CADWALADER

May 21, 2024

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This week, we discuss a downward revision to electric vehicle manufacturer Tesla Inc.'s governance grade and the equally controversial topic of diverging ESG ratings methodologies. Investigative findings published in May this year show that a U.S. retailer allegedly sold illegally sourced timber despite claims and commitments it made to the contrary. The Biden-Harris Administration announced the introduction of a final rule to reduce methane emissions pursuant to the Inflation Reduction Act. And another UK climate policy is held to be unlawful and not in keeping with the country's legally binding domestic and international commitments.

Rating Agency Applies Downward Revision to Tesla Governance Grade

On May 1, 2024, ratings agency S&P Global Ratings downgraded Tesla, Inc.'s grade for management and governance citing concerns over CEO Elon Musk's dominant role in the company. In addition, S&P pointed to the company's "uncommonly high" risk of lawsuits, such as a **previously reported case** challenging Tesla's takeover of rooftop solar venture SolarCity for a reported USD 2.6 billion and a ruling from the Delaware Chancery Court on Musk's 2018 USD 56 billion compensation plan where the judge nullified the pay package and deemed Tesla's board to be insufficiently independent of its CEO.

S&P recommended increasing board independence to reduce key-person risk by appointing directors who do not have close connections with Musk. As well as the challenges against SolarCity, Musk is subject to sanctions imposed by the Securities and Exchange Commission (SEC) for making "false and misleading" statements about having secured funding to take Tesla private.

Despite these observations on Tesla's governance and lower than expected Q1 2024 results, the company's current overall 'BBB' rating was maintained by S&P due to its overall market share and liquidity. Management and governance grades form part of the global corporate rating assessment and while it can result in a change in the global rating, this is not always the case because of the consideration of factors such as a company's competitive position, its credit metrics and the rating agency's view of the company's financial policy, as well the management and governance aspect.

We have previously discussed Tesla's ESG rating in detail, when the company was dropped from the S&P 500 ESG Index altogether. In this detailed study, we noted that the company had not been dropped from other comparable ESG indexes and that this disparity highlighted that ESG ratings providers' differing ranking methodologies often resulted in assigning divergent rankings to the same companies. In this sense, S&P's recent downward revision is similar in that no other comparable indexes have revised their ratings in relation to Tesla. However, S&P's comments do highlight the extent of the company's overexposure to serious governance and litigation risk and the downward revision demonstrates the detrimental effect that poor governance can have, not least the publicity it attracts.

Regulators in the U.S., UK, and EU recognize the disparity between ESG ratings methodologies as an important issue and are **starting to develop rules in this area**. In the U.S., the SEC adopted a set of rules aimed at standardizing climate-related disclosures by public companies which, it is hoped, will have a positive knock-on impact on the accuracy of ESG ratings. In the EU, the European Securities and Market Authority (ESMA) **launched a consultation** on proposed changes to its Credit Ratings Agency Regulation to specifically account for ESG ratings and methodologies. ESMA's aim with the proposed changes is to ensure that relevant ESG risks are systematically and consistently captured in credit ratings, in order to enhance transparency on the inclusion of ESG risks by credit rating agencies. On March 6, 2024, the UK's Chancellor confirmed that the Financial Conduct Authority would bring ESG ratings providers within the regulatory perimeter. The Board of the International Organization of Securities Commissions (IOSCO) has also published **recommendations for ESG ratings providers**. The common theme across regulators and industry bodies is a push toward increased transparency.

UK Environmental Investigation Agency Accuses U.S. Retailer of Engaging in Illegal Timber Trade

On May 8, 2024, the Environmental Investigation Agency (EIA) **published a report** finding that a major U.S. retailer sold illegally sourced tropical wood for several years. According to the EIA, Home Depot sold okoume wood, one of a number of exotic timber species, from the Republic of Congo and Equatorial Guinea across the U.S. The EIA noted that 80% of okoume produced in the Republic of Congo is illegally sourced due to bribery, fraud, and violations of forest and tax codes. Similar systemic illegalities have been **documented in the Equatoguinean timber sector** since at least 2013 by the U.S. Department of Justice.

A concern with Home Depot's conduct is that the company claims that will only source or sell Forest Stewardship Council (FSC)-certified wood from the Congo Basin. However, the EIA's investigation revealed that none of the okoume wood in question came from an FSC-certified concession, misleading both consumers and investors. The greenwashing allegations are compounded further by the fact that Home Depot affirmed the statement in its SEC Form 10-K for the fiscal year ended February 3, 2019, and repeated in 2020. This recent report by EIA is the third in a series documenting the findings. In May 2024, Home Depot reportedly responded to EIA and noted that they had "received assurances that the doors that Jeld-Wen is supplying to Home Depot do not contain okoume wood, any wood from the Congo basin that is not FSC-certified, or any wood originating from the Congo basin that is processed in China."

Home Depot's most recent wood-purchasing policy does not include traceability or transparency as requirements when sourcing, and according to EIA, fails to address the larger structural reasons the trade existed in the first place.

This investigation touches upon a number of issues at the forefront of the climate discussion – greenwashing, illegal timber trade – which plays a major role in deforestation and is therefore inextricably linked to climate change – and allegedly inadequate due diligence on the value chain.

A number of legislative, regulatory and enforcement initiatives focus on tackling illegal timber trade. **The EU Regulation on deforestation-free supply chains** will require companies to show that the products they are selling within the territory do not come from forest destruction. In order to sell their products in the EU, companies will have to show their geographical origination, which in practice means providing the relevant GPS coordinates to prove the area has not been deforested. Enforcement authorities in the relevant Member State will then carry out inspections on a percentage of operators and traders and check cargo originating from deforestation hot spots on a regular basis. The provisions are similar to the Biden Administration's **FOREST Act**, which also prohibits the importation of designated products containing commodities sourced from land that was illegally deforested. To investigate and prosecute the illegal trade of timber around the world and the deforestation that results, the U.S. Department of Justice formed the **Timber Interdiction Membership Board and Enforcement Resource (TIMBER) Working Group**. Given that the DOJ has previously looked into systemic illegalities in the Equatoguinean timber sector as referenced above, it remains to be seen whether the DOJ, perhaps in conjunction with the SEC, considers enforcement action against Home Depot.

Nonetheless, **as we discussed in our March 2023 issue**, the International Consortium of Investigative Journalists' (ICIJ) wide-ranging investigation into certain auditing firms that the ICIJ found had certified client companies' practices and products as sustainable, while ignoring that these companies were engaged in deforestation activities. The ICIJ's investigation demonstrates that the problem may be highly pervasive – so much so that the aforementioned initiatives may prove to be insufficient. Although environmental auditing is increasingly being employed by companies to increase investor confidence, it is not, unlike traditional auditing, highly regulated and for the most part, is taken up on a voluntary basis. While engaging an environmental audit ensures that a company has systems in place to collect data to be used in the audit, the lack of regulation implies that the specific data collected and/or the assessment of that data may differ among different firms or in different industries or jurisdictions. It may be that practices such as those alleged to have been employed by Home Depot will prompt regulators to rethink mandating environmental audits.

On April 24, 2024, Members of the European Parliament (MEPs) approved a scaled-back Corporate Sustainability Due Diligence Directive (CSDDD). The CSDDD contains rules "for companies regarding actual and potential human rights adverse impacts and environmental adverse impacts, with respect to their own operations, the operations of their subsidiaries, and the value chain operations carried out by entities with whom the company has an established business relationship," and liability for violations of those obligations. The CSDDD is likely to have significant global impact given that companies not headquartered in the EU, but operating there, will be in-scope. In addition, penalties for non-compliance include being publicly censured, and fined up to 5% of net global turnover. While the CSDDD may not be directly applicable to Home Depot specifically, it is a manifestation of the general increased focus on supply chain due diligence, and the EIA's findings against Home Depot are a clear demonstration of its significance, and how, if conducted inadequately, can pose a serious risk to a company.

U.S. Government Announces Final Rule to Cut Methane Emissions from Oil and Gas Facilities

On May 16, 2024, the U.S. Environmental Protection Agency announced a final rule aimed at strengthening, expanding and updating methane emissions reporting requirements for oil and gas facilities under the EPA's Greenhouse Gas Reporting Program. The rule was introduced pursuant to requirements laid out under the Inflation Reduction Act. The new rule is designed to enhance transparency and increase accountability for methane pollution, which is considered to be a leading cause of climate change, by improving the accuracy of annual emissions reporting from related operations. The Methane Emissions Reduction Program is designed to help states, industry and communities implement the Clean Air Act's methane standards and reduce methane emissions from the oil and gas sector. The rule also includes provisions that enable the use of advanced technologies, such as satellites, to measure emissions.

Due to its extreme effects on global warming, the reduction of methane has been a key focus for many states and companies. Earlier this year, Google, in partnership with the Environmental Defense Fund (EDF), **announced plans to launch a satellite** that will map, measure and track methane leakage in the top oil and gas regions in the world for regular analysis. EDF's satellite, MethaneSAT will orbit the Earth 15 times a day. Using algorithms developed by the agency, it will calculate the amount of methane in specific places and track those emissions over time. Google plans to use similar artificial intelligence used in Google Maps to detect sidewalks and street names in satellite imagery to identify oil and gas infrastructure, combine it with EDF's information and together, locate where the emissions are coming from, providing companies – and states – with important actionable information.

UK High Court Holds UK Government Climate-Related Policy Unlawful (Again)

The UK Government has again been ordered by the High Court to revise a climate-related policy – this time, in relation to its Carbon Budget Delivery Plan (the CBD Plan), which sets out its strategy for meeting its legally binding carbon budgets under the Climate Change Act 2008 (CCA) and international climate commitments including those under the Paris Agreement. The suit was brought by Friends of the Earth, ClientEarth and the Good Law Project who also **successfully challenged the government's previous plan**, the Net Zero Strategy.

The High Court gave the Energy Secretary, Claire Coutinho, 12 months to produce a revised plan.

The UK government has faced significant challenges to its climate strategies. In May 2023, Global Feedback, an environmental advocacy group based in the UK and the Netherlands, **announced that it had filed legal proceedings** against the UK government, claiming that it failed to adequately assess the environmental impacts of the UK-Australia Free Trade Agreement (the UKAFTA). The UKAFTA allows Australian producers access to the UK market in order to sell beef, lamb, mutton and dairy. Such imports will become tariff-free after a number of years and in the transition period until then, certain products will be subject to a specific tariff-free quota.

So-called "government framework" cases focus on a government's response to climate change and may include challenging a claimed lack of ambition in climate policies or a failure to implement policies or legislation, or both. This type of strategic litigation is being increasingly employed by a variety of claimants including climate activist groups whose continued wins serve to embolden them to take further action. We have previously discussed the climate litigation landscape in detail **here**.