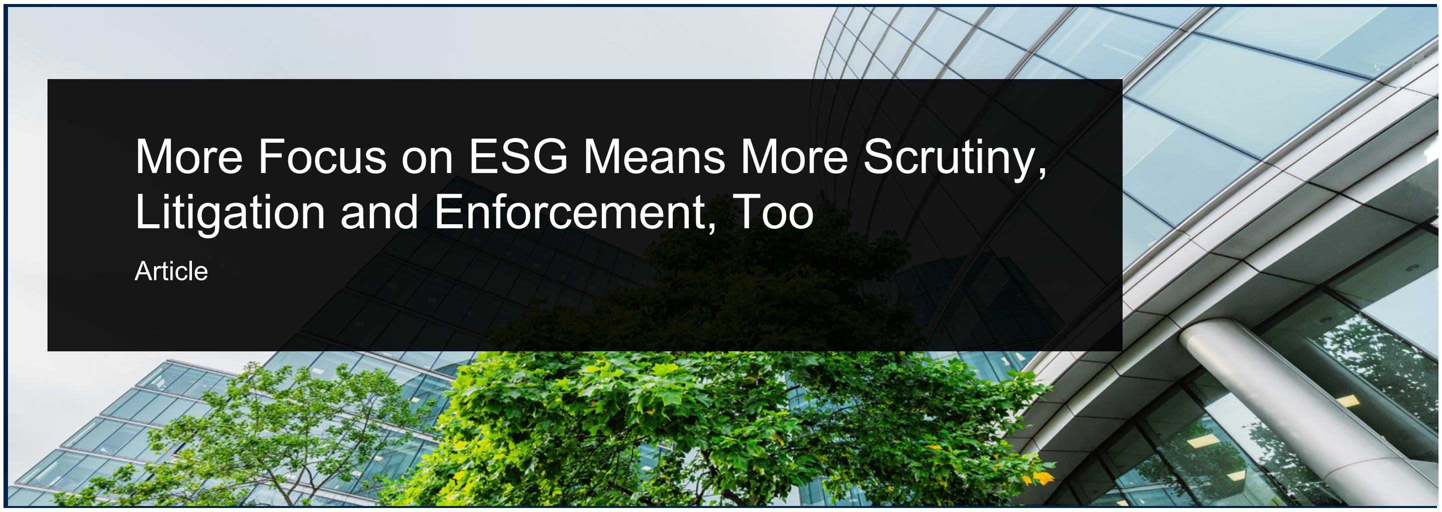
BRACEWELL



More Focus on ESG Means More Scrutiny, Litigation and Enforcement, Too

Article

March 01, 2022 | *Corporate Compliance Insights* | 5 minute read

Attention to environmental, social and governance (ESG) factors has reached a new high water mark in recent months and many companies' level of concern about the potential legal ramifications of ever-expanding ESG reporting and disclosure is not far behind. An increasing focus by stakeholders on issues such as climate change and social inequities has led companies to share new information and stake out new positions. But with those new disclosures and commitments come increases in both scrutiny and expectations. When companies' actions are deemed to fall short of their words, they should expect elected officials, regulators, ratings agencies, activists and investors to consider legal actions that can have profound consequences.

While there is no sure-fire approach to preventing ESG-related criticism, lawsuits, or enforcement actions, a serious effort to ensure strong governance and rigorous support around these issues is likely to be the best defense.

Increased ESG Focus Equals Increased Litigation and Enforcement

Management and board responsibility to prioritize ESG concerns continues to increase. For example, in his 2022 "Letter to CEOs," Larry Fink, the chairman and CEO of BlackRock, observed that, "[m]ost stakeholders – from shareholders, to employees, to customers, to communities, and regulators – now expect companies to play a role in decarbonizing the global economy. Few things will impact capital allocation decisions – and thereby the long-term value of [a] company – more than how effectively [CEOs] navigate the global energy transition in the years ahead."

In addition, commentators noted that 2021 was a very active proxy season with "record-breaking support levels for environmental proposals" and "an 100%

Related People

Rachel B. Goldman
Partner
NEW YORK
+1.212.508.6135
rachel.goldman@bracewell.com

Thomas F. Kokalas
Partner
NEW YORK
+1.212.508.6136
thomas.kokalas@bracewell.com

Timothy A. Wilkins
Managing Partner – Austin
HOUSTON
+1.512.542.2134
timothy.wilkins@bracewell.com

Related Practices

Environmental, Social & Governance (ESG) increase in the number of environmental proposals that have passed year-over-year." Social proposals on board diversity, human rights in operations and supply chains, political contributions, lobbying policies and workforce diversity, equity, and inclusion (DEI) matters also received increased support in 2021.

Meanwhile, the Securities and Exchange Commission (SEC) has been paying close attention to ESG factors, both in terms of developing new mandatory disclosure rules and identifying perceived gaps between what companies say about ESG issues in their mandatory disclosures versus their voluntary reports. By revisiting companies' need to report on climate change consistent with 2010 draft guidance and pursuing efforts to develop new rules, it is clear that the SEC has growing expectations about companies' efforts on ESG issues.

In the fall of 2021, the SEC initiated what may be its most direct action to date to address ESG matters, issuing letters to a number of major publicly-traded companies reminding them of duties to disclose climate-related risks and asking detailed follow-up questions about climate-related impacts on their businesses and about differences between climate-related disclosures in their SEC filings and statements in their voluntary ESG, corporate social responsibility, or sustainability reports. It seems certain that these inquiries will be used both to guide the SEC in its rulemaking efforts and to support enforcement actions against companies the SEC deems to have been inaccurate or misleading in their reporting.

Regulatory enforcement by state regulators examining corporate disclosures also presents a risk factor. Over the last decade, New York's Attorney General has conducted several investigations utilizing the Martin Act, the state's broad anti-fraud statute, to target companies in the energy industry. In these investigations, the AG examined how climate and other environmental risks were analyzed internally by the company and compared those internal analyses to the company's public-facing disclosures. Investigators focused on whether the risks boards and management discussed behind closed doors correlated with their communications to investors and other stake holders. Companies should anticipate scrutiny on this front as well.

Recent trends in ESG-related litigation have equally been focused on claims of false or misleading statements regarding an array of ESG issues, in both SEC filings and other public statements such as sustainability reports or marketing materials – or for failures to disclose damaging information concerning ESG. Often litigation coincides with enforcement actions, but investor and consumer litigation in the ESG arena is also leading the way.

As the Supreme Court recently held in *Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System*, seemingly generic statements in SEC disclosures, such as a commitment to ethics and integrity or touting "extensive procedures and controls" to identify conflicts of interest, can be actionable. In *Goldman*, investors claimed the company's statements regarding its commitments and compliance initiatives were misleading in the face of later-revealed conflicted transactions that led to significant stock-price drops. That case remains pending but, following remand from the U.S. Supreme Court, the District Court once again certified the class of plaintiffs and allowed the case to proceed as a class action. The lesson of *Goldman* is that companies should be mindful of the risks associated with ESG statements, even if they appear generic or aspirational in nature.

It is clear that investors and the public – not just the regulators – intend to hold companies accountable for their ESG representations. A particular focus is on greenwashing – claims alleging that a company's environmental- or sustainability-related statements are inflated, misleading or false. These cases typically have been based on the securities laws or consumer protection statutes. Recent examples include cases where companies have been sued for overstating the recyclability of their products, stating that their products were environmentally friendly or safe when alleged to be harmful, or overstating their sustainability practices in light of alleged environmentally harmful activities in harvesting or production processes by company vendors.

Litigation and investigations related to corporate governance and workplace harassment issues are also on the rise. For example, in the fall of 2021, the SEC began investigating a public company's disclosures pertaining to allegations of workplace harassment and gender-pay issues, and whether that information should have been disclosed earlier to investors and other parties. The agency sought documents, including minutes from board meetings, personnel files and separation agreements the company had reached with employees as well as the CEO's communications with other senior executives regarding complaints of sexual harassment or discrimination by employees or contractors. Notably, at the time the SEC began investigating, the California Department of Fair Employment and Housing had already filed a case against the company, an EEOC investigation was pending, and a securities class action had been commenced.

Mitigating ESG Risk with Compliance Programs and Sound Governance

Disclosures and commitments that ring false or that cannot be supported with persuasive back-up information will not only invite distrust, defeating their very purpose, but will also invite potentially serious legal action.

To mitigate risk associated with potential ESG-related claims, boards and senior management must assess their company's ESG risk profile and consider steps to monitor and manage these risks in a manner best suited to the company. While this approach is consistent with routine compliance reviews, ESG disclosure risks present specific challenges that require a broader look to determine whether the company is "getting it right." This includes understanding specific risk factors from a wide-ranging set of threats to the organization including environmental harm, supply chain, operating models and diversity and workplace issues. If the organization can recognize signals or variances in a timely manner, it can be better prepared to address those risks. Not only can these tools mitigate litigation risk, but early risk screening can also enhance an organization's ability to identify and respond to ESG risks as they evolve over time.

Companies that undertake or expand public disclosure regarding ESG factors should consider evaluating whether those disclosures are accurate, not misleading, and amply supported both by robust governance processes and sound data. Companies that wish to undertake or expand their public commitments on ESG issues should also consider carefully evaluating whether those commitments are readily achievable and can be appropriately demonstrated. While there is no sure-fire approach to preventing ESG-related criticism, lawsuits, or enforcement actions, a serious effort to ensure strong governance and rigorous support around these issues is likely to be the best defense.

Originally published in *Corporate Compliance Insights*.