “amber top” is used by IVIS to raise awareness of areas which require significant shareholder judgement

⁽³⁰⁾ IA announcement, 29 February 2020

Companies face increasing scrutiny of their plans to address any lack of female representation, not only at board level but also throughout the organisation and to demonstrate a diverse pipeline of talent. Listed companies must report in 2020 (for financial years beginning on or after 01 January 2019) on:

- how they plan to develop a diverse pipeline;
- their policy on diversity and (our emphasis) inclusion, their objectives and linkage to company strategy; how the policy has been implemented and progress in achieving the objectives; and
- the gender balance in the executive or first layer of management below board level and their direct reports.⁽³¹⁾

This is on top of their existing diversity disclosure obligations.

See “[Move over John \(and David, Ian, Mark and Andrew\)](#)” for more information.

Our view

Whilst listed companies are setting the tone, due to increasing stakeholder pressure and extensive evidence of companies with diverse management having improved profits, diversity is an issue for all companies. And that is diversity at both board level and in the senior management pipeline.

But, diversity is not just women. Companies should also be placing greater emphasis on social and ethnic diversity and planning how they can achieve the ethnic diversity targets set in the Parker Review report.⁽³²⁾

Diversity also includes neuro diversity and there is a respectable view that ESG affects the skills a board needs to have and the diversity of thought and approach it takes.

⁽³¹⁾ UK Corporate Governance Coder 2018

⁽³²⁾ Updated report from the Parker Review “*Ethnic Diversity Enriching Business Leadership*”, February 2020

What about ESG and your workforce?

Alongside the increased pressure for companies to deliver long-term sustainable success and value, there is a growing emphasis on companies to provide:

- greater transparency and alignment between executives' remuneration and pension contributions with those of the workforce; and
- greater and more effective engagement with the workforce.

This push has been stimulated by the Regulations,⁽³³⁾ the IA's Principles of Remuneration⁽³⁴⁾ and the Governance Code's expectation that pension contributions for executive directors should be aligned with those of the majority of the workforce.

In 2020, IA members expect :

- remuneration committees to set out credible plans to reduce pension contributions of all executive directors so that they are aligned with the level of contributions received by the majority of the workforce by the end of 2022. And, it will advise its members to vote against companies that do not comply.⁽³⁵⁾ To ensure transparency, companies are expected to disclose, in their remuneration reports, the pension contribution rate that they consider is given to the majority of the workforce. The impact of these expectations has
- already seen a number of UK listed banks announce that they will make significant reductions in executive pension contributions; and⁽³⁶⁾
- executive directors' base pay to be aligned to the rate of increase given to the majority of the company's workforce. We consider that the IA means that, like pension contributions, base pay increases need to be arithmetically aligned (that is, at the same percentage rate).

In addition to executive remuneration, the Code and the Regulations have placed greater emphasis on workforce engagement. For instance, UK incorporated companies with more than 250 UK employees must include a summary (in their directors' report) of how the directors have engaged with employees.

The Code suggests the following ways in which companies can engage with the workforce:

- a designated non-executive director;
- a formal workforce advisory panel; and/or
- a director appointed from the workforce.

Companies must explain in their annual report what alternative arrangements are in place if they choose not to adopt one of these methods.

⁽³³⁾ A UK incorporated quoted company with more than 250 UK employees must publish the ratio of the CEO's total remuneration to the median (50th), 25th and 75th percentile of the full-time equivalent remuneration of the company's UK employees, together with certain supporting information for financial years

⁽³⁴⁾ IA Principles of Remuneration, November 2019 and a letter to the remuneration committee chairs of FTSE 350 companies, 13 November 2019

⁽³⁵⁾ IA Guidelines on pension contributions (September 2019)

⁽³⁶⁾ For example, Standard Chartered did so after a substantial number of shareholders protested against the bank's proposed executive pension contributions following a change in policy calculations

And, according to a recent report on workforce reporting, this reporting needs to improve to meet investor needs and reflect modern-day workforces. The report provides practical guidance and examples of how companies can provide improved information to investors and it encourages companies to think of the workforce as a strategic asset and explain how it is invested in, underpinned by data on the composition, engagement, retention and diversity of the workforce. ⁽³⁷⁾

Under the Wates Corporate Governance Principles, large private companies should be looking to foster effective stakeholder relationships aligned to the company's purpose. The board is then responsible for overseeing meaningful engagement with stakeholders, including the workforce, while having regard to employees' views when decision making.

Even so, the importance of workforce engagement goes beyond mere regulatory obligations; it is having a wider impact on several areas, such as whether there are suitable opportunities for development in the workforce, adequate mental health and behavioural policies in place and open forums for employees to raise issues with management.

Our view

The Governance Code deliberately uses the broad concept of the workforce so that it also includes contractors and temporary and agency workers. Going forwards we expect increasing focus on the rights of workers, not just employees. And, we expect over time companies to develop increasing sophistication in not just hearing the workforce voice, but also taking it into account in board decision-making and improving the effectiveness of two-way communication.

Does ESG impact how you market your products?

Companies are also likely to come under pressure to produce ‘greener’ products. But, companies need to ensure that any “green” statements they make, whether in their annual reports or general marketing materials, are accurate, consistent and not misleading. Where companies are selling “green products” they run the risk of mis-selling claims based on “greenwashing” of those products (that is, seeking to gain an unfair competitive advantage by overstating or over emphasising the extent to which their product or business is aligned with ESG objectives). Where a company’s products form part of a customer’s supply chain they can likely expect increased scrutiny from the next up and higher in the supply chain and from the ultimate customer as it seeks to flow ESG requirements down through its supply chain. See also “How does ESG affect your supply chain?”

Although ever more “green” products are being developed, there is currently considerable uncertainty around the criteria by which those products qualify as socially responsible or ethical.

In Europe, the EU’s Sustainable Finance Action Plan, aims to create a unified EU ‘green classification system’. This includes disclosure and benchmark regulations and a taxonomy to determine to what extent an economic activity can be described as “environmentally sustainable”. These standards and requirements are expected to underpin any approaches taken in the UK.

See our [“Sustainable Finance and ESG Investment”](#) feature for more information.

Our view

We suggest companies look at the proposed EU taxonomy to see how their activities could be classified. Non-governmental organisations, disaffected employees and others will not be slow to highlight ‘greenwashing’ using social media and exposing companies (fairly or unfairly) to significant reputational and even litigation risk.

How does ESG affect your supply chain?

Bribery Act 2010

Companies already assume legal risk for elements of their supply chain under the Bribery Act 2010. UK companies (or those carrying on business in the UK, including international ones) can be liable for bribery and corruption by their service providers.

Modern Slavery

And, the Modern Slavery Act 2015 requires those companies which are ‘large’ enough⁽³⁸⁾ to publish annual modern slavery statements explaining the steps taken to eradicate slavery and human trafficking in their businesses and supply chains.

Social policies

Certain large companies and qualifying partnerships must already, to the extent necessary for an understanding of the company’s development, performance and position and the impact of its activity, disclose:

- their policies on environmental matters, their employees, social matters, respect for human rights, and anti-corruption and anti-bribery matters;
- the due diligence processes supporting those policies; and
- the outcome of those policies.⁽³⁹⁾

Transparency and the media bring reputational risk right the way down through a supply chain, end to end. The media doesn’t perhaps care so much where in the supply chain child labour is being used (allegedly), but it and society care deeply that any company’s products or services involve child labour or other forms of modern slavery or human rights abuses.

The likely policy direction of travel is, we think, towards modern slavery reporting on a single date and in a common form (to enable comparisons between businesses more readily) and with more mandatory content.

UK-headquartered multinational companies face the increased risk that non-UK claimants may be able to bring claims against them in the English courts for the overseas acts of their non-UK subsidiaries. There is an increasing trend for these claims, particularly in relation to environmental and human rights issues. A recent case⁽⁴⁰⁾ confirmed that a duty of care can exist between a parent company and third parties affected by the operations of its subsidiaries. This adds pressure to multinationals to manage risks effectively across their corporate groups and supply chains. A failure to mitigate these risks could create legal liability for multinational parent companies, result in litigation and cause significant harm to the reputation and brand of the wider corporate group.

⁽³⁸⁾ Any commercial organisation which supplies goods or services and (with its subsidiary undertakings) has a total turnover of £36m or more in a financial year

⁽³⁹⁾ The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016

⁽⁴⁰⁾ Verdanta Resources PLC and others v Lungowe and others [2019] UKSC 20

Over time, there may though be opportunities for companies to access “sustainable” supply chain finance which meets ESG criteria as a means of attracting ESG focused finance and investors.

See “[Modern slavery statements – a faster race to the top?](#)” and our “[Sustainable Financing and ESG Investment](#)” feature for more information.

Our view

Much of this is not new. What is new is that the increasing prominence of ESG is bringing with it greater (relatively) legal and reputational risk, more narrative reporting and more requests for ESG information/data. For directors it therefore heightens the importance of:

- the flow down of contractual protections such as rights to terminate and to audit/inspect/obtain information down a supply chain and not necessarily only to the first tier; and
- carrying out due diligence on supply chain providers, having policies for their selection and clearly establishing high standards of business conduct and generally being alert to reputational risk through suppliers.

How are ESG factors affecting M&A transactions?

ESG is starting to play a more significant role in M&A. This is from two perspectives – it will be a driver for M&A and will also impact the general M&A process.

Businesses may seek to improve their ESG credentials through acquisition or disposal. Businesses may also seek to buy in ESG capability where they find it difficult to develop substantive ESG capability organically. And, we are seeing this happening already in the market.

ESG will increasingly feature in many aspects of the M&A process and directors will need to be very alive to this. And there will be overlaps between the ESG impact and the COVID-19 impact on M&A.

Considering targets

At the outset, when looking at targets, reputational risk is obviously a key consideration and a target's ESG standing will be a very relevant factor here. ESG will have an influence on valuations, with the assessment needing to be more future looking – valuations may need to take into account any ESG actions or remedial steps which need to be taken after completion, not necessarily even in the short term and may need to consider the impact of ESG pressure on revenue streams in the future.

Deal terms

We are seeing more warranty protection being sought in relation to ESG matters and this is only set to increase. It will be interesting to see how the W&I insurance community will approach the ever-increasing ESG warranties – drawing a parallel with regulatory operational warranties. These are notoriously difficult to insure given they require operational due diligence (albeit that the consequences of a regulatory breach are likely to have a more significant immediate financial impact than an ESG warranty breach). Certain sellers are also starting to seek undertakings from buyers relating to the operation of the target post completion, to protect against seller reputational damage.

Due diligence

Buyers will need to pay more attention to the E, the S and the G during the process – so they will need to review the governance of a target, its supply chain, its diversity, its people policies and procedures, its environmental impact, its tax structuring, to name just a few – this is more than just looking at the policies that are in place, it will require an assessment of how things operate in practice and the effectiveness of those policies.

Funding

As financial institutions pay more attention to the environment in particular, there is the potential for banks to cease financing entities with exposure to “unacceptable products”, such as fossil fuels, as they move towards more climate friendly companies. In 2019, the Principles for Responsible Banking were launched to assist banks in aligning their business strategies with the goals set out in the UN Sustainable Development Goals. Over time, we expect more finance or more favourable finance only to be available to borrowers that can meet at the outset (and on a continuing basis) ESG criteria.

Our view

ESG is clearly no longer a “nice to have” or a “soft issue” and as pressure grows, fuelled by regulations, increased stakeholder pressure and increased and more established ESG financial returns, it will become an issue more and more at the front and centre of the M&A process, across all sectors and all geographies. And this will be further fuelled by the COVID-19 crisis.

See [COVID-19 impact: M&A and other corporate transactions](#).

Contact details

Edward Baker

Partner

T +44 20 7825 4062

edward.baker@simmons-simmons.com

Patrick Boyd

Partner

T +44 20 7825 3037

patrick.boyd@simmons-simmons.com

Sally Childs

Supervising Associate

T +44 20 7825 3801

sally.childs@simmons-simmons.com

Charles Mayo

Senior Advisor

T +44 20 7825 4410

charles.mayo@simmons-simmons.com

Ania Rontaler

Partner

T +44 20 7825 3052

ania.rontaler@simmons-simmons.com

Jo Weston

Partner

T +44 20 7825 4558

jo.weston@simmons-simmons.com

For additional information on our firm, please visit our website at [simmons-simmons.com](https://www.simmons-simmons.com).

© Simmons & Simmons LLP and its licensors. All rights asserted and reserved. This document is for general guidance only. It does not contain definitive advice.

Simmons & Simmons LLP is a limited liability partnership registered in England & Wales with number OC352713 and with its registered office at CityPoint, One Ropemaker Street, London EC2Y 9SS, United Kingdom. It is authorised and regulated by the Solicitors Regulation Authority and its SRA ID number is 533587. The word "partner" refers to a member of Simmons & Simmons LLP or one of its affiliates, or an employee or consultant with equivalent standing and qualifications. A list of members and other partners together with their professional qualifications is available for inspection at the above address.

46008857