CORPORATE GOVERNANCE BRIEFING

ESG liability: risks increasing for multinational companies

In recent years, companies have faced a new imperative to implement and report environmental, social and governance (ESG) compliance measures. This has been driven by regulation, investors, other stakeholders and society as a whole.

The sharp focus on ESG compliance has naturally led to increased litigation and enforcement risks for companies (*see feature article "Managing ESG compliance: challenges for UK listed companies", www.practicallaw.com/w-025-9225*). ESG-related litigation is not new in the UK, where there has been a number of attempts to bring claims against English companies related to the impact of their business activity on local communities, the environment and human rights, often arising from events occurring at overseas operations in Africa, Asia and South America. Claims have generally been based on the tort of negligence, and often focus on defendants in industries such as mining and oil and gas.

A change in direction

There has been a marked shift in the approach of the English courts in the last two years. While the English courts had been reluctant to take jurisdiction over claims involving allegations about overseas operations and subsidiaries, the Supreme Court signalled in *Vedanta Resources plc and another v Lungowe and others* in April 2019 that an English parent company may be liable for the activities of its overseas subsidiaries where the parent company has been negligent in its oversight of the foreign subsidiary (*[2019] UKSC 20; see News brief "Parent company liability: your place or mine?", www.practicallaw.com/w-020-1794*).

In *Vedanta*, the argument rested on public statements about environmental compliance throughout the corporate group (*see feature article "Managing risk in multinationals: parental responsibility", www.practicallaw.com/w-021-7622*).

In *Okpabi and others v Royal Dutch Shell Plc and another*, the Supreme Court held that a group of foreign claimants had an arguable case that an English parent company owed a duty of care to residents of a community in Nigeria who alleged that they had been harmed by oil spills in their vicinity (*[2021] UKSC 3; www.practicallaw.com/w-030-2235*). The court's decision was unsurprising. It was first and foremost consistent with the principles laid out in *Vedanta*; that is, a duty of care may arise depending on the extent to which, and the way in which, the parent intervenes in the management of the subsidiary's operations.

Vedanta and *Okpabi* may already have opened the door to so-called supply chain liability claims, where claims are brought against large corporate entities related to human rights issues that may exist in their supply chains. For example, companies in the tobacco sector are facing claims alleging hazardous working conditions and child labour in their supply chains. As other cases continue to progress through the courts, there are likely to be further developments as the scope of the duty owed by parent companies and the circumstances in which there is a breach are explored further.

Parental liability

As ESG disclosures and obligations are increasingly required, whether legally or as a matter of good corporate governance expected by stakeholders, the scope for claims relying on public statements naturally increases. Following *Vedanta* and *Okpabi,* ESG disclosures may provide an evidential foundation for a duty of care related to overseas operations. Balancing the tension between transparency, commitments to ESG targets, and mitigating litigation risks is an obvious challenge. More than ever, businesses have to strike a delicate balance.

From a liability perspective, a central question is the extent of a parent's management of its subsidiary. This is heavily fact-specific and there is no limit to the models of management and control that may be put in place within a multinational group of companies. In *Okpabi*, the vertical structure of the corporate group, where decision-making processes were organised along business and functional lines rather than according to corporate status, was significant in raising triable questions as to how the structure worked and how decisions affecting subsidiaries were made.

It is clear that corporate structure alone, in which each subsidiary enjoys separate legal personality, does not automatically shield a parent from liability, and that the reality of operational decision making is a central issue. This is not a question of piercing the corporate veil, but a question of whether the parent company has independently assumed a duty of care.

This rationale may even extend beyond a corporate group into an organisation's supply chain, particularly where a supplier is effectively captive to an organisation; for example, where the organisation is the supplier's major or only customer, or a specific manufacturing facility is dedicated to the supplier. It is not difficult to foresee claims arising from allegations relating to matters such as working conditions and environmental impact at different levels of the supply chain.

Wider ESG focus

Across Europe, the landscape for multinational companies' liability for their subsidiaries' conduct is changing, on the basis of both regulation, planned and already enacted, and recent case law (*see box "The European perspective"*).

National and EU legislators are increasing their focus on ESG issues. A number of regulatory initiatives at the EU level aim to steer the attention of companies, including multinationals, towards the long-term sustainability of their businesses and their wider impact on stakeholders.

In particular, businesses are increasingly expected to identify, disclose, monitor, address and remedy any adverse ESG impacts of their activities, which increasingly include those of their affiliates and suppliers all the way down the group's value chain. The new legislative proposals are part of the ambitious sustainable finance action plan that the European Commission (the Commission) unveiled in 2018 (*www.practicallaw.com/w-013-9244*). In particular, in March 2021, the European Parliament passed a series of legislative

The European perspective

In January 2021, The Hague Court of Appeal held that Shell's Anglo-Dutch parent company, Royal Dutch Shell Plc, owed a duty of care to a group of Nigerian claimants (*Milieudefensie and others v Royal Dutch Shell Plc and Shell Petroleum Development Company of Nigeria Ltd [2021] ECLI:NL:GHDHA:2021:132–134*). *Milieudefensie* concerned the same set of facts as *Okpabi and others v Royal Dutch Shell Plc and another* and was determined by applying Nigerian law (*[2021] UKSC* 3). The court accepted jurisdiction and allowed the claimants to bring their claim in the Netherlands because Royal Dutch Shell, a co-defendant, had its principal office in the Netherlands and was therefore considered domiciled in the Netherlands. In setting out its conclusions, the court relied on *Vedanta Resources plc and another v Lungowe and others* and *Chandler v Cape Plc* on the basis that English precedent has persuasive authority in Nigerian courts (*[2019] UKSC 20; [2012] EWCA (Civ) 525, www.practicallaw.com/6-519-6273*).

It is important to note that the court's finding of Royal Dutch Shell's liability was limited. Royal Dutch Shell was held liable for failing to ensure that its Nigerian subsidiary, Shell Petroleum Development Company of Nigeria Ltd (SPD), installed an early-warning system to identify leaks in a pipeline, despite Royal Dutch Shell's involvement in SPD's decisions specifically with respect to early-warning systems and its knowledge that SPD had failed to install warning equipment. While Royal Dutch Shell was held liable for that failure, it was not held liable to compensate the claimants for the damage resulting from the leaks. Critically, it was not held liable for having caused the oil leak, nor for allegations related to an inadequate clean up. The court also summarily dismissed the claimants' claims based on human rights. Royal Dutch Shell has appealed the finding of a parental duty of care to the Dutch Supreme Court.

While *Milieudefensie* presents a narrow finding of liability strictly within the facts of the case, it was the first decision of its kind on the merits. Accordingly, it may have far-reaching consequences as a precedent for other European courts that are considering claims from foreign claimants with respect to damage occurring abroad.

recommendations to the Commission and proposed text for a draft directive to deal with corporate accountability and mandatory supply chain ESG due diligence (*www.europarl.europa.eu/doceo/document/TA-9-2021-0073_EN.pdf*). While unlikely to be implemented before 2024, the changes are expected to be wide in scope and apply to:

- Large companies.
- Small and medium companies that are publicly listed or operate in high-risk sectors, which will be identified by the Commission based on certain activities' significant impact on human rights, the environment and good governance.

In either case, the changes will apply to companies that sell goods or provide services in the EU, irrespective of their nationality.

The draft directive proposes to extend the jurisdiction of national courts in EU member states by explicitly allowing courts to adjudicate disputes arising from damage caused by the subsidiaries or suppliers of relevant entities, including where those subsidiaries or suppliers are situated abroad.

Even if not ultimately implemented in the existing form, the draft directive clearly heralds a regulatory shift from a supervisory model based on transparency obligations, such as requiring companies to disclose risks, to a model that creates substantive new duties of care; that is, requiring companies to act.

Analogous regulatory initiatives already exist, or are developing, at the national level in certain jurisdictions including France, Germany, Belgium, the Netherlands and Switzerland. These initiatives will or, in the case of France, already do, similarly require to varying degrees that businesses carry out due diligence and remedy any negative impacts of their business activities on human rights and the environment. For example, in France, the Duty of Vigilance Law of 2017 requires companies with their headquarters and at least 5,000 employees in France, or at least 10,000 employees worldwide, to publish a vigilance plan relating to a risk assessment of the human rights and environmental impacts of their business. In Germany, a draft law on sustainable supply chains, including a new due diligence law, was published in 2020, which proposes fines and criminal liability for non-compliance.

Mitigating risks

The key takeaway is that ESG litigation and enforcement risk is increasing. Businesses operating across borders must be alive to the risk of the impact that their subsidiaries' operations and their supply chains have on local communities, the environment and human rights.

As the law and regulation develop, the net will be likely cast wider and ESG risks are likely to increasingly affect businesses beyond those operating in high-risk jurisdictions or high-risk sectors such as energy and mining. In the long term, businesses should seek to mitigate litigation and enforcement risks by continuing to focus on responsible business conduct, which takes into account all of the stakeholders that are affected by their activities.

James Brady is a partner, and Marina Zarubin, Quinten De Keersmaecker and Clara Cibrario Assereto are associates, at Cleary Gottlieb Steen & Hamilton LLP.