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ESG TRENDS 2023

– THOUGHT LEADERSHIP

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Environmental, social and governance (ESG) considerations have an increasing impact on all businesses, globally. Here we take a look at some of the issues facing businesses from sustainable finance, to developments in carbon trading and the increasing use of ESG-related litigation.

Sustainable finance trends

Sustainable finance instruments such as sustainability linked loans and sustainability linked bonds have become mainstream instruments over the last two years. The ESG specific aspects of those instruments, such as ESG related KPIs, continue to evolve and become more sophisticated and tailored to reflect the relevant businesses and industries involved and are likely to face increasing scrutiny with the growing focus on greenwashing.

We expect to see continued discussion around the role that blended finance can play in emerging markets. At COP 27, held in Egypt in November 2022, there was a focus on the fact that the current flows of finance to developing countries, where the greatest impact of climate change is felt, are well below where they need to be in order to bring about meaningful mitigation action and to address inequalities in access to finance.

Emphasis was placed on the role that MDBs and international financial institutions should play in relation to climate finance. In particular, there was a call on the shareholders of MDBs and international financial institutions to reform multilateral development practices and priorities, to align and scale up funding and ensure that simplified access to climate finance is available from multiple sources. MDBs were encouraged to use the breadth of their financial instruments to mobilise private capital and to maximise the use of concessional and risk capital vehicles in order to drive innovation and to accelerate impact.

EU sustainable finance regulation: Impacts on deal processes for equity and credit funds

EU sustainable finance regulation that applies to funds and asset managers is impacting how they select and enter into investments, depending on the commitments made at entity and product level.

In particular, fund managers with products that are categorised as either Article 8 "plus" or Article 9 for the purposes of the Sustainable Finance Disclosure Regulation (SFDR) need to consider how the requirement to assess whether an investment is a ‘sustainable investment’ can be incorporated into their transaction processes and also monitored over the course of the holding period.

For an investment to be considered a 'sustainable investment' under the SFDR: (i) it must contribute to either an environmental or a social objective; (ii) it must do no significant harm (DNSH) to any of those objectives; and (iii) any investee companies must follow good governance practices. There is still significant legal uncertainty as to how this definition should be interpreted and concepts such as 'do no significant harm' have proved difficult to navigate. Regulatory guidance has clarified that principal adverse impact (PAI) indicators should be measured in order to assess DNSH, although managers are still given discretion to determine the value for each indicator that represents the "tipping point" for DNSH. Further, to assist with assessing DNSH, it is relevant to explain how the investment is aligned with the OECD Guidelines for Multinational

Enterprises and the UN Guiding Principles on Business and Human Rights, including the ILO conventions. While those in responsible investment circles are familiar with these guidelines and principles, many managers will be looking for guidance on how these principles are implemented in practice, what factors indicate alignment, and what level of detail to provide in disclosures.

Managers that have committed to consider and report on PAIs at entity or product level also need to gather information in order to assess the principal adverse impacts of their own investment decisions on sustainability factors. In a similar vein, funds that have a commitment to invest in Taxonomy-aligned economic activities need to put processes in place to gather the underlying data required to calculate Taxonomy-alignment.

How does this impact equity fund investments?

We are helping managers review their deal due diligence questionnaires to ensure that they are asking for the information they need for SFDR purposes and considering how to engage with any technical due diligence service providers in relation to the questions that they ask. Managers also need to update their investment checklists to ensure that the latest SFDR requirements for each product are captured. Changes may also be required to transaction documentation in order to ensure that the due diligence undertaken is supported by appropriate contractual projections, that portfolio companies provide the relevant information at the requisite intervals and that the portfolio company remains a "sustainable investment" throughout the fund's holding period. The approach may vary, depending on whether the fund is taking a majority or minority stake, where the portfolio company is located and its prior experience of SFDR requirements.

And what about credit funds?

Credit funds are rapidly catching up with equity funds on ESG, and a majority of newly raised funds are now categorised as Article 8 or Article 8 "plus. In particular, we are starting to see the same approach adopted by managers with respect to their counterparty borrowers and increasingly, borrowers are being requested to complete checklists pre-contracting and agree to ongoing reporting covenants relating to the SFDR. This is being accepted with mixed results in the market, as in many cases the requests are made in the context of legacy deals where borrowers may have no obvious contractual obligation to provide such information and often requests are made where credit funds participate in transactions in secondary trading where it may be too late for the credit funds to require changes to the finance documents. There are also concerns from borrowers around default implications for not supplying the information and the onerous nature of the reporting where their lenders are advised by multiple managers with different requirements. Currently, any agreement to provide information relating to the SFDR is dictated by a borrower's need for new liquidity from the managers requesting it, although agreement may be easier where the manager sponsoring the borrower itself requires such information.

Will ESG litigation continue to grow?

The uptick in ESG-related litigation and complaints against corporate entities in 2022 is set to continue into 2023.

Using litigation to tackle greenwashing

The boom in green products and services has led investors, consumers and NGOs to use litigation and complaints to scrutinise whether businesses are living up to their assertions. Claims of 'greenwashing' have been brought before national courts across the world and complaints have been made to advertising ombudsmen and before the national contact points of OECD-adhering countries which monitor the OECD Guidelines for Multinational Enterprises. The recipients of complaints and litigation include a broad range of industries from energy companies and high carbon emitters to financial institutions. In 2022, parallel NGO litigation and a putative class action suit were filed in the Netherlands and the United States, respectively challenging the sustainability claims of a major global airline. In October, complaints were made to the UK Advertising Agency regarding a campaign by a financial institution highlighting its work to assist clients' transition to net zero by 2030. This trend is likely to continue, and the type of complaints will diversify as greenwashing becomes a priority area for more regulators. In the UK, in February 2023, the Financial Conduct Authority noted that it will "test whether firms deliver on the claims made in their communications with investors" in relation to ESG and sustainable investing.

Climate-related lawsuits will feature prominently

The number of climate change-related litigation cases has more than doubled since 2015 according to a report issued by the Grantham Institute. States are most commonly the target of climate-related litigation but there is an increasing focus on corporates. For example:

- A ruling in a Dutch court in the Netherlands required a multinational energy company to reduce its carbon emissions by 45% as against its reported 2019 emissions by 2030. The ruling is currently subject to appeal.
- In the United States, multiple climate suits under state nuisance law against oil and gas companies face a potential decision by the Supreme Court regarding the proper venue.
- In Germany, a Peruvian farmer in Huaraz continues its claim for declaratory relief and damages from a German electricity producer, claiming that the company knowingly contributed to climate change by emitting greenhouse gases, and bears legal responsibility for the impacts of the glaciers melting in Peru.
- In a derivative action brought in the UK initiated in February 2023, shareholders of an energy company claim that its directors have failed to comply with their duties to 'manage the climate risk facing the company'.

Government enforcement will play a major role

ESG-related enforcement actions are on the rise, especially in the United States under the auspices of the SEC's Climate and ESG Task Force, which in 2022 announced several enforcement actions and civil litigation regarding the disclosures of issuers and asset managers on ESG-related policies, procedures, and practices.

Cases related to forced labour are on the rise

Aside from climate change-related issues, litigation against corporates for human rights related harms or for environmental issues is not new. Supply chain litigation relating to alleged victims of forced labour is prevalent. For example, multiple Nepali and Bangladeshi migrant workers are seeking damages in the torts of negligence, false imprisonment, intimidation, assault, along with remedies for restitution of unjust enrichment against a technology company in the UK. Increased litigation by alleged victims of forced labour has run alongside a renewed attention by legislators in the US and the EU on regulating instances of forced labour using trade measures. See our briefing **Forced labour: New regulations are changing contractual obligations across the world** for further details.

Developments in Carbon Trading and Offsetting

The voluntary market for carbon credits continues to grow significantly as businesses seek offsets for their carbon emissions and increasing numbers sign up to 'net zero' commitments. Global policies and frameworks around requiring net zero commitments from businesses are developing and evolving. For example, a proposed UK Net Zero Transition Plan Standard will require net zero commitments from listed companies.

Increasingly, businesses are seeking long-term carbon offset supply via investment in the supply chains through being either the primary offtaker for a carbon project or taking equity investment or project ownership in projects. The focus on this method of sourcing through the supply chain (referred to as carbon 'insetting') can help facilitate control over emission reductions and thereby ultimately the credibility of the net zero, or other carbon, commitments of the business.

We are also seeing increased M&A activity in this space as private capital providers, such as infrastructure funds and private equity, look to invest in the carbon markets value chain in businesses which derive contracted revenue from performing services (for example consultancy, project development, agency and/or brokerage) and/or selling carbon credits.

Momentum has been building on the formal development of the Voluntary Carbon Market (VCM) structures and, in particular, building on improvements to the quality and integrity of carbon credits and offsetting claims, and this work will continue through the Integrity Council for the Voluntary Carbon Market (on the sellside) and the Voluntary Carbon Markets Integrity Initiative (on the buy-side).

Meanwhile, pressure is intensifying on businesses making net zero or other carbon claims which rely to any extent on offsets, to clarify and justify that reliance. Indeed, advertising standards, competition bodies and regulators in an increasing number of countries are beginning to scrutinise such statements (either proactively or in response to NGO complaints) for evidence of 'greenwashing'. The need for businesses to demonstrate that any offsetting activity is subsidiary to active carbon reductions / removals in meeting net zero plans, and that high-quality offsets are used, will remain key to navigating these risks.

More generally, progress has been slow on agreement of the Article 6.4 global trading mechanism, not least because of concern that levies imposed upon Article 6.4 trading might disincentivise the use of this market. More encouragingly, a greater level of agreement was reached at COP27 in relation to Article 6.2 (so-called 'co-operative approaches' between States), and this is likely to lead to increased co-operation and trading activity between individual States hosting and financing carbon reduction projects. Despite some of the recent criticisms of the VCM, carbon offsetting still has an important role to play as the most recent report of the IPCC on mitigation of climate changes has acknowledged. Focus, however, needs to be on ensuring that offset projects are of high quality leading to enhanced market confidence. For more on the VCM see our briefing **Enabling the Voluntary Carbon Market in the Context of the Paris Agreement** which examines actual and perceived barriers to its scaling and identifies recommendations for the way forward.

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