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FALL 2023

# ESG Hot Topics

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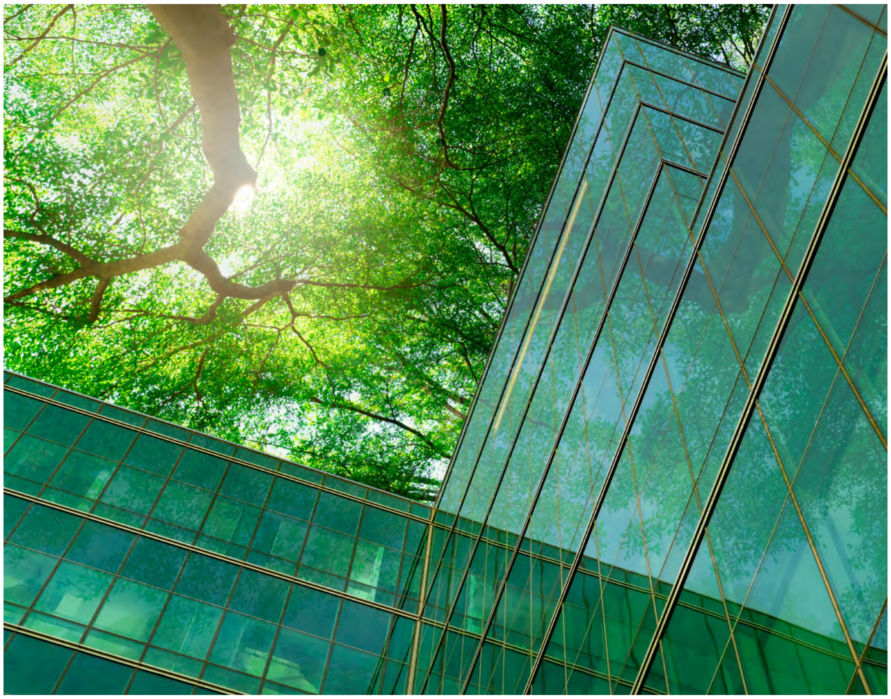
## Introduction

Welcome to the inaugural issue of our ESG Hot Topics report. We have collected articles from thought leaders from across the firm highlighting some of the emerging issues in ESG. Should you have any questions about any of the topics discussed herein, please do not hesitate to contact any of the authors of this publication or your regular contact at Hunton Andrews Kurth LLP.

Hunton Andrews Kurth's interdisciplinary ESG practice provides strategic counseling to boards, management teams and investors on a broad range of ESG issues and strategies. Our team provides advice to help our clients create long-term value through ESG strategies that mitigate key legal risks. We provide decisive, informed advice at the crossroads where nuance, ambiguity and uncertainty abound.



# Legal Considerations For Corporate Circular Economy Strategies

Over the past several years, circular economy goals have become nearly ubiquitous in corporate sustainability strategies. This trend is driven by a number of factors, including consumer interest in sustainable products, opportunities for generating circular revenue (i.e., generating revenue at multiple points in a product's lifecycle, such as through product collection and refurbishing), and the presence of circular economy metrics in commonly used voluntary sustainability standards, such as those issued by the Global Reporting Initiative (GRI) and Sustainability Accounting Standards Board (SASB). Recent legal and policy developments in multiple markets may counsel in favor of re-assessing existing corporate strategies related to circular economy. To maximize the value of existing efforts, companies should consider three categories of legal developments when setting or re-assessing circular economy goals: government incentives, regulations and reporting and disclosure requirements.

The US Environmental Protection Agency describes "circular economy" as "a change to the model in which resources are mined, made into products, and then become waste. A circular economy reduces material use, redesigns materials, products and services to be less resource intensive, and recaptures 'waste' as a resource to manufacture new materials and products." Environmental benefits include waste and pollution reduction, as well as reduced greenhouse gas emissions. In addition, circular economy efforts can help promote supply chain security by reducing reliance on imports. In recognition of these benefits, governments in many jurisdictions have started to develop new legal frameworks to promote circular economy efforts. Notably:

- In 2020, the European Union (EU) adopted a Circular Economy Action Plan. The EU continues to develop new regulatory and policy actions in support of the plan.
- In 2022, the US passed the Inflation Reduction Act, the CHIPS and Science Act, and the Bipartisan Infrastructure Law, all of which contain provisions targeted at promoting circularity and recycling.
- A number of US states have adopted or are considering laws that require producers to increase use of post-consumer content and/or take responsibility for end-of-life products or packaging.

## INCENTIVES

Companies that sell certain types of products—especially products related to renewable energy infrastructure, such as batteries or solar panels—have increasing access to economic incentives targeted at creating a domestic circular supply chain. For example, in the Inflation Reduction Act of 2022, Congress amended the definition of "new clean vehicle" to allow for electric vehicle (EV) battery materials recycled in North America, regardless of their origin, to qualify for the US clean vehicle tax credit. This incentivizes companies to establish domestic recycling facilities by creating consumer demand for domestically recycled EV batteries. Understanding available economic incentives and the criteria for obtaining them is now a critical step in making decisions about product design and sourcing.

## REGULATIONS

New regulations targeted at achieving circular economy goals address both product design and end-of-life management.

In the packaging context, several jurisdictions have begun to impose legal requirements for source reduction or recycled content that will help shape these efforts going forward. Notably, Washington, California, New Jersey, Maine and Connecticut have all passed laws mandating certain levels of post-consumer content in packaging products, and administrative rulemaking to further define requirements is underway in all of these states.

Increasingly, producers will also need to take responsibility for products at the end of their life after they have been in the hands of consumers. Several states have passed or proposed extended producer responsibility (EPR) legislation for single-use packaging, often in combination with recycled content requirements. These programs have broad applicability and may affect companies that sell products in many different industries.

As in the incentive space, US EPR programs have also targeted renewable energy technologies, including solar panels, wind turbines and batteries. Washington is leading the nation with the Photovoltaic Module Stewardship and Takeback Program, an EPR program for solar panels, and also recently passed legislation to study the feasibility of wind turbine blade reuse and recycling. Washington, California and the District of Columbia have also established EPR programs for small primary or portable batteries (i.e., common household batteries), and California is considering legislation that would create an EPR program for end-of-live EV batteries.

## REPORTING AND DISCLOSURE REQUIREMENTS

A third type of legal development that companies will increasingly need to consider when developing circular economy-related strategies is reporting and disclosure requirements. These laws are aimed at standardizing how companies report on their sustainability efforts. Depending on who a company's stakeholders are and how they are expected to react to new reporting, companies may need to consider whether any operational changes are needed in areas where disclosures are required.

As noted above, many companies have already been reporting on circular economy efforts under voluntary reporting standards. Now, the shift to mandatory reporting has begun. In July 2023, the European Commission, acting in accordance with the EU's Corporate Sustainability Reporting Directive, adopted a Sustainability Reporting Standard on Resource Use and Circular Economy known as ESRS E5. Companies subject to ESRS E5 will need to report on company policies, goals and actions related to circular economy efforts, such as use of recycled resources, transition away from virgin materials and sustainable sourcing. So far, there has not been push toward mandatory reporting for circular economy efforts in the US Companies operating in the US, however, need to be careful about how they publicize their efforts. The Federal Trade Commission is currently revising its Guides for the Use of Environmental Marketing Claims (Green Guides) and, during the rulemaking process, sought public comment on updating its guidance regarding "recycled content" claims.

## CONCLUSION

Given these changes in the legal landscape, collaboration between corporate sustainability teams and legal counsel will be increasingly important when setting, and monitoring progress toward reaching, circular economy goals.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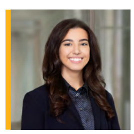

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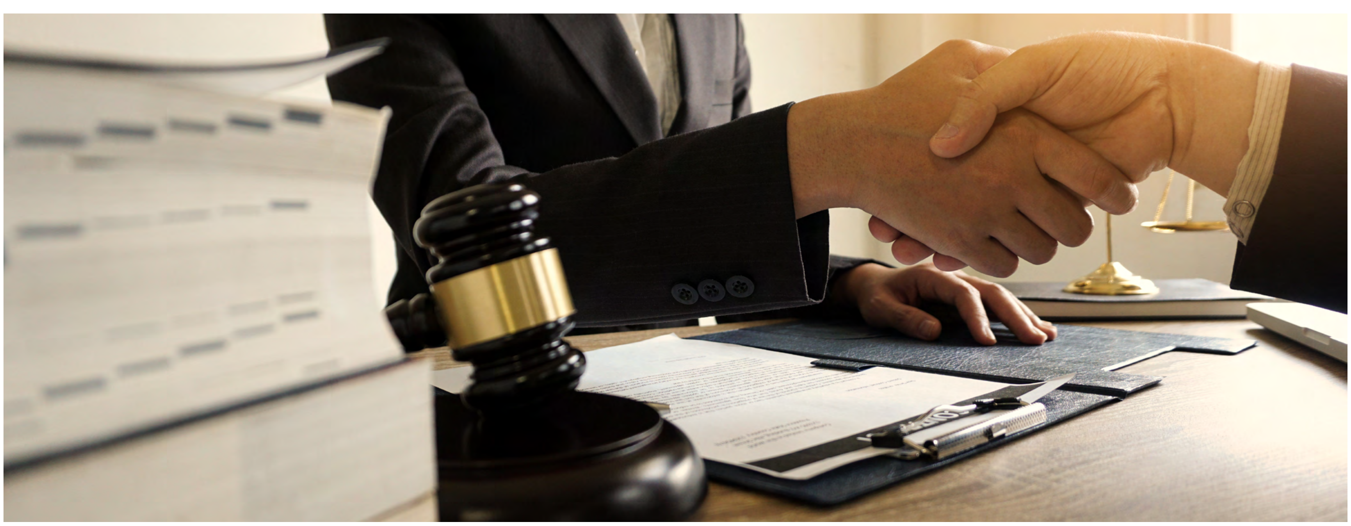


# First-In-The-Nation Climate Disclosure Bills Become Law In California

On October 7, 2023, California Governor Gavin Newsom signed two landmark climate disclosure laws aimed at making major public and private companies publicly disclose their greenhouse gas emissions and report on their climate-related financial risks. The first, the Climate Corporate Data Accountability Act (SB 253), will require companies to disclose their greenhouse gas emissions in a format accessible to the public. The second, SB 261, will require companies to publish a report on their "climate- related financial risks" on their websites. These first-in-the-nation laws will impose significant disclosure obligations on companies across the country.

## WHO IS COVERED?

Both bills are intentionally broad to encompass all business entities doing business in California that meet the relevant revenue threshold based on revenues generated during the prior fiscal year. SB 253 deems all entities with a total annual revenue exceeding $1 billion a "reporting entity." SB 261 deems all entities with a total annual revenue exceeding $500 million a "covered entity." SB 261 specifically excludes insurance companies.

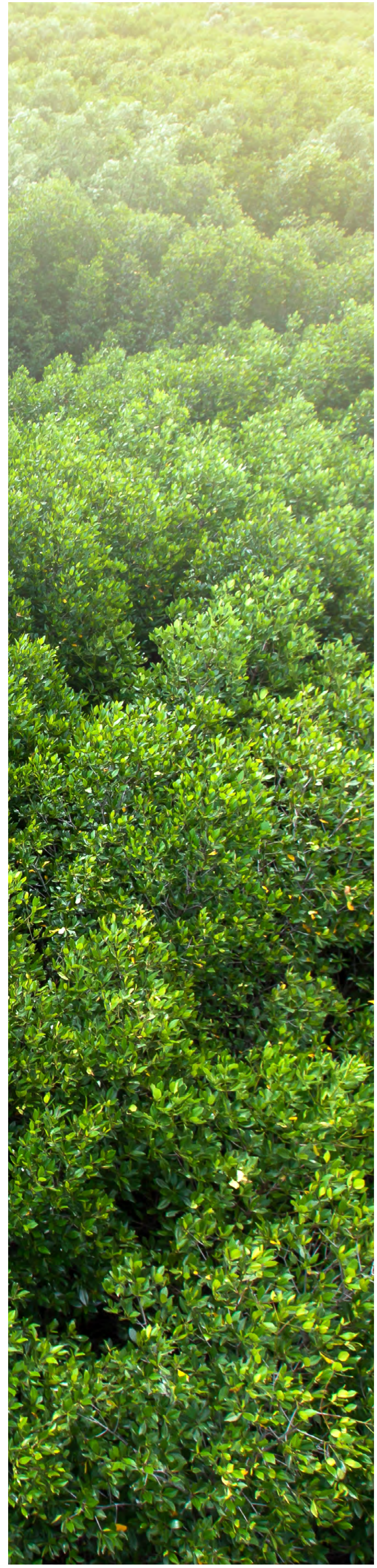
Neither bill defines what it means to be "doing business" in California. Rather, the California Air Resources Board (CARB) will define the phrase as part of the implementing regulations and could use existing California law as guidance (e.g., California Revenue & Tax Code and California Corporations Code).

## WHAT MUST A REPORTING ENTITY DISCLOSE UNDER SB 253?

Beginning in 2026, SB 253 requires all covered entities to disclose their Scope 1 and 2 emissions to an emissions reporting organization, a non-profit organization contracted by the state with experience in greenhouse gas emissions reporting. Beginning 2027, all covered entities will need to include Scope 3 emissions in their reporting.

- Scope 1 emissions are emissions that stem directly from a company's activities.
- Scope 2 emissions are indirect emissions from electricity purchased or used by a company.
- Scope 3 emissions are all other indirect emissions from a company's entire supply chain, such as purchased goods and services, business travel, employee commutes and processing and use of sold products.

CARB is directed to adopt regulations implementing these emission disclosure requirements by January 1, 2025. CARB's regulations must initially require the covered entity to measure and report GHG emissions in conformance with the Greenhouse Gas Protocol standards and guidance developed by the World Resource Institute, but CARB may assess whether there are more suitable GHG accounting and reporting standards starting in 2033 and every five years thereafter.



## WHAT MUST A COVERED ENTITY DISCLOSE UNDER SB 261?

Beginning January 2026, covered entities must prepare a biennial report disclosing (1) their climate-related financial risks and (2) measures they adopted to reduce and adapt to the disclosed climate-related financial risks. SB 261 is aimed at increasing transparency to policy makers, investors, and shareholders and improving decision making on where to invest private and public dollars.

The bill defines climate-related financial risk as a "material risk of harm to immediate and long-term financial outcomes due to physical and transition risks, including, but not limited to, risks to corporate operations, provision of goods and services, supply chains, employee health and safety, capital and financial investments, institutional investments, financial standing of loan recipients and borrowers, shareholder value, consumer demand, and financial markets and economic health." The disclosures must be made in accordance with the recommendations of the Task Force on Climate-related Financial Disclosures. Any required disclosures not made by a covered entity's report must be explained with steps describing how the covered entity will complete the disclosure report.

Covered entities must submit these reports to a climate reporting organization and make the reports publicly available on a website. Parent companies can consolidate reports at the parent level, even if the subsidiary would otherwise meet the threshold for reporting.

SB 261 provides for alternative compliance if the entity already prepares an analogous report voluntarily or pursuant to another law or regulation.

CARB has a number of open action items, including administrative rulemaking, to finalize the requirements of the new legislation. But even without that rulemaking, the broad parameters of the new laws are coming into focus. Businesses that are likely to be subject to the new reporting requirements should begin to prepare now for the upcoming deadlines.



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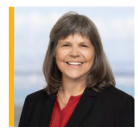
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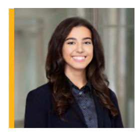
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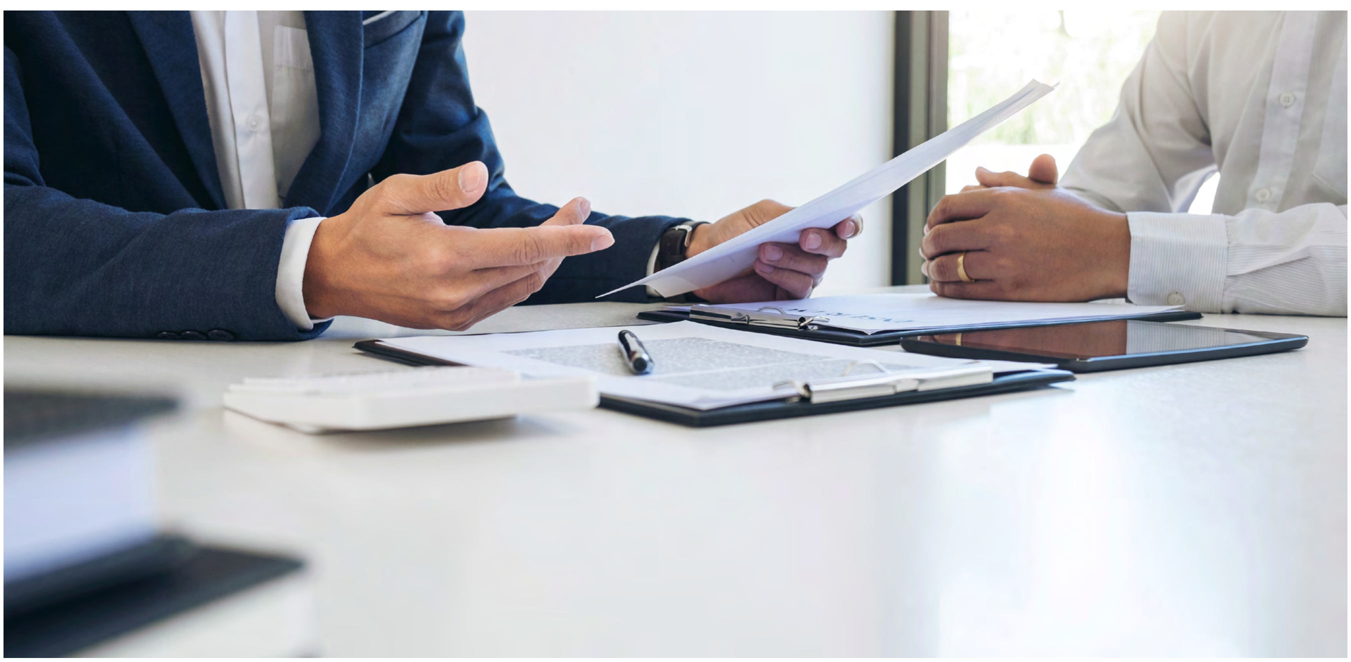

# European Union Advances Mandatory ESG Reporting Standards

A set of mandatory ESG reporting standards, the European Sustainability Reporting Standards (ESRS), are set to enter into force in the European Union (EU) at the end of this year. These standards were adopted by the European Commission (Commission), the EU's executive branch, on July 31, 2023, and barring rejection by the European Parliament or the European Council, will be implemented as part of the EU's Corporate Sustainability Reporting Directive (CSRD)—a fundamental pillar of the broad "EU Green Deal"—which requires mandatory ESG reporting for certain companies that do business in the EU.

The ESRS were developed by the European Financial Reporting Advisory Group (EFRAG), an independent, multistakeholder advisory body, majority funded by the EU, and will require companies to provide detailed sustainability information related to their direct operations and supply chains. This effort is intended to promote transparency to investors, companies, society and other stakeholders, as well as enhance the comparability and reliability of sustainability information reported across the EU.

The first 12 ESRS adopted by the Commission cover two "cross-cutting" standards comprised of general requirements and 10 additional "topical" standards which are specific to either "E" (environment), "S" (social), or "G" (governance) topics.

| ESRS 1: General Requirements<br>ESRS 2: General Disclosures | | |
|---|---|---|
| **E** | **S** | **G** |
| ESRS E1: Climate | ESRS S1: Own workforce | ESRS G1: Business conduct |
| ESRS E2: Pollution | ESRS S2: Workers in the value chain | |
| ESRS E3: Water and marine resources | ESRS S3: Affected communities | |
| ESRS E4: Biodiversity and ecosystems | ESRS S4: Consumers and end users | |
| ESRS E5: Resource use and circular economy | | |

The cross-cutting standards are applicable to all subject entities. The 10 topical standards are subject to a materiality assessment based on a "double materiality" perspective, meaning companies must determine whether disclosure under each standard is required by considering both financial materiality (i.e., how social and environmental issues create financial risks and opportunities for the company) and impact materiality (i.e., impacts of the company on people, the environment, and society in general), both of which account for positive and negative sustainability-related impacts for a business. If a company determines it has no material impacts under a topical standard, it need not disclose information under that standard and can simply report the data point(s) as "not material." Companies that determine that the climate change standard is not material for their business must nonetheless explain how that determination was made.

## APPLICABILITY OF ESRS

The CSRD provides for a phased implementation of these mandatory reporting requirements:

| Category | CSRD Subject | Report Due |
|---|---|---|
| Large, public companies already subject to the precursor to the CSRD, the Non-Financial Reporting Directive, as well as large non-EU listed companies with more than 500 employees | 2024 | 2025 |
| All other large corporations, including large non-listed companies, which meet two of the following: (1) an annual average of 250 employees or more, (2) total assets of €20 million, or (3) €40 million in sales. Notably, these criteria would increase to €25 million total assets and €50 million in revenues under an amendment recently adopted by the Commission, if the amendment is not rejected by either the European Parliament or European Council | 2025 | 2026 |
| Small and medium-sized entities (SMEs) with securities listed on an EU regulated market | 2026 | 2027 |
| Non-EU companies with subsidiaries or branches within the EU where sales exceed €150 million in the EU area over two years and either (1) a large or listed subsidiary, or (2) a significant EU branch (over €40 million in turnover) | 2027 | 2028 |

## KEY PRINCIPLES AND TAKEAWAYS

Compliance with the ESRS requires understanding of certain key principles that underlie the structure and requirements of the standards:

**Double Materiality:** As described above, the 10 topical ESRS require a double materiality assessment.

**Diligence Process**: Companies will report on the due diligence processes they use to identify potential impacts to and from social and environmental factors, such as stakeholder engagement throughout the operations and supply chain. The due diligence process informs conclusions on which standards are material.

**Reporting Logistics:** Companies will be required to prepare a sustainability statement with the disclosures required by the ESRS as part of their annual management report, effectively incorporating ESG reporting into traditional financial reporting mechanisms.

**Assurance:** Disclosures will be subject to external assurance requirements, beginning with a limited assurance requirement but potentially later transitioning to a more rigorous reasonable assurance standard. Assurances must cover both the substantive information disclosed for each topic, as well as the materiality assessments.

**Alignment with Other Global Standards:** EFRAG and the Commission made an effort to align the ESRS with other global sustainability reporting frameworks. The ESRS thus bear a lot of similarity to other global sustainability reporting standards, including primarily the International Sustainability Standards Board (ISSB) and the Global Reporting Initiative (GRI) standards. EFRAG is working with both of these entities to publish interoperability guidance materials to assist companies reporting under multiple frameworks and minimize duplication of work. Moreover, the CSRD provides for non-EU companies subject to its obligations, such as US parent companies, to use sustainability standards equivalent to the ESRS, although what standards may be deemed "equivalent" is not yet clear.

## NEXT STEPS

The first set of ESRS will enter into force as planned once it is published in the Official Journal of the EU. Next, EFRAG will publish non-binding technical guidance to support compliance with the ESRS. It has already put forth draft implementation guidance for the materiality assessment. It will prioritize issuing finalized guidance on materiality and company value chains and is expected to maintain a website to field technical questions on the ESRS.

EFRAG is also charged with developing a second set of sector-specific ESRS under the CSRD, applicable to various industrial sectors, including oil and gas, transport, agriculture, energy production and utilities, and food and beverages. Although this second set of ESRS is due to be adopted under the CSRD by 2024, the Commission announced its intent to postpone adopting the sector specific standards. EFRAG also is expected to promulgate standards for listed SMEs and voluntary standards for non-listed SMEs.

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# DEI Programs Are Under Fire: Key Takeaways For Employers From The Affirmative Action Case

On June 29, 2023, the US Supreme Court held that Harvard and the University of North Carolina's (U.N.C.) race based admissions policies (more commonly known as "affirmative action") violated the Equal Protection Clause of the Fourteenth Amendment, which prohibits States from denying any person equal protection of the laws of the United States, as well as Title VI of the Civil Rights Act of 1964. The opinion does not directly affect employers, but it has lessons for HR pros hoping to ensure their diversity, equity and inclusion (DEI) initiatives do not unintentionally create liability.

## UNDERSTANDING SFFA V. HARVARD COLLEGE

Admittedly, both Harvard and U.N.C. considered an applicant's race at various stages. Harvard considered an applicant's race in all five stages of its admission process, and U.N.C. required its admissions officers to consider an applicant's race, among other factors like academic strength and student background. The schools' stated goal in considering race was to train future generations of leaders, uncover new knowledge through a diverse student body, encourage the discussion of different viewpoints and ideas, and prepare engaged and productive citizens.

While the Court noted these goals were laudable, it held that it was well-established that colleges and universities cannot consider an applicant's race as a positive or negative factor in admissions decisions. Reviewing the selection processes under strict scrutiny, the Court noted the processes failed in three major ways:

- the affirmative action policies were too ambiguous for courts to review, as there was no practical way to quantify or qualify the racial standards and criteria imposed;
- the programs engaged in harmful stereotyping; and
- the programs contained no clear endpoint.

In his concurring opinion, Justice Neil Gorsuch noted that these admissions programs also violate Title VI of the Civil Rights Act, which prohibits a recipient of federal funds from intentionally treating any individual worse even in part because of his race, color, or national origin and without regard to any other reason or motive the recipient might assert.

## HOW THE RULING AFFECTS EMPLOYERS

While the Supreme Court's decision has no direct impact on employers, it is anticipated that the decision could raise some red flags regarding DEI initiatives and (reverse) discrimination in the workplace. Justice Gorsuch's concurring opinion noted that Title VI's prohibition against discrimination on the basis of race, color or national origin is "[j]ust next door" to Title VII of the Civil Rights Act, which makes it illegal for employers to discriminate on the basis of race, color, religion, national origin or sex (including pregnancy, sexual orientation and gender identity). It also criminalizes any retaliation against an employee for complaining about discrimination, participating in an employment discrimination proceeding like an investigation or lawsuit, or reasonably opposing discrimination (like resisting unwanted sexual advances or helping protect co-workers from unwanted sexual advances in the workplace).

As a result, poorly created and implemented DEI initiatives coupled with a lack of training can create significant liability for employers. Employers must be prepared for these kinds of complaints to ensure their good intentions are not used against them. Indeed, complaints about DEI initiatives, including (reverse) discrimination, are not new and will likely increase as a result of this highly publicized opinion.

Employers should always know (and be able to articulate) the "why" behind employment decisions. Communicating the rationale behind DEI policies is key to demonstrating a lack of discriminatory intent. They should avoid making employment-related decisions based on race, sex or other categories prone to discrimination, and should try to avoid financially incentivizing managers or leaders to meet related diversity goals.

Employers should treat employees and candidates for hire as individuals instead of representatives of their respective minority groups. Additionally, employers should refrain from taking any action that could be considered retaliatory against an employee who complains of mistreatment.

By focusing their efforts on removing barriers to inclusion instead of creating unintentional quotas for racial or gender balancing, employers can administer workplace policies and standards equally across all employees while still capturing the essence of DEI. Specific DEI tools like affinity groups, mentoring programs and trainings should be carefully tailored to avoid potential liability.

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# Greenwashing: The Newest Trend In False Advertising Litigation

Greenwashing and sustainability claims are the newest trend in false advertising litigation. Like other false advertising claims, plaintiffs have employed statutory claims under various state consumer protection laws as well as common law claims of fraud, misrepresentation and unjust enrichment to attack sustainability claims in the courts.

**The reasonable consumer:** Under most state laws governing false and misleading advertising, courts look to whether a reasonable consumer may be misled by the allegedly false claim. In the greenwashing context, the contours of this standard are still being determined. An early case against Keurig alleging that it falsely advertised its coffee pods as recyclable despite being too small to actually recycle made it past a motion to dismiss. More recently, Coca-Cola was also the subject of a putative class action accusing the company of falsely advertising their bottles as "100% recyclable" even though some of the products end up in landfills. The claims were dismissed twice, with the Court finding that the complaint did not plausibly allege that a reasonable consumer would interpret the term "100% recyclable" to mean that the bottle would always be recycled.

**Claims matter:** In the false advertising context, courts applying the reasonable consumer standard look carefully to the claims that were actually made. In a proposed class action against H&M regarding its "Conscious Fashion" line, the plaintiff identified several website statements that allegedly misled him into believing the product he purchased was "sustainable" or "environmentally friendly." In considering the complaint, the Court looked to the entirety of the website and its descriptions regarding the fashion line at issue to hold that the reasonable consumer would not interpret the line to be "sustainable" or "environmentally friendly," claims that H&M never actually made.

**Preemption:** As has long been the case in other types of false advertising litigation—such as food and beverage claims—at least one company facing a greenwashing suit is similarly arguing that any such claims are preempted. Recently, a putative class action was brought against Delta Airlines alleging that it falsely markets itself as the "first carbon-neutral airline" in violation of California's consumer protection laws. In reality, the plaintiff alleges, Delta is not achieving carbon neutrality through use of sustainable fuels and carbon removal but by purchasing carbon offsets that do not deliver with respect to actual carbon impact. Delta has moved to dismiss the case, arguing that the claims are preempted by the Airline Deregulation Act. Unfortunately, the Federal Trade Commission's Green Guides—which provide guidance on the use of sustainability claims and should be consulted by companies making such claims—are not binding and do not preempt state law. This leaves many companies without a safe harbor unless other statutes and regulations apply to the claims at issue.

Even if claims such as these pass the motion to dismiss phase, consumers face an uphill battle in establishing that such cases are appropriate for class certification. To do so, they will need to point to common evidence that establishes that sustainability claims are material to consumers, that consumers relied on such claims and that consumers paid a price premium as a result of such claims.

Whether these claims are ultimately successful or not, companies are likely to continue to see an increase in greenwashing litigation, and companies should keep them top of mind when considering whether and how to advertise sustainability initiatives.

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# Supply Chain Due Diligence: M&A and Compliance Considerations

There is increasing international momentum towards mandating ESG-related due diligence along a company's entire supply chain. Germany has enacted a robust supply chain due diligence law that requires certain companies to investigate and remediate ESG concerns along the entire supply chain. With similar laws both contemplated and enacted in other EU nations, the EU's governing bodies are in the process of crafting a uniform ESG supply chain due diligence law that is intended to harmonize existing (and contemplated) member-state laws.

It is important to be aware of these contemplated and already effective laws both from a compliance perspective and an M&A perspective, as supply chain due diligence laws could have far-reaching consequences. A US company can easily bump into European supply chain due diligence concerns through its regular business operations simply by doing business with any entity that is part of a supply chain for a company subject to mandatory supply chain due diligence. Similarly, when acquiring new businesses that depend on extensive supply chains, a company should not overlook the potential costs resulting from compliance with these due diligence laws.

## GERMAN SUPPLY CHAIN DUE DILIGENCE ACT

On July 22, 2021, Germany adopted The Act on Corporate Due Diligence Obligations in Supply Chains, commonly referred to as the German Supply Chain Due Diligence Act (Act). Under the Act, companies within its scope have substantial responsibilities to ensure compliance with certain human rights, labor and environmental standards. These responsibilities extend well beyond the company's own operations, to both direct contractual partners and indirect suppliers up the entirety of the supply chain. There is no geographical limit—a company is responsible for international suppliers to the same extent as domestic. The Act went into effect on January 1, 2023, for German companies with over 3,000 employees and will expand on January 1, 2024, to German companies with over 1,000 employees.

The obligations placed on companies under the Act include both preventative and remedial measures, going well beyond typical due diligence. Some of the key requirements under the Act are:

- companies must have an internal risk management process to identify and prevent the covered ESG violations;
- companies must conduct regular due diligence along the entire supply chain to monitor ESG risks;
- companies must implement certain preventative measures to minimize the risk of human rights violations within both the company's operations and across the supply chain;
- companies must take remedial action when covered human rights, labor or environmental violations are discovered, including certain mandatory reporting to authorities;
- companies must establish a complaints procedure; and
- companies must specify who within the enterprise is responsible for monitoring risk management, for example, by appointing a human rights officer.

The German Supply Chain Due Diligence Act applies directly to companies with their principal place of business or headquarters in Germany, as well as to enterprises with a German branch office and at least 3,000 employees in Germany. However, this supply chain law has implications well beyond the companies directly within its scope. To comply with the Act, German companies necessarily pass along some of the preventative and remedial measures required by the Act to both their direct contractual partners and indirect suppliers. The entirety of the supply chain thus bears significant costs. US companies should be attentive to any operations that are in a supply chain of a German company subject to the Act—including any new operations proposed to be added through M&A activity—and evaluate on a case-by-case basis what compliance measures under the Act are likely to impact the US company.

## EU CORPORATE SUSTAINABILITY DUE DILIGENCE DIRECTIVE

On the heels of Germany's adopting its ESG supply chain due diligence law, the EU's governing institutions have been negotiating the Corporate Sustainability Due Diligence Directive (CSDDD), which would apply many of the features of the German Supply Chain Due Diligence Act to the entire EU. On June 1, 2023, the European Parliament adopted a final position on the CSDDD, a substantial step towards its adoption. The CSDDD will now be negotiated with the European Council and the European Commission.

The version presented by the European Parliament goes beyond the German Supply Chain Due Diligence Act in various respects:

- it incorporates more environmental factors into the supply chain due diligence requirements, whereas the German law focuses primarily on human rights;
- the CSDDD would apply directly to certain non-EU companies that have a certain level of EU contacts or operations, not just companies headquartered in the EU; and
- directors' compensation would be directly tied to compliance with the CSDDD.

US companies should closely follow any developments regarding the CSDDD. If passed, its effects would be significant. Any company with EU operations or contacts could potentially come directly under the scope of the CSDDD, similarly to the EU's recently-enacted Corporate Sustainability Reporting Directive, which is discussed elsewhere in this publication. Additionally, there would be indirect compliance considerations for any company in a supply chain with an EU company subject to the CSDDD, much as with the German Act, except that the cascading effect for an EU-wide law would cast a much wider net.

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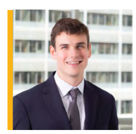

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# Commercial Property Assessed Clean Energy (C-PACE) Financing

While once a relatively abstract concern for many leaders in the real estate industry, climate change and its increasing impact have become a central consideration for commercial property owners, developers and investors alike. The intensifying physical consequences of climate change have brought a sense of urgency to the vital role of real estate, leading commercial real estate owners to seek green financing options to reach de-carbonization and sustainability goals and promote energy-efficient improvements to both new and existing real estate projects.

Commercial Property Assessed Clean Energy (C-PACE) financing is one such green financing option that has gained in popularity in recent years to help offset the significant upfront capital investment required to develop, renovate and retrofit commercial properties so as to meet increased sustainability standards. Like many existing types of project financing, C-PACE uses borrowed capital from private and public lenders to pay for costs associated with energy efficiency, water conservation and renewable energy improvements. But unlike other forms of financing, C-PACE is authorized by state and local legislation that classifies such clean energy upgrades as a public benefit, allowing Lenders to provide financing to a state or local governmental authority that is vested with the power to oversee the C-PACE program, who in turn secures the borrowed capital by way of a voluntary tax assessment levied on the property tax bill, in the form of a benefit assessment. The local tax authority collects the assessment payments much as it would payment for any other real property tax and remits such payments to the lender until the C-PACE financing is paid in full.

This is the usual C-PACE Program structure, but it is important to note that since C-PACE legislation is adopted at the state and local level, the program structure and rules vary across the country. To date, some 40 states including the District of Columbia have adopted some form of C-PACE financing legislation and it is imperative to understand how the particularities of the local C-PACE program structure might affect a project and financing strategy. Further, C-PACE capital is not available for all real estate properties, but typically can be applied to commercial property types, including hotels, health care facilities, and office and retail projects, as well as multi-family residential projects that consist of more than five units.

Notwithstanding this variation across the country of different C-PACE program structures, the benefits of this type of green financing are much the same. Because C-PACE financing is secured by the tax assessment, this type of financing typically allows for longer term financing that also matches the practical lifespan of energy-efficient improvements (generally around 20-30 years) and is usually automatically transferable upon the sale of the property. Interest rates on this type of financing also tend to be competitive, because the repayment is secured by the long-used mechanism of a tax assessment that is widely seen as more secure and lower-risk than other financing or forms of debt like mezzanine debt, which are not similarly secured by the property.

C-PACE financing can also be layered in with other forms of financing, such as mortgage loan financing and HTCs. While other such lenders and mortgage-holders may take issue with introduction of C-PACE financing, given the relative newness of such programs and the fact that this type of debt is tied directly to the property and is structurally superior to all other typical financings, lenders can find comfort in that payment of the C-PACE debt typically cannot be accelerated and does not affect a lender's foreclosure rights and remedies.

C-PACE financing opportunities are a helpful tool for real-estate players to finance the type of new construction projects and renovations to improvements that are necessary not only to face the oncoming challenges and perils of climate change, but also to satisfy new (though increasingly common) legislation demanding that commercial property owners reduce the environmental footprint of their buildings. In New York City, Local Law 97—which officially becomes active on January 1, 2024—will require that most buildings 25,000 square feet or more in size to significantly reduce their carbon emissions by 2024, or else otherwise face potentially steep fines. The City has only recently launched its own C-PACE program, but this and other green financing opportunities are likely to be a critical part of the strategy adopted by the real estate industry to meet these environmental, social and legislative demands.

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# House Financial Services Introduces Anti-ESG Legislation

As the Biden administration has taken a more forward-facing role in promoting the consideration of ESG factors in investments, House Republicans have pushed back by introducing several pieces of legislation that would undo these executive actions. Back in February, the House approved H.J. Res. 30, which would have repealed a rule issued by the Department of Labor that allowed retirement plans to use ESG criteria. This resolution received a bipartisan vote in the Senate before being vetoed by President Biden.

Not to be deterred, on July 27, 2023, the House Financial Services Committee, led by Chairman Patrick McHenry (R-NC), marked up several anti-ESG bills, which are expected to come to the House floor for a vote sometime before the end of this year.

- H.R. 4790, the Guiding Uniform and Responsible Disclosure Requirements and Information Limits (GUARDRAIL) Act, introduced by Representative Bill Huizenga (R-MI), would state that any mandated disclosure of information by the Securities and Exchange Commission (SEC) be limited to material information. It also would require a study to assess the impacts of ESG-related directives issued by the SEC.
- H.R. 4767, the Protecting Americans' Retirement Savings from Politics Act, introduced by Representative Bryan Steil (R-WI), would reform shareholder voting practices to allow issuers to exclude shareholder proposals from proxy or consent solicitation materials if a substantially similar proposal has been voted on recently (under terms set by the bill), or if the company already has implemented measures called for by the proposal. It would nullify the SEC's proposed rule on Substantial Implementation, Duplication and Resubmission of Shareholder Proposals.
- H.R. 4655, the Businesses Over Activists Act, introduced by Representative Ralph Norman (R-SC), would prevent the SEC from forcing companies to include or discuss ESG shareholder proposals.

All three of these bills passed out of committee by a party-line vote. Should these bills pass the House, they likely would face difficulty passing through the Democratic-controlled Senate.

These are just a few examples of anti-ESG legislation that has been introduced at both the State and Federal levels in the last year. Whether these anti-ESG efforts are ultimately successful or not, companies are likely to continue to experience political and regulatory uncertainty with respect to ESG. Companies should continue to monitor these developments and keep them top of mind as they seek to balance competing stakeholder interests with compliance with new (and potentially conflicting) laws and regulations.

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# SEC ESG Enforcement Efforts Continue

As we discussed in a previous publication, the SEC's climate disclosure rule, which was proposed in March 2022, would mandate, for the first time, that public companies in the US disclose climate-related risk and greenhouse gas emissions information beyond the information currently required by existing SEC rules applicable to registration statements and annual reports. Since Fall 2022, companies have been eagerly awaiting the release of the SEC's final rule. While the timing (and substance) of the final rule is still uncertain, many anticipate the release of the final rule before the end of the year. Even if that is the case, litigation challenging the final rule is expected. Despite the uncertainty regarding the SEC's final climate disclosure rule, public companies should be aware that the SEC is still focused on ESG.

For example, in March 2021, the SEC announced the creation of a Climate and ESG Task Force in the SEC's Division of Enforcement, which is mandated with identifying material gaps or misstatements in issuers' ESG disclosures. In a significant and closely watched case, in late March 2023, the SEC's Climate and ESG Task Force announced a settlement agreement with Vale S.A. (Vale), a publicly traded Brazilian mining company, for alleged violations of the antifraud and reporting provisions of the federal securities laws. The settlement resolved ongoing litigation regarding disclosures that Vale had made in its ESG and sustainability reporting. In particular, the SEC alleged Vale made false and misleading claims about the safety of its dams. The charges stem from the January 2019 collapse of the Brumadinho dam in Brazil, killing 270 people. The SEC alleged that, for years, Vale knew the dam did not meet internationally-recognized safety standards but continued to assure investors in its sustainability reports and other public filings that all of its dams were certified to be in stable condition. Ultimately, Vale agreed to pay a civil penalty of $25 million and $30.9 million in disgorgement and pre-judgment interest.

In its press release, the SEC emphasized the "interplay between the company's sustainability reports and its obligations under the federal securities laws." Significantly, the complaint referenced allegedly false and misleading statements in Vale's periodic reports, as well as its sustainability reports, investor materials and ESG webinars, stating that "public companies can and should be held accountable for material misrepresentations in their ESG-related disclosures, just as they would for any other material misrepresentations."

Even more recently, in September 2023, the SEC fined DWS Investment Management Americas, Inc. (DWS) $19 million over greenwashing claims and other issues. According to the SEC, DWS allegedly made material misstatements about its controls for incorporating ESG factors into research and investment recommendations for ESG integrated products and failed to adopt and implement policies and procedures reasonably designed to ensure its public statements about the ESG integrated products were accurate. In its press release, the head of the SEC's Climate and ESG Task Force stated "Whether advertising how they incorporate ESG factors into investment recommendations or making any other representation that is material to investors, investment advisers must ensure that their actions conform to their words…Here, DWS advertised that ESG was in its "DNA," but, as the SEC's order finds, its investment professionals failed to follow the ESG investment processes that it marketed." While this action involved alleged violations under the Advisers Act by an investment advisor, it serves as another example of an enforcement action brought by the SEC involving greenwashing claims.

These actions, along with other actions expected to be announced soon, should serve as a reminder that, with or without a final climate disclosure rule, the SEC is focused on ESG. Publicly-traded companies should carefully assess the accuracy of their ESG-related disclosures across all public-facing documents, including voluntary sustainability reports and investor materials, and put in place adequate policies and procedures to ensure the accurate and consistent disclosure of ESG information to the public.

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# D&O Insurance: An Essential Tool In The Evolving ESG Landscape

On September 26, 2023, KPMG published independent research showing that three-quarters of global businesses feel they are not ready for new ESG reporting regulations. KPMG's findings are the latest reminder to businesses—and their directors and officers and other insureds—about the important role that Directors & Officers (D&O) insurance can play as businesses and organizations strive for ESG compliance and work to mitigate ESG-related risks.

## INCREASED REGULATORY AND SHAREHOLDER SCRUTINY

As discussed throughout this publication, the evolving ESG landscape is causing considerable uncertainty for many companies, both in terms of compliance strategies, but also in avoiding lawsuits and regulatory investigations.

Companies are facing a host of new mandatory ESG reporting regulations in both the United States and abroad, including the SEC's anticipated climate disclosure rule, California's landmark climate disclosure laws and the EU's CSRD, among others. Companies are also experiencing increased risk of regulatory enforcement actions relating to ESG disclosures. The SEC, for example, has accelerated ESG enforcement efforts in recent years, highlighting the SEC's heightened focus on public-facing ESG-related disclosures.

Litigation-driven demands relating to ESG action—and inaction—are also growing. On the one hand, companies are facing increased pressure from many investors and other stakeholders to expand their ESG initiatives and commitments. Companies that ignore these demands open themselves up to litigation risk for not doing enough. On the other hand, with the growing anti-ESG movement, companies face the risk of litigation when they do take action. These developments show the bind that businesses, and their directors and officers, face. They can be sued for *ignoring* ESG. But they can also be sued for *considering* ESG.

## A PROACTIVE APPROACH TO D&O INSURANCE AND ESG

Against this backdrop, businesses should consider the important role that D&O insurance can play in mitigating risk and potential uninsured exposures, as well as its role in assuring protection for directors, officers and key employees who qualify as insureds. While D&O policies may generally respond to claims against corporations and their management spurred by these types of ESG risks, the specific policy language is crucial. For example, D&O insurance policies often afford coverage for regulatory investigations, with some policies specifically extending such coverage for books and records demands, and securities lawsuits alleging inadequate disclosure. But even when D&O insurance policies include specific coverage for these potentialities, D&O insurers, regardless of the explicit coverage provided for government investigations and other non-litigation matters, may nevertheless seek to limit coverage by asserting exclusions, sublimits or narrow definitions of covered conduct.

With the risks posed by ESG rules and disclosures evolving, and the uncertainty of how D&O policy terms may apply to ESG risks, consultation with experienced coverage counsel is essential to position businesses' insurance assets to respond to new and evolving ESG-related risks. Where businesses cannot completely avoid ESG-related liabilities, they can, by being proactive about insurance issues, at least mitigate the impact that these exposures have on the corporate bottom line.


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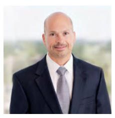

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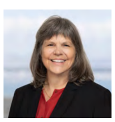

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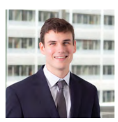

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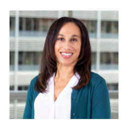

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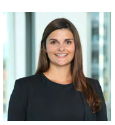

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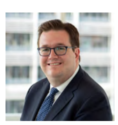

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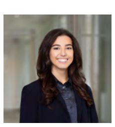

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