POLSINELLI

Publications

October 22, 2024 • Updates

DOJ Indictment Signals Increasing Scrutiny of Carbon Credits

On October 2, 2024, the U.S. Department of Justice indicted Kenneth Newcombe and Tridip Goswami, two former executives at CQC Impact Investors LLC ("CQC"), for allegedly selling fraudulent carbon offset credits to private parties. CQC was a major supplier and, allegedly, responsible for generating approximately 50% of the Voluntary Carbon Units ("VCUs") purchased in the market. The indictment alleges that the defendants provided false data to a third-party issuer of VCUs who issued VCUs to CQC. CQC then sold the VCUs to private third parties who used the VCUs to voluntarily offset their carbon emissions.

Two days before the Newcombe indictment, the SEC and CFTC announced *civil* settlements with CQC and Jason Steele, CQC's former COO. The CFTC also filed a Complaint against Newcombe in the United States District Court for the Southern District of New York for violations of the Commodity Exchange Act and Regulations.

The indictment and civil proceedings have broad implications for the carbon credits market utilized by private parties to offset their carbon footprint. Furthermore, the recent focus on the carbon credits market by the U.S. Department of Justice, SEC and CFTC may potentially lead to inquiries by other government agencies, including the IRS with respect to the carbon sequestration tax credits under Section 45Q of the Internal Revenue Code.

First, the indictment highlights just how hard it will be to police the carbon market. CQC was among the world's largest issuers of voluntary carbon credits and accounted for nearly half of the global issuances of voluntary carbon credits. As noted in the press release, the government declined to prosecute CQC because CQC conducted an internal investigation and timely self-disclosed.

The government noted that it would be very difficult for it to detect this scheme without CQC's self-disclosure. CQC obtained its credits by, among other things, developing and installing cookstoves in rural African and Southeast Asian households that, if installed and used correctly, were more efficient than the preexisting cooking methods used in those regions (the "Cookstove Projects"). To determine how many VCUs would be received from the Cookstove Projects, CQC collected data regarding how much fuel was saved by the cookstoves and the number of stoves that were installed and operational. QCQ then sent that data to an issuer of VCUs, which used a formula to calculate the amount of emission

Related Capabilities

- Government Investigations
- Tax
- Litigation
- Environmental

reductions and to determine how many VCUs would be issued.

There are a myriad of ways to reduce carbon emissions or sequester carbon. Some, like CQC's operations, span multiple countries. Others may be in one location. Different participants have different technologies and different sampling protocols. The sheer magnitude and diversity will make enforcement difficult.

Second, although CQC sold voluntary credits, those who are buying them may need to take good faith steps to ensure that the voluntary credits are valid. A recent report by Morgan Stanley found that the voluntary carbon market is expected to grow from $2 billion in 2020 to around $250 billion by 2050. Many environmental groups have claimed that the voluntary market is nothing more than "green washing," with the groups Friends of the Earth, Greenpeace, and World Wildlife Fund-UK making a joint statement on the issue as far back as 2006.

Regulators have also upped the call and are beginning to implement additional requirements for those involved in the carbon market. For example, on May 8, 2024, the SEC finalized rules requiring companies to disclose certain climate-related information, such as the amount of carbon reduction represented by offsets that are purchased, as well as the source, basis for authentication, and cost of those offsets. Similarly, on October 7, 2023, California signed into law Assembly Bill 1305, also known as the Voluntary Carbon Market Disclosures California Act. The California Act requires businesses that (1) market or sell voluntary carbon offsets in California, (2) purchase or use voluntary carbon offsets sold in California that make emissions-related claims, or (3) make claims that an entity or product has eliminated or made significant reductions to its emissions to disclose information such as the timeline and protocol for the carbon offset project. Businesses affected by the California Act are required to post their first annual disclosure by January 1, 2025, and may be subject to a civil penalty of up to $2,500 per day, not to exceed a total amount of $500,000, if they fail to do so.

Finally, the Newcombe indictment and civil litigation may be a signal that the federal government is increasing its oversight and enforcement mechanisms in carbon offset markets and potentially other alternative energy sectors. For example, the Inflation Reduction Act of 2022 (IRA) provided a significant increase in the value of the income tax credit available for certain carbon offset facilities and expanded the number of projects that potentially qualify for the tax credit. Prior to the IRA, a geologically sequestered direct air capture (DAC) facility could qualify for a $26-ton credit if the facility captured at least 100,000 metric tons. After the enactment of the IRA, a DAC facility paying prevailing wages (and subject to other qualifications) can qualify for a $130 ton credit if it captures at least 1,000 metric tons. The IRA also permits the transferability of certain tax credits to third-party purchasers that may have little to no affiliation with the carbon offset industry.

As the Newcombe indictment highlights, it will be difficult for the government to identify fraud. The IRS, EPA and other states and agencies will need to share data and expertise. Given the size of the market and the potential difficulties in enforcement, the government is likely to encourage good governance and self-disclosure by aggressively prosecuting those who do not disclose while showing lenience towards those who do.

The government's declination to prosecute CQC underscores the importance of good corporate governance, timely and thorough internal investigations and self-disclosure by companies. However, self-disclosure can be complicated and is not always a get-out-of jail-free card. Polsinelli's multi-disciplinary practice can help companies comply, conduct internal investigations and respond to regulatory inquiries. If you have questions or need assistance, please contact the authors of this article.