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ESG Mid-Year Review: Key Trends in 2023 Thus Far

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Further Developments in the Green Energy Transition

- The green energy transition continues to be a focus following the invasion of Ukraine.
- Enactment of the Inflation Reduction Act in the U.S. has led the EU to respond with the Green Deal Industrial Plan and the U.K. has outlined its own strategy to compete against the U.S. for clean energy and climate-related projects.

Almost a year and a half on from Russia's invasion of Ukraine, the dependence of many countries on Russian oil and gas continues to be apparent. Policymakers continue to seek alternative energy sources to combat this reliance, creating strong incentives to fast track renewable energy deployment.

Scaling up renewable energy projects will require considerable funding. Transmission improvements alone will entail an estimated investment of $12 trillion by 2050, equal to 30% of all investment required for the energy transition. Given the need for such investment, governments have leaned toward creating financial incentives for the private sector rather than relying primarily on direct government investment, beginning in the U.S. with the Inflation Reduction Act (U.S. IRA).

Alongside a number of other proposals, the U.S. IRA earmarked $369 billion for clean energy and climate-related projects, seeking to attract both domestic and foreign companies to establish green energy businesses in the U.S. This has resulted in a boom in green energy investments in the U.S., with Europe and the U.K. hurrying to match these incentives to prevent the loss of renewable businesses.

In response, the European Union (EU) set out proposals to compete with the U.S. IRA. The two main aspects are a relaxation of EU state aid rules and the Green Deal Industrial Plan (GDIP). First presented on February 1, 2023, the GDIP aims to provide support to scale up the EU's manufacturing capacity for net-zero technologies and further relaxes state aid rules by means of making additional tax benefits available. The GDIP also proposed a number of new pieces of legislation to encourage the scaling up of clean energy, including the Net-Zero Industry Act (NZIA), which aims to bolster the EU's renewables manufacturing capacity and strengthen its energy resilience.

In March, the U.K. government released "Powering Up Britain," a paper setting out its strategy for the transition to net zero. The U.K. seeks to match the opportunities and incentives being offered in the U.S. and the EU.

Despite these commitments to green technology, over 1,000 oil and gas projects are expected to commence operations in North America and Europe in the period 2023-27, and a considerable number of these will be new projects rather than building on existing facilities.[1]

Although activists see this as a step backward, the ongoing development of new projects alongside the push for green energy may offer a more realistic roadmap to the green energy transition, given the need to continue to meet demand while green energy providers seek to resolve supply chain issues.

Executive Remuneration in the UK

- Executive remuneration is on the rise, despite continuing economic uncertainty.
- Discussions of pay disparity between the U.S. and elsewhere are more nuanced that they may initially seem.
- The incorporation of ESG metrics into incentive arrangements remains a priority for investors.

In our February 2023 article, we discussed the ongoing scrutiny that U.K.-listed companies face regarding executive pay practices. Despite investor guidance continuing to call for restraint in executive remuneration, director compensation appears to have increased to beyond pre-pandemic levels. The Investment Association highlighted in its 2023 Principles of Remuneration that remuneration committees should be mindful of the current cost-of-living crisis, the inflationary environment and continuing economic uncertainty in determining 2022 pay outcomes and setting 2023 remuneration policies. Yet, the median FTSE 100 chief executive's pay rose by a sharp 12% in 2022, and the ratio of CEO pay to median employee pay widened from 76:1 in 2021 to 80:1 in 2022.[2]

Executive remuneration has also been a key factor in recent discussions on how to reinvigorate U.K. capital markets, given the differences in U.S. and U.K. incentives. Although remuneration packages initially do appear higher in the U.S. than in the U.K., the reality is more complex and nuanced than the media portrays and for both executives and companies alike, remuneration is just one of a number of factors considered in decisions on where to work or list. See our June 12, 2023, article, "Are U.K.-Listed Companies Paying the Price for Executive Talent?"

How the culture and approach in the U.K. toward executive compensation will develop remains to be seen. The debate continues following London Stock Exchange Group plc CEO Julia Hoggett's recent comments suggesting that executive compensation at U.K. companies may need to be increased in order to attract and retain executives and that broader, systemic reforms may be needed for the U.K. capital markets industry.

Many investors see incorporating ESG metrics into incentive arrangements as a priority and believe that any ESG measures must be objectively measurable to be meaningful.

The Financial Reporting Council (FRC), which regulates auditors and sets the U.K.'s Corporate Governance and Stewardship Codes, recently published a consultation paper for proposed revisions to the governance code. A new proposed "Principle P" highlights the importance of clearly aligning remuneration outcomes to company performance and purpose, and specifically mentions ESG objectives. This supports the argument that linking remuneration to ESG outcomes is moving from being a "nice to have" toward a necessity. A Willis Towers Watson's global study found that ESG metrics are now used by over three-quarters of companies when determining executive compensation, ranging from approximately 69% in the U.S. to approximately 90% in Europe and the U.K.

While broader stakeholder issues, including ESG considerations, continue to receive focus in remuneration, maximizing shareholder value creation is still the key objective for most companies and financial metrics remain the most prominent incentive tool for executive pay programmes. ESG metrics typically have an aggregate weighting of approximately 20% and companies will need to ensure that these ESG performance conditions are not used to guarantee or inflate vesting outcomes in an absence of appropriate performance, especially if U.K. investors become more open to more generous compensation packages in the future. ESG targets must be ambitious and not just reward "business as usual" activity if they are to avoid claims of greenwashing and truly incentivize management to pursue the company's ESG agenda.

ESG Litigation and Activist Pressure

- Climate litigation against regulators is on the rise across the globe.
- So far, derivative suits have not fared well in the courts.
- The European Court of Human Rights is hearing a case on the climate crisis for the first time.
- ESG litigation can carry risks not just for companies, but in some cases for activists who bring them.
- Though shareholder activism against oil and gas companies continues, it received less support this proxy season.

Though ESG litigation has previously focused on companies, this year has seen a large number of claims against regulatory authorities and governments across Europe. Recent examples include:

- In the U.K., the Financial Conduct Authority (FCA) is facing a potential judicial review of its decision to approve a prospectus that allegedly failed to make adequate disclosures about climate-related risks, and specifically that the prospectus did not explain how climate change risks affect the business of the company. The judicial review can only be pursued if the English High Court grants permission, but the complaint may serve to cast a spotlight on the FCA's consideration of prospectuses and to heighten the attention on climate-related disclosures.
- The European Court of Human Rights (ECtHR) has heard a case alleging that the Swiss government's failure to sufficiently reduce the country's greenhouse gas emissions violated human rights to life and health by causing more frequent and intense heat waves. This will be the first time that the ECtHR has decided a case related to the climate crisis, and its decision will be noteworthy for showing how human rights will be interpreted with reference to climate change.
- The International Court of Justice (ICJ) has been asked by the United Nations (U.N.) General Assembly to give an advisory opinion on the obligations of states with regards to climate change, with a focus on human rights and civil, political and social rights.
- Two challenges have been brought in the ICJ to the EU's decision to label nuclear and natural gas investments as sustainable under the EU Taxonomy Regulation if they fulfil certain criteria.

The common thread is that governments are being challenged not only on their current and prospective policies, but also on how they tackled climate issues in the past. Companies need, therefore, to be prepared for increased government scrutiny — even for events that may have occurred several years ago.

In comparison, as predicted in our December 2022 article "The Evolving Climates in the U.S. and U.K. for Environmental Damage Claims," derivative claims as a tool for climate activists to apply pressure on companies in the U.K. have not gained much traction. There are several hurdles to the courts permitting such claims to be heard, as evidenced in the leading case to date, *Client Earth v Shell*,[3] where the English High Court found this year that:

- There was no *prima facie* case for permission to be granted for a claim alleging that an oil company's directors' emission reduction targets are inadequate.
- The autonomy of the directors' decision-making should be emphasized and insufficient evidence was adduced to indicate that the directors had no reasonable basis for reaching the policy decisions.
- Client Earth had an ulterior motive in bringing the claim — to advance its own policy agenda — rather than to promote the success of the company, which is the goal of derivative claims. The court also noted that the overwhelming majority of the company's shareholders were supportive of its policies.

However, in the U.S. companies are facing increasing challenges from shareholders. As explored in more detail in our June 2023 article "Companies Face Increasing Scrutiny Over Their ESG Disclosures — Including by ESG Critics," shareholders have continued to file derivative and securities lawsuits alleging that companies have not lived up to their stated commitments to environmental and diversity goals. But, while initial suits in the U.S. challenging the accuracy of disclosures about corporate commitments to diversity have generally been dismissed, shareholders remain undeterred and have resorted to requesting access to corporate books and records, including board materials, under Section 220 of the Delaware General Corporation Law in hopes of gathering information to help bolster claims in amended complaints.

In addition to the scrutiny companies face from shareholders, the U.S. Securities and Exchange Commission (SEC) has proposed rules that would require detailed ESG disclosures and, while those proposals are pending, the agency has brought a number of enforcement actions challenging companies' ESG-related disclosures and initiatives.

Alongside these pressures for more robust ESG policies and disclosures, U.S. companies are also contending with countervailing forces in the form of state officials seeking to restrain ESG initiatives, as discussed below in the "ESG Backlash in the U.S." section.

It should be noted that ESG litigation is not without risk for the plaintiff. A French oil company is challenging assertions by an environmental NGO that its greenhouse gas emissions have been underestimated. The company is seeking withdrawal of the published assertions and asking that a penalty be imposed on the NGO and its supporting consultants. Where companies believe that allegations are misleading or exaggerated, they may go beyond a robust defense and actively seek vindication.

In addition to increasing litigation, climate activists have continued to utilize shareholder resolutions to challenge energy companies during the annual general meeting season. The goals of the resolutions ranged from seeking to alter internal climate policies to implementing stricter emissions standards.

Despite these efforts, most resolutions failed to gain widespread support this year and have not been implemented. For instance, support for a resolution proposed by Follow This at Shell's annual meeting fell to 20% from 30% in 2022, and the proxy advisory firm Institutional Shareholder Services recommended that investors vote against the measure.

Although ESG activism remains focused on the oil and gas sector, the introduction of climate disclosure requirements in a number of jurisdictions may result in activists exploring targets in other industries.

Competition Issues

- The EC has published revised guidelines on agreements among competitors to pursue sustainability initiatives.
- The U.K.'s Competition and Markets Authority is consulting on its own proposed guidance, which allows more latitude than the EU's approach.
- In contrast, in the U.S., competition concerns on climate-related business collaborations continue to be raised.

The debate on the role of antitrust in tackling climate change has continued to develop, with the publication of antitrust guidance on collaborative sustainability initiatives in both the EU and U.K. in the first half of 2023. This guidance is designed to help businesses seeking to work together on sustainability initiatives by providing greater clarity on how to assess these projects under competition laws.

The EC's revised horizontal guidelines, which include a new section on the assessment of agreements that pursue sustainability initiatives, were adopted on June 1, 2023, and will enter into force following their publication in the Official Journal of the EU. Now that the EC's guidelines have been finalized, the Dutch Authority for Consumers and Markets has announced that it will bring its own, more expansive, draft guidelines on sustainability agreements in line with the EC's.

In the U.K., the Competition and Markets Authority (CMA) issued for consultation draft guidance on environmental sustainability agreements on February 28, 2023. The CMA has diverged from the EC's approach and proposed a broader interpretation of the exemption criteria for climate change agreements, framing these developments as a post-Brexit dividend.

Meanwhile, in the U.S., competition concerns continue to be raised about business collaborations designed to help reduce GHG emissions and advance the implementation of the Paris Agreement on Climate Change. In May 2023, a group of 23 Republican state attorneys general sent a critical letter to the U.N.-convened Net-Zero Insurance Alliance, suggesting that this collaboration may violate U.S. federal antitrust laws and certain state laws. Several insurers have since withdrawn from the alliance.

The potential for competition authorities to take divergent views on the legality of industry ESG initiatives is likely to result in companies continuing to take a cautious approach, particularly on cross-border ESG projects.

Combatting Greenwashing

- The EC has published its proposed common criteria targeting greenwashing regarding products and services, and the U.K. FCA's anti-greenwashing rules will come into effect during the third quarter of 2023.
- The ESAs have published reports on the progress on greenwashing in the financial sector, identifying key greenwashing risks.

In March 2023, the EC published its proposed criteria aimed at limiting greenwashing and misleading environmental claims. The Green Claims Directive proposal aims to provide consumers with better quality information to choose environment-friendly products and services. Under the proposal, "green claims" made by companies will need to be independently verified and proven with scientific evidence before being communicated to consumers. Furthermore, the rules are also designed to ensure that any "green claims" are communicated clearly, including by ensuring that any comparisons made with other products or organizations are based on equivalent information and data.

The U.K. FCA's anti-greenwashing rule will come into effect during the third quarter of 2023. The rule requires firms to ensure that any references to the sustainability characteristics of a product or service are: (i) consistent with the sustainability profile of the product or service, and (ii) clear, fair and not misleading. All FCA-regulated firms will be subject to the rule and it will apply to all sustainability-related claims in client communications relating to products and services, regardless of whether the communication is with a retail client or not.

Alongside the ongoing consultations on SFDR, on June 1, 2023, each of the ESAs published their respective progress reports on greenwashing in the financial sector, reaching consensus on the definition of greenwashing as "a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services." The reports also note that the claims can occur intentionally or unintentionally, and can occur at both entity and product levels. ESMA's report is focused on investment management (including investment service providers), issuers and benchmark administrators, while the EBA and EIOPA reports are focused on the banking, insurance and pension sectors.

ESMA's report identifies key greenwashing risks, including ESG strategy and policy, ESG governance, fund names and fund manager's engagement with investee companies. In terms of mitigating such risks, ESMA has set out potential avenues for remediation, which include:

(i) Clarifying key concepts in the SFDR, such as what qualifies as a "sustainable investment," as discussed above.

(ii) Clarifying due diligence responsibilities of managers in value chains in order to reduce the risk of unintentional misleading claims.

(iii) Enhancing the reliability and comprehensiveness of sustainability data by improving ESG data methodologies and through verification and auditing.

The ESAs are due to publish their final reports in May 2024.

ESG Backlash in the US

- ESG continues to be a contentious topic in the U.S. at both the state and federal level, with pressure for both more and less emphasis on ESG considerations.
- As ESG becomes increasingly politicized, companies are working to navigate between these competing approaches.

In the U.S., ESG efforts have become highly politicized, a trend that is likely to increase as the 2024 election approaches. Approximately 100 anti-ESG bills have been introduced in state legislatures around the country. These bills cover a range of topics including blocking state entities from considering ESG factors when making investment decisions, prohibiting and defunding state entities' diversity and inclusion efforts, and protecting fossil fuel and other industries.

In addition, in a decision that may have implications for corporate diversity and inclusion efforts, the U.S. Supreme Court ruled on June 29, 2023, that college admissions processes that take applicants' race into consideration are unlawful. Although the decision was limited to the college admissions context, U.S. companies likely will review and reassess their hiring, promotion and other diversity, equity and inclusion efforts in light of the ruling. For a more detailed discussion of the case, see our July 6, 2023 client alert, "Potential Private Sector Implications of the Supreme Court's Affirmative Action Ruling."

At the federal level, although the U.S. Department of Labor adopted a rule that permits retirement plan fiduciaries to consider ESG factors when making investment decisions, Congress adopted a joint resolution to nullify the measure. President Biden vetoed that effort, but members of the House of Representatives have introduced a bill that would amend federal law to specify that retirement plan fiduciaries could consider only pecuniary factors when making investment decisions. In addition, a Republican House of Representatives working group recently issued a preliminary report that may serve as a roadmap for additional legislative initiatives including, among others, changing the SEC shareholder proposal rules and related no-action processes, and regulating proxy advisory firms.

The ESG backlash is not limited to legislative action. For example, an employee of a large U.S. company has brought a class action lawsuit alleging that the company's retirement plan has underperformed because of its investments in funds pursuing ESG goals in violation of federal law. Retirement plans will closely monitor the progress of this lawsuit, which could have a chilling effect on ESG-related investments.

Alongside legal challenges, there has also been increasing focus on the political activities of companies and how these tie to ESG considerations. Over the last two decades, shareholder proposals asking for disclosure of political activities have been commonplace, but there is growing pressure for these disclosures to be made in order to assess a company's ESG commitments. A recent Public Affairs Council Pulse survey found that more than 60% of survey respondents from the general public believe that Americans would like major companies to advocate on certain social issues, including environmental protection and ending gender, racial and sexual orientation discrimination.

As a result, nearly 20% of the ESG-related proposals filed in the 2023 proxy season related to disclosure on political activities. However, alongside this, the number of anti-ESG proposals has grown, reflecting the ongoing ESG backlash and companies involving themselves in these matters.

Given there is no sign of these contending pressures abating in the near term, companies should look to build on their strategies to combat the proposals from both sides and work on clear and objective messaging on their political activity expenditure. See our June 2023 article "Companies Face Increasing Scrutiny Over Their ESG Disclosures — Including by ESG Critics."

Download the complete memorandum here.