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WHAT THE EVOLVING LANDSCAPE OF ESG MEANS FOR FRAUD AND INSOLVENCY PRACTITIONERS

Environmental, Social and Corporate Governance, otherwise known as "ESG", are the three criteria widely used to evaluate a company's sustainability performance. The criteria, which were originally coined as investment criteria to help socially conscious investors differentiate between target companies, are intended to demonstrate whether companies are remaining conscious of their impact on the environment, their contribution to society and their accountability to the public.

The relevance of ESG to a company's business model is that more and more investors and purchasers are looking to carry out business with those who "do good" and act conscientiously to achieve a positive social and environmental outcome. For some purchasers and investors, this desire to enter into contracts with companies with good ESG ratings is part of an effort to invest purely into businesses with a commitment to responsible investment. For others, the motive is financial: it is well known that companies with a focus on socially responsible practices can often attract a larger customer base on account of the growing interest in ESG and the demand to purchase from companies who share similar values. Consequently, ESG can have a vast impact on the success of a company.

Why is ESG becoming more important?

In addition to being financially lucrative, companies are under increasing pressure to publish their ESG data in the wake of COP26 and the publication of the UK's strategy to reach net-zero emissions by 2050. ESG is now a board-level concern, and more companies are beginning to implement and publicise their ESG strategies and advocate ESG principles as part of their business model in order to keep up with this new zeitgeist.

However, increased interest in sustainable finance, ESG ratings and pressure on companies to report this data has created a number of issues for fraud and insolvency practitioners.

(1) Restructuring

As businesses begin to emerge from the Covid-19 pandemic (many with significant debts) companies adopting some form of restructuring should expect ESG scrutiny from investors and lenders. This is because ESG factors are of increasing importance to both investors and lenders given the growing popularity of sustainable practices to the public at large and the reputational hit that poor ESG practices can have on a business. Banks and other institutional lenders, for example, will be giving careful consideration to a company's business plan and the aspects related to ESG. Practitioners will therefore need to be astute to the growing demand to have proper ESG policies and guidelines in place before reaching out to investors and lenders alike.

(2) Fraud

ESG funds (namely investment funds whose portfolio of investment companies is made up of businesses who put ESG at the forefront of their business model) have seen exceptional investment in recent years ($51.1 billion of net new money was invested into ESG funds in 2020, up from $21 billion in 2019[1]). However, in circumstances where ESG remains largely unregulated and is still a term which remains open to interpretation, there is fertile ground for fraudulent activity. This was recognised in April 2021 by the U.S. Securities and Exchange Commission issuing a 'Risk Alert' stating that investment firms may have misguided investors about the ESG credentials of their funds and

[1] ESG investment funds more than doubled in 2020 (cnbc.com)

exemplified the importance of carefully articulating what investors mean by "ESG" before attempting to draw investors in[2].

Carbon offsetting schemes also have potentially fraudulent consequences. These schemes allow companies to invest in environmental projects which will balance their own greenhouse gas emissions. To offset their emissions, companies purchase the equivalent volume of carbon credits. However, the carbon credit scheme has been mired by fraud (for example, where carbon credits did not exist, or the projects invested in did not actually reduce emissions). In addition, it has come under scrutiny from the likes of Greenpeace, who claim that it 'doesn't really work'.[3]

This ties into increased instances of 'greenwashing', a term coined in the 1980s to describe the practice of labelling an act designed to increase profit as environmentally conscientious. Evidence of greenwashing often comes from spending differences, for example when a company spends significantly more money or time on advertising being perceived as 'green' than on environmentally sound practices. While there is no specific anti-greenwashing legislation in the UK to combat the number of companies misleading the public, on 20 September 2021 the Competition and Markets Authority published its Green Claims Code (the **Code**)[4]. The Code aims to help businesses comply with consumer protection laws and avoid misleading consumers in relation to their environmental impact.

(3) Disputes

With an increase in reports of false greenwashing claims and exaggerated carbon offsetting statistics, it is very likely that more and more disputes will follow, whether in the form of breach of contract or misrepresentation. Claims in the UK are also likely increase in light of the growing awareness of ESG issues and the appetite for holding companies and government bodies accountable for their environmental footprint.

Indeed, environmental organisations and other NGOs understand that litigation can be a useful tool in challenging organisations which fail to adhere to their own ESG policies, or simply do not implement ESG strategies at all. One example of this is the challenge brought by the environmental organisation, Plan B, against the government's plans to expand Heathrow Airport. Plan B claimed that the government had failed to consider that the expansion plans were incompatible with the UK's climate commitments under the Paris Agreement. While the final Supreme Court ruling was decided in the government's favour[5], the case is one of a growing number of examples of public concern regarding the environmental and social impact of government bodies and corporate entities.

Conclusion

The recognition of ESG issues, and the establishment of a coherent ESG strategy, are increasingly important for businesses and government bodies alike. Reputational considerations and the threat of court litigation will require organisations to embed ESG into their operations in order to survive and stay competitive. Failure to consider ESG issues may lead to the restructuring or demise of companies. In addition, the rise of ESG on the corporate agenda and the pressure that entails will mean that instances of ESG-related fraud will inevitably increase.

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[2] esg-risk-alert.pdf (sec.gov)

[3] https://www.greenpeace.org.uk/news/the-biggest-problem-with-carbon-offsetting-is-that-it-doesnt-really-work/?source=GA&subsource=GOFRNAOAGA024K&gclid=Cj0KCQiAqbyNBhC2ARIsALDwAsA829_nLyj8zSQN8R_gXarWxw137HDVeBfBTr_Iw0vaWFLh8rHpVngaArO7EALw_wcB

[4] Green claims code: making environmental claims - GOV.UK (www.gov.uk)

[5] R (on the application of Friends of the Earth Ltd and others) (Respondents) v Heathrow Airport Ltd (Appellant) [2020] UKSC 52