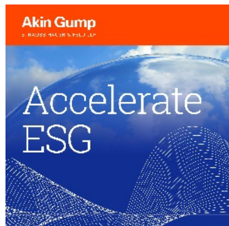

Ep. 2: ESG Litigation in the US – Disclosures and Risks

February 28, 2021

Chad Smith: Hello, and welcome to Akin Gump's *Accelerate ESG* podcast. I'm your host, Chad Smith.

Stakeholders across the marketplace continue to devote increasing attention and resources to environmental, social and governance, or ESG, factors in connection with developing sustainable financial products, operations and consumer products. As demand for ESG-tuned products and disclosures is not expected to abate any time soon, companies, boards of directors and management would be wise to evaluate their risk profiles relative to ESG.

Today, I'm pleased to have with me Akin Gump litigation partner Jackie Yecies and counsel Stephanie Lindemuth. They'll be discussing ESG from the U.S. perspective, providing an overview of the litigation risks associated with making ESG disclosures and related strategic considerations. Welcome to the podcast.

Thank you both for making the time to appear on the show today. Let's start by discussing the sources of ESG-related litigation risks in the U.S. Stephanie, why don't you start us up by talking a little bit about those sources.

Stephanie Lindemuth: So, Chad, I'd be happy to start with that. Before I dive in, I do want to note that these ESG-related liability risks that we'll be talking about today do vary for each company. And that variation depends on various factors, including the company's industry and geography, for example. But more generally in the United States, public disclosures are the primary source of ESG litigation and enforcement actions.

And these ESG-related disclosures are more prevalent and increasing in recent years. And while these disclosures present an opportunity for companies to showcase their good work, it also creates increased liability risks. We've seen a growing number of claimants using a company's own ESG marketing and disclosures against it in litigation. And we expect a rise in private actions resulting from incomplete or inaccurate ESG disclosures. In addition to these corporate disclosures, we've seen liability risks stemming from company operations or

improper corporate governance. That corporate governance piece, or the G in ESG, comes up in fiduciary litigation, for example.

Chad Smith: We all follow media reports, and we've certainly seen an uptick in recent years regarding ESG-related disclosures and undertakings by companies. Jackie, maybe can you spend a moment talking about or identifying risks that companies may expose themselves to relative to these disclosures or undertakings?

Jackie Yecies: Sure, Chad, happy to. Beyond the fiduciary litigation that Stephanie just mentioned, ESG-related liability risks in the U.S. stem from both the federal and the state levels. So, private ESG-related litigation generally arises in two contexts. Number one, consumer protection or fraud claims under federal or state laws and two, antifraud provisions and Section 10(b) of the Securities Exchange Act.

So, for example, as a number of companies discussing ESG in their annual form 10-K filings is on the rise, activist litigants may seek to use these disclosures as a basis for litigation and seek to hold these companies accountable for their existing ESG commitments under the securities laws or otherwise.

There's been an enhanced regulatory focus on ESG-related topics at both the state and federal levels again. The regulatory landscape in the ESG space is in an uncertain state. It's all dynamic, making it important for companies and directors to stay current and in-the-know about what rules or regulations may be applicable at that time. Given the increased regulatory focus of agencies, such as the SEC and the CFTC, for example, it's likely that, as more regulations and rules are rolled out, private litigation will surely follow and become more prevalent.

Chad Smith: Yeah. I mean, that's certainly the way it usually goes, but for our listeners, maybe in the context of claims implicating the Securities Exchange Act, Jackie, could you just walk us through how a claim under the Act would be brought in the context of ESG?

Jackie Yecies: Sure. Similar to other contexts, in the ESG context, litigation would most likely be brought under Section 10(b) of the Securities Exchange Act and Rule 10b-5. This applies to public companies and prohibits false or misleading statements of material facts, or material omissions of facts in connection with the purchase or sale of a security.

A plaintiff may, for example, bring a case under Section 10(b) of the Exchange Act alleging that the company provided false information about their ESG policies. In support of a Section 10(b) claim, the plaintiff needs to prove reliance, causation or knowledge, and that the defendant acted with the intent to deceive, manipulate or defraud.

Additionally, federal securities fraud claims must meet a heightened pleading standard under the Private Securities Litigation Reform Act. And that requires plaintiffs to specify the statements they allege to be fraudulent, identify the speaker of the statements, state where and when those statements were made, and explain why those statements were fraudulent.

Chad Smith: That's the conceptual framework in terms of how a litigant would bring that sort of claim. Is there a specific example of securities litigation in the ESG context that you could take us through?

Jackie Yecies: Yes. You may recall the Deepwater Horizon oil spill where a BP-operated drilling rig exploded and spilled millions of gallons of oil into the Gulf of Mexico. This was all over the press. In 2012, a securities class action was filed against British Petroleum under the antifraud provisions in Section 10(b) of the Securities Exchange Act.

The claims alleged that BP had made false statements in press releases in annual reports and in other reports about its safety and risk management programs at its various facilities. And this was after several industrial accidents had occurred years earlier. And this is an example of company operations being inconsistent with the company's public disclosures, and upon a motion to dismiss, some of the plaintiffs' claims narrowly survived at the time. This lawsuit was ultimately settled and then dismissed.

Chad Smith: The SEC has really indicated in the last few years or so that it's indeed focusing on these inconsistent disclosures relative to what the company is actually doing, but, Stephanie, in you experience what sort of ESG-related federal private litigation is taking place outside of the securities law context?

Jackie Yecies: Well, Chad, certain private litigation in the ESG space stems from allegations of greenwashing, which describes the process of conveying a false impression or providing misleading information about how a company's products or services are more environmentally sound than they actually are.

Chad Smith: I mean, it seems like every day in the press and in various professional journals and what have you, where we frequently hear this term "greenwashing." Maybe can you expand on what that term means for our listeners?

Stephanie Lindemuth: Yes, I'm sure you and many of our listeners are familiar with this term. And for those who may not be, let me just provide a couple of examples. Greenwashing can include statements touting products as environmentally friendly, for example. They can also be in statements regarding efforts to reduce greenhouse gas emissions or statements regarding ESG investing. Plaintiffs have asserted claims attempting to address greenwashing under false advertising laws, such as the federal Langham Act, which prohibits companies from using advertising that misrepresents the nature, characteristics, qualities, or geographic origin of goods and services sold.

Chad Smith: Thus far, our conversation has really focused on litigation risks at the corporate level. And, so, maybe we could turn to Jackie, what sort of liability risks do directors face?

Jackie Yecies: Sure. So director-specific litigation in this context is usually fiduciary litigation, which typically arises under state common or statutory corporate law. So, these private suits may be brought by shareholders either on a derivative basis or on a direct claim basis. And they may allege things like breaches of fiduciary duties owed by corporate directors in the form of inadequate ESG disclosures or omissions or other broader corporate governance concepts, including things like breaches of the duty of loyalty. In making decisions as corporate fiduciaries,

directors and officers have a duty of care to act in the same manner as a reasonably prudent person in their position would. The duty of loyalty is a director's responsibility to act at all times in the best interests of their company. They're expected to put the welfare of the corporation above their own personal or business interests.

Chad Smith: I seem to recall that a number of these sorts of lawsuits have been filed, if memory serves, in California. Is that accurate?

Jackie Yecies: That's exactly right, Chad, we saw a flurry of shareholder derivative and securities fraud actions filed in California federal courts in 2020, and then early 2021. The lawsuits targeted the directors of public companies such as Oracle and Qualcomm. The plaintiffs' alleged claims against the directors for breaches of the duty of care and loyalty based on alleged insufficient commitment to diversity at the company, as well as alleged misleading disclosures regarding diversity and compliance with the antidiscrimination laws.

The complaints alleged, for example, the directors failed to monitor the company's compliance with the antidiscrimination laws, that they breached their fiduciary duties by failing to ensure diverse candidates are selected to sit on the board and that they overcompensated themselves at the expense of minority and women employees. In one example, the Qualcomm complaint alleged that, despite suggesting that executive comp was linked in part to the achievement of diversity and inclusion goals, the real truth was that diversity and inclusion didn't factor at all into the executive compensation packages in that case.

Chad Smith: It'll be interesting to see how these companies continue to disclose these sorts of diversity metrics, particularly in light of the recently approved NASDAQ diversity rules and what have you. Jackie, in your experience, what sort of remedies are typically sought in these types of litigations?

Jackie Yecies: In addition to seeking typical monetary damages from the directors and officers, these derivative cases tended to seek wide-ranging injunctive relief. So, for example, complaints would ask that companies create a fund dedicated to hiring, promoting and retaining minority employees, for example. Or asking that companies publish an annual diversity report with particular information about equal treatment of employees.

Chad Smith: And, obviously, as we talked about a little earlier, regulators have continued to signal that evaluating ESG-related claims and disclosures will continue to be an area of focus during 2022, in fact. Stephanie, what else can you tell us about what the SEC is doing in this area?

Stephanie Lindemuth: I'm really glad you brought up this regulatory piece, Chad, because you know, private litigation risk is really just one species of ESG-related liability risks, and it really should be considered together with this regulatory and enforcement risk. And to answer your question more specifically, the SEC has certainly recognized the market's interest in reliance on climate and other ESG disclosures.

In March of 2021, the SEC created a climate and ESG task force to identify ESG misconduct, with an initial focus on gaps and misstatements in public company disclosures. And this task force is headed up by Kelly Gibson, who's the Director of the SEC's Philadelphia regional office.

In November of 2021, Ms. Gibson participated in a podcast in which she indicated that this year the ESG task force intends to concentrate on detecting and bringing enforcement actions for greenwashing to counteract the potential risk that investors may be misled as a result of what she called a dramatic surge in popularity for ESG-focused investment funds.

And the SEC has also signaled that it's working on a rule to mandate that public companies disclose climate-related risk. While this past summer, SEC Chair Gary Gensler stated that he asked SEC staff to unveil a proposal in order to bring greater clarity to climate risk disclosures by making them consistent and comparable.

We have not yet seen any notice of proposed rule-making on ESG matters. We expect to see more in the early months of this year on this rule-making, though. And we've also seen that the SEC Director of Enforcement, excuse me, the Acting SEC Director of Enforcement Melissa Hodgeman stated that funds advertising ESG investments will be subject to increased scrutiny, and we should anticipate potential disclosure related enforcement actions.

Chad Smith: Circling back to your point on the anticipated rule-making on climate-related disclosures, just this morning, Reuters was reporting that many companies are concerned that any updated rule will include disclosure requirements around GHG3 emissions, which I think that would be a really hard-fought rule just given some of the burdens that might come with that. So that's something for us to keep our eye on. But that having been said, Jackie, what's going on in relation to disclosure-related enforcement actions or investigations recently?

Jackie Yecies: Sure, Chad. In 2021, the SEC probed investment funds that had publicly indicated an intent to engage in ESG-specific investing. The SEC reviewed the funds, regulatory filings, websites from policies and other ESG materials searching for possible ESG mislabeling or mismarketing, but they didn't name any individual firms or advisors.

In April of that year, of 2021, the SEC issued a Risk Alert targeted at ESG investment funds and their advisors offering guidance about the adequacy of controls to ensure that ESG disclosures and marketing principles were consistent with those firms' practices. The SEC observed inconsistencies between actual firm practices and ESG disclosures and marketing materials.

Some examples: They found instances of potentially misleading statements regarding ESG investing processes and representations regarding the adherence to global ESG frameworks or policies. They also found that some compliance programs at these companies did nothing to ensure that firms had reasonable support to adhere to their ESG marketing claims. We should be mindful of investigations and reviews like these, because, of course, where there's enhanced regulation, enforcement actions and private litigation may be soon to follow.

Chad Smith: Yeah, that's always the case, isn't it? Stephanie, can you please touch on other federal agencies that are worth watching in this space?

Stephanie Lindemuth: Sure. There are a couple that come to mind. The CFTC established a Climate Risk Unit also in March of 2021. The SEC and this unit focuses on understanding pricing and addressing climate-related risk and a transition to a low-carbon economy and the role of derivatives in addressing that risk and transition. The FTC is also one to watch. For years, the FTC has been investigating and finding businesses to have misled consumers with greenwashing and has even imposed civil penalties on them. For example, one business was subject to a $450,000 civil penalty. Recently, the FTC indicated that this year it intends to review and refresh its guides for the use of environmental marketing claims, which are also known as the Green Guides, and these govern marketing products as, among other things, sustainable, organic or natural.

Chad Smith: And we focused on regulatory issues thus far. What are you seeing on the legislative front?

Stephanie Lindemuth: Legislators are also very interested in ESG. In June of last year, the U.S. House of Representatives passed the ESG Disclosures Simplification Act of 2021, which would require issuers to annually disclose ESG metrics and their connection to a company's long-term business strategy. And it would also explicitly require the SEC to issue specific ESG reporting requirements.

We can also see that state governments are very focused on ESG. In the summer of last year, the California attorney general led 12 others, including New York, Delaware, Connecticut, and Massachusetts, in calling upon the SEC to mandate disclosures related to financial risk associated with climate change.

Several states have also instituted mandates regarding board diversity or disclosure, and the list of states continues to grow. For example, in California, there is a bill mandating gender diversity on the boards of directors of publicly traded corporations. And that new law provides that these corporations, whose principal executive offices are located in California, must have specified minimum levels of women on their boards.

And the statute also requires periodic reporting to the California secretary of state, who's required to publicly report on corporate compliance. The takeaway here is, really, that companies should be aware of potential claims involving ESG issues and take advanced steps to mitigate litigation and regulatory enforcement risks such as staying up to date with regulatory developments in this evolving space.

Chad Smith: And it seems natural that claimants would call on consumer protection statutes in the context of ESG-related litigation and, without giving the spoiler, I suspect that this means that all roads are going to lead back to California. Can you, Stephanie, spend a moment describing those sorts of risks?

Stephanie Lindemuth: Sure. You're right that some of the ESG-related litigation risk arises out of private rights of action and state statutes, including unfair and deceptive trade practices laws. California, as you mentioned, has been the predominant venue for consumer claims because of state laws like the CLRA, or the Consumer Legal Remedies Act; the UCL, or the Unfair Competition Law; and the FAL, or the False Advertising Law.

The FAL prohibits false or deceptive advertising to consumers about the nature of a product or service. And this covers false or misleading statements in print, digital or any other advertising media. And to give a little bit more background on the other two statutes I mentioned, the UCL prohibits false advertising and illegal business practices, and the CLRA lists about two dozen unfair and deceptive acts of consumer fraud. And relevant to the ESG context, these business practices or deceptive acts include, for example, misrepresenting the quality or grade of a product or disparaging a competitor's product in terms of its environmental impact.

Chad Smith: Am I correct in remembering that there was a case recently or within the last couple years involving Keurig?

Stephanie Lindemuth: That's right, in 2019, Keurig was sued under the UCL and the CLRA for alleged misleading marketing that proclaimed its plastic coffee pods are recyclable based on plaintiffs' assertion that they were not in actuality. The district court there denied Keurig's motion to dismiss and later granted class certification. And the case is currently in the process of settling on a classwide basis.

Chad Smith: Now, in the context of the Keurig case, the underlying claim revolved around misleading marketing with regard to product labeling. Have we seen state law claims based on ESG statements made via other mediums?

Stephanie Lindemuth: While consumer claims most commonly are challenging the product labeling, plaintiffs have also tried to focus on ESG statements beyond labels, including on company public websites, for example. And generic statements are generally not an acceptable basis for a lawsuit, but claims regarding statements of specific and verifiable facts relating to company operations could survive a motion to dismiss.

Chad Smith: Now, as you might guess, Jackie, our listeners are going to want to have some practical takeaways from these sorts of podcasts. And, so, I'm just wondering at a high level, what sort of advice can you offer companies relative to mitigate these risks in the context of ESG?

Jackie Yecies: Thanks, Chad. And, of course, this is a pretty dynamic and ever-changing area of the law. And I'll note that the following are suggestions and best practices, which are intended to be practical, but they are still general in nature. Obviously, directors, senior managers and executives will need to consider their particular sector, their geography, the nature of their supply chains and operations, and any other relevant factors specific to their organization in taking steps when mitigating risk.

That said, here are some general thoughts that companies and other firms should consider. First, companies should carefully consider voluntary disclosures. Start with a basic policy and develop a program incrementally over time. Aspirational statements generally involve less risk than concrete statements or concrete metrics; companies should consider utilizing aspirational language or forward looking statements and disclaimers where appropriate.

Companies should also take affirmative steps always to ensure the accuracy of their disclosures and prevent inconsistencies with other company disclosures, and consider which party should make the particular disclosure and what the appropriate reporting framework is.

Companies should consider: am I making promises I can't keep? am I making any false or inaccurate disclosures that could mislead investors, regulators, customers, or anyone else who could consider making a claim?

Another thing to consider is including disclaimers specific to any ESG-related disclosures. So, disclaimers include noting that statements are forward looking and disclosing that ESG data in particular is usually non-GAAP-compliant and may not be audited. A company or a board of directors may also consider forming a specific committee or subcommittee solely responsible for reviewing and ensuring the accuracy of ESG-related disclosures and their consistency with other company statements.

Chad Smith: In that context, we've been approached by a number of clients in terms of evaluating committee charters to make sure that they're picking up those ESG-related disclosures, whether it's in the context of an audit committee in financial reporting generally, or to your point, setting up a subcommittee or a standalone committee of the board that's dedicated to ESG-related disclosures. So I think that's super-helpful, helpful feedback. Jackie, before we finish, are there other things that companies can be doing to mitigate their risk in this regard?

Jackie Yecies: In recent times, companies have taken to ensuring that compliance personnel are knowledgeable about the firm's specific ESG-related practices. The SEC recently observed that with active compliance involvement in-house, firms were more likely to avoid materially misleading claims or omissions in their ESG-specific marketing materials and other client-facing or investor-facing documents.

Businesses should review the regulatory guidance and keep apprised of the developments in this ever-evolving space. We talked a little earlier about the SEC Risk Alert targeted at ESG investment funds. That's a great place, for example, for folks in the funds industry to start in the ESG-related disclosure space. And, of course, directors and senior managers may also want to take advice from their relevant professionals or attorneys as part of their ESG analysis.

Chad Smith: That's always wise advice. Stephanie, Jackie, I want to thank you again for taking the time to be on the show today, and listeners, I want to thank you for taking the time to listen to our show. Down the road, we will be releasing additional podcasts on all things ESG. So, please be sure to subscribe to our channel on iTunes or wherever you find your podcast.

If you're interested in learning more about Akin Gump and our ESG know-how, please visit us at the environmental, social and governance page at akingump.com. I'm your host, Chad Smith. Thank you for listening.

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