Social factors – Time to focus on the „S“ in ESG

By Dr. Hagen Köckeritz, LL.M. oec. int.

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Social criteria are often harder to measure than, for instance, environmental exposure. This is one of the reasons why social sustainability reporting lags behind.

Dr. Hagen Köckeritz, LL.M. oec. int.
Mayer Brown LLP, Frankfurt/Main
Partner/Attorney

hkoeckeritz@mayerbrown.com
www.mayerbrown.com

A company's ability and commitment to include environmental, social, and governance (ESG) factors in its strategy becomes more and more important to investors, consumers, policy makers, civil society organizations and other stakeholders. There is a fundamental societal shift towards sustainability and responsibility. Managers are held accountable for ESG compliance. While environmental and governance aspects have always been key criteria, social sustainability criteria such as diversity and inclusion, human rights, health and safety at work and equal employment opportunities for minorities have become a focal point only more recently. Many companies still have a rather vague understanding of what ESG actually means and how ESG criteria can be addressed by a company's compliance organization. At the same time, disclosure and reporting obligations make a company's approach to ESG very transparent for both internal and external stakeholders, so looking into this topic behind closed doors is no longer an option.

ESG-related disclosure and reporting requirements

There is a growing number of hard and soft legal requirements for the disclosure of non-financial information in corporate reports of larger companies, in particular on the environmental and social impacts of their activities. Above all, the EU Corporate Sustainability Reporting Directive (CSRD), for which a proposal is currently in the legislative process as well as the EU requirements on sustainability-related disclosure obligations in the financial sector, which also and in particular concern employee matters, should be mentioned. The CSRD is expected to replace the existing Non-Financial Reporting Directive (Directive 2014/95/EU - NFRD), which has been considered an inadequate responsse to the desire of stakeholders to receive adequate and detailed sustainability information.

Under the NFRD, only large public-interest companies with more than 500 employees and parent companies of groups with more than 500 employees on a consolidated basis have been required to publish information with respect to (i) environmental matters, (ii) social matters and treatment of employees, (iii) respect for human rights, (iv) anti-corruption and bribery, and (v) diversity on company boards (in terms of age, gender, educational and professional background). Unlike the NFRD, which applies to approximately 12,000 companies in the EU, the CSRD is expected to ultimately apply to almost 50,000 companies.

According to the existing proposal, the CSRD will have to be transposed into national law by the EU member states by December 31, 2022. Larger companies will have to meet certain reporting standards from January 1, 2023 and a second set of standards from October 23, 2023. Large companies are defined as those meeting at least two of the following criteria: (i) EUR 40m in net turnover, (ii) EUR 20m on the balance sheet and (iii) 250 or more employees. Small and medium-sized enterprises have to comply with the CSRD reporting standards only from January 1, 2026.

The proposal of the CSRD intends to make sustainability reporting requirements more consistent with the existing sustainable finance legal framework, including the Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation, and align with the objectives of the European Green Deal.

Purpose and standards of social sustainability reporting

Ultimately, all of these disclosures and reporting requirements to the extent that they relate to social sustainability criteria serve to provide meaningful information on the strategic importance of the workforce and its value added as well as on any personnel-related risks within a corporate organization. The ultimate purpose is to increase the value of the company in the medium and long term. For the practical implementation of these reporting requirements in HR management, standards and criteria are needed for employment-related matters. There are a number of non-binding standardization initiatives, such as the so-called GRI standards (GRI = Global Reporting Initiative), standards developed by the Sustainability Accounting Standards Board (SASB), the German Sustainability Code and the DIN ISO 26000 guidance. These standards provide criteria for ESG-compliant reporting, in particular on traditional labor law topics such as occupational health and safety, co-determination, anti-discrimination/D&I, and employee data protection. In practice, corporate social sustainability reports often have a narrow scope and focus on human rights compliance, employment promotion and charitable initiatives. ESG-compliant reporting around social sustainability goes much further, so there is quite a big information gap to fill by com-

panies. Social criteria are often harder to measure than, for instance, environmental exposure. This is one of the reasons why social sustainability reporting lags behind.

Implementation of social sustainability criteria in HR management

Social sustainability criteria should not only be reporting items but should be something companies and company leadership live up to. ESG reporting should not be viewed as just another requirement that companies have to meet. It is rather an opportunity to provide the desired clarity to investors and other stakeholders who want to assess the value added for a company that is associated with the human component. The following are common areas of interest when it comes to acting in a socially sustainable way:

- Consideration of ESG criteria in executive compensation/executive compensation metrics
- Consideration of responsible investment criteria in company pension systems/pension investment
- Occupational health and safety
- Diversity & Inclusion (D&I)
- Employee data protection/privacy
- Whistleblowing
- Agile working/working from home
- Pandemic management
- Deployment of external personnel
- Employee mobility and migration
- Company training and qualification
- Co-determination

Recent legislative and other developments linked to the „S“ in ESG

Also, recent legislative developments are directly related to the “S” in ESG.

The Act on Corporate Due Diligence Obligations in Supply Chains (*Lieferkettensorgfaltspflichtengesetz*), for instance, will enter into force on January 1, 2023. It is intended to ensure that internationally accepted human rights standards and certain environmental standards are observed. While, initially the new law will apply to companies or groups of companies that normally have more than 3,000 employees, a lower threshold of 1,000 employees will apply from 2024. Companies will be required to perform risk assessments in their supply chains and make reasonable efforts to avoid, mitigate or eliminate violations. The act establishes certain reporting obligations and documentation requirements. There is also an obligation to set up a whistleblowing system. When it comes to renegotiating or concluding new supplier contracts, provisions will have to be included to allow companies to take preventive measures and allow for proper selection and monitoring of suppliers and sub-suppliers. Companies that do not meet the legal requirements under the Act on Corporate Due Diligence Obligations in Supply Chains may face administrative fines and penalties. Depending on the type and severity of the violation, the maximum amount for administrative fines is up to EUR 800,000 or, for companies with an annual revenue of more than EUR 400,000, up to 2% of the average annual revenue of the last three fiscal years of the economic unit that the company belongs to. Companies that have been subject to a high fine can be excluded from public tenders and public contracts for up to three years.

Another act, the Second Law to Increase the Number of Women in Leadership Positions in Private and Public Sector Companies (*Zweites Führungspositionen-Gesetz*) entered into force in August 2021. For publicly traded companies that are co-determined, i.e. regularly employ more than 2,000 employees, fulfilling the previously existing obligation to have at least 30% women and 30% men in supervisory board positions, will no longer be sufficient. From August 1, 2022 private companies that are publicly traded and co-determined will also be required to appoint at least one woman and one man to any management board that has more than three members. For other private sector companies that have either been publicly traded or co-determined, the obligation to set a target figure for female representation on the supervisory board, management board and at the two managerial levels below the management board remains. So far, it was legally acceptable to set the target figure for female representation to

zero, provided this did not lead to a decrease in female participation. Going forward, setting the target figure to zero will need to be explained in detail and included in the company's annual reporting. The explanation must describe the considerations made including, without limitation, the facts assessed and how they were weighted by the supervisory board. The explanation must be sufficiently detailed to make a conscientious decision plausible to the public. Companies failing to report a target figure or failing to justify a zero target properly will be faced with fines of up to EUR 10m, or 5% of the annual turnover, or twice the amount of the economic benefit gained for publicly traded companies. For companies in which the federal government is the majority shareholder, even stricter rules apply and the long-term objective is to achieve equal participation of women and man by the end of 2025.

Summary and outlook

Social sustainability criteria become increasingly important for companies. In addition to dealing properly with short-term developments such as the handling of the coronavirus pandemic and managing its impact on a workforce, there is a significant amount of legal requirements in the social space that impact the long-term journey of a business. Companies need to be aware of what their obligations are, what compliance mechanisms they should implement, how they can efficiently measure their level of social sustainability and ultimately market the results in the best interest of the company and its workforce.

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