Corporate Legal Liabilities Associated with SRI Methodologies

Are corporations storing up massive legal liabilities by continuing to implement SRI Methodologies?

SRI Reporting & Disclosure

The ever increasing volume and embedding of current SRI Rating Methodologies, a trend that is set to rise substantially in the near future brings with it substantial new business risks if no common global standards are developed and the SRI Industry remains entirely based upon corporate self-reporting.

SRI involves the implementation, tracking and self-reporting of corporate behavior relating to Environmental, Social and Governance (ESG) issues. From “green” initiatives to community service to responsible hiring and workforce practices, the SRI movement has taken hold in companies across the globe which are keen to improve and promote their corporate image. SRI has created global compliance issues for many of these companies, triggering internal control obligations, litigation risk and the risk of injury to brand equity for non-compliance. Further complicating issues involve the plethora of differing Codes of Practice, total lack of common compliance and the lack of global norms for ESG issues.

As states find themselves ill-equipped to address global environmental, social and economic issues on their own, business stakeholders have discovered that global corporations with footprints enshrined in the social and economic fabric of many states have the ability within their own organizations to establish rules and guidance addressing ESG issues. In this context, spurred on by increasingly powerful interest groups and public opinion, SRI started in its first phase as a voluntary, positive business initiative that looked beyond legal compliance toward a diverse range of environmental, social and economic areas. As it now progressively reshapes the business landscape, it is becoming increasingly subject to legal scrutiny and day-to-day operational consequences.

Many investors mistakenly view SRI as a means of mitigating a corporation’s reputational and regulation risk and as a performance factor enhancing stakeholder relations, brand image, risk assessment and management, customer loyalty, and employee recruitment, retention and motivation.

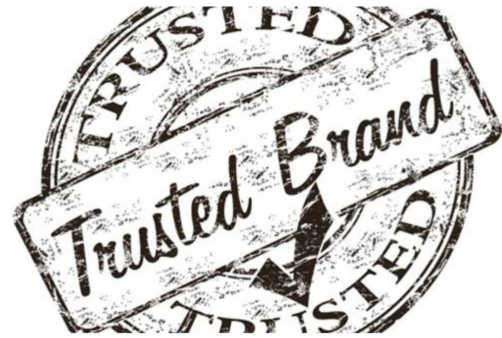
The substantial rise in socially-concerned customers who are interested in buying ethically and environmentally friendly produced products is being harnessed by the Corporates, Shareholder SRI Activism is rising. The past few years alone has seen several instances of shareholder activism in the SRI realm. For example, a core group of state treasurers and controllers in the United States (including those from California, New York and

Florida) decided to move billions of investment dollars in pension funds and other state monies into environmentally friendly and clean-tech funds.

These many examples suggest that shareholder activism is crossing the threshold of being an emerging trend and beginning to solidify as standard conduct across the globe.

Brand Equity Value Drives Sustainability

A brand is a symbolic embodiment of all the information connected to a company, product or service. It serves to create associations and expectations among products made by a producer. The key objective of a brand is to create a relationship of trust. Now, stakeholders have increasingly higher expectations of how organizations should run their businesses. Failing to live up to these expectations can harm trust and have an impact on the company's "license to operate."



The BP disaster is a very good illustration of Greenwash supported by SRI based Ratings Agencies costing BP shareholders $ Billions in legal claims. This disaster was entirely due to BP "paying for ESG Credibility", and avoiding transparency and accountability, (Please see: BP & ESG Report)

The twin forces of globalization and digitalization in a newly connected world make news instantly and widely available. This includes both good news and bad news, news which is true and that which is not. In a world where every action and new piece of information can be quickly and widely scrutinized by the public, those who are responsible for running businesses are under great pressure not only to act ethically, but to be seen as doing so.

SRI Rules, Norms and Standards

What at the beginning had been seen as merely a "feel-good" issue is on its way to becoming a day-to-day operational constraint. Facing the rising tide of SRI, lawyers are asking whether there are any legal duties that arise out of such efforts. In fact, several issues should be considered when corporations publicize their SRI policies and programs.

Securities laws

Listed companies, accustomed to broad regulations over their financial reporting, now have to consider the fairness and accuracy of their non-financial communications as well. In the U.S., there is no mandatory disclosure of SRI issues, yet. However, **securities law**

prohibits material misrepresentations or omissions in connection with the purchase or sale of any security registered on a national exchange in registration statements, prospectuses, proxy statements. Materiality is defined as a "substantial likelihood, under all circumstances, that the omitted (or misrepresented) fact would have assumed actual significance in the deliberations of the reasonable shareholder.

What does materiality mean in the context of SRI?

As socially responsible investment rises, it modifies the perception of what is material. In 2008 in a case involving Pax World Management Corp, the SEC alleged that Pax's negligent failure to comply with its self-imposed socially responsible investment restrictions as announced to the market violated securities laws. Pax also failed to consistently follow its own SRI-related policies and procedures requiring that all securities be screened by its Social Research Department prior to purchase to ensure compliance with SRI disclosures. In addition, Pax did not consistently adhere to other SRI-related policies and procedures, including continuous monitoring of fund holdings. The alleged failures did not result in any loss for the investors. Nevertheless, in August 2008, Pax agreed to a $500,000 civil settlement. This case seems to indicate that in light of the growing importance of SRI in the United States, a company's negligent failure to comply with its own SRI policy may result in a securities law violation.

In Europe, the tools to hold listed companies accountable for disclosing misleading non-financial information are progressively being put into place. In France, a listed company's annual report must include information concerning the manner in which the company deals with the social and environmental consequences of its business and the key performance indicators of a non- financial nature which relate to the company's specific business, such as information pertaining to environmental and personnel matters. The annual report must also include a description of the main risks and uncertainties the company faces, and as of July 3, 2008, French Law No. 2008-649 requires a specific reporting of "internal control and risk management procedures put in place." The wording of the law suggests that the reporting requirement goes beyond internal controls and risk management procedures that pertain to purely financial matters, and includes those related to non-financial matters as well. Thus it appears to require a company to have effective internal controls in place to manage and reduce risks related to material information that a company communicates to the market, including information about SRI initiatives.

In the UK, the Companies Act codifies directors' duties of companies that are publicly listed in the UK. The Companies Act provides a mandatory list of six factors for directors

to take into account in their decision-making which is designed to promote the success of the company for the benefit of its members as a whole. Among these six factors are the interests of the company's employees; the need to foster the company's business relationships with suppliers, customers and others; the impact of the company's operations on the community and the environment; the desirability of the company maintaining a reputation for high standards of business conduct; and the need to act fairly as between members of the company. A company must also issue an annual business review in order to keep its members informed and help them assess how the directors have performed their duties.

In Germany, management must pursue business in the best interest of the corporation. Under the business judgment rule, decisions should take into account all relevant factors –both those likely to contribute to the corporation's sustainability and success, and those which may endanger such success. Also, management reports must include non-financial performance indicators (such as employees and environment), and corporate governance reports must include reference to corporate governance codes and practices which the company voluntarily applies. If a company communicates that SRI issues are factors in its success and sustainability, the company should be able to demonstrate that its decisions have effectively taken SRI into account.

Jurisdiction for SRI-related claims

Because of the U.S. courts' willingness to view their jurisdiction broadly, **SRI-related claims may be initiated in the U.S. against European companies which have not conducted business in the U.S**. For example, U.S. courts may find jurisdiction inherent in SRI statements posted on a European company's website since such statements may be viewed by U.S. stakeholders and used as the basis of business and investment decisions made in the U.S.

Testing the Boundaries of Legal Exposure

For U.S. companies, legal exposure appears not only to be linked to disclosure obligations, but to the trend of greater corporate accountability and transparency. **There is an active and creative plaintiffs' bar that is testing new grounds for liability and legal exposure, a trend that should be carefully monitored in particular with respect to "green washing" claims.**

In recent years, there has been an increase in the number of state law claims being brought on the basis of consumer protection statutes, as well as claims alleging negligence

and vicarious liability, breach of contract (plaintiffs including workers alleging claims against companies for breach of their "standards for suppliers" asserting third-party beneficiary status), unjust enrichment (plaintiffs alleging a company was unjustly enriched via its relationship with its suppliers), and voluntary assumption of a legal duty – **all with SRI at their core.**

The Alien Tort Claims Act (ATCA) was enacted in 1789 and provides district courts with "original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States." For nearly 200 years, the ATCA was virtually dormant. Starting in the early 1980s, however, the ATCA began to be used as a basis for lawsuits brought against States and private actors to redress alleged violations of international law. Of the over 2,000 decided and pending ATCA cases reported since then, approximately half have involved corporations. Notwithstanding the Supreme Court's 2004 decision in Sosa vs. Alvarez-Machain, the types of claims that are recognizable under the ATCA remains unclear and continues to evolve as the U.S. lower courts hear more and more ATCA claims.

For now, the courts are divided on whether aiding and abetting liability exists under the ATCA. In a split decision, the Second Circuit held that aiding and abetting violations of customary international law can be a basis for liability under the ATCA.25 In another circuit, a court recently concluded that the theory of aiding and abetting was not available under the ATCA, but permitted the case to go forward based on common law tort claims.

Reality

For companies around the globe, concrete consequences can be drawn from the above discussions of securities laws and jurisdiction – **SRI has moved from a philosophical concept to a legal and technical one.** SRI charters and policies can no longer Greenwash. They are operational instruments which must be defined with respect to creating standardized ESG criteria. These criteria must be related to business issues of material importance to the corporation. Business operations must comply with SRI policies both to mitigate reputational and regulation risks and to effectively bring about business and reputational benefits linked to SRI communications and behaviors. Both Enron and Worldcom's codes of business conduct were viewed in their heyday as state of the art, but they were not a management priority and thus not enshrined in the companies' business behavior. To achieve such integration, SRI policy must be an announced priority of management and viewed as inherently important to the business. Members of an organization only comply with that which they perceive as management priorities, and management can only prioritize issues of business importance. Relegating SRI to boilerplate

status belies this reality, not to mention that it is extremely difficult (if not impossible) to monitor and ensure compliance.

SRI Norms

Since current SRI analytical methodologies are disparate, opaque and without any common codes of practice, norms for the SRI Industry are somewhat irrelevant. Business stakeholders now tend to consider that once norms are established, these norms **should go beyond local law and abide by international standards as identified most notably by international treaties**, (ISO, WTO. etc) this may only be achieved by basing risk analysis upon not Socially Responsible Investment, (SRI) which has no ability to comply with International Treaties and/or ISO Standards but by basing risk analytics upon the defined principles of sustainability, ESG, (Environmental, Social and Governance) has ability to comply with International Treaties and if based upon ISO standards and are designed to do so.

Summation

Clearly, sustainably based Environmental, Social and Governance, (ESG) is an entirely different and more quantitive approach to fulfilling corporate obligations to it's stakeholders, then SRI has the ability to fulfill. Despite the SRI Industry claiming that their approach is an ESG Approach, sadly it is not. The call for demonstrable sustainability practices throughout the corporate world shows that sustainability and ESG are the key to future corporate success, many governments are now demanding tangible Sustainability/ESG policies and procedures are embedded in their procurement rules, these are not SRI Policies and Procedures but sustainably and, quantitively based, ESG Procedures, an entirely different set of metrics. The dangers and legal exposure of implementing SRI and not sustainability/ESG are now being realised. Sustainably based ESG policies and Metrics comply with all the important International Treaties such as WTO Rules, the fully compliant ISO Standards implemented by The WTO ensures that basing ESG Metrics upon an existing tried and tested compliant framework, an already embedded accepted system, reduces legal risks and brand equity risks and produces accurate and predictive risk metrics for ESG.