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Navigating in the eye of the ESG storm

Baker McKenzie's Joanna Ludlam and Jon McLeod of DRD Partnership set out how to deliver combined legal and communications response to contentious ESG challenges.

'The problem'

In today's rapidly evolving business landscape, Environmental, Social, and Governance (ESG) considerations have become pivotal for organisations across all sectors. ESG has become an established framework that helps stakeholders understand how an organisation manages core risks and opportunities beyond traditional financial metrics.

Under a broad spectrum of factors, businesses are increasingly scrutinised for their environmental footprint, long-term sustainability, ethics, and consistent application (and cultural implementation) of their values. This scrutiny comes from a variety of stakeholders, including investors, customers, employees, regulators, and the wider community. As core elements of ESG continue to prove an important factor in consumer decision-making, there has been a trend of businesses marketing their environmental and social impact, projecting a positive brand identity, at times misleadingly. However, expectations from investors, consumers, policy makers, and regulators have now become more sophisticated, leading to greater exposure for firms who do not prove they are 'walking the talk' behind their ESG claims.

In the UK, with emboldened regulatory actors and an evolving body of case law, the potential for an ESG-related crisis is higher than ever before. To guard against this risk, and to ensure they are well prepared should a crisis arise, clients must adopt a proactive and co-ordinated approach.

Frameworks of exposure

UK businesses face significant risks across various frameworks, encompassing regulatory scrutiny, stringent reporting obligations, the growing threat of civil litigation, and even the potential for criminal prosecution. These challenges underscore the critical importance of robust compliance and proactive risk management strategies to navigate the increasingly complex ESG landscape.

The regulatory landscape

The regulatory framework surrounding ESG in the UK has become progressively more stringent, driven by domestic initiatives and international influences, against a backdrop of increasingly interventionist regulators.

In its annual plan for 2024/5, the CMA made it clear that sustainability is a key focus area for how it intends to protect consumers, and that it is reviewing how consumer protection legislation can be utilised to tackle misleading environmental claims in particular.

This follows a pattern of actions taken by the regulator, including its review of the 'fast-fashion' sector, which resulted in substantial enforcement action against major brands ASOS, Boohoo and George at Asda. The regulator has since expanded its anti-greenwashing efforts to include tackling the fast-moving consumer goods (FMCG) sector. In December 2023, the CMA announced a review into claims made by FMCG giant Unilever in relation to a number of their products, demonstrating its commitment to addressing these issues, and to make an example of the biggest players.

In a similar vein, the ASA has been increasingly active in clamping down on misleading ESG claims made by companies in their marketing and advertising efforts. The Committees of Advertising Practice (CAP) Code lays out guidelines for adhering to truthful advertising practices, and includes specific guidelines for environmental claims and social responsibility.

The regulator has shown no reticence when taking action against companies that are found to be in breach of these guidelines. In 2023, the ASA investigated and subsequently banned numerous advertisements from several airlines, on the basis that they had made a series of misleading claims about their sustainability efforts. The ASA has also banned misleading climate-related ads from both Shell and HSBC. These rulings highlight the ASA's commitment to combating corporate greenwashing and ensuring that companies provide accurate and clear information about their environmental practices.

The FCA's anti-greenwashing rule, among a range of measures that came into effect in May and June 2024, also marked a significant regulatory development, mandating that all references to sustainability in marketing and product descriptions must be clear and fair. Companies failing to meet these standards could face legal challenges under the Financial Services and Markets Act 2000, notwithstanding significant reputational damage.

With the Digital Markets, Competition and Consumers ("DMCC") Act 2024 due to come into force imminently, the CMA will for the first time be able to impose significant financial penalties on companies found to be in breach of consumer protection regulations, including claims found to be greenwashing. This expansion of the CMA's enforcement powers poses a significant risk for companies, as non-compliance could now result in severe financial and reputational consequences.

Civil litigation – emerging themes

Outwith the increased risk of sanction by regulatory means, or via legal action taken by public bodies, more scrutinous investors, activists, and the public are increasingly pursuing civil litigation to hold companies accountable for their ESG claims.

Those seeking to bring claims are at times applying an ESG lens to existing laws in an innovative way, across a broad spectrum of legal grounds.

Several claims have been brought against UK-based parent companies for alleged environmental damage caused by their international subsidiaries. For instance, the case against Vedanta Resources and its subsidiary in India, brought by a group of Indian farmers seeking damages for losses suffered from the alleged severe pollution caused by its copper smelter, was allowed to proceed in the UK by the Supreme Court on the basis of the English-based parent company's duty of care.

In 2023, the ESG disputes landscape shifted further with ClientEarth's claim, pursued under the Companies Act 2006, against Shell's board of directors for falling short of their duties to mitigate their climate impact by failing to implement a strategy that aligns with the Paris Agreement goals. This was the first of its kind in the UK, where a shareholder claimant has taken action against the board of a company on environmental grounds. Despite the High Court dismissing the case, this still marked a significant development for the UK's ESG litigation arena, highlighting a trend of shareholders using litigation to push for better corporate governance and more robust environmental strategies.

Meanwhile, litigation around greenwashing and misrepresentation in the UK is still a developing area, with regulatory enforcement being the primary 'battleground' for tackling these issues. However, as regulators continue to refine their enforcement strategies in relation to ESG-related matters, legal action is likely to become more prevalent.

The increasing awareness and activism among stakeholders means that companies must be vigilant in their ESG practices to avoid falling foul of similar claims. Such lawsuits not only result in financial liabilities but can also severely tarnish a company's reputation, leading to broader and longer term negative impacts on business operations.

Criminal – Fraud and other offences

Under a new, more interventionist Labour government, and with ESG related criteria becoming increasingly entrenched in UK law and regulation, as well as ever advancing consumer expectations, companies must also take notice of the range of penalties that could be imposed should they be found to be in breach of certain requirements. Notably, instances of fraudulent activities, including falsifying ESG reports, misrepresenting environmental impacts, or engaging in corrupt practices, can lead to criminal charges for the company and its executives. Such criminal behaviour not only attracts significant legal penalties, but can also have a devastating impact on the company's reputation.

In an era where corporate accountability and transparency are highly valued, any involvement in ESG-related fraud can erode stakeholder trust and result in the loss of business opportunities, investor confidence, and market position. It is crucial for companies to implement stringent internal controls, ethical guidelines and training to mitigate the risk of criminal activities, both within their own organisations and by their suppliers, contractors, customers and other third parties. One example of 'external' ESG risk is the sale of fraudulent investments to supply carbon omission credits to offset greenhouse gases. The sale of these fraudulent investments represents fraud risk for companies and their investors, as companies which buy these may unknowingly misreport their carbon position and suffer reputational and regulatory consequences.

Businesses must stay abreast of evolving regulations and ensure that their ESG practices and reporting mechanisms are robust and transparent. Failure to comply can lead to investigations, fines, and mandatory corrective actions, which can disrupt business activities and damage relationships with stakeholders, including investors, customers, and the community.

Recommendations for managing a crisis successfully

Should businesses find themselves in an ESG crisis, this report outlines DRD's recommended approach to effectively prepare for, manage, and respond to the situation. While this lays out some suggested guidelines, it must be noted that any crisis response should be tailored to the specific context of the issue to minimise reputational damage.

Crisis preparedness

In the contemporary business environment, crisis preparedness is paramount, particularly when considering ESG factors. Proactive crisis management ensures that organisations can swiftly and effectively respond to unforeseen events, safeguarding their reputation and operational stability.

While tempting as it may be to maximise the 'trendiness' of ESG, companies must remain authentic in how they project their environmental and social impact. Remaining transparent is the most effective guardrail against the risks set out above. To enhance crisis readiness, businesses should also undertake a series of key activities aimed at robust preparation and rapid mobilisation.

Firstly, it is crucial to conduct a thorough audit of current crisis capabilities. This involves a comprehensive evaluation of existing procedures and resources to identify strengths and weaknesses. For instance, conducting a materiality assessment would enable the company to identify specific vulnerabilities and potential threats that could impact the organisation's ESG performance. Ensuring that the client is identifying and tracking the evolving public, political, and regulatory landscape is another vital step, to stay ahead of potential crises that may arise from external pressures.

Developing and implementing effective communications infrastructure and protocols is also essential for ensuring appropriate and rapid mobilisation during a crisis. This includes establishing clear lines of communication and predefined response plans that can be activated immediately.

Additionally, preparing defensive positions for material risks is crucial. This involves creating contingency plans and mitigation strategies to minimise the impact of potential crises. Ensuring that corporate material anticipates the needs of potential scrutiny helps maintain transparency and trust with stakeholders, even during challenging times.

By following these comprehensive steps, organisations can bolster their crisis preparedness, ensuring they are well-equipped to handle ESG-related challenges effectively.

Navigating an ESG crisis

When an ESG crisis arises, a swift and effective response is crucial.

The first step is rapid deployment. Assembling specialist teams with cross-disciplinary and tailored expertise, and drawing on political and regulatory insights is essential in mitigating risks and influencing policy outcomes favourably.

Managing multiple stakeholders effectively is also critical. This involves robust stakeholder mapping and transparent communication to build trust and manage expectations. Key messaging should be clear, consistent, and aligned with the company’s values and ESG commitments.

Gaining control of the narrative during an ESG crisis requires transparency, rapid reaction, and adherence to core messaging. Effective social media monitoring allows for real-time tracking of the crisis, enabling swift responses to emerging issues and misinformation.

Demonstrating continuous improvement is vital post-crisis, with businesses reviewing their response, gathering stakeholder feedback, and incorporating lessons learned into future plans. Additional recommendations include regular training and simulations, committing to sustainable practices, and engaging third-party auditors for unbiased assessments. By implementing these strategies, businesses can respond to ESG crises more effectively, protecting their reputation and ensuring long-term sustainability.

Work towards recovery

Recovery in the aftermath of an ESG-related crisis requires a strategic and tailored approach, addressing the specific reputational, operational, and regulatory needs of the organisation. Working in tandem with advisers and partner organisations can significantly enhance the recovery process, ensuring sustained trust and stability among stakeholders.

One of the initial steps in recovery is developing an enhanced compliance function to address any gaps that may have contributed to the crisis. Businesses must conduct a comprehensive audit of all relevant regulatory frameworks to ensure that all requirements are met and maintained. Enhancing reporting activities with additional supplementary information can further demonstrate the organisation’s commitment to transparency and accountability.

Targeted outreach programmes are essential to reassure and build confidence with customers and supply chain partners. These programmes should focus on clear, honest communication and actively engage stakeholders to rebuild trust. Exploring open-door policies, interactive workshops or transparency initiatives through various communication activities can also help to foster a culture of openness and integrity within the organisation.

DRD also recommends that businesses continue to hold themselves to account by regularly reviewing their progress against a reputation scorecard. This allows organisations to track their activity and make necessary adjustments to their recovery strategies. This continuous monitoring ensures that the organisation remains aligned with its ESG commitments and can respond promptly to any emerging issues.

Fostering positive public engagement is another critical aspect of recovery. This can be achieved through campaigning, thought leadership, sponsorships, partnerships, and third-party endorsements. By actively promoting the organisation’s efforts and achievements in ESG, businesses can gradually rebuild their reputation and demonstrate their dedication to sustainable and ethical practices.

Overall, recovering from an ESG-related crisis requires a multifaceted approach, involving robust compliance measures, transparent communication, continuous monitoring, and proactive public engagement. There is no one size fits all solution - by working closely with advisers and partner organisations, businesses can effectively navigate the recovery process, restore stakeholder trust, and ensure long-term sustainability.

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