CLIENT ALERT

Corporate Sustainability: No Longer a Question of Choice, but Only of Timing

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1. Why should you be concerned with corporate sustainability principles?

A. General overview of the EU Sustainability Reporting Regulation.

In the last few years, the EU legislator adopted several legal texts requiring certain companies to disclose information regarding sustainability, and more particularly, environmental, social and governance ("***ESG***") aspects.

The **Non-Financial Reporting Directive** (Directive n° 2014/95/EU dated 22 October 2014, the "***NFRD***"), as implemented in the new Belgian Code of Companies and Associations (*Code des Sociétés et Associations*) (art. 3:6 §1st), requires that the management report contains, to the extent necessary for an understanding of the company's development performance, certain information relating to environmental and social matters. For listed and large companies, the management report must also contain certain information relating to respect for human rights and anti-bribery rules.

On 21 April 2021, the European Commission adopted a proposal for a **Corporate Sustainability Reporting Directive** (the "***CSRD***") which would amend the existing reporting requirement under the NFRD. This proposal aims to extend the scope of the reporting requirements to all large companies and listed companies and to require more detailed reporting based on mandatory EU sustainability reporting standards. The proposal also requires that the reported information is externally assured.

Another pillar of the EU "Sustainability" law is the **Sustainable Finance Disclosure Regulation** (Regulation n° 2019/2088 dated 27 November 2019, the "***SFDR***"), as amended by the Taxonomy Regulation (Regulation 2020/852 dated

18 June 2020). The SFDR sets out rules on sustainability reporting requirements for financial market participants and financial advisers (hereafter also referred to as "financial firms") with regard to the integration of sustainability risks, the consideration of adverse sustainability impacts and the provision of sustainability-related information with respect to the firm itself and certain financial products[1].

These are only a few regulations and it is to be noted that some new directives/regulations are now in preparation, in particular, amendments to the directives and delegated regulations on MiFID, UCITS, AIF managers and the distribution of insurance products.

Even if your company is not subject to these reporting obligations, the fact remains that the Corporate Sustainability also relies on two other sets of duties (due diligence and directors' duties), as well as on a more general and growing demand for non-financial information disclosures and for taking into consideration ESG interests.

This requires companies, even if not subject to the aforementioned reporting obligations, to duly take into account ESG principles.

B. Due diligence obligations in Belgium.

The due diligence duty refers to a legal requirement for companies to establish and implement adequate processes with a view to prevent, mitigate and account for human rights, health and environmental impacts, both in the company's own operations and in the company's supply chain.

In line with the European Parliament resolution of 10 March 2021 and with recommendations to the European Commission on corporate due diligence and corporate accountability, a legislative proposal introducing a vigilance duty and a liability duty of the undertakings throughout their value chain (in French, entitled "*Proposition de loi instaurant un devoir de vigilance et un devoir de responsabilité à charge des entreprises tout au long de leurs chaînes de valeur*") was filed with the Belgian Chamber of Representatives on 2 April 2021 (the "***Vigilance Proposal***").

This Vigilance Proposal encompasses material obligations for all companies established or active in Belgium, among which we might emphasize the following:

- a duty of vigilance is imposed with the requirements to respect human rights, labor rights and the environment, as well as to implement internal mechanisms in order to continuously identify, prevent, mitigate and cease environmental or sanitary harm, labor and human rights violations, or any risk thereof, throughout all their value chain (including subcontractors and customers);

[1] For more details in this respect, we refer to a previous client alert published earlier this year, available here.

- a due diligence plan must be developed with the view to identifying, analyzing and prioritizing the risks, as well as taking appropriate action to mitigate such risks or prevent serious harm, collecting reports on such risks and developing mechanisms to monitor the effectiveness of the implemented measures, …and;

- a detailed liability regime (criminal fines, civil liability for breach of duty of vigilance, injunctive measures, collective redress action, exclusion from public procurement, …).

According to such duty of vigilance, violations of or adverse impacts on human rights and social, environment and climate standards by companies (resulting from their own activities or those of their business partners, in particular suppliers, sub-contractors and investee undertakings) shall be sanctioned, and this will require intense oversight by the business world in order to implement accurate mechanisms relying on a risk-based approach.

This vigilance proposal is clearly in line with the broader movement towards more corporate responsibility and accountability, both at EU level (see for instance the legislations currently in force in France and in the Netherlands) and at international level (see the aforementioned European Parliament resolution) and should likely be passed into law in the future.

C. Directors' duties and Corporate Governance code.

Directors have the legal duty to act in the interest of their company. But what does this notion of "company's best interest" cover?

The meaning of this notion has evolved, and, whereas traditionally one associates the interest of the company with the financial interests of its shareholders, the notion is more and more understood as including the stakeholders' interests, and thus also the ESG interests. It nevertheless remains that, under Belgian law, there is currently no fixed and unanimous position in this respect.

This being said, it is worth mentioning that the well-known "European Green Deal" sets out that "*sustainability should be further embedded into the corporate governance framework, as many companies still focus too much on short-term financial performance compared to their long-term development and sustainability aspects*" and that, on this basis, an initiative has been taken by the European Commission, which launched a public consultation on 26 October 2020 and announced a legislative proposal for the second quarter of 2021 (still expected). The idea would be to require:

- companies to take measures to address their adverse sustainability impacts (such as climate change, environmental, human rights harm in their own operations and in their value chain) by identifying and preventing relevant risks and mitigating negative impacts (due diligence duty);

- directors to take into account all stakeholders' interests which are relevant for the long-term sustainability of the company, or which belong to those affected by it, as part of their duty of care to promote the interests of the company and pursue its objectives; and

- an appropriate facilitating, enforcement and implementation mechanism accompanying these duties, including remediation where necessary.

Directors of listed companies must also refer to the 2020 Belgian Corporate Governance Code (hereinafter the "***2020 Code***") which contains provisions related to stakeholders' interests and sustainability. The 2020 Code is a soft-law instrument containing and developing 10 corporate governance principles applicable to Belgian listed companies, subject to the "comply or explain" rule (it being understood that non-listed companies may also voluntarily rely on it).

One of the targets of the 2020 Code is to place "*more emphasis on sustainable value creation. This involves an explicit focus in the long term, on responsible behavior at all levels of the company and on the permanent consideration of the legitimate interests of stakeholders*". Therefore, stakeholders' interests and sustainability are put forward in several provisions of the 2020 Code.[2]

D. Financial, litigation, reputational and operational risks for any kind of company.

The aforementioned principles and rules will impact every economic actor, even if not specifically targeted by them, and the lack of serious ESG policies could create litigation, operational and reputational risks for the companies.

Below are some examples of the risks that companies could face should they decide not to "go green".

Financial risks

Investors and capital providers have growing expectations for increased transparency and a need to gather financial and non-financial information to understand long-term value creation and to make financing or investment decisions.

Under the SFDR and its reporting obligations, financial firms must report on their policies on the identification of principal adverse impacts, as well as on the actions they have taken to mitigate these impacts, such disclosure requirements relating both on the firm level (how the firm should manage the sustainability issues from an organisational point of view) and on the product level (obligation to disclose risks and factors when offering financial products or services). As a consequence, one might anticipate that banks and financial firms will prefer to invest in companies with few or no principal adverse impacts, or to offer financial instruments related to those companies. Accordingly, if a company wants to be

[2] See in particular Principles n° 2.1, 2.2, 2.16, 2.18, 3.17, 7.1 and 7.8 of the 2020 Code, available here.

granted a loan or to be a target for investors, it should make sure it is as sustainable as possible. The SFDR might therefore have direct consequences for companies even if they are not subject to its obligations.

To illustrate such risk, a well-known international insurer has been reported to have decided to stop insuring the operations of a majorCO^2 creator in Europe. Indeed for the French insurer, the strategy put in place by this company to transition away from coal is not in line with the Paris Agreement. In the past, insurers have refused to insure specific projects relating to coal but here, this insurer has gone one step further and refused to insure the company in its entirety.

Litigation risks

In a recent case, which made headlines, a collective of environmental NGOs obtained from a Dutch court a decision that a big Dutch fuel company be compelled to decrease its CO^2 emissions by 45% for the year 2030. The court held that a worldwide consensus exists on the fact that a temperature rise of 1.5 C° represents a great danger for humanity and even if no specific legal rule exists, there is a general obligation of diligence, *i.e.* a general obligation not to put others in danger.

Pressure from shareholders

In addition, even if companies do not feel the need to become more sustainable to attract investment and financing, they may be forced to by their shareholders.

Recently, two oil giants have been compelled by their shareholders to follow a greener path despite resistance from the companies themselves.

At a large international oil and gas company, one of its investors , which only owns a mere 0.02% of the company and which has been instigating an activist campaign to turn the company away from fossil fuels, recently managed to get two of its nominees elected to the company's board.

At another big US energy company, a proposal to force the company to decrease the greenhouse gas emissions of its products has obtained 61% of the votes, despite strong opposition from the board of directors .

These two examples show the significance of shareholders' votes in the acceleration of the transition from fossil energies to renewable energies.

The same pressure might come from the supply chain entities (producers, vendors, warehouses, transportation companies, distribution centres, retailers, …).

Other reputational risks

The OECD Guidelines for Multinational Enterprises (the "***Guidelines***") are the most comprehensive international standard on responsible business conduct, and provide recommendations on expected business behavior in key areas in which business activity impacts people and/or the environment. The basic premise of the Guidelines is "*that enterprises should act as soon as possible, and in a proactive way, to avoid, for instance, serious or irreversible environmental damages resulting from their activities*".

Despite the fact that the Guidelines are not legally binding for enterprises, OECD and adhering states are required to ensure they are implemented and observed. In that respect, adhering States must install a National Contact Point (the "***NCP***") which shall promote and encourage implementation of the Guidelines but, above all, shall handle any specific instance submitted by adversely impacted stakeholders or civil organizations (trade unions, NGOs or individuals, …) alleging that an enterprise has breached a specific chapter of the Guidelines.

Should the NCP consider that the specific instance is eligible (according to various criteria among which the materiality of the alleged breach), then a mediation procedure is initiated. At the end of such procedure, a document is published either pointing out that the "parties" have reached an agreement on the issue raised or reporting that no agreement has been reached and making a recommendation.

The increasing number of environment-related specific instances submitted to NCPs illustrates the growing attention being paid to the application of the Guidelines to business-related impacts on the environment.

As an example, one may refer to a case instructed by the Dutch NCP. On 8 May 2017, referring to the Guidelines asking for "*measurable objectives*" and "*targets for improved environmental performance*" and encouraging "*disclosure of greenhouse gas emissions*", four NGOs notified to the Dutch NCP an alleged violation of the OECD Guidelines by ING and requested ING to identify, and make public, its indirect greenhouse gas emissions and, to establish objectives which the company will pursue to align the bank's indirect greenhouse gas emissions with the objectives of the Paris Agreement.

Considering that, under the Guidelines, companies are expected to conduct a due diligence process in respect of their environmental impact, including climate impact, and that this relates not only to their own negative environmental impact, but also to the impact in their value chain, the Dutch NCP concluded that this specific instance merited further consideration and offered its good office to facilitate a mediation between the parties. The Dutch NCP issued a Final Statement in March 2019 emphasizing that an agreement had been reached by the parties.

This again illustrates that even when the rules recommending sustainable behavior are not legally binding, enterprises may be well advised to pay attention to these rules to avoid being publicly criticized.

2. What should you do now?

For companies, the challenge is now to ensure a smooth transition towards corporate sustainability and to set up a roadmap with a time frame setting short-term, as well as mid-term goals. Such time frame will indeed illustrate that the company considers any accomplishment as partial and that it is still targeting more sustainability. Needless to say, such roadmap is also critical to enable companies to survive the (ecological) transition instead of getting an ice-cold shower in the future.

The **first step** would be to establish a general framework for a **Sustainability Strategy** which would determine the sustainability priorities of the company and its stakeholders (employees, customers, regulators, business partners, etc.), and describe the (financial, market, operational, reputational and other) risks which could affect not only the company – by impacting its position in the market vis-à-vis its competitors and its image,… – but also its stakeholders.

The management must ensure adequate resources (internally or by deferring to external specialists) to collect data, to proceed with detailed analysis of these data, and to integrate ESG criteria in companies' activities and strategies. This might be done with a step-by-step approach (product-by-product, region-by-region, activity-by-activity, …) and might require carrying out due diligence in order to determine ESG risks and to anticipate, prevent or mitigate their adverse impacts on the company or its stakeholders. A stakeholders' dialogue might be helpful for understanding their priorities, assess sustainability topics for the global supply chain, and determine a benchmark with peers.

With this first step accomplished, an internal **code of conduct** should be drafted setting the rules and the values that the company will implement in order to be sustainable. This code of conduct could for instance include not only large-scale goals, but also simple day-to-day actions such as reducing the consumption of paper (printing), of plastic (bottles etc.), of electricity (*e.g.* by switching off the lights or by removing the plugs timely), of CO^2 (*e.g.* by encouraging transport by bike instead of by car) and by being kind, polite and gratifying towards (fellow) employees. After all, raising people's awareness is a key to sustainability.

It is important to implement a **risk management system** which ensures monitoring and effective internal controls. This system might entail the nomination of directors with a strong expertise in sustainability, the nomination of an ESG committee or a Corporate Responsibility Manager, internal training for key employees, and a frequent regulation scan in order to be ready when new regulations enter into force.

It might also be beneficial to look for external assurance on all the data and processes used by the company in its Sustainability Strategy.

Finally, it remains essential for companies to ensure a full transparency regarding their commitment to becoming sustainable. In that respect, besides any legal reporting obligations, every company should draft a Sustainability Report demonstrating the importance the company attaches to Corporate Sustainability. The report should, among others things,

describe the ESG issues affecting the company and its stakeholders, describe the specific policies put in place to prevent or mitigate such risks, and describe the commitments to becoming more sustainable in the future. Such Sustainability Report must be easily accessible to employees, shareholders and stakeholders (it could be part of the management report as suggested by the CSRD proposal).

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