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Title. "Mind the gap" the importance of Human Rights Due Diligence in closing the gap between ESG and reality

1. Introduction

The climate emergency has focused attention on corporate behaviour and its impact on the environment and social issues. Corporate behaviours and their impact on the rights of others has also been in the legal news as UK Courts allow actions against mining and energy companies to proceed in the UK courts in respect of harms caused by overseas members of their groups.

We have also just celebrated 10 years from the introduction of the United Nations Guiding Principles on Business and Human Rights which as you may know were incorporated into the OECD Guidelines for multinational enterprises the breach of which may found a complaint before a national contact point. In this talk I will focus on the increasing importance for business of understanding the impact they (or a "business") may have on the rights of others, the responsibility to remedy and the significance of human rights due diligence.

2. The "gap"

"ESG" is not new, even the current focus on "E" is building on a movement which has been around for more than 20 years although there is a developing coherence around seeking to press businesses to reduce their impact on climate change through reporting pressures. In another but related "push" business is often asked to report on its "purpose". As you can tell from my title my experience of ESG as practised in many organisations is that although it may be well meaning it is not always effective. ESG often started as an offshoot of the "Comms" (usually headquarter) team responsible for Comms and market announcements and wasn't always connected to the realities of the underlying businesses. Some corporates were successful in using it as a tool to drive meaningful change in their businesses. Many used it as window dressing. Some corporates had values which were embedded in their businesses and were used as real drivers for change. This talk is not about ESG as such, it is about some of the issues which arise from the gap between an organisation's stated policies and both reality and frequently what the "law" or ethical practice requires. The "gap" may arise for a number of reasons one of which is as a result of the nature and complexity of modern corporate groups and the distance or gap between Head office and distant subsidiaries. There are, of course, some whose bad practice is a result of calculated risks or actions designed to produce profit and the risks of being "outed" simply priced in or ignored as a temporary inconvenience any effects of which good political contacts and effective PR can counter.

It is my view that for meaningful change to take root corporates will need to commit to respect the human rights of those their businesses affect or impact on and undertake meaningful assessments of what this impact is through the conduct of properly considered and tailored human rights due diligence. Knowledge of adverse impacts within a business is not sufficient in itself it needs to be connected to governance structures which themselves embed upholding fundamental standards whether in relation to human rights or environment/ climate change. The same comment applies to anti-corruption standards and there are many similarities to changes in corporate practice over the last 10 to 20 years in ABC and BHR.

3. The “law”

Lawyers frequently refer to the “law” and few question what it is. My experience as a practicing lawyer is that “law” can cover many areas and jurisdictions and is not always consistent. In any one transaction many “laws” could be involved. There is a law (you hope)chosen to govern the contract being negotiated. The relevant assets might be in many jurisdictions and be governed by multiple even on occasion “conflicting “ laws. There will be a collection of regulatory provisions ranging from employee matters to competition laws. The actions you advise on in one jurisdiction may have impacts or consequences in other and indeed many jurisdictions. In many circumstances you may simply be looking at the implications of past actions (due diligence) but past actions are rarely without ongoing consequences. Issues around “law” can be difficult in certain jurisdictions. In an M&A transaction due diligence tends to look at corporate history and prospects. In project finance the corporate entities may be SPVs so there is greater emphasis on the “project” and its related cash flows. That said, in any corporate related due diligence it is important to focus on money flows. The last 10+ years has seen the application of increasing due diligence to supply and value chains of differing standards.

It is also obvious that the law changes and the things which matter or drive transactions (or advice) change. The most obvious recent example of a new area is “data protection” and the related area of “privacy”. 10+ years ago investigations lawyers used to simply take a “view” on some of these issues now they often drive what you can do. There are also bodies of rules which may have significant effects although may not be recognised as “law” as such. The current most significant example of this to which I will refer are the UN Guiding Principles which are now 10 years old. These are commonly referred to as “soft law” but which are rapidly hardening. As a result of recent developments in a number of jurisdictions (mainly EU) elements of these are being incorporated into legal systems.

Much complexity comes from the economic substance of a modern “group” of companies, which might behave in many respects as one “undertaking” but be built of entities owning assets and operating in a number of jurisdictions. Complexity becomes an issue in itself and groups put adherence to some legal systems as more important than others. Some legal systems (of most note the US laws applicable to corruption, but not forgetting the Bribery Act) have significant effects outside the geographical jurisdiction (“Foreign Corrupt Practices Act” being the most notable example but Competition law provides many others)

When giving advice and taking a judgement I and certain of my colleagues used to refer to what we called a “look back principle”. This means considering the direction that law and regulation is going in and remembering to evaluate actions as if you were doing it in 10 years time. This depends on the area to some extent and flies in the face of much City practice where refined and precise advice based on the law as understood at the time is what City some institutions require (“Angels dancing on pinheads” is one expression used to describe advice being given in the first Iran sanctions crisis). Whereas very refined and calculated views on UK or US corporate law may be appropriate, advice on human rights or environment in an emerging or developing market might require a completely different style of evaluation. In mining and energy projects in for example Africa much has been written on the significance and effect of “stabilisation agreements” which started as agreements to limit change to taxation regimes but may also have significant effects on the rights of affected peoples.

4. Transactions

An M&A transaction is a good vehicle for demonstrating what a commitment to respect human rights in business can mean. Most significant transactions involve due diligence but not always by that name. Looking at an M&A transaction also provides a useful tool to illustrate the similarity and the difference between commercial or financial due diligence and human rights due diligence.. There are similarities with due diligence in relation to a project finance and M&A and also some important differences of detail but these do not affect the principles. Regulatory due diligence especially in the ABC (and related AML) spheres is more closely related to HRDD.

M&A-the significance of due diligence

M&A transactions come in many forms, sizes and even natures. Size also matters, on a £50m transaction what is significant can be very different to what is looked at on a £1 bn transaction. Human Resource issues can drop out of consideration early and the larger the transaction the greater the importance of regulatory issues is the normal pattern. Some issues such as “title” are nearly always significant.

In M&A working for an acquirer it has been a key part of practice for the buyer’s lawyers to conduct what is known as “due diligence” for more than 30 years. This has many strands but would always include looking at “regulatory” and “commercial” matters. What you look at is what is important for the business or, sometimes referred to as what is “material”. “Material” in business terms usually means something which would have a significant or material effect on the relevant business and its finances. An assessment of what is important often starts with looking at the accounts of the target. In M&A the level of materiality for contractual purposes is often defined so for example circumstances below a certain amount of value may not be taken into account in calculating warranty claims. There is a related concept of materiality in the production of accounts but the numbers involved can be very different.

What is the same is that “materiality” is defined by reference to its impact on a business, often by reference to impact on earnings, liabilities or value. This can be difficult for example in high tech industries but nonetheless the principle for ascertaining what is material is the same. Regulatory issues require a different discipline. they may give rise to disgorgement, fines, procurement bans, financing exclusions and AML concerns etc. and in relation to ABC or similar issues “materiality” should never be a factor precluding examination. Reputational issues may in themselves be indicators of concern.

Regulatory issues such as ABC or corruption require a different type of assessment for a number of reasons principally because the magnitude of the business related consequence may bear little relation to the apparent size of the underlying business issue . First the implications of what might appear initially as minor could prove to be severe. Their existence may also be indicative of governance, accounting and financial control issues. If you suspect corruption exists in a target the implications can be severe ranging from commercial through to structural and may even be “terminal” for an enterprise. These issues are possibly more difficult for a seller to manage as the implications may continue to taint the seller group even after a target has been sold. If discovered by a purchaser after the event they may cause severe damage to a seller. Well advised Seller's will now also conduct due diligence and in high risk areas this will almost certainly focus on regulatory risks such as corruption but increasingly will look at human rights and environmental issues. One of the skills of a good adviser is being able to assess which issues should stop a transaction and which issues can be dealt with by way of price adjustment or structure.

Nonetheless the focus of all of these different due diligences is impact or potential impact on the business being bought or sold.

The UNGPs (and for that matter the OECD Guidelines, for ease of reference I will only refer to the former) place the emphasis firmly on the impact a business has on the rights of those on which the business impacts and they expressly require due diligence. This is a very significant difference in focus. On a multi billion $ transaction the financial value of slavery or forced labour in far off subsidiaries in a supply chain may be unnoticeable. The total land value of a community which is excluded from its land might be small, the value of the water which is now too polluted for an indigenous group to use may also be too small to feature in "Group Accounts" as a contingent liability. Nonetheless the impacts on the rights of these affected people could be significant.

Under the UNGPs you are said to be responsible for providing a remedy if you "caused" or "contributed" to a harm but only required to use your "leverage" to reduce a harm if you are merely "linked" to it. These were new concepts when introduced and have caused some debate especially from financial institutions some of whom have advocated that a provider of finance is only "linked" to a harm caused by a borrower and has not contributed to it. **The UNGPs require all those who have "caused or contributed" to a harm to provide a remedy or "remediate".**

In an M&A deal traditionally you would be assessing the assets and liabilities of group members. You may look at material supply contracts usually to ascertain contractual security. Ie is there a change of control clause? is there a default? what are the termination rights and pricing provisions etc. There will be many contracts which are too insignificant to look at. Eg the printer or copier contracts, cleaners, chauffers etc etc. In fact on big deals the extent you are involved in looking at HR matters could be quite limited. If there is DD it will usually be done in conjunction with the HR department of the seller or target or both. Similarly most everyday commercial contracts may fall below the materiality threshold M&A Counsel will look at.

There are a number of very significant differences in the way HRDD needs to be constructed. First because you are looking at the "impact" or "potential impact" a business has you will need to consider its downstream contractual relationships. Not just those of direct suppliers but sub suppliers and below. This is especially significant where there are outsourcings. There are indeed well developed OECD guidelines on doing just this sort of due diligence which are industry specific. It is important to understand that the scope of "who" you are looking at goes outside the target group of companies. **The scope of a human rights due diligence is not qualified by business materiality but instead ought to be determined by an assessment of the risk of an adverse human rights (or environmental) effect either being present in the business (M&A) or arising as a result of the transaction (M&A, Project finance and any commercial contract).**

Indeed, supply chain due diligence ought to be a fundamental part of the operation of any business including everyday contracting and operations so in an M&A deal you might start by looking at the processes and procedures for contracting and operations that the target has. For many years a statement has been required to be made by many UK companies as to their policies for ensuring there is no slavery or forced labour in their supply chains. Looking at these statements and the procedures behind them can be revealing as to general standards. A company's "ESG" communications are another starting point but beware in my experience even if they are believed to be true by the HQ of the entity promulgating the statements our experience on many occasions was that there can be a significant gap between these statements and the reality on the ground.

Another key distinction is the need to speak to stakeholders in order to effect proper HRDD. Given the confidentiality requirements which usually surround M&A deals this might be challenging. What you do will depend on the risks involved and the nature of the stakeholders. If the target has good practices you might choose to rely on them but if the risks are high you will probably choose to implement DD which involves checking for adverse impacts with stakeholders.

In an M&A transaction there is always the option of relying on a contractual claim (eg based on indemnity) but whereas this may be effective where a claim is based on loss to the company it could be much more difficult to get an effective contractual remedy for a target's adverse human rights impacts. You will need to understand and carefully implement the difference between "indemnity against loss" and "covenant to pay" in this area as a starting point to create any meaningful contractual protection. It can be hard to create a mechanism which proves a contractual remedy for future reputational loss. There are many parallels with the world of corruption and drafting for price adjustments resulting from, for example, disbarment can be very difficult indeed. For example, slavery in a target supply chain which comes to light could lead to exclusion from significant markets in the US and increasingly elsewhere.

Supply chain due diligence is increasingly understood to be fundamental. Depending on the industry of the target it could also be important to conduct **value chain due diligence** (eg looking at the impacts of the products sold). If the target is in the defence industry or sells surveillance technology you might want to know whether it reviews the conduct of its customers or simply relies on the relevant Government to issue an export license.

HRDD as envisaged by the UNGPs has one other significant difference to more transactional DD such as is conducted on an M&A transaction or a new project. This is that HRDD needs to be continuous and to embody systems to check its effectiveness.

5. Provision of finance

The same considerations arise in finance transactions. If a bank is providing finance to a customer the question arises as to what assessment is done as to the impact of the borrower's business. In the news at present are the various steps (for example at EU level- see the EU taxonomy) being taken to restrict finance to fossil fuel based industries. It is likely that all multilateral finance institutions will increasingly adhere to this. The same issues arise in relation to human rights and the need to assess whether a borrower's business is producing adverse impacts on the rights of others. There has been significant criticism and litigation for example against IFC in relation to a project loan it made to finance a power station in India which caused significant damage to a local community (the

Jam case). Project finance structures are recognized as providing a close connection between the provider of finance and harm to those affected by the implementation of the project. Indeed the Equator principles now expressly include the standards of the UNGPs.

The same need to conduct HR DD arises in relation to equity investments especially in private equity type investments but it also arises in relation to investment into listed companies.

6. The role of a lawyer, do lawyers have an "impact" in their own right

A certain firm had just completed what it considered to be an exciting finance transaction in the energy sector in a "Stan". In the course of listening to the transaction leader I asked the proud partner who had lead for the banks, how did you deal with the slavery issues? His answer indicated he hadn't considered them and didn't know there were any. In his defence the role of a lawyer in some financing transactions is said to be to simply "document" and it is possible that others had been considering these issues. In my view that should not happen whatever your role.

Humans rights issues come in many forms. For example humanitarian law in Western Sahara and the West Bank also affects the structure of commercial arrangements. Abusive regimes in, for example, Eritrea can lead to the conclusion that the only advice you can give is not to attempt to do business there. Clients sometimes want lawyers to " wash away" or move concerns through "contract" or "legal opinion". My view is you cant, you always need to understand the effect or impact of what is happening and indeed what your own role as lawyer is. Or you may find you are "linked" to a harm and may even have "contributed" to it.

It is always important to consider the impact of what you are doing whether you are in house or an external adviser or simply working for a company. If you do find yourself in situations where the risks of finding an issue are high you should give careful consideration to the situation. The answer might be that someone else is engaged in dealing with these issues so the risks are being managed. I think it is for each person to decide their own comfort levels but I recognize this may give rise to practical difficulties for indivudals.

In my M&A example I focused on buyer due diligence. As a seller it can sometimes be important to consider the impact or consequences of your selling the business can be. Myanmar gives rise to lots of issues. For a good recent example look at Telenor and the NCP complaint brought against them by SOMO. Note the complaint about the absence of DD. Telenor was in a difficult position, they are state owned. They felt they couldn't remain in Myanmar. They have sold to an allegedly tainted buyer. But note telecoms businesses are particularly susceptible to state influence because of the need for ongoing licenses. So I doubt Telenor had much choice in the choice of buyer.

In all areas of the law lawyers like to refer to "practice". On a banking or finance transaction the legal processes and the form of the related legal opinions can be tightly regulated. Increasingly as risk management policies and economic pressures bite law firms become increasingly "process driven". This can result in increased fragmentation of roles with very few being aware of the complete or "big picture". Roles can differ from leading a transaction or investigation to doing a particular bit of due diligence or advice. Even leading a transaction might mean only that bit of the transaction your firm is engaged on. There may be many law firms and professionals each fulfilling different roles.

This can mean it becomes very difficult to assess what impact your actions are having and indeed what impact the transaction, investigation or advice you are involved in is having. That said there will be many situations where you are acting as overall (trusted) adviser and in effect helping define what matters. In short, you cant duck and will need to make an assessment of the issues.

7. Conclusion and Legislative trends 2021

We are all waiting to see what the EU Commission finally proposes in relation mandatory Human Rights due diligence. We have a new German law, proposals in a number of European countries in this area. California ,the UK, the Netherlands, Singapore, Australia have laws seeking to eradicate slavery form supply chains. There are related rules on procurement. The 2017 French law on the Corporate Duty Of Vigilence which required large companies to assess and publish an assessment of their impacts on people and the planet was groundbreaking.

It is fair to say that this area will give rise to significant new requirements in the practice of due diligence. Whilst good current practice already does this it will move from being good practice to being required. This will have an impact in all areas of business . From everyday contracting to major transactions. What I can say for certain is that knowledge of how to conduct human. Rights related due diligence which is now the preserve of a few will need to become widespread.

(I have not covered “reporting”. The last 10 years have seen significant developments in “non financial reporting” by listed companies. In some areas this has been extended to private companies. Climate change is already driving enhanced reporting requirements and it is arguable they already exist for businesses with significant human rights impacts in relation to “risks”. However that is a subject in its own right.)

Underlying all of these comments is my strong view that the biggest danger facing lawyers is they forget to “think” while “implementing clients’ instructions. Whatever the working practice, precedent or market you should always question the “impact “of what you are involved in and at least consider the risks. There may be good answers but the higher the risks the greater the need to consider the impacts of what you are doing.

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