ESG DISPUTES AND BUSINESS VALUATION

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INTRODUCTION

Environmental, Social and Governance ("ESG") factors have gained increasing importance in recent years as society has become more aware of how corporate conduct affects stakeholders, the environment and humanity at large. From issues such as climate change to socially responsible sourcing and corporate transparency, the ESG umbrella encompasses a wide and diverse variety of issues. In this article, we explore how ESG-related legal disputes may arise and how this will impact business valuations in a litigation context.

ESG-RELATED DISPUTES

As businesses incorporate ESG criteria in their operations and reporting, it will present both challenges and opportunities in the corporate world. ESG is also increasingly important to shareholders, investors and governments, who are calling for action, particularly on climate change, diversity and transparency. This environment of growing awareness and desire for accountability means that litigation risk will invariably increase. Examples of where ESG-related disputes may arise include:

1. ***Financial Reporting and Disclosure claims*** – Businesses are facing rising pressures from investors to provide more ESG-related disclosures, which in turn are subject to greater scrutiny after being published. Businesses are therefore exposed to litigation risk if stakeholders deem that published disclosures are insufficiently adhered to, or outrightly false.
2. ***Greenwashing claims*** – This is a concept where businesses present a more socially or environmentally friendly image, without making any real commitment to green initiatives, or not to the extent implied.
3. ***Fiduciary Duty of Care*** – The concept of fiduciary duty is not novel, however, ESG-related responsibilities are increasingly being included. Disputes may arise from when a company's management deviates from its statutory or self-imposed ESG goals.

As a result of the above, we foresee an increase in ESG-related disputes requiring forensic accounting and valuation expertise in the following areas:

1. ***Post M&A disputes*** – As ESG factors have become more common place, they will also be incorporated into the M&A process. Consequently, disputes where ESG factors were represented by the seller but are subsequently discovered not to be true by the buyer will increase. Examples may include mining disputes, where the buyer discovers the acquired mine or company has not complied with the environmental

legislation leading it to be exposed to potential government fines and civil litigation.

2. ***Supply chain claims*** – In order to comply with ESG regulations, businesses increasingly have to ensure not only their own operations are compliant but those of their suppliers. For businesses with complex supply chains such as automotive or electrical goods manufacturers, legal disputes may arise if the company discovers that its supplier has not complied with workplace safety standards, or the materials supplied came from unethical sources.
3. ***Mis-selling claims*** – The investment industry has embraced ESG criteria, with many investment managers touting their incorporation of ESG criteria into their investment process and the dis-investment or avoidance of less socially responsible investments. Funds that fail to comply with their ESG criteria will face claims from their investors.
4. ***Securities claims*** – As ESG reporting requirements increase for publicly listed entities, so will scrutiny by investors. Public entities' jurisdictions where class action suits by investors are common will face legal risk from these sorts of claims, particularly when they have encountered an ESG policy failing. An example of this was the securities claim BP faced following the Deepwater Horizon Incident in 2010 in *re BP PLC, Sec. Litig., No. 4:12-cv-1256 (S.D. Tex. Sept. 30, 2013).*
5. ***Employee claims*** – Where companies fail in the 'S' of ESG compliance, they are likely to face litigation from employees from the top to the bottom of the seniority ladder. Claims may range from unsafe work practices on the factory floor to gender or racial discrimination in the boardroom.

It is likely that the valuer may have to consider how ESG factors affect business performance, and hence, value. In the sub-section below, we explore the ways in which ESG factors can affect the value of a business.

HOW ESG AFFECTS BUSINESS VALUE

ESG factors will present both opportunities and risks to a business' value and profitability. Ultimately, ESG can impact the cash flows of the subject company, and the risks it faces, which are typically recognized in the discount rate when valuing a company.

REVENUES

A strong ESG proposition can help companies tap new markets and expand into existing ones. One of the earlier, more well-established CSR or ESG initiatives was the 'fair trade' movement related to agricultural goods, where purchasers would negotiate 'fair prices' with producers, and also ensure the products purchased wouldn't be farmed using child labor. A study by MIT, Harvard University and the London School of Economics found that adding a fair-trade label could boost a brand's coffee sales by 10%[1]. It should be noted, however, that while there may be benefits in businesses publicly promoting their ESG policies, there are also risks associated with this approach especially if these policies are later perceived by consumers to be greenwashing. These risks and other risks associated with ESG criteria are most likely to be reflected in the discount rate applied to businesses, which is discussed further below.

COSTS

The increased adoption of ESG policies may result in companies being more efficient in their use of resources, which should ultimately result in reductions in some operating expenses, such as raw materials and utility costs. However, the increased adoption of ESG policies will also result in increases in other costs, such as legal and compliance costs in ensuring ESG goals are being followed.

From the perspective of a business valuer, when reviewing or estimating cash flows related to ESG matters, they would need to assess whether these costs are continuous expenses or one-off items. If these are continuous expenses that are likely to continue into the foreseeable future, are they going to increase over time if a business is growing? If its supply chain network is expanding at a similar rate, would the business need to increase its ESG compliance costs to ensure that supply chains are being properly vetted?

DISCOUNT RATE

Perhaps one of the most widely publicized aspects of ESG and value is the concept that 'greener' companies are less risky, as they are less likely to face legal or regulatory actions. Typically cited reasons include the fact that these companies will have better and more responsible governance, are less likely to face reputational risks associated with being seen as 'dirty' or less environmentally responsible and engaging in fair working practices means they don't face worker strikes. It is also suggested for all these reasons that they face fewer government interventions or legal actions which can have a detrimental effect on their operations and profitability.

From a business valuation perspective, businesses with higher ESG ratings may have a lower cost of capital, meaning that they may have a higher value than companies with a similar level of profitability but a lower ESG rating. In this regard, when considering the discount rate to be applied to a company, valuers should be conscious of the subject company's ESG policies and how that will affect the risks it encounters.

CONCLUSION

As ESG issues continue to grow in importance and public awareness, ESG-related litigation is likely to increase. As we have noted above, this can take a variety of forms involving various stakeholders and interested parties. Understanding how ESG matters can impact profitability and business values will be crucial to management and investors alike when navigating these pertinent issues. This is where forensic accounting and valuation advice can assist parties in understanding the impact of ESG factors and how it will affect their claims.

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[1] https://www.washingtonpost.com/business/fair-trade-products-turn-profits-creating-problems-for-a-movement/2011/12/27/gIQAYy31SP_story.html