Cos. Must Prepare For More ESG Scrutiny From All Sides

By **Tansy Woan, Anita Bandy and Matthew Jang** (July 10, 2023, 5:08 PM EDT)

Tansy Woan

Anita Bandy

Matthew Jang

As public interest and scrutiny into environmental, social and governance issues continue to rise, companies face an ever-evolving landscape relating to their ESG disclosures.

For example, the U.S. Securities and Exchange Commission has proposed rules that could require increased ESG disclosures. Although those rules are still pending, the agency has brought enforcement actions challenging ESG disclosures under the existing regime.

Additionally, shareholders have continued to file securities and derivative actions challenging ESG disclosures, and are using books and records requests to obtain information to support their claims. Meanwhile, anti-ESG efforts are also challenging the validity of companies' ESG efforts.

Accordingly, companies should carefully manage how they implement and disclose their ESG initiatives.

Environmental Disclosures

Regulatory Actions

On March 21, 2022, the SEC issued a press release announcing proposed rule changes that would require registrants to include disclosures in their registration statements and periodic reports regarding climate-related risks and companies' greenhouse gas emissions.[1]

Although these proposals have not yet been adopted, the SEC has already brought enforcement actions under existing law. For example, in April 2022, the agency brought SEC v. Vale SA, an action in the U.S. District Court for the Eastern District of New York, against a Brazilian mining company, stemming from a dam collapse that resulted in the release of toxic mining waste.[2]

The SEC asserted that representations about safety that the company made in its sustainability reports — including statements about "environmental responsibility," adherence to "best practices" and audits certifying safety — were false and misleading.[3] The action ultimately resulted in a $55.9 million settlement payment by the company.[4]

And In May 2022, the SEC charged BNY Mellon Investment Adviser Inc. with misrepresenting that investments in certain funds had undergone an ESG quality review. The company ultimately agreed to pay a $1.5 million penalty.[5]

Shareholder Actions

In addition to the SEC, shareholders are filing actions to hold companies accountable for their environmental-related disclosures.

Fagen v. Enviva Inc.

In November 2022, a securities suit was filed in the U.S. District Court for the District of Maryland against Enviva Inc., the world's largest producer of wood pellets, a renewable alternative to coal. Investors challenged Enviva's statements touting sustainability as "the foundation of [its] business," relying on a short-seller report stating that Enviva was "flagrantly greenwashing its wood procurement," and that Enviva's claim to being a "pure play ESG Company" was "nonsense on all counts."

In re: Danimer Scientific Inc. Securities Litigation

In May 2021, investors filed a securities lawsuit against Danimer Scientific Inc., a biodegradable plastics company, in the the Eastern District of New York, challenging the accuracy of statements that the company's plastic substitute was 100% biodegradable and sustainable.

Although these two lawsuits remain pending, earlier suits provide insight into how courts have addressed similar claims.

In re: Peabody Energy Corp. Securities Litigation

In September 2020, for example, an investor filed a securities lawsuit against Peabody Energy, the world's largest coal mining company, in the U.S. District Court for the Southern District of New York, challenging the company's disclosures on its commitment to safety after a fire at a mine in Australia halted coal production at the mine for over a year.[6]

In March 2022, the court granted a motion to dismiss in part, finding many of the challenged statements — including statements that Peabody "maintains constant vigilance toward safety," "commits to safety and health as a way of life" and "achieved record safety this past year" — to be generic, nonactionable puffery.[7]

But the court denied the motion to dismiss as to other claims, holding that, once the company disclosed the detection of elevated gas levels at the mine at issue, it had a "duty to disclose the whole truth about the situation," which would have allegedly included disclosure of the sighting of smoke — details that could constitute material omissions.[8]

Moab Partners LP v. Macquarie Infrastructure Corp.

Similarly, in December 2022, the U.S. Court of Appeals for the Second Circuit vacated the dismissal of a securities suit, finding that the complaint adequately pled a duty to disclose the impact of an impending environmental regulation that would restrict fuel use, and thus threatened sales of a significant fuel product.

The Second Circuit agreed with the district court that most of the challenged statements were nonactionable — including several that were considered puffery and corporate optimism.

But it found that omissions regarding the impact of the impending regulation, which was allegedly known to defendants, would likely have a material effect on the company's financial condition or operations, thus creating a duty to disclose under Item 303 of SEC Regulation S-K.[9]

Separate from a statutory duty to disclose, the Second Circuit also found that, in light of the defendants having chosen to make specific disclosures about their customer base, the defendants had a duty to make more fulsome disclosures — including that most of the customer base stored a specific type of oil that was the subject of the impending regulation.

Accordingly, given these specific disclosures about their customer base, the court did not find defendants' failure to disclose risks associated with the impending regulation cured by general disclosures on risks associated with "changes in government regulations."[10]

Diversity and Other Social and Corporate Governance Disclosures

Regulatory Initiatives

On the diversity front, the SEC approved a NASDAQ Inc. board diversity rule requiring NASDAQ-listed companies to disclose board diversity data and comply with board diversity requirements, or explain their reasons for noncompliance.

The rule, which is the subject of Alliance for Fair Board Recruitment v. SEC, a case currently on appeal before the U.S. Court of Appeals for the Fifth Circuit, is emblematic of the broader corporate movement toward promoting inclusion, and underscores the importance of considering boardroom diversity and related disclosures.[11]

The SEC has also commenced enforcement actions scrutinizing social and governance issues.

For example, in January, the SEC issued a cease-and-desist order charging McDonald's Corp. and its former CEO for failing to adequately disclose information about the termination of its CEO "without cause," after the company learned of the CEO's undisclosed and improper relationships with company employees.[12]

The SEC asserted that the company's failure to disclose to investors that its CEO would have forfeited substantial equity compensation absent the company's "discretion in treating [the] termination as without cause" violated Section 14(a) of the Exchange Act, and Exchange Act Rule 14a-3.[13]

Shareholder Actions

In the last three years, shareholders have filed more than a dozen lawsuits challenging the accuracy of public companies' stated commitments to diversity.

These lawsuits have generally been dismissed, frequently because the challenged statements were deemed nonactionable puffery, or because plaintiffs failed to plead specific facts demonstrating that the statements at issue were false.[14]

Further compounding plaintiffs' challenges, courts have rejected narrow definitions of diversity limited to race or gender.[15] Many plaintiffs have thus resorted to requesting access to corporate books and records — including board materials — under Section 220 of the Delaware General Corporation Law, in hopes of supporting more specific allegations of how companies may not have been living up to their stated commitments to diversity.

For example, in March 2021, in Kiger v. Mollenkopf, a case brought in the U.S. District Court for the District of Delaware, a shareholder challenged representations made by Qualcomm Technologies Inc. in its proxy statements about its policy to instruct any search firm it engages to include candidates of diverse backgrounds in the pool from which the company selects director nominees.

In dismissing the complaint, the court found that the plaintiff failed to plead facts supporting a reasonable inference that the statements were false or misleading.[16]

But the same shareholder later filed a Section 220 demand to gather more information to support her claims, which were used to file another suit, also captioned Kiger v. Mollenkopf, in the Delaware Court of Chancery earlier this year.[17] That case is currently pending.

Other shareholders have adopted the same strategy as the one in the Qualcomm case, including in the two cases below, which are currently pending:

- Asbestos Workers Philadelphia Welfare & Pension Fund v. Scharf, filed in March in the U.S. District Court for the Northern District of California, in which shareholders relied on Section 220 demand documents to allege that the Wells Fargo board ignored "pervasive issues of discrimination" that resulted in multiple scandals, including allegations that the bank held fake interviews with minority candidates.

- In re: Tesla Inc. Stockholder Derivative Litigation, filed in June 2022 in the U.S. District Court for the Western District of Texas, in which shareholders relied on Section 220 demand

documents to allege that the Tesla board ignored repeated warnings of a company culture tolerating sexual harassment and racial discrimination.

Anti-ESG Efforts

As companies grapple with the demands of regulators and shareholders that they improve their commitment to ESG initiatives, they should also be aware of anti-ESG efforts challenging such initiatives.

For example, the U.S. Senate passed legislation in March to nullify a U.S. Department of Labor rule allowing retirement plan managers to formally consider ESG factors in investment decisions.

And earlier in the year, a group of 25 Republican attorneys general brought an action against the DOL in the U.S. District Court for the Northern District of Texas, alleging that the rule violates the Employee Retirement Income Security Act, and undermines protection for retirement savings.[18] That case, Utah v. Walsh, is currently pending.

Although President Joe Biden vetoed the Senate bill, many states are passing their own anti-ESG bills. Florida, for instance, recently adopted a law barring state officials from investing public money based on ESG standards.[19]

Growing anti-ESG sentiment has also led a number of state attorneys general to investigate whether collaborative ESG initiatives in the financial sector violate antitrust laws by restricting financing and investments in carbon-intensive industries.

Recently, state attorneys general have also begun inquiring about ESG efforts in the insurance industry, raising similar concerns that collaborative efforts may be restricting the supply of underwriting services to high-emission sectors.

Growing anti-ESG scrutiny has already affected participation in these collaborations, with The Vanguard Group Inc. recently exiting the Net Zero Asset Managers Initiative, and major insurance companies leaving the Net-Zero Insurance Alliance.

Further, shareholders have recently started challenging diversity-based initiatives and seeking more information about them via Section 220 demands. For instance, they have claimed that such efforts violate Title VII of the Civil Rights Act and corporate anti-discrimination policies, while also failing to further corporate profits or maximize shareholder interest.

In Sum

Courts have often held that generalized statements about a commitment to safety or environmental sustainability are too vague to be actionable under the securities laws. At the same time, a company may have a duty to make more detailed disclosures, including about potential risks, if it provides specifics about a particular environmental matter.

Companies should be aware that there may also be a duty to disclose specific risks of impending changes in environmental regulations, and they should consider including those in their risk factor disclosures.

Although most suits challenging corporate diversity disclosures have been dismissed for failure to plead falsity with the requisite particularity, plaintiffs have resorted to books and records demands in hopes of uncovering information to bolster their claims.

Companies should be mindful in crafting disclosures that characterize the termination of an executive or other key employee as without cause — particularly when the termination takes place in the backdrop of an internal investigation into allegations of harassment or other workforce issues.

Companies should also be mindful of how they are documenting discussions of, the implementation of, and any progress updates on diversity-related initiatives.

While companies continue to grapple with increased scrutiny of their ESG efforts and disclosures, they should monitor anti-ESG efforts challenging the validity of those initiatives as well.

Given the constantly evolving landscape surrounding ESG-related issues and their controversial nature, it will be important for companies to monitor further developments closely, and to carefully manage their ESG-related initiatives and disclosures to help reduce the risk of litigation.

Tansy Woan is a partner at Skadden Arps Slate Meagher & Flom LLP.

Anita Bandy is a partner at the firm. She previously served for 17 years in the U.S. Securities and Exchange Commission's Enforcement Division.

Matthew Jang is an associate at the firm.

[1] Press Release, Securities and Exchange Commission, SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors (March 21, 2022), https://www.sec.gov/news/press-release/2022-46. While the SEC's ESG disclosure rule is still under consideration, there has been speculation that the SEC is considering whether to scale back on the proposed rule in light of potential litigation risks stemming from the U.S. Supreme Court's decision in West Virginia v. EPA, where the court expressly stated that "it is not plausible that Congress gave EPA the authority to adopt on its own" carbon emission regulation under the Clean Air Act, even if it "may be a sensible 'solution to the crisis of the day.'" 142 S. Ct. 2587, 2616 (2022). As a result, companies have been closely monitoring for updates, which may significantly affect their public disclosure obligations and litigation risks.

[2] Press Release, Securities and Exchange Commission, SEC Charges Brazilian Mining Company with Misleading Investors about Safety Prior to Deadly Dam Collapse (April 28, 2022), https://www.sec.gov/news/press-release/2022-72.

[3] SEC v. Vale SA, No. 1:22-cv-02405 (E.D.N.Y. Apr. 28, 2022), ECF No. 1, Compl. ¶ 237.

[4] Press Release, Securities and Exchange Commission, Brazilian Mining Company to Pay $55.9 Million to Settle Charges Related to Misleading Disclosures Prior to Deadly Dam Collapse (April 28, 2022), https://www.sec.gov/news/press-release/2023-63.

[5] Press Release, Securities and Exchange Commission, SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations (May 23, 2022), https://www.sec.gov/news/press-release/2022-86.

[6] See In re: Peabody Energy Corp. Sec. Litig., 2022 WL 671222 (S.D.N.Y. Mar. 7, 2022).

[7] Id. at *13-14; see also Del. Cty. Emp. Ret. Sys. v. Cabot Oil & Gas Corp., 579 F. Supp. 3d 933, 949 (S.D. Tex. 2022) (statement of general "unwavering commitment to comply with or exceed all regulations to enhance the environment" is a "generalized, optimistic, statement[] that a reasonable investor would consider corporate puffery").

[8] In re: Peabody Energy Corp. Sec. Litig., 2022 WL 671222, at *12.

[9] Moab Partners LP v. Macquarie Infrastructure Corp., 2022 WL 17815767, at *2-3 (2d Cir. Dec. 20, 2022), petition for cert. docketed, No. 22-1165 (U.S. June 1, 2023).

[10] Id. at *4.

[11] See Alliance for Fair Board Recruitment v. SEC, No.21-60626 (5th Cir.).

[12] Press Release, Securities and Exchange Commission, SEC Charges McDonald's Former CEO for Misrepresentations About His Termination (Jan. 9, 2023), https://www.sec.gov/news/press-release/2023-4.

[13] Stephen J. Easterbrook et al., Securities Act Release No. 11144, Exchange Act Release No. 96610 (Jan. 9, 2023), https://www.sec.gov/litigation/admin/2023/33-11144.pdf.

[14] See, e.g., City of Pontiac Gen. Emps.' Ret. Sys. v. Bush, 2022 WL 1467773, at *4 (N.D. Cal. March 1, 2022) (dismissing derivative complaint, finding alleged Section 14(a) violation inadequately pled because "aspirational statements" of commitment to diversity in proxy statements were "vague statement[s] of optimism ... not capable of objective verification") (cleaned up); Ocegueda on behalf of Facebook v. Zuckerberg, 526 F. Supp. 3d 637, 650-51 (N.D. Cal. 2021) (dismissing derivative complaint, finding plaintiff failed to plead an actionably false statement under Section 14(a) based on statements regarding Facebook's commitment to diversity).

[15] See Lee v. Frost, No. 21-20885-CIV, 2021 WL 3912651, at *12 (S.D. Fla. Sept. 1, 2021) (dismissing derivative complaint, finding allegations of a lack of "Black or Lantix individuals" on the company board are insufficient to plead that the board did not value "diversity of knowledge base, professional experience, and skills") (cleaned up).

[16] Kiger v. Mollenkopf, No. 21-409-RGA, 2021 WL 5299581 (D. Del. Nov. 15, 2021).

[17] Kiger v. Mollenkopf, No. 2023-0444-JTL (Del. Ch. April 21, 2023).

[18] Utah v. Walsh, No. 2:23-cv-00016-Z (N.D. Tex. Jan. 26, 2023).

[19] See Press Release, Ron DeSantis, Governor of Fla., Governor Ron DeSantis Signs Legislation to Protect Floridians' Financial Future & Economic Liberty (May 2, 2023), https://www.flgov.com/2023/05/02/governor-ron-desantis-signs-legislation-to-protect-floridians-financial-future-economic-liberty/.