



Assessing ESG factors in the energy sector: a handbook

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Introduction

In 1970, Milton Friedman published his seminal essay, “The Social Responsibility of Business is to Increase its Profits.” The cornerstone of his thinking was shareholder primacy.

The influence of this essay has been vast – it has served as a touchstone for capitalist thinking for 50 years.

But in recent times, the central themes of the Friedman doctrine have been challenged. A new “stakeholder capitalism” model is developing and is being discussed in boardrooms and virtual meetings across the US and around the world.

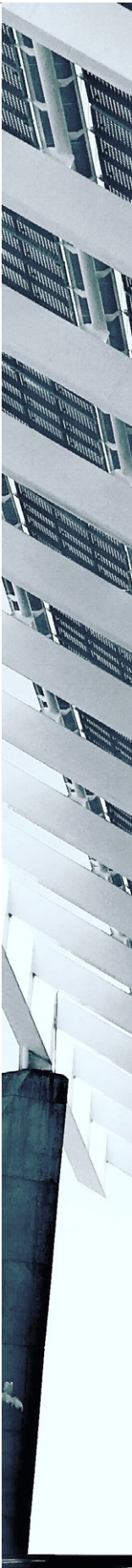
A cornerstone of this new model is ESG – standing for Environmental, Social and Governance – a matrix for assessing the impact of positive social and environmental practices of a business on its financial performance and operations. ESG investing, a term that connotes sustainable investing, socially responsible investing, mission-related investing or screening, has become a standard for top-tier institutional and public investors, financial institutions, private lenders and other stakeholders. This new model takes into account some of the broader issues around stakeholder capitalism. Clearly, in this emerging way of doing business, a company’s ability to manage its particular ESG risks and take advantage of new market opportunities is driving value for its stakeholders.

We have seen that ESG information is tied to positive price adjustments in financings and loans. ESG information disclosed through corporate sustainability

reporting and survey responses is being incorporated into assessments, tools and analytics that inform mainstream investors’ responsibly investing strategies and products. The increased emphasis on ESG presents new and additional opportunities for the energy industry. Companies with high ESG rankings and ratings seem to have a lower cost of capital for both debt and equity, indicating that more and more investors are looking for energy companies that are committed to conducting their business in a manner that accounts for ESG factors.

Though the nomenclature is changing, the energy industry has been at the forefront of ESG-related matters for some time and, in fact, this is where some of the greatest gains and best practices have been shaped. For 20 years now, renewable energy companies have led in advances in sustainable and environmental technology. Exploration, production and distribution companies are leaders in conserving water usage, reducing greenhouse gas emissions and chemical exposure, and minimizing land disturbance and traffic and noise impacts.

In this handbook, we offer several sets of Q&As examining ESG business issues in the energy sector through various lenses – corporate M&A, regulatory, litigation and dispute resolution, funds, finance, employment, and corporate governance policies and procedures. We created this handbook for energy companies as a reference tool in discussing and refining their ESG programs. We hope you will find it useful and look forward to engaging with you on this topic.





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ESG policies and procedures in the energy sector

By Marcelo Paramo, Mario Rego, Deanna Reitman and Sanjay Shirodkar

1. WHAT COMPONENTS SHOULD AN ENERGY COMPANY CONSIDER AS PART OF ITS INTERNAL GOVERNANCE POLICIES AND PROCEDURES?

The implementation of a tiered governance structure, or a layered approval process, is a mechanism that energy companies can use to demonstrate that their internal governance policies and procedures are comprehensive and effective. A tiered governance structure is formed by requiring multiple approval levels prior to the implementation of energy projects and/or the execution of energy transactions. A vertical approval requires different levels of management to approve a project and/or transaction. A horizontal approval requires different business units to provide input and/or approval to a project and/or transaction.

For example, a deep-water offshore exploration and production project usually starts under the responsibility of a dedicated technical area and, depending on its complexity or the financial commitment involved, moves upwards (ie, the vertical phase) for approval via several management committees, ultimately achieving approval from the company board.

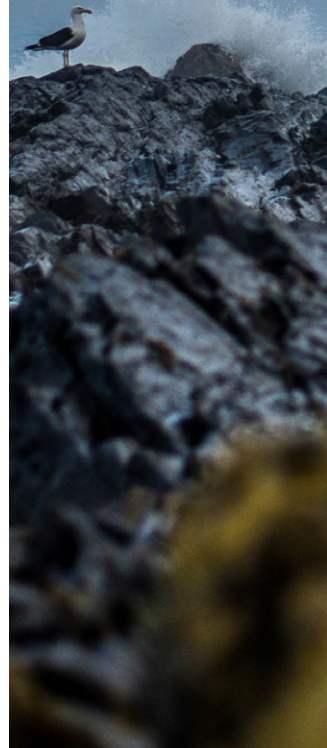
That same project should also be vetted through the organization's horizontal tiers. These are the various disciplines opining on certain aspects of the project that will ultimately lead to its approval or rejection during the vertical phase. Some examples of horizontal tiers are the legal, technical, employment, environmental and commercial areas.

The horizontal tiers should assess the project against minimum requirements *before* it moves up each of the vertical tiers. Companies should set minimum requirements for projects at each approval level. If all horizontal requirements are met, the project progresses vertically; if not, it reverts for further development. Another example of energy companies implementing a vertical and horizontal review and

approval process is when an energy commodity trading company provides a certain dollar-value limit for a particular trader in a particular product. If that particular trader would like to trade above that dollar-value limit in that particular product, she must obtain approval from her manager – a vertical approval. If she would like to trade in a new product, she will need to obtain approval from different departments, such as legal, IT or risk – a horizontal approval. In the latter case, however, she would still need the vertical approval from management.

2. WHAT ARE SOME WAYS AN ENERGY COMPANY CAN ASSESS THE OPPORTUNITIES FOR THE EXPANSION OF OPERATIONS OR INVESTMENTS IN COMPANIES LOOKING TO REDUCE CARBON EMISSIONS OR IMPROVE THE ENVIRONMENT?

The starting point is to review the company's internal processes, procedures and policies relating to project development, health and safety, and risk management and mitigation. Ensure that the company's risk identification, mitigation, and management practices are designed to ensure that potential public-health risks of expansions and investments can be managed to acceptable levels. Does the company have a policy that provides a framework to manage the health and safety of its employees, contractors, facilities, and communities? Does the company monitor and manage ongoing facility integrity and seek to continuously improve its weather resiliency and environmental and safety performance? The benefit of such a policy and such monitoring is that these frameworks can also be used to manage facility risks, to guide the design, construction and startup of new or modified facilities, and to audit its performance against operational objectives and regulatory requirements. Finally, any operational and economic advantages of investments should be weighed against any potential for environmental, socioeconomic and health risks as part of project





development considerations. Identifying risks in the project-development phase should allow the company to develop measures to avoid, mitigate, or remedy them before making new investments.

3. SHOULD AN ENERGY COMPANY PUBLISH SUSTAINABILITY REPORTS TO DESCRIBE ITS POINT OF VIEW ON SHORT- AND LONG-TERM ESG-RELATED ISSUES THAT ARE MOST IMPORTANT TO THE COMPANY?

The Code of Business Conduct and Ethics (or another similar policy) is generally a great place to outline the company's core values and describe additional corporate policies on ESG issues. Many companies adopt additional policies to address a variety of topics. For example, pursuant to an Environmental, Health and Safety (EHS) Policy Statement, the company could ensure that its employees and contractors are expected to share the company's commitment to pursuing its goals, such as protecting the environment; being a good neighbor; reducing greenhouse gases; using materials, natural resources and energy efficiently and promoting environmental best practices; and contributing to sustainable development. What is important to include in an EHS policy statement is principally dependent on a company's values, business initiatives, and prospects. Some companies incorporate EHS performance in allocating incentive compensation among its business units and to individual employees. Some companies adopt a Biodiversity Policy which describes the strategies the company employs in the planning, development, construction and decision-making process to minimize impacts on biodiversity in areas where its employees work and/or where it operates, in accordance with applicable laws and regulations.

It is also important when preparing a sustainability report to adopt the correct guidelines. For example, some companies adopt the Global Reporting Initiative's (GRI) Sustainability Reporting Guidelines. The GRI

is an international organization developed with representatives from business, environmental, human rights, and labor communities. While these guidelines provide a flexible reporting system that allows for the omission of content irrelevant to company operations, some companies prefer to publish the relevant data in vertical reports and to publish ESG performance data on their website. This may be the most appropriate route for many companies in the current landscape, in which ESG reporting and rating standards are still emerging and are still inconsistent.

4. WHAT IMPROVEMENTS MAY BE IMPLEMENTED IN A COMPANY’S REQUEST FOR PROPOSALS (RFPs) AND BIDDING PROCESSES POLICIES TO HELP SELECT THE MOST QUALIFIED, DIVERSE, ECONOMICALLY ATTRACTIVE AND SOCIALLY RESPONSIBLE SERVICE PROVIDERS?

Energy companies should maintain a healthy pool of prospective providers to invite to RFPs and require providers in the pool to update their information and credentials from time to time. In case of public bids, where all service providers can participate, energy companies should establish a minimum set of additional credentials that prospective bidders should fulfill in order to have their proposals considered. The energy company should devise a strong compliance and vetting process to make sure the pooled prospective providers are socially responsible, have effective anticorruption and diversity policies, have robust technical/operational capabilities, and are financially healthy. It is important, however, to balance these practices with the need to avoid excessive bureaucracy that can affect competitiveness by reducing the number of participants. Energy companies should also require/create minimum diversity- and socially related obligations for a company to participate in the RFP pool.

It is also a good practice for energy companies to require parent company guarantees (PCGs). In many cases, the entity that ultimately signs the agreement is not the winning bidder, but rather is a special-purpose company, such as a newly incorporated subsidiary, specifically created to serve as the contractor-party. This is to help ensure that the entity committing to the terms and conditions of the energy company’s RFP service agreement will have the financial strength to perform its obligations under the scope of work.

5. PUBLIC POLICY ENGAGEMENT IS ESSENTIAL TO PROTECT THE INTERESTS OF THE COMPANY, CUSTOMERS, EMPLOYEES, SHAREHOLDERS, AND COMMUNITIES. WHAT ARE SOME POLICY ISSUES ENERGY COMPANIES SHOULD BE CONSIDERING?

Corporate political contributions are subject to regulation by the state and federal governments and, as such, there are disclosures required to provide by law. These disclosures are regarded as part of the public record and should be made available on the company’s website, preferably linked to a “Political Expenditures” webpage. Consideration should also be given to adopting, and publicly disclosing, a political expenditures policy, which could address such issues as the principles governing corporate political expenditures and political action committee contributions.

6. SHOULD AN ENERGY COMPANY EXPERIENCE AN ENVIRONMENTAL INCIDENT, WHAT ARE SOME OF THE ISSUES TO BE AWARE OF WHEN REPORTING OR DISCLOSING SUCH AN INCIDENT?

Reporting or disclosing an environmental incident is a complicated task and is largely dependent on the type of incident (eg, oil spill, freight car derailment, charter vessel sinking or border-related matters). The rules governing environmental disclosure have been in place for some time. Determining environmental costs and liabilities can take various forms; the key facts are often difficult to ascertain and the underlying environmental laws – and their enforcement – are constantly changing.

Further complicating matters is the fact that a company’s operations could be subject to multiple jurisdictional requirements, from very local to international or supranational regimes. Finally, many environmental matters often take many years to investigate, address, and resolve, which raises significant estimation and other challenges.

In the US, disclosure of any such incidents is subject to the principles of “materiality,” which can vary considerably based on the size and possible scope of the incident. Some questions to consider in this respect include:



- The reasonably likely impact of a “loss contingency” related to the incident or – if the company is unable to estimate such impact, but a range of amounts is determinable based on the facts
- A quantification of the accruals and adjustments, costs of legal defense and reasonably likely exposure to additional loss as a result of the incident
- The assumptions management has made concerning the amounts described above, the reasons these assumptions best reflect the company’s exposure and the extent to which the resulting estimates of loss are sensitive to changes in these assumptions
- The timing of the accounting effects related to the incident and
- Whether a company provides indemnification for matters associated with the incident.

Many of these questions involve a mix of legal and financial issues and it is best to have a team of advisors who have the capacity to engage and advise on these matters. This is particularly true with environmental incidents since they could have a long-term impact on the company’s financial results and prospects.

Learn more about the implications of these issues for your business by contacting any of the authors:

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The impact of ESG metrics on M&A transactions in the energy sector

By Jonathan Axelrad, Edgar Romo, Dino Barajas, Vanessa Wilson and Craig M. Tighe

1. HOW DO ESG FACTORS INFLUENCE THE SELECTION OF POTENTIAL TARGETS AND BUSINESS PARTNERS IN THE ENERGY SECTOR?

There is growing recognition that partnering with companies with strong ESG profiles can enhance a company's ability to deliver long-term sustainable value to its stakeholders. Institutional investors and other stakeholders, such as BlackRock and State Street Global Advisors, have shown a growing interest in understanding and assessing the performance of companies based on ESG metrics.

ESG factors are increasingly being used by investors to scrutinize oil and gas companies and other targets, as global efforts to promote clean energy, sustainability and energy transition build momentum. There are various examples of global funds divesting of oil and gas holdings or projects involving the use of coal and investing in renewable energy, so there is a general sense that investors are embracing cleaner energy solutions. However, the oil and gas industry is also involved in energy transition efforts in its operations and business models as it strives to contribute to reducing greenhouse gas emissions. Shell and BP, for example, have both recently announced the intention to restructure with a new focus on low-carbon technologies.

In addition, a number of investment funds have been established in the US with specific mandates to invest in renewable energy, renewable fuels and other related technologies such as energy storage. These funds join many established energy companies pursuing projects consistent with evolving ESG standards.

2. HOW RELEVANT ARE ESG FACTORS IN AN M&A DUE DILIGENCE PROCESS FOR COMPANIES IN THE ENERGY SECTOR?

Given the fact that the way a company handles ESG matters can affect its long-term performance and its valuation, ESG due diligence can have a strong impact on business valuations and thus influence bidding prices or even the decision on whether a deal is carried out. Due diligence is also critical to negotiate the right terms for a deal.

Probably no other sector is more subject to all risks deriving from inadequate ESG policies and controls than the energy sector. Oil and gas assets function in complex operating environments where there can be negative impacts on natural habitats, greenhouse gas generation, water contamination, oil spills and leakages. Renewable energy provides a clean form of energy generation which is essential to the transition to a low-carbon economy; however, it is not exempt from risks, such as impacts on protected areas or natural habitats due to land conversion, ecological damage, reduction of water quality and disruption of river flow patterns. The closeness of energy companies with regulators may lead to various corporate governance risks, such as corruption, money laundering and illegal price fixing. A thorough assessment of such risks in due diligence processes is critical to investors to determine whether an investment is made.

3. HOW CAN WE FACILITATE PARTNERSHIPS WITH EARLY-STAGE COMPANIES?

Strategic partners hoping to collaborate with startups should carefully consider how these deals can be most efficiently documented. Startups often do not have in-house counsel and can only afford to rely on outside counsel for the most material agreements. Thus, strategics wanting to successfully partner with startups should develop agreements that can be



quickly negotiated and do not unduly restrict a startup's ability to develop its core intellectual property. Material terms should ideally not be put into voluminous terms and conditions, but rather should be set forth in the agreement itself as simply as possible. Ideally, strategics would engage as counsel attorneys who understand startups and the need for cost-efficient negotiations and for fair, collaborative agreements.

4. WHAT ARE TYPICAL WAYS OF INVESTING IN EARLY-STAGE COMPANIES?

Corporate strategics often invest in startups by purchasing convertible notes or preferred stock. Typically, such investment is made in tandem with, or in anticipation of, a separate business agreement with the startup, such as a pilot agreement or other agreement by which the strategic can determine whether the startup can help it more quickly adjust its current business to meet its ESG goals or its entry into a new market or business that is part of its ESG vision. This collaboration can be beneficial to the startup as

well, as it can give it a better sense of the potential market demand for its product or service and provide an opportunity to refine its product or service or its overall business plan based on the feedback and guidance the strategic provides. Moreover, the strategic's early financial support can serve as a marketplace validation that encourages venture capital and other investors to back it. Given that a strategic does not invest for purely financial reasons, it will often negotiate for special rights or impose special obligations on the startup. From the startup's perspective, it needs to take care that the strategic's special requirements would not make it less marketable to the financial investors or less attractive to potential acquirers. Finally, because a strategic can drive early revenue or other achievements for a startup, it may seek additional equity return, separate from that provided to the financial investors, by, for example, requiring the startup to issue a warrant, with the number of shares that may be purchased pursuant to it tied to achievement of specified revenue numbers or other performance metrics.



5. HOW WOULD INVESTMENT IN OR THE ACQUISITION OF RENEWABLE GENERATION PROJECTS OR PROJECTS INTENDED TO REDUCE CARBON EMISSIONS IMPACT A COMPANY'S PERFORMANCE UNDER ESG OR SUSTAINABILITY STANDARDS?

Standards vary but generally speaking the use of renewable technologies would contribute to a company's ability to meet ESG or sustainability standards especially if greenhouse gas emissions are reduced as a result. For example, performance standard 3 of the ESG Performance Standards published by the International Finance Corporation World Bank Group directs companies to "integrate practices and technologies that promote energy efficiency, use resources sustainably and reduce greenhouse gas emissions."

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ESG issues in energy project finance

By: Glenn Reitman, Vanessa Wilson, Rachel Ramos, Amala Nath, Claire Hall and Dino Barajas

1. WHAT ARE THE DIFFERENCES AMONG GREEN BONDS, GREEN LOANS AND SUSTAINABILITY-LINKED (OR ESG-LINKED) LOANS?

Although all financial products, green bonds, green loans and sustainability linked (or ESG-linked) loans are different, the following chart reflects the notable distinctions:

	Use of proceeds	Interest rate provision	Reporting	Liability
Green bonds	Net proceeds earmarked for eligible green projects	Similar to non-green bonds	Periodically provided Disclose quantitative and qualitative information on projects financed	Issuers are not bound by indentures, though disclosures may subject them to SEC liability Bondholders rely on tort claims and other sanctions generally available to bondholders
Green loans	Net proceeds earmarked for eligible green projects	Similar to non-green loans	Periodically provided Disclose quantitative and qualitative information on projects financed	Borrower is typically bound by loan agreement Missed sustainability performance targets (SPTs) can trigger penalties, including an event of default or margin increase
Sustainability-linked (ESG-linked) loans	Net proceeds used for any purpose, including general corporate purposes	Dependent on borrower's ESG rating or other performance standard Rates may vary based on performance	Periodically provided Borrowers disclose performance against SPTs	Borrower is typically bound by loan agreement Missed ESG targets can trigger penalties, including an event of default or not being able to utilize a margin decrease

2. WHAT CAN WE EXPECT AS MARKET PROVISIONS IN CONNECTION WITH GREEN LOANS OR A SUSTAINABILITY-LINKED (OR ESG-LINKED) LOAN?

Currently there are no "market"-standard provisions for a sustainability-linked (or ESG-linked) loan, but standardization is accelerating quickly. The Loan Syndications Trading Association (LSTA), together with the Loan Market Association (LMA) and Asia Pacific Loan Market Association (APLMA) in the US, established their Sustainable Finance Working Group

and tasked it with the maintenance of their Green Loan Principles (GLP) and Sustainability Linked Loan Principles (SLLP). The GLP and SLLP were published in 2018 and 2019, respectively. On February 3, 2020, the LSTA distributed an ESG due diligence questionnaire (ESG DDQ). The ESG DDQ is intended to "be completed by the borrower during the due diligence phase of the loan origination process." On May 5, 2020, the LSTA, together with LMA and APLMA, published Guidance on Green Loan Principles (G-GLP) and Guidance on

Sustainability Linked Loan Principles (G-SLLP). The G-GLP and G-SLLP are guidelines and intended to be flexible in order to continue to be applicable to sustainability-linked loans as their terms evolve.

3. WHAT IS THE CURRENT STATUS OF THE MARKET FOR ESG-LINKED DERIVATIVES?

ESG derivatives are in their infancy. Banks sold the first ESG OTC derivative in 2019, which was designed to hedge against interest rate and currency risk; the swap becomes more expensive if the relevant company fails to meet certain ESG or sustainability targets. In addition to bespoke OTC trades, several exchanges also offer ESG derivatives products. In 2019, Eurex launched STOXX Europe 600 ESG-X index future and the Commodity Futures Trading Commission subsequently gave the green light for the Eurex ESG contracts to be traded in the US. Nasdaq also offers ESG exchange-traded products. Currently, there is an industry consultation on the development of ESG-friendly credit derivatives.

4. WHAT ARE GREEN BANKS (SUCH AS THE NEW YORK GREEN BANK), AND WHAT TYPES OF FINANCING OR OTHER SERVICES DO THEY PROVIDE?

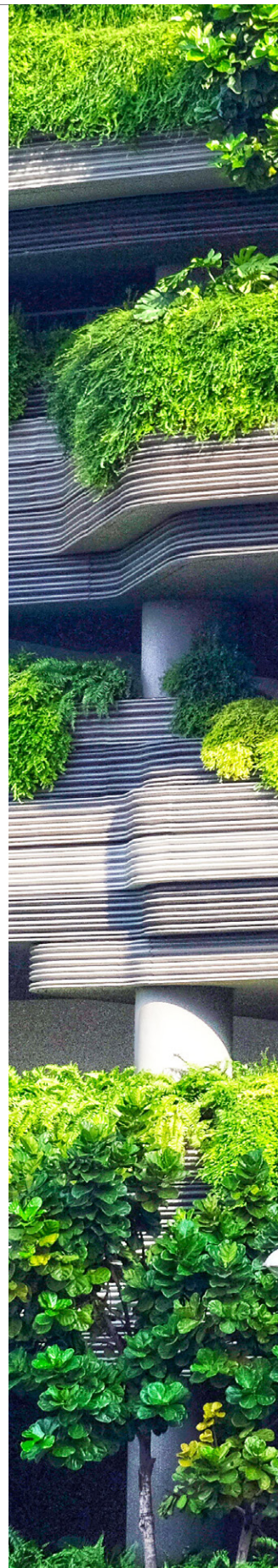
Green banks are public and nonprofit financing entities that have been established by national and local governments to leverage public dollars for the purpose of driving private capital into clean power technology and accelerating the entrance of such technologies into the market. In the US, several states have established their own green banks, including California (California CLEEN Center), Connecticut (Connecticut Green Bank), Hawaii (Green Energy Market Securitization, or GEMS), New Jersey (New Jersey Energy Resilience Bank), New York (New York Green Bank) and Rhode Island (Rhode Island Infrastructure Bank). Additionally, at the county level, Maryland's Montgomery County has established its Montgomery County Green Bank. While the mandates and approaches of green banks are similar to each other, they are not identical. Green banks are tasked

with finding innovative solutions to address under-investment in low-carbon technologies. In addition, many green banks have been established with the further motivations of carbon emissions reductions, lowering the cost of capital and energy costs, creating jobs, promoting energy security and furthering local development of green technology markets.

As a practical matter, green banks often aim to bridge the financing gap faced by many clean-energy technologies. Because of the new and innovative technology that is a hallmark of this sector, private investors frequently consider this market high-risk and are often hesitant to lend to projects that are smaller in size or that feature new technology. Green banks can help mitigate private investors' risks in the financing process. First, green banks can provide institutional backing or credit enhancements for loans. For example, they may offer loan loss reserves or loan guaranties to help mitigate the risks taken by private investors. This type of credit enhancement is one-way: green banks are able to use limited public dollars to attract private funding into the sector. In addition, green banks may also issue bonds, such as green bonds, environmental impact bonds and social impact bonds, to fund clean energy projects. While green banks create immediate efficiencies simply by being an aggregator for clean energy projects, green banks also frequently utilize warehousing or securitization to underwrite loans and hold them until they can be bundled and sold to the private sector.

5. WHAT ESG OR SUSTAINABILITY-RELATED STANDARDS DO COMMERCIAL BANKS CONSIDER IN EVALUATING PROJECT FINANCE LOANS FOR ENERGY INFRASTRUCTURE PROJECTS?

In addition to offering specific green products such as green bonds, commercial banks active in the energy project finance market are taking significant steps to incorporate ESG considerations and standards of sustainability into how to approach traditional commercial loans for energy infrastructure projects.





Like other companies, banks have responded to public demand to operate responsibly and consider global environmental challenges like climate change.

Some banks have formally adopted the Equator Principles as a basis for assessing projects, their impact and ongoing compliance. A handful have adopted the United Nations Principles of Responsible Banking. Both standards use recognized ESG principles in assessing projects to which the bank may choose to provide financing, among other things. Both include not only consideration of potential negative impacts on society or the environment, but also the potential for banks to advance efforts to achieve sustainability goals and support new technologies or policies intended to improve society.

Almost all banks active in the project-finance market have adopted sustainability policies which may expressly prohibit advancing loans to certain projects, such as coal-fired generation plants. In addition to their societal impact, carbon-intense industries are viewed as involving increased risk of being affected by a negative change in law or government policy. Internal sustainability policies adopted by commercial banks often give priority to financing projects which are viewed as sustainable or as scoring well when evaluated using ESG standards, including a focus on renewable generation, energy efficiency solutions, green buildings and infrastructure serving the public, such as projects addressing water supply or waste management. This willingness to prioritize such projects may come in the form of targets as to the dollars advanced to such projects or a general policy. Sustainability policies often include additional considerations in evaluating projects, such as the likelihood it will create additional jobs, its impact on the local community, conservation areas or wetlands and indigenous people. Many of these policies were updated or adopted in the last year and, during that time, many banks made public announcements adopting specific goals.

6. HOW DO TAX OR CASH INCENTIVES AVAILABLE TO PROJECTS USING RENEWABLE, CARBON REDUCTION OR SIMILAR TECHNOLOGIES IMPACT THE FINANCING OF ENERGY INFRASTRUCTURE PROJECTS IN THE US?

Federal tax incentives for renewable generation projects, including the production tax credits and investment tax credits, have long formed the basis for standalone financings. These transactions, referred to as tax equity financing, involve the financing party taking an ownership interest in the applicable project company in order to claim such tax benefits and allow the developer/ sponsor of the project to monetize such credits. The Internal Revenue Service has and continues to issue specific guidance as to qualifying projects, structures and activities in order to provide additional certainty in claiming such tax credits.

State tax incentives and cash incentives can create additional revenue streams that improve project economics and make it easier to obtain financing. The ability to rely on such incentives as recognized revenue may depend upon the firmness of the award, the likelihood the project will qualify and the risk of recapture.

7. WHAT ARE THE WORLD BANK GROUP'S ENVIRONMENTAL, HEALTH, AND SAFETY GUIDELINES (THE EHS GUIDELINES), AND HOW DO THEY BENEFIT COMPANIES DEVELOPING POWER PROJECTS?

While there are several ESG resources and standards available to investors and lenders to evaluate whether an energy project complies with their ESG criteria, one of the leading set of international guidelines which have been adopted by development financial institutions, export credit agencies and commercial lenders across the globe are the EHS Guidelines. They provide general and industry-specific examples of Good International Industry Practice (ie, the exercise of professional skill, diligence, prudence and foresight that would be reasonably expected from

skilled and experienced professionals engaged in the same type of undertaking under the same or similar circumstances globally) and are referred to in the World Bank's Environmental and Social Framework and in the International Finance Corporation's Performance Standards. When host-country regulations differ from the levels and measures presented in the EHS Guidelines, projects are required to achieve the more stringent standard. The EHS Guidelines primarily focus on mitigating environmental impact of projects, ensuring community and occupational safety, and facilitating construction and decommissioning activities. In carrying out these objectives, the EHS Guidelines provide a general approach to the management of EHS issues at the facility or project level to assist, for instance, in identifying EHS hazards and risks, prioritizing risk-management strategies and improving EHS performance through ongoing monitoring. Specifically, for the power sector, in addition to the general guidelines for all projects, there are four industry guidelines that apply to (a) electric power transmission and distribution, (b) geothermal power generation, (c) thermal power and (d) wind energy. For example, for thermal power projects, the EHS Guidelines identify heat exposure during the operation of a plant as an occupational safety hazard. In order to mitigate this risk, they recommend conducting regular inspections of pressure vessels and maintaining adequate records to monitor heat levels. By implementing the relevant recommended measures, energy companies not only benefit from improved operational efficiency and ESG performance, but also have an opportunity to increase revenue through the delivery of environmentally and socially sound products and services and to gain access to lower-priced capital.

8. WHAT ESG ISSUES ARE RELEVANT FOR FOSSIL-FUEL DEVELOPMENT PROJECTS IN LATIN AMERICA?

ESG standards have become extremely relevant in all fossil-fuel-related projects (currently being developed throughout Latin America – among them, fossil-fuel-fired power generation facilities, pipelines, oil refineries, and petrochemical processing facilities. Regional economic downturns and shifting demand for commodities, manufactured goods and agricultural products produced primarily for export mean that traditional project-finance commercial bank lenders have retracted from lending into certain countries and industry sectors. This has opened the way for multilateral lending agencies and development banks, which have stepped in to anchor the financing of critical fossil-fuel-related projects. Each of these multilateral lending agencies (eg, IFC, IDB, CAF, CABEI, NADBank) and development banks (eg, FMO, Proparco, DEG, JBIC) active in the Latin American and Caribbean markets has created ESG standards which are tailored to the hydrocarbon-related industry; in order to access their financing programs, these standards must be met. Indeed, project developers working in Latin America would be well served to develop their projects with ESG principles in mind from the onset in order to assure themselves that they will have the widest selection of potential lenders available to them at the time financing is required, regardless of the economic environment in which they find themselves.



9. HOW CAN AN ENERGY PROJECT DEVELOPER IN LATIN AMERICA CREATE A COMPREHENSIVE ESG STANDARDS COMPLIANCE PROGRAM FROM THE ONSET?

Many multilateral lending agencies, development banks and commercial bank lenders active in Latin America utilize the International Finance Corporation's (IFC) Performance Standards as the basis or guide for their respective ESG assessment programs. This suggests that developers should consider creating ESG checklists addressing the various areas (eg, environmental, labor standards, community involvement) covered by the applicable IFC Performance Standards. Additionally, certain development banks, such as FMO (the Dutch development bank) and Proparco (the French development bank), have developed specific ESG requirements for their institutions which should be overlaid on the IFC Performance Standards-inspired checklist to ensure that projects will be eligible for financing by the most diverse lender base once a project sponsor begins to secure project financing.

Another consideration is financing available from institutions, such as the Japan Bank for International Corporation (JBIC) and EDC (the Canadian export bank), based on the involvement of project participants or sourced equipment/services from certain countries. If a project developer anticipates the potential involvement of an investor or EPC contractor, or sourced equipment from a certain country, it should also incorporate the ESG requirements from lending institutions from the related country in order to gain access to low-cost loans tied to that specific country's involvement. The diverse requirements of potentially applicable ESG standards requirements should be included in third-party project documentation during the drafting stage in order to avoid costly post-execution documentation amendments that may be required to retroactively adjust construction or operational requirements in line with ESG requirements imposed by lending institutions.

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Funds and the energy sector: ESG strategies

By Steven Bartz and Trevor Wong-Chor

1. HOW MANY FUNDS FOCUSED ON ENERGY AND NATURAL RESOURCES INVESTMENTS EMPLOY ESG STRATEGIES?

- Based on our June 2020 review of approximately 200 private equity and venture capital closed-end funds and their sponsors who make investments in the energy sector, only approximately half (48.52 percent) employ an ESG strategy.
- Of the energy and natural resources funds reviewed (ENR funds) that focus on investments in the US, only 37.21 percent employ an ESG strategy.

2. DO ALL ENR FUNDS EMPLOY ESSENTIALLY THE SAME STRATEGY WITH REGARD TO ESG?

No, not all ESG strategies are the same. In fact, there are a variety of different strategies that fund sponsors employ with respect to ESG. The following are three broad categories of ESG strategies utilized by investment funds (as well as a few sub-categories)¹:

- **ESG consideration:** The strategy considers or otherwise includes ESG factors alongside the traditional investment analysis, but ESG factors are not a central part of such analysis.
- **ESG focus:** The strategy has an ESG focus, whereby:
 - ESG factors are incorporated into investment selection and analysis (ESG integration).
 - ESG factors may be used to:
 - disqualify potential investments from further consideration (Exclusionary-ESG Portfolio Screening); and/or
 - identify potential investments for further consideration based on their relatively high ESG ratings vis-à-vis industry peers or other investment

opportunities (Inclusionary-ESG Portfolio Screening); and

- the fund sponsor engages in some degree of active ownership concerning ESG factors (ESG advocacy).
- **Impact/thematic:** The strategy has an intentional ESG impact or similar ESG thematic focus, whereby:
 - the fund seeks an ESG impact (*i.e.*, the generation of some positive environmental, social or governmental impact) alongside financial returns;
 - the fund and its sponsor employ ESG Integration;
 - exclusionary-ESG portfolio screening and/or inclusionary-ESG portfolio screening is utilized in making investment determinations; and
 - the fund and its sponsor engage in some degree of ESG advocacy.
- In our analysis, we do not separately account for ENR funds that focus on a particular green economy sector (e.g., renewable energy, energy efficiency) but instead have classified them according to the categories listed above.
- Of the 48.52 percent of ENR funds that employ an ESG strategy (ENR-ESG funds):
 - Most employ an impact/thematic strategy (63.41 percent of ENR-ESG funds or 30.77 percent of all ENR funds); and
 - The remainder of ENR-ESG funds are evenly divided between ESG focus (19.51 percent of ENR-ESG funds or 9.47 percent of all ENR funds) and ESG consideration strategies (17.07 percent of ENR-ESG funds or 8.28 percent of all ENR funds).

¹ These categories are based primarily on the work of Jon Hale, Director of Sustainability Investing Research at Morningstar.



- Of the 37.21 percent of ENR funds that focus on investments in the US (US ENR funds) and that employ an ESG strategy (US ENR-ESG funds):
 - Most US ENR-ESG funds employ an impact/thematic strategy (50 percent of US ENR-ESG funds or 18.6 percent of all US ENR funds);
 - ESG consideration strategies constitute the second-most popular ESG strategy among US ENR-ESG funds (34.38 percent of US ENR-ESG funds or 12.79 percent of all US ENR funds); and
 - ESG focus strategies are the least frequently utilized among US ENR-ESG funds (15.63 percent of US ENR-ESG funds or 5.81 percent of all US ENR funds).
- Given the popularity of ENR funds that focus on alternative energy and green energy investments, it may not be surprising that so many ENR-ESG funds employ an impact/thematic strategy when such strategies tend to be in the minority across closed-end investment funds in general.
 - But this also means that a substantial number of ENR funds, particularly in the US, are not utilizing any ESG strategy at all.
 - We believe this represents an opportunity for many US ENR funds that might be able to enhance their marketability to investors – and the marketability of

their portfolio companies to potential buyers – by implementing some form of ESG strategy.

- Given the numerous ESG methodologies and principles available and the multifaceted, multilayered analyses that can be utilized within those frameworks, ENR funds that do not focus on alternative energy and green energy investments may be shortchanging themselves by not addressing ESG issues.

3. HOW DO ENR FUNDS DISCLOSE THEIR APPROACH TO ESG PRINCIPLES TO PROSPECTIVE INVESTORS?

ENR funds disclose their respective approaches to ESG in a variety of ways, including formal disclosure in their private placement memoranda (PPMs), disclosure in their fund agreements (LPAs), disclosure in pitch materials, and more generalized disclosure regarding the sponsor's investment principles in communications with prospective investors and the sponsor's website.

- When disclosed in PPMs, the particular ESG strategy that the sponsor intends to utilize with respect to the applicable fund's investments is typically disclosed as a subsection of the broader investment strategy and process.
- As you might expect, fund sponsors who utilize an ESG consideration strategy typically provide fewer

details than a fund sponsor who utilizes an ESG focus or impact/thematic strategy.

- Some sponsors who utilize an ESG Focus or impact/thematic strategy will cover key aspects of their ESG principles in the PPM with more detailed information available to interested investors in a virtual data room.
- Some ENR-ESG funds form specific ESG committees that are responsible for monitoring ESG matters at the fund and portfolio-company levels.
- When disclosed in LPAs, the disclosure is typically in the form of information regarding the distribution of reports to partners and, if applicable, the formation/operation of an ESG committee.

4. HOW DO ENR FUNDS MEASURE ESG?

ENR funds employ a variety of approaches to measuring ESG. Common ESG benchmarks and reporting metrics are based on IFC Performance Standards on Environmental and Social Sustainability, the Equator Principles, principles and reporting requirements developed by the Climate Disclosure Standards Board, recommended disclosures and metrics developed by the Task Force on Climate-Related Financial Disclosures formed by the Financial Stability Board, Sustainability Accounting Standards Board standards developed using their Sustainable Industry Classification System®, UN Sustainable Development Goals (also known as the Global Goals), the United Nations Principles for Responsible Investment (UNPRI), the United Nations Global Compact principles, Global Reporting Initiative standards, B Impact Assessment by B Corp, initiatives championed by Business for Social Responsibility, CDP scoring methodologies, the EU Non-Financial Reporting Directive and updates thereto, and guides promulgated by various securities exchanges.

- A plurality of ENR funds incorporate the UNPRI into their ESG strategies.

5. HOW DO ENR FUNDS REPORT ESG PERFORMANCE TO THEIR INVESTORS?

ENR-ESG funds and their sponsors who utilize ESG focus and impact/thematic strategies typically deliver quarterly or annual updates to their investors.

- Those reports often provide an overview of the ESG principles that animate the sponsor's approach to investments, some information about the individuals responsible for setting and implementing those principles, and a summary of related performance, sometimes including metrics and ratings and/or narratives describing sponsor activities that exemplify the relevant ESG principles in action.

Some ESG reports provide fund-level analysis of ESG performance, but the reports are often sponsor-level documents that provide an overview of sponsor initiatives and activities across platforms.

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ESG regulatory issues for the energy sector

By Robert J. Alessi, Alissa Pollard and Jeffrey D. Kuhn

1. DOES US LAW REQUIRE COMPANIES TO DISCLOSE THEIR ESG STANDARDS OR IMPLEMENTATION OF ESG INITIATIVES?

Not yet.

Many European countries and the EU itself have adopted mandatory ESG reporting requirements. For example, a 2016 French law requires companies to disclose how they address ESG. In 2019, the UK government released its Green Finance Strategy, which, among other things, will likely require companies to disclose environmental and climate-related information starting in 2022. The EU non-financial reporting directive (NFRD, Directive 2014/95/EU) required large companies to include ESG and diversity information in their annual reports starting in 2018.

In contrast, US lawmakers have resisted mandating European-style ESG reporting standards. In 2019, legislation that would have required the US Securities and Exchange Commission (SEC) to write ESG disclosure rules was defeated in Congress. However, notwithstanding the lack of a broad ESG reporting mandate under US law, many energy companies are required to make specific environmental disclosures under existing law, such as the US Environmental Protection Agency's Greenhouse Gas Reporting Program.

The failure of the US to adopt mandatory ESG disclosure rules has contributed to a patchwork of different reporting regimes in different parts of the world. Some governments or financial regulators have established broad strategies, some have mandated specific requirements and others have tended to leave it to market forces.

In May 2020, a subcommittee of the SEC's Investor Advisory Committee asserted that "everyone is frustrated" by the lack of consistent ESG disclosure requirements and recommended that the SEC update its reporting requirements for public companies "to include material, decision-useful, ESG factors." The subcommittee found that "ESG is no longer a fringe concept" but "an integral part" of global business, and that consistent disclosure requirements are critical because "major business risks, decisions and strategies stand upon ESG factors and investors are not being served or protected by the piecemeal, ad-hoc, inconsistent information currently in the mix." The subcommittee concluded that "if the SEC does not take the lead, it is highly likely that other jurisdictions will impose standards in the next few years" that US companies "will be bound to follow" because of "the global nature of the flow of investment into the US markets."





2. ARE THERE ANY COMMON VOLUNTARY ESG REPORTING FRAMEWORKS?

Yes. The most widely adopted ESG reporting frameworks are the guidelines issued by the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB) and (to a lesser extent) the International Integrated Reporting Council (IIRC, publisher of the Integrated Reporting Framework). GRI and SASB are the two leading global ESG reporting standards, although they have different focuses. The GRI standards are designed to frame the impact a company has on the world, whereas the SASB standards are more focused on how ESG issues affect the company and its financial performance. GRI and SASB have taken steps in the last few years to align their frameworks.

More than 600 US companies voluntarily use the GRI standards to disclose ESG information, including approximately 80 percent of the companies in the Dow Jones. Many of the largest energy companies in the world currently use the GRI standards.

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ESG employment issues in the energy sector

By Michael Massiatte

1. RECENT REPORTS SUGGEST THAT EMPLOYEE WELFARE IS A TOP PRIORITY FOR INVESTORS AND OTHER STAKEHOLDERS IN THE ESG SPACE, PARTICULARLY AMID THE COVID-19 PANDEMIC. WHAT ACTIONS SHOULD AN ENERGY COMPANY IMPLEMENT TO DEMONSTRATE ITS COMMITMENT TO SUPPORTING ITS WORKFORCE?

The COVID-19 pandemic has caused companies, particularly those in the energy sector, to face unprecedented financial and economic challenges. As a result, companies have either had to or presently are facing the need to reduce general and administrative (G&A) costs. The go-to options in this regard include reducing wages or salaries; reducing benefits; and furloughing or terminating employees. In some cases, such decisions are unavoidable. However, increasing a commitment to employee welfare and reducing costs are not mutually exclusive. For instance, companies can choose to maintain healthcare benefits during a period of furlough, or they may decide to reduce executive and director compensation instead of impacting mid- and lower-level personnel. Companies that are perceived to invest in their employees will likely realize stronger shareholder investment and support in the coming months and years.

Notably, demonstrating support for employees may require minimal, if any, net cost. For example, expanding benefit options to include telemedicine options or mental health resources, like an employee assistance program, do not materially increase employee healthcare costs but can materially improve employee morale and health.

Moreover, energy sector companies are encouraged to take particular note of the current movement toward greater social justice and racial equality. According to Department of Labor statistics, only 12 percent of workers in the oil sector are minorities, compared to 23 percent of the general US workforce. A large US trade

association in the energy sector has made working with communities of color a priority and has announced its commitment to achieving greater diversity within the industry. Instituting recruiting and hiring initiatives aimed at diversifying the workforce and taking affirmative steps to focus on diversity and inclusion in the workplace are likely to be excellent investments a company can make in the current environment, and these actions are relatively low in cost.

2. AMID THE COVID-19 PANDEMIC, EMPLOYEE HEALTH AND SAFETY HAS ASSUMED A GREATER LEVEL OF IMPORTANCE. ARE THERE ANY INDUSTRY-SPECIFIC REQUIREMENTS OF WHICH AN ENERGY COMPANY SHOULD BE AWARE?

The US Department of Labor and other federal, state and local administrative agencies have issued guidance materials regarding workplace safety in the face of COVID-19. Our Employment team has published several alerts concerning these issues, examples of which can be accessed [here](#) and [here](#). Generally speaking, because it is currently not possible to completely eliminate the hazard of COVID-19 from the workplace, companies are urged to utilize a hierarchy of controls (eg, engineering controls, administrative controls and personal protective equipment) in order to mitigate risk of infection. Additionally, the California Department of Public Health has issued [COVID-19 Industry Guidance for the Energy and Utility industries](#).

Furthermore, companies in the energy sector are urged to take note that OSHA's general duty clause – *to provide a place of employment free from recognized hazards that are causing or are likely to cause death or serious physical harm – applies to employer-provided employment-related housing*. According to OSHA's Field Operations Manual, the following three factors establish employment relatedness: 1) the employer requires employees to live in the housing, 2) the isolated location of the work or the lack of economically comparable

alternative housing makes it a practical necessity to use employer-provided housing; or 3) the housing is provided or made available as a benefit to the employer. As such, companies are required to comply with OSHA's standards with respect to any such employment-related housing if any of the following factors apply: 1) the housing is provided free or at low cost; 2) the housing is owned, controlled or provided by the employer; (3) no other alternative housing is reasonably accessible to the employees considering the distance from the alternative housing to the worksite, the absence of transportation from the alternative housing to the worksite or the cost of the alternative housing; (4) the housing is made available to ensure that the business is provided with an adequate supply of labor; or (5) the employees living in the housing are required to work for the employer upon demand.



3. AMID INCREASED ESG INTEREST AMONG INVESTORS, INCLUDING RETIREMENT INVESTORS, THE DEPARTMENT OF LABOR RECENTLY ISSUED A PROPOSED RULE THAT WOULD REGULATE ERISA PLAN FIDUCIARIES IN CONSIDERING ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) INVESTMENTS. WHAT DO ENERGY COMPANIES NEED TO KNOW ABOUT THE DOL'S PROPOSED RULE?

First, the role of ESG investing in ERISA plans has shifted markedly when presidential Administrations change from one political party to another, with the only certainty being that the DOL's position will inevitably reflect the then-prevailing attitude of the Secretary of Labor and their political hue. However, the Trump Administration's effort to codify the DOL's current position regarding ESG investing may provide retirement plan fiduciaries with certainty that will last beyond the next election.

The comment period for the proposed regulation closed on July 30, 2020. Until the proposed regulation is adopted, it is subject to revision. However, plan fiduciaries considering investing on the basis of ESG are urged to consider the principles contained in the DOL's proposed rule, including the following:

- "Providing a secure retirement for American workers is the paramount, and eminently-worthy, 'social' goal of [retirement] plans; plan assets *may not* be enlisted *in pursuit of other social or environmental objectives.*"
- "Given the increase in ESG investing, the Department is concerned that, without rulemaking, ESG investing will present a *growing threat to fiduciary standards* and, ultimately, to investment returns for plan participants and beneficiaries."

Ultimately, if adopted, the proposal would impose certain new investment duties, including those that require plan fiduciaries:

i) To evaluate investments “based *solely* on *pecuniary factors* that have a material effect on the return and risk of an investment based on appropriate investment horizons and the plan’s articulated funding and investment objectives” and

ii) Not to “*subordinate*[] the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to unrelated objectives, or sacrifice[] investment return or take[] on additional investment risk to promote goals unrelated to those financial interests of the plan’s participants and beneficiaries or the purposes of the plan.”

4. FALLING ENERGY PRICES, COUPLED WITH THE ECONOMIC DOWNTURN TRIGGERED BY THE COVID-19 PANDEMIC, HAVE CAUSED A SIGNIFICANT LABOR CONTRACTION IN THE ENERGY SECTOR. WHAT ARE SOME UNINTENDED CONSEQUENCES ABOUT WHICH COMPANIES IN THE SECTOR SHOULD BE AWARE AND/OR FOR WHICH COMPANIES SHOULD PLAN?

The unprecedented challenges faced by companies in the energy sector cannot be understated. According to the US Bureau of Labor Statistics, the oil and gas labor market alone has shed approximately 100,000 jobs when compared with pre-COVID-19 levels. In addition to making deep cuts to their workforces, companies continue to face the financial strain caused by decreased energy demand and an increased cost of keeping workers safe and healthy during the pandemic. As a result, companies face the prospect of making significant pay cuts in order to further reduce G&A expenses to control their balance sheets. Indeed, energy consulting firms estimate that wages in the energy sector may decline by 8 percent to 10 percent heading into the end of 2020 and the beginning of 2021.

The combination of increased worker fears about workplace safety and decreased worker wages and benefits can create a fertile ground for the resurgence of worker activism and union organizing. It is anticipated that employees may increasingly express their concerns about such issues as safety of working conditions; wages or benefits; paid leave; and discipline or discharge of coworkers. In anticipation of increased union organizing activity (and other concerted activity by employees that may be “protected” under federal law even where an employer does not presently have a union), companies are strongly encouraged to proactively, and transparently, address employee concerns, as well as seek legal counsel where appropriate. Such steps may include evaluating employee compensation and benefits to determine if any (upward) adjustments can or should be made; communicating with employees regularly about workplace concerns; training managers and supervisors about union organizing campaigns and tactics, and their rights and responsibilities under applicable law; and developing a plan to respond in the event of a petition for a union representation election.

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ESG issues in energy sector litigation and disputes

By Robert J. Alessi, Allissa Pollard and Jeffrey D. Kuhn

1. ARE THERE ANY LITIGATION RISKS ASSOCIATED WITH MANDATORY OR VOLUNTARY ESG REPORTING?

Yes. Over the last decade, courts have increasingly recognized a right to rely on ESG reporting (including voluntary reporting) in making investment decisions. Plaintiffs have successfully maintained lawsuits against several companies in US courts for making false statements in ESG reporting.

In 2012, a federal district court in West Virginia denied a motion to dismiss a claim that Massey Energy violated federal securities law and misled investors by making various ESG statements in its annual reports regarding its commitment to worker safety. For example, the court found that statements that safety was Massey Energy's "job one every day" or that Massey Energy was a "recognized industry leader in safety" could be actionable because they were demonstrably false (the company had a below-average safety record) and plaintiffs alleged that they relied on those statements in making investment decisions. The court rejected Massey Energy's arguments that the ESG statements constituted "immaterial puffery" or opinions because the truth or falsity of the statements could be determined, and they were not future predictions but false assertions of the company's past achievements.

Similarly, in May 2020, a federal court in New York State denied a motion by Vale S.A., a multinational mining company head quartered in Brazil, to dismiss federal securities law claims against it based on voluntary ESG statements that preceded the collapse of a tailings dam that killed 270 people. Plaintiffs in that case claimed Vale's statements were materially false and misleading and/or lacked reasonable basis at all relevant times. The court held that, while Vale's statements about safety and sustainability were generic (eg, statements that "sustainability is part of the core business" at

Vale, or "it is necessary for the mining company to be environmentally, socially, and economically sustainable for its survival" or "sustainability is one of the pillars to the company's growth and prosperity"), Vale's repeated emphasis on its commitment to those priorities meant that an investor could find those statements material. The court held that "while certain statements, 'viewed in isolation, may be mere puffery,' when the statements are 'made repeatedly in an effort to reassure the investing public' about matters particularly important to the company and investors, those statements may become material to investors" and thus actionable.

The spread of the Internet into nearly every aspect of society means that investors and other stakeholders have increasingly easy access to information regarding a company's ESG performance and can readily evaluate the accuracy of ESG reporting. Inaccurate or incomplete ESG reporting can thus create significant litigation and liability risks. In addition, ESG disclosures that are inaccurate or misstated can create reputational risks, such as allegations of greenwashing (ie, unsubstantiated, deceptive claims that a company's products or practices are environmentally friendly).

2. WHAT STEPS CAN BE TAKEN TO MITIGATE LITIGATION RISKS ASSOCIATED WITH ESG REPORTING?

Because material misstatements or omissions can give rise to significant liability, companies should subject all ESG reporting to thorough internal review processes to ensure accuracy – regardless of the format or setting of ESG disclosures. The internal review process should include approval by subject matter experts, the legal department and senior management; furthermore, someone within the company should bear clear, ultimate responsibility for verifying the accuracy of all statements within ESG disclosures.



All personnel involved in preparing ESG reporting should understand the potential litigation and reputational risks to the company associated with erroneous ESG disclosures. The best way to mitigate or eliminate those risks is of course to ensure the accuracy of all ESG disclosures. Litigation risk can also be mitigated by couching ESG statements, when necessary, in aspirational language (eg, broadly discussing ESG-related goals, objectives or targets as opposed to firm statements about past achievements or current programs). Risk can also be reduced by framing ESG objectives in general or estimated terms and avoiding commitments to realize concrete measurements by definite dates.

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