Greenwashing: A Liability Trap for Management

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By: Sven Henrik Schneider and Malte Wundenberg

The German Financial Supervisory Authority (BaFin) is set to tighten the reins in its battle against greenwashing. In July 2023, BaFin published its sustainable finance strategy, which makes the battle against greenwashing a priority. According to BaFin, the term 'greenwashing' describes the practice of presenting sustainability-related information that does not clearly and fairly reflect the sustainability profile of a company or product.

Without doubt, greenwashing is not just an issue for the financial services sector. The European Commission recently presented a draft "Green Claims Directive" which is intended to provide consumers with the certainty of knowing that something sold as being environmentally-friendly (or "green") is indeed what it claims to be. The draft directive was preceded by the publication of an EU study, which found that over 50% of EU-based environmental claims examined by the study were judged to be vague, misleading or unfounded.

Legal Compliance Duty

If the draft directive is implemented, the sustainability-related disclosure requirements will be tightened further. In the current legal environment, companies and/or their managers can become liable under various aspects if they make any sustainability-related claims which prove to be inaccurate.

These developments are significant for company managers because management is obliged by general principles under corporate law to ensure compliance within the company (so-called duty of legality). This encompasses two aspects. First, managers themselves must comply with applicable laws and regulations. Second, management must organise the company in a way which prevents other board members or employees from violating legal regulations. If there is any suspicion of misconduct, this must be investigated and immediately stopped. Otherwise, management may face civil and possibly criminal liability.

Organisational compliance must therefore be directed at preventing greenwashing. Although not new in principle, this will pose various management challenges, particularly given the regulatory zeal of European legislators. In the financial sector in particular, a veritable tsunami of ESG regulation has emerged in recent years.

This trend is also prevalent outside the financial sector. In addition to the draft Green Claims Directive, examples include the EU Corporate Sustainability Reporting Directive (CSRD), which came into force in January 2023, and supply chain legislation. For market participants, the task of keeping an eye on relevant developments should not be underestimated. The legal provisions also contain numerous undefined terms that have yet to be clarified by further regulations and case law.

Greenwashing Prevention as Part of ESG Governance

From a management perspective, another challenge is that the requirements for sustainability-related disclosure affect various functions within the company (such as investor relations, financial reporting, legal, compliance, sales, etc.) and therefore trigger a need for coordination at a company-wide level.

Against this backdrop, managers are well advised to review existing compliance structures to determine whether they adequately cover any risks of greenwashing. Conceptually, greenwashing prevention measures form part of the processes for implementing ESG (environmental, social and governance) requirements within the company (ESG governance).

Available Guidance

The following questions arise in connection with green claims: Procedurally, how can the data used for sustainability-related claims be guaranteed as accurate and methodologically sound? How is information systematically collected, validated and consolidated within the company? And which function within the company is responsible for these tasks in each case? Depending on the business activity and risk situation, various organisational models are feasible. Guidance can be provided by input from standard setters and associations, such as the position paper on ESG published by the German Institute for Compliance (DICO) in June 2023.

Regardless of which organisational model is chosen, managers are collectively responsible for the implementation of the ESG requirements, and therefore for greenwashing prevention. Of course, managers cannot fulfil all the requisite tasks by themselves. Instead, management must ensure that the tasks are delegated appropriately to suitable bodies and that their responsibilities are clearly documented.

Documentation Compliant with Regulatory Standards

In this context, documentation that complies with the standards set by the competent regulatory authorities is of particular importance. It should relate both to the data on the basis of which ESG-related claims are made and to the measures taken to validate this data. It is imperative that the information can be restored, even years later should the relevant employee(s) have left the company. Other measures to reduce risk include traditional compliance instruments, such as conducting employee training, spot checks and establishing whistleblower systems.

Dealing with Greenwashing Allegations

Even the most sophisticated compliance system cannot always prevent violations of sustainability-related disclosure requirements, and greenwashing allegations can be made through various channels.

It is conceivable, for example, that the relevant facts are reported internally by whistleblowers, or that they are identified as part of audits by internal control functions (compliance, internal audit). More recently, companies have also been confronted with greenwashing allegations by external stakeholders, such as environmental authorities or consumer protection organisations.

How should management deal with such allegations? It follows from their duty to legality mentioned above that allegations must be investigated. Experience shows that the facts are often complex: it follows that investigating them can require considerable time and effort. In such cases, it is important that management initiates appropriate data preservation measures at an early stage. These measures must ensure that data, potentially relevant to the investigation, is not deleted or modified.

Governance Plays a Major Role

Governance is also of great importance in investigations. The organisation should generally be structured in such a way that it can withstand an "investigation of the investigation" by internal bodies or auditors (e.g. the supervisory board or a special auditor appointed by the general meeting), or external third parties (e.g. public authorities or audit firms). Typically, precautions should be taken to ensure that the key players are sufficiently independent.

Respective responsibilities should be specified and documented as precisely as possible. If the organisation is structured accordingly, this reduces the risk of claims being brought against managers for any violations. In addition, the precautions described above can help to identify and remedy any internal deficiencies in sustainability-related communication.

AUTHOR

Sven Henrik Schneider
Partner
+49 69 17095 143
sven.schneider@hengeler.com

Malte Wundenberg
Counsel
+49 69 17095 713
malte.wundenberg@hengeler.com