Why ESG matters in restructurings

Over the last couple of years, there has been a surge in interest in ESG considerations across different sectors. Whilst businesses can thrive with successful ESG strategies, ESG considerations can also play a key role in the restructurings of distressed businesses. We examine below what should be in the ESG playbook for companies or insolvency practitioners implementing a restructuring.

What are ESG considerations?

ESG stands for **E**nvironmental, **S**ocial and **G**overnance. ESG factors are often used to evaluate how sustainable, responsible and ethical businesses are. They cover a broad range of issues, such as:-

E	• Climate change • Greenhouse gas emissions • Waste management
S	• Employee relations and diversity • Human rights and labour standards
G	• Bribery and corruption • Tax compliance

Why ESG is a relevant consideration in restructurings

The level of support a distressed business can garner from buyers, lenders and investors affects what restructuring options are available to the business. It is therefore key to understand why ESG factors affect the decision-making of these stakeholders:

- **ESG-related risks and credit ratings**: Lenders and investors are aware that ESG issues pose material risks to a business and such risks can be sizable enough to impact the business's long term financial performance, value and credit rating, for example:-

  ***Regulatory Risks* -** ESG due diligence has started to and will continue to be a key aspect of deal processes. For example, where a manufacturer has not taken the initiative to mitigate climate change and only does the minimum to comply with applicable environmental regulations, it is expected to face a greater hit than its greener competitor when compulsory environmental regulations are imposed (say reduction of carbon dioxide emission, which is highly likely).

  Litigation Risk - breaches of ESG provisions can spiral into actions and subsequent litigation by regulators. These would be widely reported and can seriously impact the reputation and goodwill of a business, not to mention the fines, damages and legal expenses a company may be required to pay. Accordingly, any questionable practices and the accompanying risks of ESG-related litigation may drive away lenders and investors especially in case of an underperforming or distressed business which will not have the financial resources to defend itself in court or indemnify the buyer. To read more about ESG and litigation risks, please see: ESG and litigation risks | Stephenson Harwood - ESG (esglegalhub.com).

- **Continued growth of sustainable finance**: The already growing recognition of ESG importance has been further heightened during COVID-19 pandemic as there is some financial commentary that ESG stocks have outperformed and are more resilient than others in the market[1]. The practice of socially

[1] "Increasing risk management & resilience through ESG investing" published by WBCSD dated 19 August 2020 (https://www.wbcsd.org/Overview/News-Insights/WBCSD-insights/Increasing-risk-management-resilience-through-ESG-

responsible and/or sustainable investing is valued in the financial markets and contributes to the continued growth of ESG-related finance and investing. This also presents opportunities to both lenders and borrowers as interest in green and sustainable loans, and hence their availability and variety, keep increasing. To read more about green finance in different sectors, please see Green shoots: the rise of the green finance revolution | Stephenson Harwood - ESG (esglegalhub.com).

- **Enhanced regulatory requirements**: In various jurisdictions, regulators and governments are imposing stricter ESG disclosure and reporting requirements on various financial institutions, investors and advisers and these entities in turn increase scrutiny on their investments and portfolios to enable compliance with their own requirements. Potential investors in a distressed business will also want to ensure the business is complying with relevant regulatory requirements before providing new capital. Some recent changes in Hong Kong include:-

  a. In June 2021, the Hong Kong Securities and Futures Commission ("**SFC**") published a revised circular to provide guidance to managers on enhanced disclosures for authorised ESG funds (to read more: The SFC adopts a firmer approach to ESG funds | Stephenson Harwood - ESG (esglegalhub.com)).

  b. In August 2021, the SFC announced its requirements for fund managers to take climate risks into account and accordingly make disclosures to investors (to read more: Hong Kong enters into a climate friendly era for investment funds | Stephenson Harwood - ESG (esglegalhub.com)).

  c. For listed companies and IPO applicants, the Stock Exchange of Hong Kong has also amended its Listing Rules and Corporate Governance Code with effect from 1 January 2022 to enhance ESG requirements such as prohibiting single gender boards.

As the momentum of ESG keeps going, we expect the scope and depth of regulations around ESG in Hong Kong to expand in the near future.

ESG playbook for distressed companies

Below is a brief list of steps in relation to ESG which a distressed company considering restructuring (or provisional liquidators seeking to implement a restructuring) should take:

1. **Assess**: Given how ESG considerations affect the attitude of investors, lenders and buyers, they must form part of any planned restructuring at an early stage. Some companies overlook ESG considerations as they may appear unquantifiable. In fact they are measurable - third-party ESG scoring companies (such as Sustainalytics, Vigeo Eiris (now part of Moody's), and MSCI) are available and financial institutions have been using ESG questionnaires to evaluate potential investment opportunities. Businesses can assess their current scorecard, compare against competitors and use this as a baseline to improve from.

2. **Consult**: ESG considerations are wide-ranging and can be very sector specific. It may therefore be worthwhile to engage appropriate technical and legal experts to advise on the ESG issues, regulatory requirements and the forward looking strategies.

3. **Spinoff or reform**: One restructuring option may be to spin out the businesses in a group which are high risk from an ESG perspective. In the attempt to sell the "bad" ESG businesses, one can consider appealing to activist investors who see opportunities in reforming such businesses. Alternatively, funds from these activist investors could be used to turn the underperforming businesses around.

4. **Enhance, gain access to sustainable funds, and increase appeal to buyers**: Where a business is not distressed because of ESG reasons, steps should be taken to maintain and enhance the ESG performance which can reduce the cost of borrowing or otherwise assist in securing funding. Good ESG performance allows a business to access funds from the sustainable finance market, including ESG linked lending (which links achievement of certain ESG-related KPIs to a pricing toggle / margin ratchet) and green loans (which are set

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investing); and "Most ESG funds outperformed S&P 500 in early 2021 as studies debate why" published by S&P Global dated 16 June 2021 (https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/most-esg-funds-outperformed-s-p-500-in-early-2021-as-studies-debate-why-64811634) up with the commitment to invest in a "green" purpose). It may also attract interest from buyers looking to acquire ESG-positive businesses to create synergy and maximise their own ESG credentials.

5. **Pay attention to ESG clauses**: In the context of ESG linked loans and green loans, lenders will usually insert clauses requiring borrowers to meet certain KPIs and attention should be paid to the consequences which will be triggered by a failure to meet the KPIs or report. Current standard market documentation for ESG linked and green loans do not usually provide that a failure to meet the KPIs or report is an event of default. Usually, a failure to meet KPIs or report will lead to an upward adjustment to the margin. Such lending is therefore sometimes criticised for its "lack of teeth", and it remains to be seen if the market participants will further strengthen the sustainable integrity of the loans by contracting in express terms that such failure would result in default. In the more general context, there is a trend for lenders, buyers and investors to add covenants to protect them against material ESG risks, for example, litigation risks or ESG reporting and disclosure requirements as discussed above.

How we can help

Our advisory and transactional teams continue to support our clients to adapt and conform to the evolving ESG and sustainability legal and regulatory landscape across a broad range of sectors and geographies. Coupled with our restructuring and insolvency expertise, we can help insolvency practitioners navigate towards developing and reshaping ESG strategies to create, preserve or unlock value of distressed businesses attempting a restructuring.

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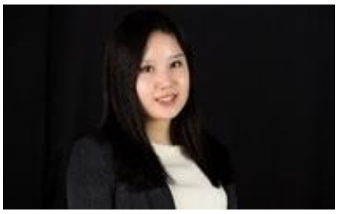

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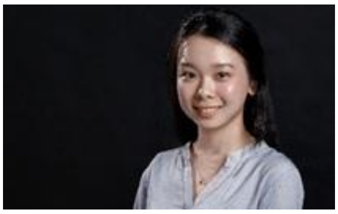

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