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JULY 2022

Environmental, Social & Governance standards remain patchwork quilt, but HARMONIZATION MAY BE ON THE HORIZON

Competing ESG standards threaten to trip up even the most well-intentioned of companies.

In EMEA, companies have been facing a period of sustained activism and litigation initiated by investors and shareholders around ESG issues. To mitigate these risks, organizations must engage in robust sustainability reporting, and be prepared to back up those reports with evidence of their commitment to ESG principles.

In the U.S., ESG has mainly been the realm of environmental tort cases, but the SEC's newly announced requirements on climate change disclosures for public companies and issuers will add another layer of complexity. After the public has a chance to offer comments, we expect the SEC to finalize these disclosure rules by 2023, although requirements to comply with the rules could very well be phased in over time.

To clarify these differing regulatory and legal requirements, the International Financial Reporting Standards (IFRS) Foundation has set up an International Sustainability Standards Board (ISSB) with a mandate to find common ground among standards such as those from the Global Reporting Initiative (GRI), the Value Reporting Foundation (VRF, formed by a merger of the Sustainability Accounting Standards Board and International Integrated Reporting Council), Climate Disclosure Project (CDP), and the Task Force on Climate-Related Financial Disclosures (TCFD).

The ISSB is simplifying a reporting framework through harmonization of the standards and coming out with a 'gold standard' that companies can use to measure and report their progress on ESG metrics. This will give investors, consumers, and most likely regulators a clear benchmark to see if a company has shouldered its ESG responsibilities and applied appropriate standards of care to ESG risk management.

FOLLOWING EMISSIONS DOWN THE CHAIN

One of the most critical elements in ESG reporting involves Scope 3 supply chain emissions. It is relatively easy for companies to measure and work to reduce Scope 1 emissions, which come directly from sources that the company itself owns and controls – for instance a fleet of company vehicles. Similarly, it's not especially challenging to calculate Scope 2 emissions, which are the indirect emissions associated with the electricity, steam, heating, and cooling used and purchased by the reporting company. Indeed, companies that commit to purchasing only renewable energy could conceivably drive Scope 2 emissions down close to zero in short order.

But it's much more challenging for many companies to perform a full accounting of Scope 3 emissions, which usually account for more than 70% of a company's carbon footprint and cover indirect emissions that occur up and down the business supply chain.[1] Since a company's Scope 3 emissions are largely the result of its suppliers' emissions, reducing those emissions often involves negotiating with suppliers to establish acceptable emissions thresholds and then monitoring suppliers' carbon reduction efforts. In the U.S., if the finalized SEC climate and environmental reporting guidelines resemble those that were proposed, companies will have to accurately calculate and disclose Scope 3 emissions, targets and progress toward reduction goals. To do this, they will need to rely on suppliers to monitor and fulfill carbon reduction commitments. Importantly, the SEC will likely demand the same level of accuracy and transparency in climate and environmental disclosures as it does for financial reporting requirements. Given the SEC's enhanced focus on disclosures in general and ESG disclosures in particular, government litigation will follow closely on the heels of the new reporting requirements.

1. The United Nations Global Compact provides a helpful primer on Scope 3 Emissions at https://www.unglobalcompact.org.uk/scope-3-emissions/?msclkid=a96e0481ce7d11ecb3b56e45e722fdaa

TAKE CARE ON PUBLIC STATEMENTS

Companies also need to be careful to avoid exposing themselves to environmental lawsuits by consumers or governments related to the assertions they make about the products and services they sell.

Companies must consider the reputational and financial risk of ‘greenwashing’, including in consumer marketing campaigns built around a public embrace of environmental sustainability and various social goals. Lawsuits could hinge on whether consumers would have behaved differently if a company had provided full disclosure regarding the environmental harm associated with its products. For instance, a driver could argue she would not have purchased a large SUV or truck if she had known that the heavy gasoline consumption was contributing to climate change, and that the auto manufacturer had a responsibility to place warnings on its products to this effect. Meanwhile, multiple companies have declared goals to reach Net Zero emissions as soon as 2030. These declarations presumably seek to influence and entice investors and consumers by making the companies seem 'greener' and more 'impactful'– yet there is little data disclosed to support such statements or how the companies plan to reach Net Zero. Companies keen to limit these sorts of risks could start doing their own research to help define how a ‘reasonable’ consumer would act given various levels of information about the ripple effects of buying or using a certain product.

The danger is even greater if companies engage in more blatant types of greenwashing, for instance advertising that they are planting trees in order to mitigate carbon emissions and then failing to follow through.[2] If companies do not living up to the behavioral standards they proclaim in their advertisements, this sort of alleged misrepresentation has the potential to lead to a massive wave of litigation. To avoid this type of risk, companies would be wise to reexamine their public assertions around ESG and make sure they have data to support any statements they make about efforts to protect the environment, support diversity and equality, or implement good governance.

HOW GOOD GOVERNANCE CAN DEFUSE REPUTATIONAL RISKS

Not all reputational risks are created equal. History has shown that plenty of companies get slapped with fines for paying bribes or engaging in other unsavory financial behaviors yet are able to quickly put such negative publicity behind them.

The environment is different. People care deeply about issues that they feel could have a direct impact on their health and the well-being of their families now and in the future. In many cases, the driving force escalating the threat of ESG litigation comes not so much from regulators as from investors and consumers. Companies that say they are leading the way on ESG issues while actually engaging in environmentally harmful practices risk taking a severe hit to their reputations and losing investors and customers if and when the truth comes out.

Today, many companies have published sustainability reports that are full of glossy marketing statements and assertions around ESG goals and successes. As regulators push companies to measure and provide evidence of their ESG performance, relying on standards for calculating and reporting these figures will be important. The risk here is that a whistleblower will file a complaint alleging that their boss pushed them to falsify a number to hit some environmental benchmark.

Here is where the 'G' in ESG comes into play. Companies that make public statements of environmental and social aspirations can mitigate their ESG risk by taking a structured governance approach and defining clear policies, procedures, and management accountability around reaching ESG goals. Good governance not only allows companies to do a better job managing ESG risks, but also can help businesses identify measurable opportunities that can be reported accurately and transparently to investors and regulators.

To head off lawsuits and other reputational harm, we already see some companies trying to find common ground with activist investors. That can be a legitimate strategy for defusing ESG-related tensions and heading off lawsuits. For instance, companies may be able to diversify their boards by adding new members and giving them ESG mandates. This could seem like a concession to companies, but ultimately it may represent an opportunity to invigorate boards with new thinking. After all, by taking action on ESG, companies may not only reduce certain legal risks, but also gain business opportunities. For instance, finding ways to reduce energy usage not only has the potential to reduce carbon emissions, but also to cut costs. And finding ways to make a company more welcoming and inclusive allows an enterprise to benefit from the talents of a more diverse talent pool.

2. BBC News, “How phantom forests are used for greenwashing,” May 3, 2022, https://www.bbc.com/news/science-environment-61300708

SEVEN WAYS TO REDUCE ESG LEGAL RISKS

1 **Think holistically, identify and track risks and develop action plans.** Consider ESG risk from multiple angles – reputational, legal, financial, operational, and emerging. Identify the biggest and most critical risks, then make action plans on how to address those risks. For emerging risks, consider areas that could impact one or more dimension – for example, the growing risk of geopolitical disruption on global labor, working conditions, and corruption, factoring into Social and Governance aspects.

2 **Develop and harness the data.** Just about every ESG lawsuit filed in the future is likely to be data-related. What ESG data does your company collect? Are there gaps where it would be beneficial to ramp up data collection? How are you measuring carbon emissions, especially in the Scope 3 category? And what data are you using to calculate progress on other ESG metrics including DEI and working conditions? ESG cases will be won or lost on the basis of data, so make sure you have accurate, organized, and comprehensive data at the ready.

3 **Find the quick wins.** What changes can your organization make today to remove or reduce the threat of potential ESG litigation? Do you have any market-facing ESG assertions that are not supported by good data? Any ESG statements that cannot be backed up should be addressed and resolved very quickly. On the operations side, what actions are you taking in procurement and throughout the supply chain? Could suppliers be onboarded differently from either a carbon emissions or DEI standpoint?

4 **Check your governance.** What policies and procedures does your organization have in place that sound nice to read, but that nobody actually understands or implements? Where do you need more training to bring employees up-to-speed on good governance practices? Who is accountable for ESG at the Board, C-suite, and management levels? Having strong governance protocols in place can go a long way toward reducing many of the legal risks associated with ESG.

5 **Put adequate resources in place.** Companies need to have dedicated staff focused on ensuring ESG compliance, otherwise it's easy for ESG issues to slide by the wayside. One practical step that companies can take is to review past complaints made through their whistleblower hotlines for ESG-related red flags. For instance, if they detect a pattern of Social complaints that were sent to HR for adjudication, perhaps that's a symbol of a larger problem that the company should address proactively.

6 **Plan for the worst-case scenario.** In cybersecurity, it's not unusual to hire hackers to check for cracks in IT defenses. In the ESG space, companies may want to have their legal advisors assume an activist stance, for instance by reading through a sustainability report and looking for public statements that could be litigated. This sort of 'attack simulation' can give board members a good idea of how and where to take proactive steps to reduce exposure and risk in the event of a real lawsuit.

7 **Recognize local nuances.** We all share one planet, but ESG topics play out differently in specific locales. Right now, shareholder activism is strongest in Europe and the UK. We expect to see more such activism in the U.S., particularly as the SEC rules are likely to shine a spotlight on ESG leaders and laggards. In Asia, Singapore and Japan are leading the charge on ESG activism, but the situation is different in China, where policymakers and many citizens alike may be reluctant to place too many demands on the manufacturers that drive much economic growth, but also are responsible for high CO_2 emissions and other pollution. The point here is that 'ESG' is three little letters that can mean different things and inspire different emotions in various parts of the world. Companies will need to consider not just local legal rules, but also cultural elements when considering how to harmonize their actions on ESG.

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LOOK FOR OPPORTUNITIES IN DISRUPTION

When it comes to prioritizing ESG issues, activists, investors, and regulators are all determined to disrupt the status quo and push companies to make their operations more sustainable, equitable, and ethical. This clearly constitutes a disruption to business as usual, but companies have a choice – either to act or to react.

At AlixPartners, we like to say that it is better to recognize the opportunities in disruption than to be disrupted. As companies observe the growing importance of ESG, they may want to consider the implications for their business model. The flip side of risk is opportunity, and the truth is that the emphasis on ESG will give certain farsighted companies a chance to build brand value and capture burgeoning business opportunities.

Striking the balance among mitigating risks, implementing governance, and recognizing opportunities will help to address threats of litigation. Surely there will be other opportunities for companies to benefit from the paradigm shift to a world where ESG matters more than ever.

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These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.