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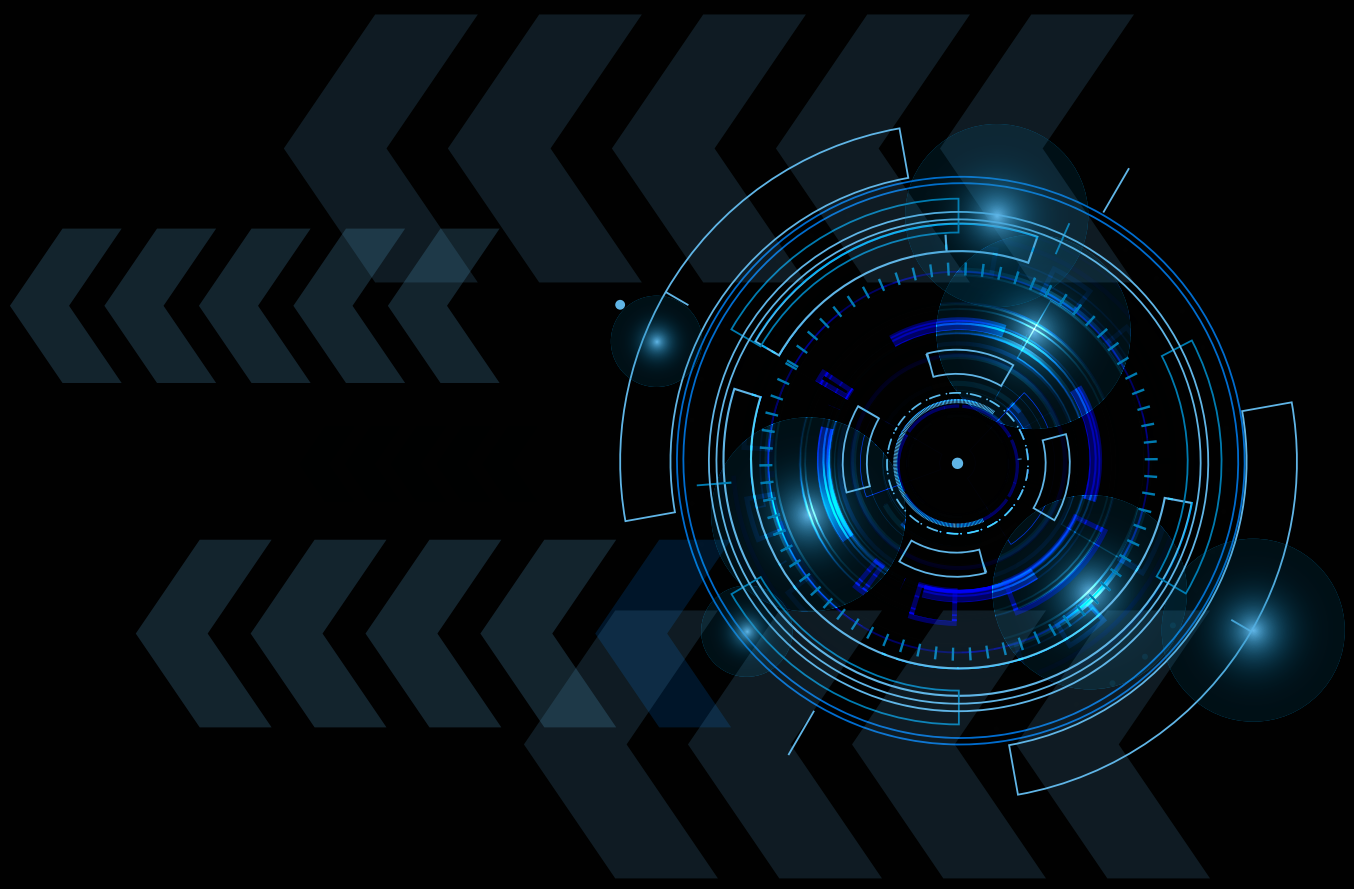

Why legal entity management is a critical part of ESG

Environmental, social, and governance (ESG) issues are among the most relevant ones that organizations face today. During the 2022 proxy season, shareholders offered 924 ESG-related proposals at annual meetings of companies listed on the Russell 3000 index, compared with 837 proposals in 2021 and 754 in 2020.[1] In early 2021, the U.S. Securities and Exchange Commission (SEC) created a Climate and ESG Task Force, increasing its focus on climate change disclosures, and hiring its first senior policy adviser for climate and ESG.[2] In March 2022, the agency proposed a rule entitled "The Enhancement and Standardization of Climate-Related Disclosures for Investors," which "would require registrants to include certain climate-related disclosures in their registration statements and periodic reports." [3] And the SEC is not alone in its increased scrutiny of corporate ESG initiatives. Both the New York Stock Exchange[4] and the NASDAQ[5] consider ESG reporting to be a best practice, and both Institutional Shareholder Services[6] and Glass Lewis[7] have propagated voting guidelines. Similarly, overseas, the International Sustainability Standards Board, Taskforce on Nature-Related Financial Disclosures, the European Union, and United Kingdom all have proposed new climate and sustainability reporting standards.

But what is the upshot of all this activity?

Many companies have focused on making broad commitments to ESG-related goals, and much of that activity has focused on sustainability and diversity. For example, Amazon has pledged to achieve net-zero carbon emissions by 2040 and has challenged other organizations to join them.[8]

What should companies be concerned about?

Some of the areas of concern for regulators, investors, and other stakeholders include how a company performs as a steward of the environment; how it views its relationship with the community; and how it manages executive pay, diversity, and shareholder rights. Examples include a company's management of water or carbon; its policies around diversity, wellbeing, and safety; and its political stances and lobbying.

Transparency around an organization's tax position is one such area of concern. Tax transparency has become an element of the effect a business has on society and regulators, and investors are increasingly using it as a measure of sustainable governance.

These are laudable goals but investing too little in governance initiatives to oversee these practices can leave companies vulnerable to risk. Governance requires organizations to follow sound practices in their controls and operations, including ethics, risk management, tax, and compliance, and as these issues have affected parent companies in recent years, they may affect subsidiary level governance going forward. As such, ensuring that ESG practices and reporting remain uniform through a company's legal entities is an emerging area that will likely see increased scrutiny over the next few years.

Potential risks for parent organizations to consider

Organizations – even those with mature ESG functions – still need to invest time and resources into shoring up their legal entity management to ensure ongoing uniformity between the parent and subsidiary. And even organizations with a robust entity management operation likely will need to address new challenges arising from a series of potential risks, including those in the following categories.

The failure to treat governance as a strategic, rather than compliance, task

Good governance is the foundation of effective boards, sound management, solid relationships with stakeholders and shareholders, and comprehensive management of all facets of the business. In other words, governance underpins environmental and social initiatives, and it should drive legal entity management as well. In our view, governance is 80% of the legal entity management equation.

Companies that have more robust ESG functions often have an ESG officer in place to manage ESG-related initiatives and reporting: However, many of these functions do not have a legal reporting structure in place. While the corporate secretary is sometimes also a company's general counsel, organizations often view managing legal entities as primarily a compliance task. It may be worthwhile to consider legal entity management, along with the rest of governance, as a strategic opportunity for the organization to advance its ESG initiatives.

New research by Deloitte[9] identified that legal teams can deliver substantial value from taking a strategic approach to entity management. This research suggests that, as the SEC rolls out its new rules around ESG reporting and the M&A market becomes more aware of these nuances, buyers will feel more comfortable making an investment. Buoyed by that confidence, when considering an acquisition, buyers are often willing to expedite both due diligence and the overall deal timeline, and are thus more likely to offer a higher price for a deal. Conversely, when acquirers have unanswered questions about their target's subsidiary management, including around ESG, they're likely to delay a deal in order to conduct additional due diligence. Along the way, they're likely to hedge their bets, double down on other concerns, and lower their offer.[10]

The differences between ESG reporting and financial reporting

Organizations are beginning to incorporate ESG initiatives in their corporate disclosures. But as they do, they are realizing that ESG

reporting differs markedly from traditional financial reporting, which focuses exclusively on the allocation and usage of the organization's capital resources. ESG reports, by contrast, address the company's impact on the environment, labor factors including diversity and inclusion, and management issues such as CEO pay. They also include both quantitative and qualitative measurements that address ESG risks, opportunities, and related strategies. Organizations should consider putting a process in place for staying up to date on the constantly evolving ESG requirements and learn how to report effectively on both the qualitative and quantitative aspects of ESG at the parent level – and that those aspects roll down uniformly to their subsidiaries.

At the same time, organizations need to also consider how ESG initiatives may materially affect their financial statements and tax filings. To get a clear picture of an organization's potential ESG impact, compliance and legal personnel must consider not only the parent company, but also subsidiaries and even suppliers. This will be especially important as new SEC reporting expectations are rolled out as a result of ongoing work being done to create new rules by an ESG taskforce at the SEC. Take, as an example, the impact of just one rule being proposed for investment funds that market themselves as ESG-friendly. It would require funds and advisers to provide more specific ESG-related disclosures in fund prospectuses, annual reports, and adviser brochures.[11] This makes entity management critical for companies that hold subsidiaries and are included in these types of funds because, without adequate understanding and controls on the entity structure, it will be difficult to meet these new reporting expectations.
Identifying the potential risks can be especially challenging in subsidiaries, as they tend to operate in different locations and sometimes in different industries.

Subsidiaries need to be in compliance with the parent company's ESG practices and protocols. Subsidiaries failing to align put the reputation and validity of ESG practices at risk across the entire organization.

Divestiture risks

Often, organizations divest subsidiaries to mitigate their risk, thus removing problematic divisions, products, or services that risk hurting a company's reputation and profitability. But divesting subsidiaries, which is a core element of entity management, may lead to additional problems.

If a business sets a goal of achieving net-zero emissions but one of its subsidiaries generates significant emissions, it may elect to divest that business rather than working to find ways to reduce the subsidiary's emissions. However, the divested subsidiary would be unlikely to completely disassociate from the company entirely; instead, it may end up as a vendor in the parent company's supply chain.

A change in entity structure in this type of situation does nothing to help the company achieve its goals, as investors and regulators will, at some point, scrutinize its supply chain. And even if the subsidiary does disassociate completely, there would be no overall reduction in its emissions.

Regulatory and litigation risks

As noted above, the SEC recently increased its scrutiny of climate-related corporate disclosure practices. But in the US, clear and consistent disclosures remain largely voluntary. The current SEC guidance suggests that organizations must disclose information that is "material," or substantially likely that "a reasonable investor would consider it important" in making an investment or voting decision, or if it would have "significantly altered the 'total mix' of information made available."[13]

But this nebulous standard puts the determination about what is material in the hands of the organization and runs the risk that critical information will not be disclosed. Establishing clear ESG-related policies and reporting standards within one's own organization may mitigate this regulatory risk. And propagating the policies through the company's subsidiaries will help to ensure they are adhered to uniformly. The SEC also signaled that it will step up scrutiny of corporate cybersecurity, which it classifies as an ESG issue. The agency has proposed amending Form 8-K to require disclosure of material cybersecurity incidents.[14] The proposed rule suggests that organizations should disclose whether they believe cybersecurity risks are part of their business operations. Organizations should also describe their policies and procedures for identifying and managing cybersecurity risks, which may be difficult for subsidiaries that may not work closely with a parent company's centralized IT and security teams.

Additionally, the proposal requires disclosure about management's role in overseeing cybersecurity risk and implementing the company's policies, procedures, and strategies.

Regulators are likely to continue examining ESG-related issues and increase the number of regulatory enforcement actions. Organizations that fail to monitor their ESG-related risks and ensure they are enacted uniformly at its subsidiaries may struggle to meet the SEC's standards for material disclosure.

Organizations with international subsidiaries may be at even greater risk of falling short of the emerging standards in the EU and UK for disclosing ESG-related threats to their assets. The European Council of the European Union recently adopted a new corporate sustainability reporting directive that strengthens the requirement that companies follow a double materiality standard – where they report on both how sustainability affects their performance, position, and development as well as their own impact on the environment and society. The directive enhances detail and transparency requirements for the information that companies must publish and includes a certification requirement for sustainability reporting.[15]

ESG-related issues at subsidiaries may also create or exacerbate litigation risk. Plaintiffs' firms that are already focused on environmental and social issues may begin to pursue governance claims on the premise that organizations are not acting quickly enough on ESG issues, and they can be savvy enough to compare performance at parent companies to their subsidiaries. Class actions are also likely to follow the path of regulatory enforcement. Clear corporate standards that include legal entities can be critical to avoid exposing an organization to litigation risk due to subsidiaries' lax ESG practices or reporting.

How organizations can improve ESG at their subsidiaries

Following these proactive steps can help organizations avoid ESG-related risk by actively engaging with their subsidiaries and streamlining their corporate structure where possible.

1. ***Establish a clear governance structure***
   Parent organizations would be wise to define the division of responsibilities between themselves and their subsidiaries with respect to ESG policy. While they cannot disclaim all responsibility for the subsidiary's actions, they can set standards that require the subsidiary to escalate important ESG-related matters to the parent, which may serve them well if the subsidiary runs afoul of ESG standards.

   The key is to ensure that companies and their subsidiaries have clear accountability mechanisms and controls. Where possible, companies may establish mechanisms to make certain that their leaders understand how they are following through on the commitments, assertions, and targets they set in their corporate disclosures.

2. ***Ensure management holds itself***
   accountable for their disclosures
   Directors and officers can be held personally responsible for ESG disclosures in corporate filings. Investors and regulators want to see proof that organizations are offering more than minimal efforts around ESG. Directors and officers, including those who serve on subsidiary boards, should ensure that they are fulfilling their obligations as fiduciaries to oversee the business and keep their commitments. Otherwise, they could be as liable as if they had no structures or commitments in place.

3. ***Practice tax transparency***
   Organizations should make sure to live up to their declarations about tax transparency. Disclosures related to tax contributions, including clarity around the corporate structure and the impact of subsidiaries on taxation, can be helpful for building trust among tax authorities, investors, and other interested stakeholders.

4. ***Simplify the corporate structure***
   Paring down the corporate structure can help lower a company's risk profile, reducing its potential for reputational damage and other harm. Keeping dormant subsidiaries could expose parent companies and their subsidiaries' board members to additional risk, particularly if there are hidden problems in subsidiaries' books or if they pose potential ESG risks.

   There should be a sound business reason for the continued existence of every legal entity. A leading practice is for organizations to prune their corporate structure, as appropriate, so that it is no more complex than necessary for ease of tracking and maintenance.

Conclusion

ESG issues are increasingly top of mind for investors, stakeholders, regulators, and even plaintiffs' attorneys, and companies are being called upon to provide in-depth answers about their efforts in these areas to an unprecedented degree. As the profile of ESG grows in importance, so do the risks at the parent and subsidiary level: from tax to divestitures to M&A activity to regulatory inquiries and litigation, companies must ensure that they are following all the relevant rules and laws. The key to doing so lies within transparent, consistent controls and operations at both parent companies and each subsidiary. Sound governance processes and procedures are the foundation for ensuring success around ESG and other entity management considerations and minimizing any potential issues.

That means that companies concerned about ESG – which is most companies, these days – should be careful to make sure that ESG policies extend well past the parent company through all its subsidiaries, both international and domestic. Furthermore, it is wise to take steps to make sure that subsidiaries implement and enforce policies, so that strong ESG takes place in practice and happens uniformly throughout the organization, as we expect increased scrutiny over the next few years.

Endnotes

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