ESG Considerations For Trustees

In brief

ESG is an acronym for environment, social and (corporate) governance - factors considered originally (and separately) to be a measure of an organisation’s corporate social responsibility, and which are becoming increasingly important in determining its financial and general success.

ESG encapsulates a broad range of issues including (but by no means limited to) sustainability, corporate ethics, human rights, social good, climate change and corporate culture.

Why is ESG important?

The broadness of the term can lead to difficulty, particularly for those seeking to grapple with it for the first time and who may find themselves overwhelmed by the various issues they have to consider. Additionally, over recent years, ESG obligations have become enshrined into a mixture of soft and hard law, with reporting requirements being proposed and/or implemented in numerous jurisdictions. As a result, it is increasingly crucial for organisations to understand ESG opportunities and risks and to be aware of their obligations in every market in which they operate. The risks associated with ignoring these issues means that corporate social responsibility is no longer a ‘nice to have’ but rather a business imperative; whether that is manifested in investment decisions, supply chain management, geographic footprint or simply in the way an organisation treats its employees and whether it is considered a good place to work.

Why is this relevant to trustees?

The common myth used to be that trustees’ fiduciary duties restricted them from favouring ESG investments over traditional investments. However, this myth has well and truly exploded over recent years. Whilst it remains the case that trustees’ primary duties are to act in their beneficiaries’ best financial interests, there is now indisputable evidence that many ESG factors (most notably good corporate governance and climate risk) have a material financial impact on investments. As such, it is now being viewed as essential for trustees of discretionary trusts to factor ESG principles into their investment decisions (including in appointing investment managers, making decisions as to investment objectives and asset allocation, and in voting on company and shareholder resolutions).

For the uninitiated, the implications of a misstep in respect of ESG could be significant and as this article explains, the potential for legal risk for trustees is increasing.

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1 Cowan v Scargill [1985] Ch. 270
## Global developments

There are a number of global examples of rules and legislation that have been introduced to codify certain ESG principles and obligations. For example:

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<th>Legislation</th>
<th>Obligations</th>
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<tr>
<td><strong>UK Modern Slavery Act 2015</strong></td>
<td>Organisations which fall within this legislation are required to produce an annual statement setting out the steps they have taken to prevent modern slavery and human trafficking from occurring in any part of the business, including in the supply chains. The statement must be signed by a director and published on the organisation’s website.</td>
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<td><strong>Australian Modern Slavery Act 2018</strong></td>
<td>Requires large Australian entities and foreign entities carrying on business in Australia to report annually on the risks of modern slavery in their operations and supply chains and the actions taken to address those risks.</td>
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<td><strong>EU Non-Financial Reporting Directive 2014</strong></td>
<td>Required to be transposed into member states’ rules by the end of 2016, this directive requires certain large companies to disclose non-financial information about social and environmental impact, (e.g., environmental matters, social matters, and treatment of employees) and diversity information (i.e., the age, gender, educational and professional background of board members).</td>
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<td><strong>EU Regulation on sustainability disclosures in the financial services sector 2019</strong></td>
<td>Imposes sustainability disclosure obligations on manufacturers of financial products and financial advisers and disclosure obligations in relation to adverse impacts on the environment and society.</td>
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<td><strong>UK Occupational Pension Schemes (Investment) Regulations 2005, as amended in 2018 and 2019</strong></td>
<td>Requires trustees of occupational pension schemes to publish a statement of investment principles (SIP) that includes ESG principles. Since October 2020, trustees have also been required to report on how they have followed their SIP.</td>
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<td><strong>Potential EU-wide rules on corporate due diligence and accountability and corporate sustainability reporting, 2021</strong></td>
<td>In March 2021, the European Commission adopted a report on corporate due diligence and accountability that proposed the introduction of a mandatory corporate due diligence obligation to identify, prevent, mitigate and account for human rights violations and negative environmental impacts in business’ supply chains. Proposed new legislation is expected later in 2021 and could capture all companies that are either governed by the law of an EU Member State, established in the EU or operate in the EU’s internal market. In April 2021, the European Commission also adopted a proposal for a Corporate Sustainability Reporting Directive which would amend the existing reporting requirements of the 2014 Directive described above and extend its scope.</td>
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1 Commercial organisations supplying goods or services in the UK and with a worldwide turnover of more than £36 million.
Factors for trustees to take into account

Unless the terms of a particular trust deed provide otherwise, a trustee's primary duty is to act in the best financial interests of the beneficiaries and to exercise a duty of prudence when investing.3

In acting in accordance with these duties when making investment decisions, a prudent trustee should therefore take ESG factors into account as it is now generally accepted that companies with poor ESG ratings are at considerably higher risk of financial losses. As Guy Opperman MP commented in his foreword to a best practice guidance for pension trustees,4 “it would take a brave trustee, though, to conclude that absolutely none of these issues are material, or that they are all solely matters of personal ethics”. A negative ESG report or incident can have a significant adverse impact and can affect sales, customer loyalty, and brand value.

For example, Dr Condoleezza Rice cites the low-budget 2013 documentary film about how SeaWorld treated its orcas as a particularly stark example of the potential financial impact on companies when ESG risks are not addressed. This US$77,000 documentary led directly to Sea World’s greatest asset - the killer whale, Shamu - becoming its greatest liability, with corporations cutting sponsorship ties, investors divesting themselves of shares, regulators opening investigations into the parks’ safety practices and SeaWorld’s stock price plunging by 60 per cent.5 More recently, companies’ responses at the start of the Coronavirus pandemic have been scrutinised closely, with one survey into attitudes across 12 jurisdictions highlighting the real impact of dissatisfied stakeholders (for example, a third of respondents stated that they had convinced other people to stop using a brand that they felt was not acting appropriately in response to the pandemic).6 It seems likely that we will see future litigation involving trustees who have invested in companies with poor ESG indices where the value of these companies subsequently declines due to ESG failures. The clear message to trustees is that it is becoming increasingly important for them to factor ESG considerations into their investment decisions and that failing to do so will have adverse financial impacts on their investments.

The difficulty for trustees arises when an ESG factor is considered to be non-financial and/or detrimental from a financial perspective. Trustees may well be asked by some beneficiaries to invest in assets that are viewed as having a positive social or environmental impact, but which may have an adverse financial impact on the fund. For example, certain beneficiaries may be ethically opposed to trust assets being invested in certain sectors or asset classes, e.g., tobacco, fossil fuels or munitions, even if these sectors generate good financial returns. The current state of the law in the UK suggests that trustees of ordinary discretionary trusts should only take into account non-financial factors in their investment decisions if this would not involve a significant risk of financial detriment to the trust fund and if they consider that the beneficiaries would support their decision.7 More guidance is likely soon, as the High Court has granted permission for charity trustees to bring proceedings to obtain declaratory relief and directions about their wish to adopt environmentally-friendly investment policies.8 It is hoped that the substantive hearing will provide some new guidance as to trustees’ investment duties and the relevance of ESG factors.

In the meantime, it is important to note that ESG investing is not the same as impact investing. Whilst ESG investment analyses the environmental, sustainability and governance factors to understand the financial effect on returns, impact investing goes further by investing in companies, organisations, and funds with the express purpose of creating a positive social or environmental impact, alongside achieving a financial return. In our view, pure impact investing currently gives rise to greater risks to trustees, as

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3 Cowan v Scargill [1985] Ch. 270
4 ESG and Stewardship: a practical guide to trustee duties (June 2019)
5 Political Risk, How businesses and organisations can anticipate global insecurity, Condoleezza Rice and Amy Zegart
7 In R (on the application of Palestine Solidarity Campaign Ltd & Anor) v Secretary of State for Communities and Local Government) [2020] UKSC 16, it was said that: “Schemes… may also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision”.
8 Butler-Sloss v Charity Commission for England and Wales [2021] 4 WLUK 58
beneficiaries could bring claims against a trustee for its investment decisions if these lead to losses and a trustee is unable to demonstrate that its investment decisions were based upon financial considerations.

A cautious trustee will therefore ensure that all of its investment decisions are based on financially material considerations and will not rely only upon non-financial considerations. In practice, most ESG factors will be financially material on close analysis, given the potentially huge financial impact of an ESG failure. For example, a company’s approach to diversity could be viewed as a non-financial factor but there is increasingly compelling evidence that diverse companies achieve greater financial performance.9

For those trustees who control the shareholdings of ‘family’ businesses, there are potentially further considerations. Whilst ‘anti-Bartlett’ clauses will often narrow the scope of duties imposed on trustees to be involved in or to oversee the management of wholly owned or controlled trading companies, modern trustees may nonetheless wish to engage in high-level dialogue with those in control of management to better understand the management’s state of understanding of ESG issues. Such a dialogue should reveal whether the business is sufficiently well-versed in the issues affecting its market sector in order to help trustees assess whether the response of the business to ESG pressures is likely to be adequate to protect the interests of the trust beneficiaries.

Ultimately, if a settlor wants their trustees to adopt focused impact investing (as opposed simply to making ESG investments in the best financial interests of the beneficiaries), the best approach would be to establish a settlor-directed trust rather than a standard discretionary trust. This would greatly limit the risks to the trustees in adopting an impact investment strategy and would thereby increase the likelihood of the trustees in fact undertaking impact investing.

ESG risk management: recommended best practice

In light of the considerations above, trustees should carefully consider their powers and duties and how ESG factors affect them. While legal advice should always be sought by a trustee if there is any uncertainty about its powers and duties, broadly speaking, trustees who have decided that they can and should make a commitment to ESG and/or factor it into their decision-making regularly, should consider implementing the following steps (either themselves or by their delegated investment managers):

• Creating an ESG policy and communicating this with their beneficiaries and investment managers;
• Conducting a periodic risk assessment of investments (including ESG risk factors);
• Implementing training and ensuring effective communication of ESG policies and practices; and/or
• Voluntary or mandatory reporting as required or appropriate.

Investment decisions made by trustees have always been ripe for scrutiny by dissatisfied beneficiaries. The advent of ESG and ESG investing will only increase this scrutiny—particularly once we reach a post-pandemic world. Therefore, the sooner trustees are able to navigate the decisions that ESG will throw up and the challenges it will present, the better.

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