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Evaluating ESG In The Aftermath of FTX

Legal Alert

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Recent events show how very dicey the issues can be as we attempt to transition to a more sustainable way of life and doing business. This became front and center last week with the collapse of the crypto-currency firm FTX, including an alleged fraud potentially involving billions of dollars connected to its founder, Sam Bankman-Fried.

At recent conferences of the major business, governmental and airport organizations, the concept of ESG has been front and center. This involves attempting to give an organization a valuation not just based on financial figures such as net worth, capitalization, profitability etc. The ESG score, which stands for "Environment, Social and Governance," attempts to look beyond those factors and also evaluate externalities that might be affected by the organization, such as its commitment to environmental responsibility and social equity.

At this time, there is no fully agreed-upon measure of what items should be evaluated in determining an ESG score, and there also is no agreement on how these items should be evaluated. That remains up to the individual entity itself, which obviously causes problems. There are organizations that try to publish their own guidelines about how to do this, but so far there is no "rating agency" using metrics generally agreed-upon in the same way as Moody's and Standard & Poors work in the financial agency (although we saw in 2008 how susceptible they are to malfeasance).

Now comes FTX, which in one day literally wiped out billions of dollars of shareholder value, and is threatening the entire crypto-currency industry. As more information comes out about FTX, it becomes more likely that even the most basic levels of corporate governance and institutional transparency may not have been met. Indeed FTX's new CEO, John J. Ray III, wrote in a bankruptcy court filing that "never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here."

What makes this failure at FTX relevant to the corporate, governmental and airport world is that, just last week, it became public that one of the agencies trying to rate companies for ESG, Truvalue Labs, had given FTX a higher ESG score for governance than it had given to Exxon Mobil. Again, this score was given to FTX by an ESG rater despite the fact that it appears FTX had almost no level of corporate governance.

As institutions like corporations, governmental agencies and transit and airport authorities try to move forward with determining ESG scores, it becomes essential to evaluate the organization on legitimate metrics, and not on a wish list involving any politically popular position. This will be a very delicate proposition. It should also be noted that in developing ESG scores and guidelines, organizations must remain vigilant not to contradict representations, promises and commitments made in prior agreements and disclosures, including prior financing and bond disclosures.

I have been appointed to the ESG Committee of the Real Estate Section of the New York State Bar Association. On December 9 we will be running a webinar on ESG scoring and evaluation criteria. It will be available here. Similar webinars are being planned by different entities and organizations. All entities that are intending to participate in the ESG rating process should familiarize yourselves with the specifics, and consult your knowledgeable legal counsel so that potentially serious legal pitfalls are not fallen into while engaging in this process.