Introduction to ESG Disputes

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Overview

'ESG' stands for 'Environmental, Social and Governance' and began as one of a number of matrixes used to assess companies for investment decisions. It has now become a term used more broadly to refer to the 'good conduct' of companies, both internally (in how they are governed) and externally (in the impact they have on the environment and society). 'Environmental' addresses issues such as climate change and waste disposal; 'Social' covers matters such as workers conditions, diversity and human rights; and 'Governance' includes anti-corruption, corporate reporting and data protection.

This article provides a brief look at where ESG has come from; its status globally; how disputes arise from it; and the current position in the Middle East.

Practical Guidance

A brief history of ESG

The idea that companies can and should be judged on how they are governed and their impact on society and the environment is as old as companies themselves and has manifested in different ways. For instance, when in the 1850's legislation for the modern limited liability company was being debated in England, those in support were often motivated by the desire to improve the conditions of workers by enabling them to invest in their employers' businesses without incurring the risks of the business. And those who opposed argued that limiting the liability of shareholders would be bad for society because it was contrary to the moral obligation to pay debts and compensation for wrongs.

In the US, as far back as the 1950s and 1960s investments were being motived by social concerns, with the Electrical and Mine Workers Union investing pension capital in affordable housing and health facilities. In the 1970s the Pax World Balanced Fund was launched to provide a fund for religious investors to avoid investing in the supply chain for Agent Orange, a chemical controversially used in the Vietnam War. The 1990s saw the creation of the MSCI KLD 400 Social Index, designed to help socially conscious investors by highlighting those US listed companies with positive ESG characteristics. It was also at this time that the Global Reporting Initiative was set-up, which aims to help businesses understand and communicate their impact on issues such as climate change, human rights and corruption. KPMG reported in 2020 that 96% of the world's largest 250 companies report on sustainability issues.

As for the origins of the term 'ESG', it has been traced back to 2005 when a British law firm used it in a report for the United Nations Environment Programme Finance Initiative. They argued that using ESG to assess a company was compatible with an investor's fiduciary responsibilities as it would help avoid climate change, human rights issues and poor corporate governance, thereby reducing the risk of the investment. This illustrates a key difference between ESG and other forms of sustainable investing. With ESG, the aim remains profitability, it simply recognises that the way a company is managed and its environmental/social impact can adversely affect that profitability, at least in the long term. Sustainable investment strategies, such as 'Ethical and Values-Based Investing', or 'Socially Responsible Investing', prioritise the avoidance of certain types of investment irrespective of the profitability in order to remain consistent with a set of beliefs (such as an Islamic fund avoiding investments in breweries). At the furthest end of the sustainable investment spectrum are 'impact-driven' or 'impact-first' funds, where investors seek impact as a priority and in some circumstances are willing to sacrifice market returns.

Monitoring ESG

Self-reporting remains the key method by which a company's ESG credentials are reviewed and assessed, but recently there has been a move away from voluntary reporting toward mandatory reporting. Mandatory reporting and disclosure requirements are designed to ensure a flow of 'decision-useful' information about a company's sustainability to its stakeholders, including its investors. This type of requirement typically bites on the world's most economically significant companies – publicly listed or the largest private businesses. However, it's clear that policymakers are preparing to widen the net in the next two to three years, bringing more companies within the direct scope of mandatory disclosure rules. The rules are designed to permeate the entire private sector so that they 'catch' companies not directly in scope through investment and supply chains – to comply, those at the top of the corporate and investor ecosystem will have to extract the same sustainability-related information from any company they acquire or invest in, and from organisations in their supply chain. This means that ultimately all companies will be working to the same ESG disclosure standards, even if – for smaller organisations – it is their investor or commercial counterparties holding them to it, and not a regulator.

In the UK mandatory ESG disclosure and reporting regulation is ramping up, with certain large companies required by the Companies Act 2006 to report on the effect of climate-related financial risks and opportunities within the new non-financial and sustainability information statement as part of their annual report since April 2022. Also in the UK, the Financial Conduct Authority are preparing to implement new Sustainability Disclosure Requirements to help consumers to navigate the sustainable investment product landscape and address greenwashing of financial products. Europe is further advanced – the EU's Sustainability Finance Disclosure Regulation requires financial institutions to comply with extensive reporting obligations, and the EU Taxonomy Regulation has changed the question of whether a product is sustainable or not to an objective test, rather than a subjective test, to make reporting more robust. European regulation is also ahead of the US, however the US Securities and Exchange Committee is catching up this year with their own proposal for climate-related disclosure requirements. For the UK, the EU, the US and elsewhere around the globe, the mandatory ESG disclosure scope is expanding for both corporates and investment funds each year.

Independent monitoring and assessment is done by assigning an ESG score constructed by professional data providers, such as S&P Global and Reuters Refinitiv ESG. Concerns have been raised about the reliability of such scores. A study in 2020

compared the ESG scores prepared by one leading rating company for the same companies at different times (2018 and 2020). It found that due to an apparent change in rating methodology, there were dramatic differences that meant that whilst on the revised data high-scoring firms performed better during the recent covid crisis, if the original ratings were used there was no difference.

Different methodologies create different results, and whilst an average can be taken using the scores prepared by a variety of data providers, it remains difficult to determine the accuracy of such scores and whether a company or fund's ESG credentials are justified. In August 2022 a review by Morningstar Inc. concluded that 23% of funds that claim to promote sustainability under EU regulations did not deserve to be identified as ESG funds. This means that such funds could be accused of 'greenwashing', but equally it may be the result of different criteria being applied by Morningstar Inc.

There is also criticism of the fact that ESG covers a broad range of activities, and that having a high ESG score can obscure deficiencies on other ESG aspects. It is expected that monitoring ESG will improve, with more sophisticated and robust methods being used, but it remains a developing area and there is currently a lack of labelling standards to provide an accepted objective assessment criteria for ESG. The most dominant global standard for sustainability reporting is GRI ('Global Reporting Initiative'), which was created in 1997, but it is not universally used.

ESG in the Middle East

Concerns regarding ESG are widespread across the Middle East. According to a report by the marketing consultancy firm Edelman, ESG is the top priority of most Middle Eastern investors. Furthermore, Middle Eastern investors are more concerned than other investors that companies may not be able to deliver on their ESG disclosures and promises.

Governments in the region share these ESG concerns and are taking action. For example:

- The UAE, Saudi Arabia and Bahrain have all pledged to reach net zero carbon emissions by either 2050 or 2060.
- Two annual climate summits are being held in the Middle East, COP27 in Egypt, and COP28 in Dubai (UAE announced 2023 as the Year of Sustainability to coincide with this).
- In October 2021 Riyadh hosted the first 'Middle East Green Initiative' conference, involving a pledge to plant 50bn trees in the Middle East. Saudi Arabia's stock exchange, Tadawul, was the first in the GCC to announce plans to launch a national ESG index.
- Saudi Arabia is in the process of creating a city, Noam, to be run entirely on renewable energy, and UAE has committed to created Masdar City on the same basis. Dubai already has a 'net zero energy' residential development ('Sustainable City').
- The UAE is implementing 'Energy Strategy 2050', which aims to increase the percentage of clean energy used in the country from 25% to 50% by 2050. There is also the UAE Green Agenda 2015-2030, which aims to implement a broad framework for various actions to achieve a green economy.
- Qatar aims to reduce greenhouse gases by 25% by 2030.
- In 2021 Kuwait launched its ESG guide, corresponding with the UN Sustainable Development Goals, and the Global Reporting Initiative (GRI) framework.
- Four of the six sovereign wealth funds that founded the One Planet Sovereign Wealth Fund Framework in 2017 (which aims to accelerate efforts to integrate financial risks and opportunities related to climate change in the management of large, long-term asset pools) are from the GCC (Kuwait, Saudi, Qatar, UAE; the other two being Norway and New Zealand).

Action is being taken to get better ESG information to investors. In 2020 it became mandatory in the UAE for companies listed on the Abu Dhabi Securities Exchange and the Dubai Financial Markets to publish a sustainability report as well as details demonstrating the company's long-term strategy in respect to ESG. Companies listed on these stock exchanges also have to comply with the Global Reporting Initiative (GRI) Standards. Whilst these requirements do not apply to non-listed companies, it indicates a promising start that will likely begin filtering down to smaller companies, starting with those in the supply chains for listed companies.

Companies are also voluntarily taking steps to enhance their ESG credentials given its importance to investors and the younger generation, and the expectation is that such initiatives will soon become the norm. For example:

- The National Bank of Kuwait has appointed a board member with an extensive background in ESG to ensure a focus on ESG at board level, and has created a sustainability committee.
- In Egypt, Commercial International Bank issued the country's first corporate green bond (USD100m, taken up entirely by the World Bank).
- In 2019 DP World became the first company in the region to sign a green loan transaction, the margin for which was linked to DP World's carbon output. This creates an incentive for the company to reduce its carbon output.

ESG litigation

Litigation arising from ESG can be divided into two categories. The first is a broad category of disputes and regulatory investigations that arise from a company's poor governance and/or negative impact on society or the environment. The second are investor-led disputes that may arise where a company fails to live up to its ESG claims - these are essentially mis-selling claims.

To date most ESG litigation globally has been in the first category and has taken a number of different forms depending on the procedures available in the specific jurisdiction. They also tend to be brought by (or funded by) non-profit organisations and often take the form of class action disputes.

One approach that has seen some success in the UK has been to seek to hold a parent company (based in the UK) responsible for the environmental harm caused by its subsidiaries abroad. In Okpabi v Shell (2021), the UK Supreme Court reversed a Court of Appeal decision and confirmed that in principle a parent could be sued for environmental damage and human rights abuses caused by its subsidiaries depending on the degree of control and de facto management. In that case, Shell was being sued for damage arising from leaking oil pipelines in Nigeria. The Supreme Court stated that such claims arise like any other tort claim (i.e. identification of a duty of care, a breach of that duty, causation, with the damage not being too remote). The claim itself has not been resolved, but we have already seen similar claims spring up, for example the recently announced claim intimated against Tesco by workers in a Thai factory that supplied clothes to Tesco in Thailand.

Another possible area of liability is in respect to fiduciaries. In Australia, a student claimed his pension fund failed in its fiduciary duty to provide enough information about the fund's impact on climate change and how the risk would be mitigated. The case settled, with the pension fund accepting that climate change was a material risk that needed to be managed.

Claims may arise based on assertions that a company is liable for the ESG wrongdoings of companies in its supply chain, in much the same way that anti-money laundering and corruption obligations can extend beyond the immediate actions of a company. Countries have begun passing legislation to better enable such claims. Germany has passed the 'Corporate Due Diligence in Supply Chains Act' that will require certain companies to identify and report risks of human rights abuses and environmental damage caused by those in its supply chain, and the law also allows NGOs and other groups to bring representative claims to better enable such companies to be held to account for any violations. There are other examples of European countries implementing similar supply chain legislation (France, the Netherlands), and the EU is working on a new Corporate Sustainability Due Diligence directive, expected to become law in 2025, which will impose a new corporate due diligence duty to identify, bring to an end, prevent, mitigate and account for negative human rights and environmental impacts in their own operations, subsidiaries and value chains. The directive will give rise to civil liability for companies in litigation brought by those adversely affected by a company's direct operations or their supply chain.

Claims arising from supply chains have already started to appear. The aforementioned Tesco matter is one such case, where Tesco is alleged to be liable for the poor working conditions of workers in a Thai factory that Tesco do not own. It is alleged that if Tesco had properly audited the factory the abuse of workers would have been identified and remediation action taken which would have stopped the abuse.

Large civil claims will also arise where regulators have determined breaches of domestic regulations. In 2015 Volkswagen was found to have intentionally programmed its cars so that it showed it was producing the correct amount of emissions when undergoing laboratory emissions testing, when in reality it was producing 40 times more. It has had to pay various fines, but also settlements on class action disputes, running into the billions of dollars.

The Volkswagen example also illustrates how claims in the second category can arise. Once the scandal came to light, shares in Volkswagen dropped 40%. That led to claims from shareholders who argued that Volkswagen failed in its duty to inform investors about the financial impact of the scandal, and that had they known about the rigging of the emissions tests they may have sold their shares earlier or not have bought them. These claims are ongoing. Whilst such claims are currently rare, as more companies seek to sell themselves on their ESG credentials it would seem likely that any Volkswagen-type scandals that destroy a company's share price will result in class action claims by shareholders. Governments, especially in Europe, have already begun to be found liable in court for failing to meet their climate-change obligations, so holding companies liable for their commitments seems to be the logical next step.

Legal action can also be taken by a company's shareholders on behalf of the company against directors ('a derivative action') to hold them to account for the mismanagement of ESG commitments. In March 2022 the first claim of this kind in the UK was announced against Shell, brought by shareholders organised by ClientEarth. The shareholders argue that the Board of Shell has failed to properly manage the climate risk to Shell itself, as it has failed to implement a climate strategy that aligns with the Paris Agreement, breaching s172 and 174 of the UK Companies Act (i.e., to act in a way that promotes the company's success, and to exercise reasonable case, skill and diligence). This means that ClientEarth is in fact taking action via Shell's shareholders to protect Shell itself, although clearly the real aim is to highlight shortcomings in Shell's environmental plans and seek to improve them. The claim is also different to the Volkswagen litigation mentioned above in that there is no claim for loss of share value.

Finally, in some circumstances it can be companies who are doing the suing rather than being sued. An example of this is the claim brought by a German energy company under the Energy Charter Treaty against the Netherlands. Legislation was passed in the Netherlands to phase-out coal-powered power plants by 2030. The German company claims this destroyed its investment in these power plants, an investment that should have been protected under the Energy Charter Treaty to which the Netherlands is a signatory. The Dutch legislation did not have a mechanism to compensate those companies impacted by the Dutch law, forcing the German company to issue a claim. Other countries do offer compensation, like Germany which made compensation payments of EUR 4.3bn to enable the phasing out of coal-powered power plants.

ESG litigation in the Middle East

Whilst there are no high-profile ESG claims in the Middle East at present, given the increase in explicit ESG reporting requirements and awareness it seems likely that they will arise in some form although we are unlikely to see the kind of high-profile cases that have occurred internationally, for a number of reasons:

- ESG-disputes often take the form of class action claims and such actions are not generally possible in Middle Eastern countries.

- A common tactic in ESG disputes is to claim that the parent company is liable for the actions of its subsidiaries (e.g., Okpabi [2021], discussed above). Whilst the corporate veil can be pierced in certain situations, generally speaking courts in the Middle East are slow to assign liability to a parent company in the absence of fraud.
- ESG claims are often pursued either explicitly or covertly by non-governmental organisations and charities. This is less likely to occur in the Middle East where such organisations are largely non-campaigning.
- Even if ESG-claims are brought, we may not see them. Large international companies tend to be the defendants and they often use arbitration clauses in their agreements. As arbitration is private it is unlikely that the dispute will come to the attention of the public. Arbitral awards also do not create precedents or develop the law.

In recent times a number of common law courts have sprung up in the Middle East, namely the courts of the Qatar Financial Centre, Dubai International Financial Centre, and Abu Dhabi Global Market. These courts have largely Western common law judges, operate in English, and apply versions of English common law. The courts are concerned with commercial disputes and will not hear claims for judicial review or criminal matters, but to the extent ESG claims are brought, it is possible that litigants will attempt to bring them before these courts in the hope of a more sympathetic approach.

In respect to the Energy Charter Treaty, most Middle Eastern countries are not signatories to the charter and so we are unlikely to see claims under that particular treaty. However there are many other bilateral investment treaties which may protect investors in the Middle East, so similar claims cannot be ruled out.

Practical steps to take

There are a range of practical steps that companies can take to mitigate the risk of ESG litigation.

Firstly, a review should be conducted to map out any existing commitments already made by the company in relation to ESG matters, so that these can be tracked and fulfilled. If necessary, past statements should be clarified or corrected, but only after carrying out a risk assessment to determine if any change in position could itself lead to claims. Future statements on ESG should be controlled, and internal training made available to those responsible for such statements

Secondly, a company should review its relationships with its subsidiaries and its suppliers and ensure they are not a source of potential liability or reputational harm. A system should also be put in place to screen new suppliers and business partners for ESG issues. Given the likelihood that legislation in this area will spread from Europe to the Middle East, it would be prudent to look to complying with the legislative frameworks in the EU to ensure best practice is being followed.

Thirdly, put in place a system to keep on top of ESG legislative developments and regional expectations, and consider developing a crisis management plan so that the company can quickly contact relevant external professionals (such as specialist lawyers and public relations teams) and form a taskforce to better manage unexpected problems.

Fourthly, those sitting on the company's board should be made aware of its duties in respect to ESG so that they can better monitor the work being done by the company to manage the risks involved. Consideration should be given to creating a sustainability committee and appointing a board member with a background in ESG to ensure an ESG focus permeates through the company from top to bottom.

Finally, keep in mind that whilst ESG claims may involve claims for money, they may also be motivated by a desire to change the company's behaviour, or that of the industry more broadly, and be driven by non-governmental organisations and third-party funders. This should be factored in when considering how to resolve the matter amicably.

Conclusion

Countries in the Middle East are competing to grow their economies and attract foreign investment, so we can expect further ESG legislation to be passed to bring the region in line with developments globally. Support also continues to gather pace for a unified global set of standards to produce consistency, clarity on what ESG is and how it is to be assessed. Given the importance of ESG in the Middle East, the region is well placed to contribute to the development of these standards.

Related Content

Cases

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- RWE AG and RWE Eemshaven Holding II B.V. v Netherlands, ICSID Case No.ARB/21/4 (2021)

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Biography

Dalal has over ten years' experience managing and advising on a broad range of complex and multi-jurisdiction disputes across the Middle East as well as the UK. Her clients have included financial institutions, shareholders, property developers, and hotel owners. She has also acted as co-arbitrator in an ICC commercial arbitration.

Dalal is a member of the sub-committee for the Campaign for Greener Arbitrations, and has been an Assistant Editor for Kluwer Arbitration Blog (Middle East coverage), and the ICC YAF representative for Kuwait. She has published articles and co-authored chapters in practitioner texts concerning dispute resolution in the region.