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The impact of ESG on directors' duties

Rachel Eng and Pei Yin Yap of Eng and Co discuss the different business areas impacted by ESG concerns that should be addressed by directors in discharging their fiduciary duties

Boards play a key role in steering companies to address environmental, social and governance (ESG) issues. With the growing focus of regulators, investors, consumers and wider society on ESG, directors must be mindful of the interplay between ESG factors and the discharge of their fiduciary duties.

Directors are under a duty to act in the best interests of the company, which has commonly been thought of as a duty to act in the shareholders' interests. While a company is accorded a separate legal personality from its shareholders, shareholders are often viewed as the primary beneficiary of the company and have exclusive rights such as the right to vote at general meetings and to appoint or remove directors. Naturally, directors are driven by the need to maximise profits and shareholder value.

However, directors' duties are not static. They evolve and adjust in response to changes in regulations, policies and market demands. There has been a growing trend towards the concept of enlightened shareholder value, where shareholder value remains paramount but the 'best interests of the company' is construed in accordance with the long-term, rather than short-term, notion of shareholder value. This corresponds to the pressing need for companies to account for ESG risks to achieve enduring commercial viability.

In light of the potential enormity of environment-related issues – especially for sectors heavily dependent on coal, oil and natural gas – failure to account for environmental risks may constitute a breach of directors' duties. Last year, ExxonMobil was dealt a blow in a proxy fight led by a small hedge fund, Engine No. 1, which rallied support from institutional investors (including ExxonMobil's second largest shareholder, BlackRock) to replace three board members. This came on the back of shareholders' dissatisfaction with ExxonMobil's approach to climate change.

Eng and Co. LLC
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www.mail.engandcollc.com

Rachel Eng
Founding partner
Eng and Co
T: +65 6597 3343
E: rachel.eng@mail.engandcollc.com

Rachel Eng is the founding partner of Eng and Co. She is a corporate lawyer with almost 30 years of experience, specialising in corporate advisory, mergers and acquisitions, listing, real estate investment trusts, funds and corporate governance advisory work.

Rachel is the firm's ESG leader and heads the structuring and documentation for ESG-related work. She has been recognised as a leading corporate lawyer by numerous independent legal publications, including IFLR and IFLR1000's Women Leaders Guide 2022, as being among the top female transactional experts globally. Rachel is a graduate of National University of Singapore. Prior to founding the firm, she was the deputy chairman of a major Singapore law firm with various regional offices.

Pei Yin Yap
Associate
Eng and Co
T: +65 6597 3330
E: pei.yin.yap@mail.engandcollc.com

Pei Yin Yap is a corporate lawyer at Eng and Co with experience in regulatory and transactional matters, as well as corporate governance advisory and ESG projects.

Pei Yin co-authored an article with Rachel Eng in IFLR's Asia ESG Report 2021 on 'Tracking the growth of carbon credits in Singapore and beyond.' Pei Yin is a graduate of the University of Bristol. Prior to joining Eng and Co, she practised commercial litigation and international arbitration under a senior counsel.

More recently, in March 2022, environmental firm ClientEarth started legal action against Shell's directors for breach of directors' duties, alleging a failure to prepare adequately for a net-zero transition. At the time of writing, it remains to be seen how this first-ever attempt at holding directors personally liable for mismanagement of climate risk will unfold.

Environmental-related risks are not, however, exclusive to emissions-intensive sectors. These risks affect most businesses in one way or another. Along with these challenges, climate change also presents significant opportunities for businesses that are ready and able to be a part of the solution.

This article focuses on directors' duties in the context of these growing environmental concerns (the E in ESG). It covers some of the key areas impacted by environmental trends that directors should take note of.

Business and revenue

As businesses focus on reducing their carbon footprint, some have started to impose procurement requirements relating to the emissions of their vendors and suppliers. These emissions are classified under the GHG Protocol Corporate Standard as scope 3 emissions. This refers to all indirect emissions (excluding indirect emissions from the generation of purchased energy which come under scope 2) that occur in the value chain of the company, including both upstream and downstream emissions.

If boards overlook the issue of supply chain emissions or if their companies are unable to adapt in time, these businesses may find themselves disqualified from procurement processes by customers who take such emissions seriously.

From the business angle, if a company offers or is able to offer products or services that could help their customers transition to the circular economy, the directors would be remiss if they failed to recognise and tap into this growth opportunity.

Carbon pricing

Many jurisdictions have established a price on carbon emissions, through the imposition of carbon taxes or establishment of emissions trading systems. Some have also introduced incentives and subsidies for certain 'green' services and technologies.

In 2019, Singapore became the first Southeast Asian country to introduce a carbon tax, which captures any business facility with emissions above a prescribed threshold. The tax was set at an introductory rate of S$5/tCO2e (approximately $3.70/tCO2e), to allow businesses time to adapt.

However, a higher carbon tax is needed to meet Singapore's ambition of achieving net-zero emissions by mid-century (for reference, the average carbon tax rate in Europe in 2021 was $42.29/tCO2e, with Sweden imposing the highest tax rate at $137/tCO2e).

Singapore will raise the carbon tax rate to S$25/tCO2e in 2024 and 2025, and S$45/tCO2e in 2026 and 2027, with a view to reaching S$50-80/tCO2e by 2030. These hikes are paced so as to give businesses more certainty and time to manage emissions.

Businesses that are subject to carbon pricing will experience a direct hit. Boards must oversee the implementation of viable plans to cut emissions or supplement decarbonisation efforts with effective carbon-offsetting strategies to mitigate any direct adverse impact on the company's bottom line.

Sustainable financing

In recent years, the appetite in the capital markets for sustainable financing has increased significantly. It was announced in the Budget statement 2022 that Singapore is committed to issuing around $26 billion of green bonds by 2030 to fund public-sector green infrastructure projects.

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The Monetary Authority of Singapore (MAS) has also introduced schemes to reduce borrowing costs and defray certain expenses (e.g. costs of independent external reviews) involved in sustainable financing. More than S$8 billion of green, social and sustainability bonds have been issued in Singapore since the introduction of the Sustainable Bond Grant Scheme in 2017. A similar grant was also introduced in relation to sustainability-linked loans, given the inclination for corporates in Asia to rely on bank loans more than bonds.

Unlike green instruments (where proceeds must typically be applied towards specific eligible projects), sustainability-linked loans can be used for general corporate purposes. The lender and borrower will agree upon sustainability performance targets and the borrower will either be rewarded for meeting or penalised for missing them, typically by way of an interest rate or coupon toggle. Sustainability-linked loans are thus suitable for borrowers looking to build incentives to achieve sustainability targets into their financing, but who do not intend to use the proceeds for particular green projects.

Sustainable financing may offer lower interest rates or other borrowing costs and may also be used to attract a wider range of lenders who are keen on sustainable investment opportunities. Boards should ensure that companies are well-positioned to tap into such financing alternatives, or risk losing competitiveness.

Environmental risk management and credit

In some sectors, regulators have already imposed mandatory environmental risk management policies. The MAS issued its Guidelines on Environmental Risk Management (Banks) in December 2020.These cover banks extending credit to corporates or underwriting capital market transactions. Boards and senior management of these banks are required, among other things, to identify environmental risks, evaluate the impact of such risks on the bank's strategies and oversee the implementation of an environmental risk management framework.

Under the guidelines, banks will have to assess each customer's environmental risk as part of the assessment process for credit facilities and capital markets transactions, including the customer's ability and willingness to introduce mitigation measures. Transactions with higher environmental risks should be subject to the bank's enhanced due diligence and may even be escalated to appropriate persons for approval, with all such decisions documented appropriately.

Banks may use financing conditions or covenants to require customers to take steps to manage environmental risks adequately and within an acceptable timeframe. If they do not, banks are encouraged to reflect the cost of the additional risk in loan pricing, apply limits on loan exposure or even exit the relationship or decline future transactions.

With the confluence of environmental risks and credit, businesses that are adept at managing environmental risks are likely to have better credit ratings while those that fail to address environmental issues could be met with higher financing costs and challenges in obtaining financing.

Reporting and financial statements

Regulators and investors increasingly emphasise the need for companies to report the impact of climate-related risks on their

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business and operations. BlackRock recently requested its investee companies to disclose ESG information in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), which go beyond existing non-financial disclosure requirements to focus on climate-related financial reporting. In the UK, reporting in accordance with TCFD recommendations is on track to becoming mandatory for certain listed companies.

The Singapore Exchange has also introduced a phased approach to climate reporting based on TCFD recommendations, with climate reporting becoming mandatory for issuers in the financial industry, agriculture, food and forest products industry and energy industry from FY2023 onwards.

These developments effectively reframe climate-related risks as financial risks affecting an organisation's balance sheet and profitability, rather than just non-financial or reputational concerns. Disclosure of financial implications also affords investors more transparency and ensures greater consistency and comparability across different businesses.

Further, while climate-related risks are predominantly discussed outside financial statements, factors such as the industry in which the company operates and the prevailing investor expectations may make some risks material and warrant disclosures in financial statements. The International Financial Reporting Standards (IFRS) Foundation has published guidance stating that while the IFRS do not refer explicitly to climate-related matters, these must be considered where the effect is material (i.e., if omitting, misstating or obscuring it could reasonably be expected to influence decisions investors make based on the financial statements).

Climate-related matters should be considered if, for instance, they cause inventories to become obsolete, selling prices to decline or costs of completion to increase, or if the useful lives of assets are affected because of obsolescence, legal restrictions or inaccessibility of assets. Climate-related matters may even create material uncertainties that cast doubt on a company's ability to continue as a going concern. In addition, companies whose financial positions are particularly affected by climate-related matters may be under overarching requirements to provide additional disclosures.

Directors must approve or attest to the accuracy and completeness of disclosures made in financial filings and must, among other things, ensure that the information presented in financial statements gives a true and fair view of the company's financial position. This requires directors to understand and assess climate-related risks and opportunities, and the consequential financial impact on the business.

Aside from the potential liability exposure, disclosures can also be a useful tool to ensure compliance with directors' duties, insofar as the disclosures are made accurately and with adequate specificity and relevance and are accompanied by appropriate cautionary language around associated limitations and uncertainties. Where appropriate, directors should consider engaging disclosure counsel for advice on how best to maintain oversight of disclosure and accounting issues.

Internal controls

To ensure accuracy and reliability of climate-related disclosures and financial reporting, companies will have to implement suitable internal controls to collect and process data. Boards must set the tone at the top by demonstrating a commitment towards reliable climate-related disclosures and should oversee the implementation of effective internal controls. These may include developing rigorous data collection processes and creating central repositories or reference sets for sustainability performance data analytics, as well as building organisational capacities to ensure that relevant people have the requisite expertise for collecting and analysing the data.

Boards may delegate climate-risk identification and evaluation to suitable teams or committees that report directly to them and the CEO. Ultimately, all relevant departments (e.g. legal, strategy, procurement, audit and investor relations) should have a clear understanding of their functional contribution to the company's climate-related efforts and be jointly accountable to the board.

Not to be ignored

In August 2021, BHP, the world's largest mining company, announced a sale of its oil and gas assets, as part of its plans to shift away from fossil fuels and towards 'future-facing' commodities. Investors are demanding action and voting with their feet; if businesses do not act fast, investors may exit, the company may face difficulties raising financing and directors may even find themselves subject to claims for breaches of fiduciary duties.

Environmental concerns and the need to transition to a low-carbon economy cannot be ignored, particularly by directors who play a crucial role in helping their companies navigate the sustainability landscape.