Recent ESG Litigation and Regulatory Developments

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Key Points

- In March 2022, the SEC released long-awaited proposed rules mandating ESG disclosures, controls implementation, risk management, corporate governance and financial reporting. Meanwhile, the agency continues to use its existing enforcement authority to bring actions related to ESG disclosures and statements.
- Driven by what appears to be increased focus on sustainability and ethical supply chains, consumers are more frequently bringing lawsuits alleging that ESG-related statements violate state laws. Misstatements, not omissions, tend to form the basis of the claims that are successful.
- Despite recent dismissals of securities claims challenging ESG-related disclosures, plaintiffs remain undeterred, filing amended complaints alleging fraud and breach of fiduciary duty claims. They have also increasingly turned to books-and-records demands, seeking company documents and other information.
- Companies should carefully manage their ESG-related initiatives, performance and disclosures.

As public scrutiny and interest in corporate commitments aimed at environmental, social and governance (ESG) criteria continue to increase, mechanisms to enforce ESG-related disclosures have developed as well. The Securities and Exchange Commission (SEC) has proposed new rules aimed at ESG disclosures and initiated enforcement using its existing regulatory framework. Plaintiffs are also pursuing consumer actions and alleging securities fraud for ESG-related disclosures. Companies should be conscious of this increased enforcement and litigation landscape when determining ESG initiatives and disclosures.

SEC's Regulatory ESG Landscape

Proposed Rulemaking

The SEC has proposed three significant rules this year aimed at mandating ESG disclosures:

- **Climate-related disclosures.** Rules proposed on March 21, 2022, would take a prescriptive approach in mandating certain climate-related disclosures, regardless of materiality considerations, in annual reports and registration statements for all companies with SEC reporting obligations under Securities Exchange Act of 1934 (Exchange Act) Section 13(a) or 15(d) and for companies filing a Securities Act of 1933 (Securities Act) or Exchange Act registration statement. The gamut of requirements range from disclosing direct and indirect greenhouse gas emissions to sharing climate-related risks, targets or goals, as well as corporate governance practices to manage such risks. (See our March 24, 2022, client alert "SEC Proposes New Rules for Climate-Related Disclosures.") The public comment period for the proposed rulemaking was extended to June 17, 2022. The proposed rules, if finalized, include a phase-in period for compliance by SEC registrants, with the compliance date dependent on the company's filing status. Large accelerated filer companies, for example, would be subject to reporting requirements for the 2023 fiscal year.

- **Disclosures by certain investment advisers and investment companies.** A proposed rule announced on May 25, 2022, would apply to registered investment companies, business development companies, registered investment advisers and certain unregistered advisers. It would require funds and advisers engaged in ESG investing to provide more specific disclosures related to their ESG strategies in fund prospectuses, annual reports and adviser brochures. The proposed rule also requires enhanced disclosures by funds using proxy voting or relying on an issuer to implement ESG strategies and an affirmation that compliance policies reasonably ensure that the fund management aligns with ESG disclosures.
- **Changes to prevent misleading or deceptive fund names.** To combat the SEC's concerns about "greenwashing" concerning fund names, a rule proposed on May 25, 2022, would, among other things, require a fund to invest 80% of its assets in the ESG factor suggested by its name. Funds that consider ESG factors alongside, but not more than, non-ESG factors may not use ESG terms in their name.

There are several key areas in the proposed rulemaking that are important to highlight for companies subject to SEC jurisdiction. With the proposed rules, the SEC has moved away from its historic principles-based approach of allowing issuers to make disclosures based on what a reasonable investor would deem material to a prescriptive model of requiring climate-based disclosures regardless of materiality, including whether climate disclosures are tied to stock price, earnings or financial performance. The proposed rules also require companies to disclose qualitative and quantitative disclosures in audited financial statements if certain climate risks and expenditures impact the related reporting item by 1% or more.

Based on the proposed phase-in period for the climate-related rules, certain large companies would be subject to the new disclosure, controls and record-keeping requirements for the 2023 reporting year. Directors who are identified as having climate expertise may be subject to additional risk; the proposed rulemaking does not provide a safe harbor for purposes of Securities Act Section 11 liability.

Enforcement

Even without finalized rules, the SEC has begun ESG-related enforcement. It announced in March 2021 the creation of a Climate and ESG Task Force in the Division of Enforcement to identify possible misconduct. And with regard to registrants subject to the SEC's exam and inspection authority, the SEC's Division of Examinations intends to focus on the accuracy and adequacy of ESG disclosures.

Since then, the Enforcement Division has been using its existing authority to pursue ESG actions and will continue to hold issuers accountable for voluntary material misstatements regarding ESG-related disclosures. We have seen two such examples so far:

- On April 28, 2022, the SEC filed a litigated complaint against a Brazilian mining company in the U.S. District Court for the Eastern District of New York, alleging the company violated anti-fraud provisions of the securities laws and made material misrepresentations regarding the safety of its dams.
- On May 23, 2022, the SEC charged a registered investment adviser in a settled action for representing that investments in certain funds had undergone an ESG quality review even though that was not always the case. The investment adviser agreed to pay a $1.5 million penalty.

Social and Governance Considerations for Boards

ESG considerations are becoming increasingly relevant to shareholders, including activists. The 2021 proxy season, for example, saw an increase in shareholder proposals submitted pursuant to Rule 14a-8 of the Exchange Act for companies to conduct racial equity audits. These audits range from a review of a specific event that occurred at the company to a general workplace culture temperature check, aimed at ensuring best practices are in place to address issues of racism and unconscious bias. Companies are increasingly opting to conduct general workplace culture audits on their own to assess racial and gender equity and other ESG-related issues.

Consumer Actions

In addition to the SEC, other plaintiffs are pursuing actions to hold companies accountable for their ESG-related statements. Recent case law suggests that consumers are becoming increasingly focused on statements concerning products they interact with regularly, such as food, beverages and apparel. State attorneys general, nonprofit and advocacy groups and private plaintiffs are filing cases with the stated purpose of protecting consumers from allegedly false or misleading ESG disclosures. Plaintiffs have brought these consumer claims under a variety of state laws, including statutes related to consumer protection, unfair trade practices, competition and fraud.

Given this increased focus, companies should take note that general, aspirational language is often less susceptible to consumer fraud claims than firm commitments or factual claims. Recent case law also suggests that misstatements, not omissions, tend to form the basis of more successful ESG disclosure consumer claims. In the past year, court decisions have involved disclosures about the sourcing of fur for luxury winter jackets, the labor conditions of workers who produce cocoa beans and the environmental sustainability of shoes. General, aspirational statements such as “Sustainability Meets Style” and “Our Sheep Live the Good Life” were determined to be nonactionable. In contrast, plaintiff allegations regarding a company’s more specific statement—for example, that its fur sourcing was “ethical, responsible and sustainable”—were sufficient to survive a motion to dismiss.

Finally, companies should ensure the accuracy of all materials, as plaintiffs have based their claims on a wide variety of public statements beyond SEC disclosures, including product labels, websites, social media, marketing materials and environmental reports.

Securities Litigation

In addition, shareholders have brought derivative actions alleging securities fraud and breach of fiduciary duty claims based on a company's ESG disclosures. For example, plaintiffs have filed a number of lawsuits challenging the accuracy of public disclosures related to diversity and inclusion, including disclosures about board diversity and issues arising out of the #MeToo movement (including sexual harassment and discrimination), primarily bringing claims under Sections 10(b), 14(a) and 20(a) of the Exchange Act. These claims are frequently paired with breach of fiduciary duty claims against individual directors and officers involved with the challenged disclosures, alleging that they breached their duties of care and loyalty to the company, including the duties of good faith, oversight and candor.

Board Diversity

Starting in the summer of 2020, shareholders have filed more than a dozen lawsuits accusing large public companies and their directors and officers of failing to follow through with diversity commitments in their proxy statements and other public disclosures. (See our April 13, 2021, client alert "Shareholder Suits Demand More Progress on Diversity.") For instance, plaintiffs have alleged that a company's statement that its "goal" was to assemble a board with diverse perspectives was false and misleading because the board was purportedly not diverse. Although plaintiffs have generally not defined what they mean by "diverse," they have focused on the racial and gender composition of boards.

Such claims generally have not succeeded. A number of courts have dismissed claims based on a company's statements about its "goals" or other expressions of its aspirations, holding that such statements are nonactionable puffery that could not be objectively verified. Numerous courts also have dismissed such claims on the basis that plaintiffs failed to allege sufficient facts to support a reasonable inference that the company's statements were false, including that the company did not actually consider diverse board candidates. However, one case recently resulted in a settlement agreement requiring the company to commit $50 million to workplace and board-level reforms designed to promote diversity, equity and inclusion throughout the company.

On the heels of such dismissals, we have seen an uptick in shareholder demands for books and records, seeking documents or other information to help bolster their claims.

#MeToo

The #MeToo movement has also led to new theories of liability. Plaintiffs have filed securities fraud lawsuits seizing on stock price declines following company disclosures of purported sexual harassment or discrimination. Plaintiffs have challenged the accuracy of statements that the company "has a 'zero tolerance' policy for sexual harassment" or that it "will promptly and thoroughly investigate" allegations of harassment.

As in the board diversity cases, courts have rejected many of these claims, holding that the challenged statements were too general and aspirational to invite reasonable reliance. In *Construction Laborers Pension Trust for Southern California v. CBS Corporation*, however, a securities fraud claim survived a motion to dismiss based on a statement by a former senior executive at an industry event. There, the former executive stated, "[#MeToo] is a watershed moment … it's important that a company's culture will not allow for this. And that's the thing that's far reaching. There's a lot we're learning. There's a lot we don't know."

In this highly fact-specific decision, the court found that because the former executive had allegedly engaged in prior sexual misconduct involving at least six women, the plaintiffs' allegations gave rise to a strong inference that he knew that his statement and its implications were false or that he was "highly unreasonable" in failing to appreciate that possibility. After the motion to dismiss was denied, the parties agreed to settle the case for $14.75 million.

Given plaintiffs' persistence in pursuing ESG-related securities claims, companies should carefully manage their disclosures and public statements on this topic and prepare for shareholder books-and-records demands seeking information on their ESG initiatives.

Associates Shirley Diaz and Hope B. O'Leary also contributed to this post.