# Managing and Mitigating ESG Integrity Risks

## Navigating the Nexus between ESG-related Misconduct, Civil Liability and Financial Crime

## 1. Introduction

Environmental, Social, and Governance (ESG) considerations have rapidly attracted attention in recent years, permeating various sectors of society including corporations and financial institutions. This surge of interest can partly be attributed to a growing intrinsic motivation to act as a responsible business. At the same time, there is an increasing recognition of existing and upcoming EU-legislation which is expanding the responsibility of businesses for their own ESG impact and that of their supply- and disposal chains.

While many businesses currently focus their ESG efforts primarily on reporting obligations, there is relatively little emphasis on the exposure to potential misconduct related to ESG factors and the nexus between such misconduct and civil and criminal liability. This article aims to shed light on that intersection, highlighting the need to take action in the identification, prevention and mitigation of ESG-related integrity risks.

To thoroughly understand the emerging ESG integrity risks, various examples of ESG-related misconduct will be described in this article. Next, the expanding scope of responsibility for such misconduct will be discussed, highlighting the growing expectations and requirements placed on businesses. The increasing criminalisation of ESG-related misconduct will then be delved into, exploring the legal and regulatory measures being implemented to address such violations. Furthermore, the nexus between ESG-related misconduct and financial crime will be uncovered, demonstrating how unethical practices in the ESG space can intersect with criminal liability, highlighting money laundering and fraud. Additionally, the same misconduct will be looked at from a civil-liability perspective for both companies and their directors. Examples of risk-mitigating measures will be given. Finally, a call to action will be presented, emphasising the crucial role businesses have in managing and mitigating ESG integrity risks.

To prevent involvement in money laundering allegations, fraud and civil liability claims, companies should implement robust supply chain due diligence processes. These should be aligned within existing risk management frameworks that are aligned with businesses' risk appetite through risk assessments, risk-based policies and procedures and the implementation of risk-mitigating operations. By understanding the complex dynamics between ESG-related misconduct and (criminal and civil) liability risks, organisations can proactively navigate this challenging landscape and promote responsible and ethical business practices.

## 2. Examples of ESG related misconduct

ESG-related misconduct refers to actions or practices which violate environmental, social, and governance principles and standards. The term encompasses a wide range of activities that have negative impacts on the environment, human rights and the integrity of governments and businesses. ESG integrity issues have many guises, some of which are listed below as examples:

### Environmental Misconduct

01 Pollution: Releasing harmful pollutants into the air, water, or soil without proper permits or control measures, causing damage to climate, ecosystems and human health.

02 Deforestation: Engaging in large-scale logging or clearing of forests without sustainable practices, contributing to biodiversity loss and climate change.

03 Illegal Mining: Unauthorized extraction of minerals or resources, often in violation of environmental regulations and without proper permits. This often leads to environmental degradation.

### Social Misconduct

01 Labor rights violations: Exploiting workers through unfair wages, forced labor, or child labor, disregarding human rights and labor standards.

02 Unsafe working conditions: Neglecting to provide a safe and healthy work environment and violating occupational health and safety regulations. This can involve inadequate training, lack of safety equipment, or failure to address hazardous conditions.

03 Discrimination and harassment: Creating a hostile work environment based on factors such as race, gender, sexual orientation, or disability, undermining diversity and inclusion.

### Governance Misconduct

01 Bribery and corruption: Offering or accepting bribes, kickbacks, or other illicit payments to secure business advantages or favors, compromising ethical business practices.

02 Insider trading: Trading securities based on material non-public information, taking advantage of privileged information for personal gain, and undermining market fairness.

03 Lack of board independence: Failing to maintain an independent and diverse board of directors, leading to conflicts of interest and inadequate oversight of company decisions.

Environmental, social, and governance misconduct often intersect. Looking at illegal mining for example, the environmental aspect involves pollution and ecological damage caused by unregulated mining practices, such as deforestation, water contamination, and soil erosion. Socially, illegal mining often exploits vulnerable communities through labor exploitation, including child labour, unsafe working conditions, and violations of human rights. Moreover, governance misconduct emerges through corruption, bribery, and lack of regulation, allowing illegal mining activities to persist and evade accountability. Consequently, the overlapping nature of these ESG concerns in illegal mining exacerbates the negative impacts on the environment, society, and good governance.

## 3. Expanding scope of responsibility for ESG related misconduct

Companies are increasingly being held responsible for identifying and addressing harmful actions throughout their value chain, moving towards a concept of responsibility from "cradle to grave." This shift is not in the least driven by European "Green Deal" initiatives such as the Corporate Sustainability Reporting Directive (CSRD) and the proposed Corporate Sustainability Due Diligence Directive (CSDDD) and Green Claims Directive (GCD). These directives are part of the broader sustainability agenda of the EU and reflect the commitment to promote sustainable practices, transparency, and accountability within the corporate sector.

### CSRD – Non-financial reporting requirements

The CSRD aims to radically expand the existing reporting requirements of the EU's Non-Financial Reporting Directive (NFRD). The CSRD establishes a comprehensive framework for larger companies to disclose sustainability-related information. It intends to enhance the quality of sustainability reporting across the EU by further defining comparable and consistent information.

### CSDDD – supply chain due diligence obligations

The proposed CSDDD is aimed at due diligence obligations for larger companies regarding their environmental and human rights impacts throughout their value chains. The directive seeks to ensure that companies identify, prevent, halt, mitigate, and account for adverse impacts resulting from their operations and business relationships. It focuses on areas such as environmental protection, human rights, labour rights, and responsible business conduct. As such, the CSDDD is evidently inspired by the UN's Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises. However, the CSDDD seeks to formalise the obligations in statutory laws in the EU member states.

### GCD - Eliminating greenwashing

The proposed GCD aims to eliminate misleading environmental messaging across EU markets and address greenwashing concerns by setting out the EU's first set of detailed rules for how companies should market their environmental impacts and performance. The new requirements will necessitate significant changes to the way many companies currently evidence and communicate their environmental claims, as well as how they manage information related to their environmental credentials. The GCD is in line with recent increasing efforts by supervisory authorities in the EU to combat greenwashing.

## 4. Increasing criminalisation of ESG related misconduct

Parallel to the expanding scope of responsibility for ESG related misconduct, such misconduct is increasingly being criminalised through national legislation and international regulations such as the European Environmental Crime Directive (ECD). This directive, which is currently being updated, aims to combat serious environmental offenses by imposing criminal penalties for activities like illegal waste disposal, deforestation or (other forms of) damage to protected habitats.

The combination of the expanded scope of responsibility for harmful actions and the fact that such actions are increasingly criminalised reinforces the need for companies to proactively prevent and address these harmful actions. Companies must take greater responsibility for their entire value chain, from raw material extraction to product disposal. This includes identifying and mitigating risks, promoting sustainable practices, and addressing any harmful actions or impacts associated with their operations and supply and disposal chains.

# 5. The Nexus between ESG-related misconduct and (Criminal and Civil) Liability, and how to navigate this

The nexus between ESG-related misconduct and (criminal and civil) liability is multifaceted. The complex intersection with financial crime highlights the potential for unethical or illegal actions to have significant financial and personal implications. Financial crime encompasses a range of illicit activities such as fraud, money laundering, and corruption. In this context, ESG-related misconduct can provide fertile ground for financial crimes to occur.

Business risks in this regard will significantly increase due to the combination of expanding statutory obligations in the ESG domain and extensive sustainability reporting requirements.

In this paragraph, specific examples of ESG-related misconduct will be explored that underscore the risks and challenges businesses face in maintaining ethical standards and financial integrity. From a criminal-liability perspective, we will focus specifically on the risk of money laundering and fraud. But also from a civil-liability perspective, ESG-related misconduct may have significant consequences for both companies and their directors. For each form of misconduct, we will give some examples of risk mitigation measures.

## *Supply chain due diligence failures: risk of money laundering and civil liability*

Although much attention is currently paid to the obligation to identify and neutralize misconduct in the supply chain, it is less well-known that when such misconduct is deliberately ignored, a business runs the risk of falling within the scope of the criminal money laundering provisions and liability claims. In addition, a company as well as its directors may be held civil liable (for damages) due to insufficient supply chain due diligence.

### Money laundering

Money laundering can occur when a company processes or trades products while it knows or should reasonably suspect that those products originate from a a criminal activity. Think of a clothing company that trades clothing made by child labour. Or luxury yacht builders who use teak wood originated from illegal logging. These companies come within the scope of the money laundering provisions if they knew about these misconducts or should reasonably have known about them.

Often the defense in such cases is that the company did not know – and could not have reasonably known – that wrongdoing had occurred in their supply chain. For the time being, such defenses are reasonably successful, unless the Public Prosecution Service can indeed demonstrate that knowledge.

The upcoming CSDDD (reinforced by more specific EU legislation, such as the Conflict Minerals Regulation, the Regulation on Deforestation-Free Products and the – proposed – Forced Labour Regulation) could become a game changer in this regard. After all, the proposed obligation to actively investigate the supply chain for potential misconduct in the field of human rights and the environment considerably increases the likelihood of a company becoming aware of misconduct. And if misconduct is subsequently discovered, the question arises as to whether the company properly investigated their supply chain (i.e., undertook sufficient due diligence). If it then turns out that the company should have known about the misconduct on the basis of the CSDDD obligations, the company – and possibly also its directors and supervisory directors – could both be criminally convicted of money laundering.

### Civil liability due to insufficient compliance

In case of non- or insufficient compliance with supply chain due diligence obligations, also civil liability risks may come into play. As this liability is – in essence – by reason of a wrongful act, damage as a consequence of the lack of compliance is required for civil liability. The remedy for such a wrongful act is typically payment of damages to the injured party.

The civil-liability risks lie with the company, the party being obligated to perform supply chain due diligence under applicable legislation. However, also the board members of non-compliant companies may be exposed to civil-liability risks. These directors already have a statutory obligation to act in the best interest of the company when fulfilling their duties. The proposed CSDDD gives content to this general duty of care by stipulating that directors should consider the consequences of their decisions for sustainability matters, including, where applicable, human rights, climate change and environmental consequences, in the short, medium and long term. A failure to comply may result in civil liability of a director towards the company and/or a third party.

Thus, the existing anti-money laundering obligations and directors' duties of care appear to be gaining momentum and strength through the implementation of the upcoming ESG legislation. To prevent involvement in money laundering allegations and civil liability claims, companies should implement robust due diligence processes. This should include conducting thorough assessments of suppliers, verifying the origin and legitimacy of raw materials, and monitoring the adherence to labour standards. By doing so, companies can mitigate the risk of unwittingly supporting illegal practices or benefiting from illicit proceeds.

Additionally, companies should embrace transparency and open communication regarding their supply chains. This involves disclosing relevant information about sourcing practices, sustainability initiatives, and compliance efforts. By providing clear and accurate information, companies can enhance trust, demonstrate their commitment to responsible business practices, and foster a more sustainable and ethical business environment.

## *Sustainability reporting failures: risk of Greenwashing and Fraud*

Companies increasingly face fraud and misrepresentation claims related to ESG. Examples described in this article vary from greenwashing - where vague or misleading marketing statements are made regarding sustainable behavior and performance - to fraudulent ESG related statement in annual reports, concealment of ESG-related criminal activities in sustainability reporting and the fraudulent use of ESG-related subsidies and transformation budgets.

From a criminal-liability perspective, these actions may qualify as fraud. From a civil-law liability perspective, these actions may lead to liability for damages due to misleading reporting or wrongful acts.

### Misleading disclosures, Greenwashing or Fraud

One significant liability risk lies in the potential for companies to present misleading or false information in their sustainability reporting, particularly concerning the harmful impact of their supply chains and their own operations. This form of misleading disclosures or - under certain circumstances – even greenwashing or fraud, can distort the true environmental performance of a company and mislead stakeholders and investors. By downplaying or misrepresenting their ecological and human rights footprint, companies may create an impression of greater sustainability than they actually practice. For illustration, this includes using positive words or understating explanations where it regards negative impacts, presenting the positive information eye-catching and/or upfront in reporting and reporting great examples of sustainability achievements extensively whilst disclosing only briefly on some of the key challenges.

To mitigate this risk, companies should implement robust internal control systems for monitoring and verifying sustainability-related data and information. It is essential – amongst others - to conduct thorough assessments of supply chains, engage in independent audits, and establish clear guidelines for accurate and transparent reporting. Additionally, third-party certifications and industry standards can play a crucial role in validating sustainability claims and reducing the potential for greenwashing.

In this regard, we also refer to the proposed GCD. Under the proposed rules, companies will need to substantiate environmental claims using life cycle assessment, communicate them accurately and holistically, and have them externally verified. Common phrases such as 'net zero', 'carbon neutral' and 'eco-friendly' would be prohibited in advertisements, in social media posts or on packaging unless they were sufficiently substantiated and verified.

### Concealing ESG-Related Criminal Activities in Sustainability Reporting

Another critical risk is the concealment of ESG-related criminal activities within supply chains or a company's own operations. This involves the deliberate omission or obfuscation of information regarding activities that may breach environmental regulations or violate human rights. By presenting a false image of the harmful impact of their business practices, companies may try to avoid legal consequences or damage to their reputation.

To address this risk, due diligence plays a crucial role. Companies should conduct thorough background checks on suppliers and their own operations, ensuring they adhere to environmental and labour standards. Transparency initiatives, such as traceability systems and supply chain audits, should be able to help identify potential criminal activities and ensure the accurate representation of ESG performance. Collaboration with industry peers, NGOs, and regulatory bodies can provide further insights and enhance accountability.

### Misuse of Subsidies

The fraudulent acquisition or misuse of subsidies intended for sustainability initiatives should also be identified as a significant risk. Companies or individuals may submit false or misleading information to secure subsidies, misrepresent the scale or impact of their projects, or misuse the funds for purposes unrelated to sustainability. Such actions undermine the effectiveness of the subsidies and divert resources away from genuine sustainability projects.

To mitigate this risk, robust evaluation, monitoring mechanisms and corporate governance with emphasis on adequate checks and balances should be in place. Authorities responsible for granting subsidies should perform thorough due diligence to verify the legitimacy and viability of proposed projects. Regular audits and site visits can ensure that funds are being utilized as intended. Increased transparency in the subsidy application and selection process, coupled with effective enforcement against fraudulent activities, can act as deterrents and promote fair allocation of resources.

### Misuse of Transformation Budgets

Similarly, there are fraud risks associated with the allocation and utilisation of transformation budgets for sustainability initiatives. These budgets are intended to support large-scale transformations in sectors such as renewable energy, circular economy, and sustainable infrastructure. However, there is a risk of misappropriation, embezzlement, or inflated project costs, leading to a misallocation of funds and a failure to achieve the desired sustainability outcomes.

To address these risks, robust governance frameworks and internal and external oversight mechanisms are crucial. Clear guidelines for the allocation and utilisation of transformation budgets should be established, emphasising transparency and accountability. Independent audits and regular reporting can help ensure that funds are used appropriately and effectively. Collaboration between government entities, auditors and relevant stakeholders can enhance the detection and prevention of fraudulent activities.

## 6. A Call for Action: Managing and Mitigating ESG Integrity Risks

The complexity of ESG integrity risks may overwhelm companies, leaving them unsure of where to begin. However, adopting a comprehensive approach to managing and mitigating these risks shares similarities with other risk assessments.

First of all, culture plays a pivotal role in managing and mitigating ESG-related integrity risks. It serves as the foundation upon which ethical behaviour and responsible practices are built within an organisation. Businesses should enhance an effective corporate culture that promotes transparency, accountability, and a strong sense of ethical values. By fostering a culture that emphasises integrity, organisations encourage employees to make ethical decisions, uphold environmental sustainability, prioritize social responsibility, and maintain strong governance practices.

At a more operational level, businesses should conduct a thorough ESG integrity risk assessment, identifying and prioritising risks based on their potential impact and likelihood of occurrence. Next, organisations must determine their risk strategy and appetite by assessing which risks they are willing to take, and which exceed their risk tolerance. To manage and mitigate ESG integrity risks effectively, organisations should implement policies and procedures aimed at meeting ESG integrity standards. These may include reducing negative environmental impacts, improving working conditions, and adhering to ethical standards. Continuously monitoring and evaluating the effectiveness of risk mitigation efforts is essential to identify weaknesses and minimise net risk. Organisations should also be prepared to terminate cooperation with suppliers or other entities that fail to comply with ESG integrity agreements.

## 7. Conclusion

ESG integrity plays a crucial role in the sustainable and responsible business landscape. While more and more attention is given to ESG factors and a growing volume of legislation focuses on reporting obligations, the nexus between ESG integrity misconduct, financial crime and risk of civil liability of companies and its directors remains an area that requires significant attention.

Addressing ESG integrity risks necessitates collaborative efforts between the public and private sector, as well as in-company (involvement of share- and stakeholders) and intercompany (supply chain) collaborative efforts. The public sector is responsible for setting the legal and regulatory standard and for effectively enforcing the adherence to these standards, while private actors need to take proactive measures in identifying, preventing and neutralising ESG integrity risks. This includes conducting thorough risk assessments, implementing robust policies and procedures, and continuously monitoring and evaluating the effectiveness of risk mitigation efforts.

The ESG integrity landscape encompasses three main (criminal) misconduct areas of potential exposure to ESG-related crimes: engaging in harmful and criminalized activities, laundering the proceeds of ESG-related crimes and fraud – in some cases related to greenwashing. From a civil-liability perspective, risks mainly concern misleading disclosures and wrongful acts. Organisations must be vigilant in identifying and addressing these risks to maintain their integrity and credibility.

To navigate this complex landscape effectively, companies must embrace a comprehensive approach to managing and mitigating ESG integrity risks. By doing so, they can not only uphold their ethical responsibilities but also protect themselves from criminal or civil liability and reputational damage. Embracing sustainable and responsible practices not only benefits the organisation but also contributes to a more sustainable and equitable future.

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