

Legal actions as responsible investor

Marcel Jeucken, founder and director SustFin BV

The world of legal actions and responsible investing is becoming increasingly connected. This extends from a portfolio company investment risk, to an opportunity for achieving engagement results, to litigation risks for the investor themselves.

Although a few institutional investors have already developed a policy and/or approach in the field of legal proceedings on share ownership, whether as part of an ESG/responsible investment policy or not, the interface between responsible investment and legal proceedings is still uncharted territory for many. These are often two separate worlds.

The experience with and acceptance of legal actions differs from country to country. It is much more commonplace in the United States than in other parts of the world. However, the instrument of legal action is also gaining ground in Europe amongst others. Legal actions can: 1. be initiated by investors, 2. be initiated by other interested parties and directed at investee companies, and 3. be directed at the investor themselves.

Legal actions started by investors

Institutional investors can initiate, support or passively (via class actions) participate in legal proceedings themselves. This requires active monitoring and analysis of possible cases. Participating in the pay-outs of class actions in the US is typically called passive litigation. Such class actions are led by other investors who represent all investors with damages through e.g. securities fraud in the class period. Whether ESG improvements are part of such a settlement fully depends on the objectives of those lead investors. An investor can also choose to be a (co) lead plaintiff themselves. This can be the case when damages are sufficiently high and/or the investor wishes to pursue ESG objectives. This is called active litigation. These active and passive scenarios are the typical routes that are quite well-known amongst investors, and typically for equity portfolios.

Less well known are the opt-in (outside the US), opt-out (inside the US), and derivative actions (see below). Legal actions for other parts of the investment portfolio, such as credits and FX, are also lesser known. Antitrust cases surrounding FX fixing are an example of the latter. All of these actions offer the possibility of achieving compensation for financial losses suffered and/or achieving ESG objectives and thus have both a curating and preventative effect.

ESG improvements can be a reason for initiating a case (as (co-)lead plaintiff or via opt-in), or for doing an opt-out (because the designated lead plaintiff(s) does not sufficiently insist on ESG improvements). A well-known example is the settlement reached by PGGM as co-lead plaintiff in the case against Bank of America concerning deception around a takeover situation. In addition to a settlement of \$2.4 billion, a package of corporate governance improvements was enforced. The settlement e.g. required the Board to provide detailed disclosures to shareholders if the Board determines not to accept the resignation of a director who fails to receive a majority of shareholder votes and prohibits a director who has not received a majority vote from standing for election at the

next shareholder meeting¹. Legal actions can also be relevant in impact investing, so for portfolios that are deemed to do well for the environment and society. An example is the case against QuantumScape Corporation, which, partly because of an expected 'green premium', is alleged to have misled investors about the inadequate battery technology for the electrification of cars.

In the US there does not always have to be a deception or fraud that has led to financial damages to start a case. An investor can start a derivative action (a so-called 220 route) for a company listed in Delaware (this applies to many US companies). This is an interesting tool for responsible investors for whom engagement with a company on an ESG issue has been unsuccessful. Via a derivative action, an investor can demand a books and records request of a company. Any discrepancies or gaps between a company's policies or statements and actual practices can then be resolved through mediation or settlement. This way the ESG engagement objective can still be achieved through a legal process. Such adjustments within the company can correct or prevent (future) ESG and/or financial damages. For example, Swedish pension fund AP7 reached a settlement with Alphabet Inc in 2020 regarding diversity and sexual harassment and US SCERS reached a settlement with 21st Century Inc in 2018 to address harassment, discrimination and other misconduct in the workplace.

Legal actions started by other stakeholders

Institutional investors may also face legal actions initiated by other stakeholders targeting companies or entities in which they have investments or to which they have exposure as investors. Well-known examples are the legal actions targeting tobacco companies, which have resulted in huge settlements. Consider the longstanding settlement with states in the US totalling USD 368 billion.

Other examples are cases due to the use of asbestos (worldwide) or more recently the sale of opioids in the US. These, too, concern human health and therefore have a clear link to ESG. A new development are legal proceedings due to companies' inadequate climate policy. In 2020, the NGO Friends of the Earth Netherlands won a case against Shell, forcing it to reduce CO2 emissions by 45% by 2030.

According to a 2021 report, approximately 800 cases were filed by various stakeholders worldwide between 1986 and 2014, compared to more than 1,000 in the past six years. In the area of climate alone, this growth is expected to continue². Increasingly, an investor needs to understand and manage the investment risks of such legal proceedings and settlements. In a 2021 report, a global network organization of central banks highlighted the importance of adequate oversight of financial institutions' management of these risks³.

Legal actions aimed at the institutional investor

Legal actions directed at institutional investors themselves are a growing area. This can focus, for example, on misleading the prospectus about the risks of a financial product. Legal actions are now

¹ <https://www.prnewswire.com/news-releases/pggm-announces-2425-billion-recovery-for-shareholders-in-bank-of-america-securities-class-action-171877811.html>

² Setzer J and Higham C (2021) Global trends in climate change litigation: 2021 snapshot. London: Grantham Research Institute on Climate Change and the Environment and Centre for Climate Change Economics and Policy, London School of Economics and Political Science.

³ Network for Greening the Financial System (NGFS, 2021), Climate-related litigation: Raising awareness about a growing source of risk, November 2021

also focusing on institutional investors with respect to their contribution, or lack thereof, to ESG or sustainability issues. For example, the Australian pension fund REST was sued by a REST beneficiary for the lack of a climate policy and climate action at the pension fund. This eventually led to a settlement in which the pension fund committed to shaping and implementing a far-reaching climate policy. This includes carrying out scenario analyses, achieving net-zero emissions of CO2 by 2050 and preparing reports in accordance with the TCFD. In The Netherlands, ABP faced the threat of legal action from beneficiaries in 2021 because of its investments in fossil energy. Also the NGO Fiends of the Earth Netherlands had ABP and PFZW in its sights in 2022, following its success in the Shell case.

Policy and procedure of great importance

Every institutional investor should conduct a policy and risk analysis on the three dimensions of litigation mentioned above. It is advisable that this doesn't take place in isolation from the legal department, but in cooperation with the investment department, ESG specialists, product development and communication departments. Every institutional investor should ask itself what the influence of legal actions can be and how cooperation between different bodies within the organisation can help to achieve the objectives of the (responsible) investment policy. This requires a sound policy, approach and process to ESG and litigation and should, at a minimum, be a policy item on the board agenda.

In Brief/Summary:

- The world of legal action and responsible investment is becoming increasingly connected.
- An institutional investor can initiate legal proceedings aimed at financial compensation and/or ESG improvements.
- If another stakeholder initiates legal proceedings, an investor may have to deal with it if such actions are directed at investee company.
- Legal actions aimed at the institutional investor itself are a growing area.
- This issue requires better understanding and more attention of senior management at every institutional investor.