LEGAL RISKS AND ESG DISCLOSURES: WHAT CORPORATE SECRETARIES SHOULD KNOW

Society for Corporate Governance

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SOCIETY for Corporate Governance
Empowering governance professionals

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Founded in 1946, the Society is a professional membership association of more than 3,600 corporate secretaries, in-house counsel and other governance professionals who serve approximately 1,200 entities, including about 1,000 public companies of almost every size and industry across the U.S. Society members are responsible for supporting the work of corporate boards of directors, their committees, and the executive managements of their companies regarding corporate governance and disclosure. For more information, please visit www.societycorpgov.org.

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Executive Summary

Boards, corporate secretaries and governance professionals operate in a dynamic landscape of evolving environmental, social and governance ("ESG") issues and risks, growing importance of ESG research and analysis, and high levels of ESG-related shareholder proposals and engagement. Once limited to a small set of investors, ESG investing has expanded to the mainstream of mutual funds, exchange-traded funds (ETFs), and even private equity. ESG investing is not a new phenomenon, but its perceived importance has increased dramatically over the past five years.

As a result, companies face increasing demands from investors, research and ratings firms, and others for greater and more detailed disclosure on ESG topics. This brief examines the legal risks associated with ESG disclosures[1] and recent case law, and discusses practices companies can adopt to mitigate their legal risks while still being responsive to investor demands for more disclosure.

I. *Introduction*

Companies are expanding their environmental and social responsibility efforts at significant rates. This includes taking positive steps in areas such as environmental sustainability, human rights, and community involvement. Companies are also increasingly disseminating significant amounts of information about these current efforts and future commitments, including on corporate social responsibility web pages, in lengthy corporate responsibility and sustainability reports, in public speeches and presentations to investors, and even in filings with the U.S. Securities and Exchange Commission ("SEC") and on company products. These statements often are not audited by third-party consultants for accuracy or reviewed or approved by boards of directors. Moreover, most of these statements are voluntarily made. Companies make social responsibility statements for a variety of reasons, including growing investor and consumer interest in ESG issues and to address company-specific concerns, such as negative attention regarding operations or practices. In addition to these voluntary disclosures, disclosures regarding environmental and social issues are also increasingly being required or encouraged by international, federal and state laws and regulatory bodies.[2] Regardless of the motivation, these statements and disclosures can create significant litigation and liability risks for

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[1] As used in this brief, an "ESG disclosure" includes any statement or published policy related to environmental, social, or governance issues.

[2] *See* Annex A (listing a sample of laws requiring disclosure on environmental and social issues).

companies unless appropriate care and diligence are exercised. This includes providing for oversight at the board level, so the board understands what the company is saying about ESG aspects of the company's business and what controls and processes the company has in place to review ESG disclosures before they are made public.

More broadly, boards of directors should be aware that their oversight responsibilities, and the attendant prospect of claims seeking to hold directors liable for oversight failures, extend to ESG matters. ESG issues that create significant risks for a company may lead investors and others to ask, "Where was the board?" in the event of a significant environmental incident like an oil spill or a significant compliance failure that impacts the safety or privacy of customers. This, in turn, suggests an evolving expectation that, as part of the board's oversight role, the board will be actively engaged in overseeing ESG matters that are central to a company's business, and that investors and regulators may seek to hold the board accountable for perceived failures to perform this responsibility.

II. Litigation Risks of ESG Disclosures

A. Potential Liability under Federal and State Securities Laws

Over the last decade, public companies have increasingly included ESG-related information on their corporate websites, in corporate responsibility/sustainability reports (often available through corporate websites), and in public speeches. More recently, public companies have begun including these disclosures in their SEC filings. Typically, this occurs when companies include ESG highlights in their proxy statements with links to websites containing additional information on ESG efforts, including social responsibility web pages and corporate responsibility reports. An increasing number of companies are also beginning to include ESG disclosures in other SEC filings, such as quarterly and annual reports.

Inclusion of this information in proxy statements and other SEC filings makes it subject to the same scrutiny as other information included in SEC filings, and, if false, may subject companies to significant liability under federal securities laws. Moreover, even where ESG disclosures are provided outside of SEC filings (such as during earnings calls, in investor presentations, or on public websites), they can still create potential liability under the federal securities laws.

Federal securities laws and SEC regulations make statements in securities filings (including hyperlinked materials)[3] and other statements to investors, actionable for material misrepresentations. For example, under Sections 11 and 12(a)(2) of the Securities Act of 1933, companies may be strictly liable for material misstatements made in connection with securities offerings, like statements in registration statements and prospectuses.[4]

Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act")[5] and SEC Rule 10b-5, the anti-fraud provisions of the federal securities laws, apply more broadly, creating liability for fraudulent statements made to investors regardless of when or where those statements occurred, and even if the statements were made outside of SEC filings. Additionally, public company CEOs and CFOs—who are required to certify quarterly and annual reports filed with the SEC—could face "control person" liability under Section 20(a) of the Exchange Act[6] if ESG disclosures included or hyperlinked in those filings are not accurate.

Thus far, most federal securities class actions arising from public ESG disclosures have been brought under Sections 10(b) and 20(a) of the Exchange Act. Often, these suits follow large industrial accidents or problems that cause a significant drop in a company's stock price. Results in these cases have been mixed, but a few early motion-to-dismiss decisions are instructive regarding how courts analyze ESG disclosures. Generally, decisions have turned on whether the ESG disclosures at issue were sufficiently concrete and measurable to form the basis for a misrepresentation claim. A statement must be false or misleading and material to a reasonable investor to be actionable under Section 10(b) of the Exchange Act.[7]

Multiple courts have rejected securities litigation challenges to ESG disclosures on the ground that the disclosures were either sufficiently vague that they could not be shown to be objectively false or misleading, or were so clearly aspirational that a reasonable investor could not rely on them. For example, in *Bondali v. Yum! Brands, Inc.*, the Sixth Circuit affirmed the dismissal of a

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3 Under Item 105(c) of Regulation S-T, 17 CFR § 232.105(c), "[A]n external hyperlink within a filed document . . . will cause the filer to be subject to the civil liability and antifraud provisions of the federal securities laws with reference to the information contained in the linked material."

4 15 U.S.C. § 77k.

5 15 U.S.C. § 78j.

6 15 U.S.C. § 78t.

7 *See, e.g.*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, (2008); *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988); *In re Omnicare, Inc. Sec. Litig.*, 769 F.3d 455, 470 (6th Cir. 2014).

Section 10(b) action against Yum! Brands ("Yum") challenging statements in Yum's SEC filings, analyst calls, and Code of Conduct (which Yum cited in its proxy statement), describing its commitment to responsibly sourcing its food in response to prior food-safety problems.[8] Following public reports of new food safety problems in Yum's supply chain, plaintiffs challenged statements in Yum's SEC filings and earnings calls about the company's commitment to "strict" food quality and safety standards, "work[ing] a lot with suppliers" and "having the right suppliers," and in the company's Code of Conduct such as "food safety is a primary responsibility . . . and nothing, including cost, is allowed to interfere."[9] In dismissing the case, the district court found that these statements were "too squishy, too untethered to anything measurable, to communicate anything that a reasonable person would deem important to a securities investment decision."[10] The court stated that the "vague, subjective assertions" made in SEC filings and on earnings calls, "such as 'strict' food safety standards" and "having the 'right' suppliers," were "the mere opinions of management" and held "no obvious objective meaning to a reasonable investor."[11] The court also rejected claims based on statements in the Code of Conduct, holding that even though it had been referenced in the company's proxy statement, such codes are "inherently aspirational," and thus could not be relied on by a reasonable investor.[12]

Other courts, however, have found that where ESG disclosures are sufficiently concrete or measurable, they may be actionable under state and federal securities laws. For example, in a Section 10(b) action brought against BP in 2012, after the Deepwater Horizon incident, the Southern District of Texas found that the plaintiffs had adequately pled materiality and falsity for several statements BP made highlighting safety reform efforts after previous industrial accidents in 2005 and 2006.[13] The statements challenged were made in sustainability reports, in annual reviews and reports, and during analyst calls.[14] In finding the statements actionable, the district

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8 *Bondali v. Yum! Brands, Inc.*, 620 F. App'x 483 (6th Cir. 2015).

9 *In re Yum! Brands, Inc. Sec. Litig.*, 73 F. Supp. 3d 846, 862-863 (W.D. Ky. 2014), *aff'd sub nom. Bondali v. Yum! Brands, Inc.*, 620 F. App'x 483 (6th Cir. 2015).

10 *Id.*

11 *Id.* at 863.

12 *Id.* at 864.

13 *In re BP plc, Sec. Litig.*, No. 4:12-cv-1256, 2013 WL 6383968 (S.D. Tex., Dec. 5, 2013).

14 *Id.* at *23.

court pointed to statements such as BP's assertions that its safety operations management system "covers all aspects of our operations," when it allegedly did not apply to contractor-owned sites.[15] The court also found that a number of the challenged statements were "statement[s] of existing fact" rather than forward-looking, and were thus not entitled to protection under the SEC's safe-harbor provisions for forward-looking statements.[16]

In another case precipitated by an industrial disaster, a fire in a coal mine in 2006, the Southern District of West Virginia similarly found that the plaintiffs had adequately pled materiality and falsity pertaining to ESG disclosures for Section 10(b) claims.[17] The plaintiffs in *Massey Energy* alleged that Massey made "statements professing that safety was the 'first priority every day' at Massey," that it was an "industry leader in safety," and that "safety at its mines [was] improving," in its corporate social responsibility reports, press releases (furnished on Form 8-K), and Forms 10-K and 10-Q.[18] The court agreed with plaintiffs that these statements were "capable of being proven false given the number of safety violations" alleged and a comparison of the accident and fatality rates in the mines at issue to the national average.[19] The court held that because Massey's statements were "not stated in a context of a future prediction, but generally recognize[d] the company's past achievements and current goals," and Massey "closely aligned their statements of commitment to safety to their productivity and success of a company," they could form the basis for a Section 10(b) securities fraud action.[20]

As these decisions indicate, there is a "razor-edge" dividing "material representations from immaterial corporate puffing."[21] While truly vague or aspirational statements of company ideals are not actionable, an unwary company could find itself facing costly discovery and potential liability for statements that it thought were sufficiently vague, but a court found concrete and falsifiable. Companies should be particularly cautious when including concrete metrics or standards with provided or established definitions in their ESG disclosures.

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15 *Id.*

16 *Id.* at *31

17 *In re Massey Energy Sec. Litig.*, 883 F. Supp. 2d 597 (S.D. W. Va. 2012).

18 *Id.* at 617.

19 *Id.*

20 *Id.* at 618.

21 *In re BP plc, Sec. Litig.* 2013 WL 6383968, at *21.

The *BP* and *Massey* decisions also demonstrate that ESG information need not appear in SEC filings to expose a company to liability under federal securities laws. ESG statements on websites, as well as in corporate responsibility reports, may be actionable under federal securities laws if the court finds that the information was intended to "reach shareholders and the investing public."[22] The risk of class action liability from website statements is generally lower than for disclosures in SEC filings, due to the reliance element of securities fraud claims, and the legal presumption that statements in SEC filings are incorporated into the company's stock price and therefore that investors relied on those statements for class certification purposes. However, the increasing number of hyperlinks to corporate responsibility websites and reports in companies' SEC filings, and courts' increasing willingness to find such materials directed toward investors, make risks relating to statements on websites very real. Moreover, in light of growing investor and consumer interest in ESG issues, and an increasing number of studies suggesting that institutional investors consider environmental sustainability efforts in their investment strategies, there is also an increasing likelihood that courts will find statements regarding ESG activities material to investors in securities litigation.

B. Potential Liability under Federal and State Consumer Protection and Anti-Fraud Statutes and Regulations

ESG statements on websites, on products, and in corporate responsibility reports can also generate litigation and potential liability under federal and state consumer protection and anti-fraud statutes. Under most consumer protection laws, consumers must plausibly allege, and ultimately prove, that they relied on a material misrepresentation in making their decision to purchase from the company. As with liability under federal and state securities laws, a key question is whether the company's statements forming the basis of the action are sufficiently concrete as to be false or misleading.

A number of recent decisions have dismissed consumer class actions challenging statements in corporate responsibility reports or on corporate websites as insufficiently concrete or material to state a misrepresentation claim. In *Ruiz v. Darigold, Inc./Northwest Dairy Association*, for example, the Western District of Washington dismissed claims under California, Oregon, and Washington consumer protection laws challenging statements regarding the treatment of dairy

22 *In re BP plc, Sec. Litig.* 2013 WL 6383968, at *49.

workers and cows in a 2010 corporate responsibility report published by the defendants.[23] Plaintiffs alleged that Darigold and the Northwest Dairy Association used the report to mislead consumers into thinking "'that the company's member dairies treated their workers and cows well' and/or that Darigold 'treat[ed] its workers and cows with respect and in compliance with the law.'"[24] The court disagreed, finding that "[e]ven if the Court considers the [language] on which plaintiff's claims of misrepresentation and omission rely, when read in context they reflect a nuanced assessment of the current situation, are aspirational statements, or have not been shown to be false in any material respect."[25] However, the court also implied that statements like "[o]ur producers care for their herds by providing a nutritious diet, good medical care, and healthy living conditions" or "Darigold follows 'a rigorous quality assurance program to ensure food safety and the highest quality products for our customer,'" could have been actionable if plaintiffs had alleged facts sufficient to show that "producers do not provide 'world class animal care' and/or 'healthy living conditions'" or that "Darigold [did] not have a quality assurance program or that its products [were] unsafe or subpar."[26]

Similarly, in *National Consumers League v. Wal-Mart Stores, Inc., J.C. Penney Corporation, Inc., and The Children's Place, Inc.*, the plaintiff, a nonprofit organization, brought suit under the District of Columbia's Consumer Protection Procedures Act ("DCCPPA"), alleging that the defendants violated promises supposedly made to the general public in ESG statements available on the defendants' websites.[27] The challenged statements described the defendants' general codes of conduct applicable to their suppliers, which prohibited child labor and promoted compliance with workplace safety requirements.[28] The statements also described the auditing practices the retailers used to promote compliance with these standards.[29] The plaintiff alleged that the statements were misleading, based on the collapse of a building containing factories that the retailers allegedly sourced clothing from, where many people, including some

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23 *Ruiz v. Darigold, Inc./Nw. Dairy Ass'n*, No. 14-cv-1283, 2014 WL 5599989, at *3 (W.D. Wash. Nov. 3, 2014).

24 *Id.* at *2-3.

25 *Id.* at *4.

26 *Id.* at *4.

27 *Nat'l Consumers League v. Wal-Mart Stores, Inc., J.C. Penney Corp., and The Children's Place, Inc.*, No. 2015-CA-007731, 2016 WL 4080541, at *1 (D.C. Super. Ct. July 22, 2016).

28 *Id.* at *2.

29 *Id.*

children, were injured and killed. The court granted in part and denied in part the defendants' motion to dismiss. It held that most of the ESG statements challenged included terms like "expect," "goal," and "ask," and were aspirational in nature and therefore non-actionable.[30] It also noted that the majority of the statements were "general in nature outlining the expectations of each retailer and efforts by each retailer to place pressure on its suppliers to be more socially responsible," and not "promises" or guarantees to "consumer[s] that the retailer[s] [were] ensuring compliance on the suppliers' part."[31] With respect to the defendants' factual descriptions of their auditing efforts, however, the court found that the statements were "capable of being verified," and could thus form the basis for a claim that consumers were misled, if proven false.[32]

A number of other recent decisions have also dismissed consumer class actions bringing omission-based claims challenging companies' alleged failure to disclose information to consumers, such as the existence of slave or forced labor in supply chains. In *Hodsdon v. Mars, Inc./Mars Chocolate North America, LLC*, the Northern District of California dismissed claims brought under California's consumer protection laws alleging that Mars had a duty to disclose that its chocolate likely contains cocoa beans picked by children and forced laborers.[33] The court found that because Mars had not made "any statement at all" about the presence or lack of cocoa beans harvested by children and forced laborers in its products, and the presence of those beans did not "pose safety risks to chocolate consumers," Mars was under no obligation to disclose their likely presence.[34] A series of very similar cases have extended this holding to other companies and industries.[35]

30 *Id.* at *6-8.

31 *Id.* at *5-6.

32 *Id.* at *7-8. Notably, the court did not address the issue of reliance on the challenged statements because the DCCPPA is one of the few consumer protection statutes that does not require a plaintiff to show reliance on a purportedly deceptive practice.

33 *Hodsdon v. Mars, Inc./Mars Chocolate N. Am., LLC*, 162 F. Supp. 3d 1016, 1029 (N.D. Cal. 2016).

34 *Id.* at 1023-26.

35 *See, e.g.*, *Wirth v. Mars, Inc., Mars Petcare US, and Iams Co.*, No. 15-cv-1470, 2016 WL 471234 (C.D. Cal. Feb 5, 2016) (holding that Mars had no affirmative duty to disclose that seafood used in pet food may have been caught by Thai fishing boats using forced labor); *Dana v. The Hershey Co.*, No. 15-cv-04453, 2016 WL 1213915, at *9 (N.D. Cal. Mar. 29, 2016) (holding that Hershey had no affirmative duty to disclose that its products likely contained cocoa beans harvested by children and forced laborers and noting that "the weight of authority limits a duty to disclose . . . to issues of product safety, unless disclosure is necessary to counter an affirmative representation").

In *Sud v. Costco Wholesale Corporation*, for example, the Northern District of California similarly dismissed claims brought under California's consumer protection laws.[36] The plaintiffs alleged that Costco's "Disclosure Regarding Human Trafficking and Anti-Slavery" ("Disclosure") on its website and Costco's "supplier Code of Conduct" created a duty for Costco to disclose its failure to meet the ethical sourcing commitments outlined in its disclosures with regard to its farmed prawns products.[37] The plaintiffs alleged that in the Disclosure, Costco "affirmatively represents to consumers that it makes efforts to monitor its suppliers to eradicate human rights abuses in the supply chain." The plaintiffs also alleged that the Code of Conduct "purports to prohibit the type of labor abuses" allegedly used in the production of its farmed shrimp.[38] The court found that because the plaintiffs failed to allege that they "read or relied on the Disclosure" or the Code of Conduct on Costco's website prior to purchasing, they lacked statutory standing to bring claims relating to those statements.[39] The court then held that with respect to the products' packaging, which bore no affirmative statements relating to the challenged conduct, Costco was under no affirmative duty to disclose the likely use of forced labor in the supply chain for the farmed prawns, following the *Hodsdon* court's logic.[40]

At the moment, absent statutory or regulatory mandates like those discussed in Annex A, companies are generally not required to make ESG disclosures about their products, methods, or supply chains. However, *Ruiz* and *National Consumers League* demonstrate that when companies choose to do so, they face potential liability if their disclosures contain verifiable claims or measurable standards, and they arguably fail to follow through on those promises or misrepresent the information stated. Additionally, several of the decisions discussed in this section are currently on appeal in the Ninth Circuit. The Ninth Circuit heard consolidated oral argument for seven cases, including *Hodsdon, Wirth,* and *Dana* on December 7, 2017.[41] While

36 *Sud v. Costco Wholesale Corp.*, No. 4:15-cv-03783, 2017 WL 345994, at *5 (N.D. Cal. Jan. 24, 2017).

37 *Id.* at 1083-84

38 *Id.* at 1084.

39 *Id.*

40 *Id. at* 1084-87.

41 *See, e.g., Dana v. The Hershey Co.*, No. 16-15789 (9th Cir.).

the Ninth Circuit affirmed the district court's decision in *Hodsdon* on June 4, 2018,[42] appeals in the other cases are still pending, and the law in this area may change.

C. Books and Records Requests

ESG disclosures may also lead to books and records requests pursuant to Section 220 of the Delaware General Corporation Law and similar provisions in other states by shareholders (and their counsel) looking for documents and details to form the basis of a securities or shareholder derivative action. In at least one instance, a challenge based on and relating to ESG disclosures has survived the motion to dismiss stage in a Section 220 case. In *Louisiana Municipal Police Employees' Retirement System v. The Hershey Co.*, the Delaware Court of Chancery denied a motion to dismiss a Section 220 action seeking inspection of The Hershey Company's ("Hershey") books and records for evidence of mismanagement and possible breaches of fiduciary duty related to the use of child labor on West African cocoa farms in Hershey's supply chain.[43] In denying Hershey's motion to dismiss, the court pointed to public statements and promises Hershey made that it would certify that its chocolate products were free of cocoa tainted with child labor and human trafficking violations by 2020, as evidence that Hershey's board of directors was aware of at least some instances of child labor use in its supply chain. The court further found that the plaintiffs had adequately alleged that this knowledge would trigger a "duty to inform" the relevant authorities under illegal labor and human trafficking laws in Ghana and the Ivory Coast.

D. State/Municipal Investigations and Lawsuits

Finally, ESG issues and disclosures can lead to investigations, enforcement actions, or civil suits by federal, state, or municipal actors. For example, several companies in the energy sector have recently come under attack for their alleged contributions to, and statements about, global warming. In 2017, several counties and municipalities in California brought California state law nuisance claims against BP, Chevron, ConocoPhillips, Exxon Mobil ("Exxon") and Royal Dutch Shell ("Shell"), and several other municipalities and counties sued a larger group of

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42 *See Hodsdon v. Mars, Inc.*, No. 16-15444, 2018 WL 2473486, at *1 (9th Cir. June 4, 2018) ("California consumer protection laws do not obligate the defendants-appellees to label their goods as possibly produced by child or slave labor. In the absence of any affirmative misrepresentations by the manufacturer, we hold that the manufacturers do not have a duty to disclose the labor practices in question, even though they are reprehensible, because they are not physical defects that affect the central function of the [] products.").

43 *La. Mun. Police Employees' Ret. Sys. v. The Hershey Co.*, No. CV 7996-ML (bench decision overturning Master's recommendation made after oral argument on March 18, 2014; transcript available at http://lawprofessors.typepad.com/files/hershey-ruling.pdf).

energy companies, including these five.[44] On January 9, 2018, New York City filed suit against BP, Chevron, ConocoPhillips, Exxon, and Shell seeking damages and injunctive relief under New York nuisance law for contributing to global climate change.[45] On March 9, 2018, King County, Washington, filed a similar suit against the same five companies.[46] And on April 17, 2018, the city of Boulder, Colorado filed suit against Exxon and Suncor Energy seeking damages and injunctive relief under the Colorado nuisance law.[47]

While the climate change cases focus primarily on the underlying business activities of the energy companies—namely, the production of fossil fuels—state and federal regulators have taken a keen interest in statements the companies made regarding the effects of climate change and climate change regulation on their business, and the ways they account for those effects in their official filings. In November 2015, for example, Exxon received a subpoena from the New York Attorney General's Office ("NYAG") seeking "documents related to its historical knowledge of climate change and its communications with interest groups and shareholders regarding the same."[48] In 2016, the Massachusetts Attorney General's Office launched its own, related, investigation of Exxon in connection with alleged "materially false and misleading statements" regarding the risks posed by climate change and future regulation.[49] Additionally, in September 2017, Exxon disclosed that the SEC was investigating the way in which it valued its oil and gas reserves in light of increasing climate change regulations.[50] Exxon has aggressively litigated the New York and Massachusetts investigations, filing suit in federal court seeking injunctive relief ordering the New York and Massachusetts Attorneys General to cease the

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44 *California v. BP p.l.c.*, No. 17-cv-06011 (N.D. Cal., filed Oct. 20, 2017).

45 *City of N.Y. v. BP p.l.c.*, No. 1:18-cv-00182 (S.D.N.Y., filed Jan. 9, 2018).

46 *King County v. BP p.l.c.*, No. 2-18-cv-00758 (W.D. Wash., filed Mar. 9, 2018)

47 *Board of County Comm'rs v. Suncor Energy USA Inc.*, No. 2018-cv-030349 (Colo. Dist. Ct., filed Apr. 17, 2018).

48 *Exxon Mobil Corp. v. Schneiderman*, 17-cv-2301, 2018 WL 1605572, at *2 (S.D.N.Y. Mar. 29, 2018).

49 *Office of the Attorney General of the Commonwealth of Massachusetts*, Civil Investigative Demand No. 2016-EPD-36 (Apr. 19, 2016), *available at* https://www.mass.gov/files/documents/2018/04/13/ma-exxon-cid-_0.pdf.

50 *See SEC probes Exxon's climate, reserves accounting: report*, Reuters (Sep. 20, 2016), https://www.reuters.com/article/us-exxon-mobil-probe-sec-idUSKCN11Q2EC.

investigation.[51] On March 29, 2018, the Southern District of New York dismissed Exxon's complaint, clearing the way for the investigations to continue.[52]

The Exxon investigation is not the first NYAG investigation into potential securities violations in connection with ESG disclosures. On November 9, 2015, the NYAG entered into an Assurance of Discontinuance with Peabody Energy Corporation ("Peabody").[53] This marked the end of the NYAG's investigation into Peabody regarding alleged misrepresentations to investors about risks posed by climate change and the potential effect of climate change regulation on its business.[54] Specifically, the NYAG was investigating allegations that Peabody had internal economic projections indicating that climate change and climate change regulation could be far more damaging to its business model than the economic projections it released to the public and relied on in its SEC filings.[55] Peabody did not pay any fines under the settlement, but it agreed to provide "disclosures concerning projections that the company has been able to make regarding the impact on the company's business of certain potential laws, regulations, and policies involving climate change, and . . . projections of demand for coal."[56] Peabody further agreed "not to represent in any public communications that it cannot reasonably project or predict the range of impacts" that future climate change regulations might have.[57]

Although Peabody avoided any monetary fines, the cost of responding to these investigations alone is considerable. The Peabody and Exxon investigations demonstrate the risks involved in preparing disclosures dealing with highly scrutinized ESG issues, even where the disclosure itself may be fairly routine.

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[51] *Exxon*, 2018 WL 1605572, at *1.

[52] *Id.* at *21.

[53] Press Release, *A.G. Schneiderman Secures Unprecedented Agreement with Peabody Energy to End Misleading Statements and Disclose Risks Arising From Climate Change*, N.Y. State Office of the Attorney Gen. (Nov. 9, 2015), https://ag.ny.gov/press-release/ag-schneiderman-secures-unprecedented-agreement-peabody-energy-end-misleading.

[54] *Id.*

[55] *Id.*

[56] *Id.*

[57] *Id.*

III. Legal Issues Stemming from Board Oversight of ESG Issues

As investors, regulators, consumers and other stakeholders have shown an increased interest in a host of ESG issues, these issues increasingly have been elevated to the board level. In addition, there is a growing recognition among boards that ESG issues are inextricably linked to a variety of areas for which the board already has oversight, so these issues cannot be viewed in isolation. Instead, ESG issues must be evaluated as one component of what the board considers in overseeing key areas like strategy, risk and compliance. Diligent board oversight of the ESG aspects of a company's business helps to build long-term value for a company and its shareholders. It can also help reduce the risk that a company will face securities or consumer-protection litigation of the type described in the first part of this section, and protect the board from so-called "Caremark" claims that directors breached their fiduciary duties by failing to perform their oversight responsibilities effectively.

Directors owe fiduciary duties to a corporation and its shareholders under state law. These duties primarily include a duty of care and a duty of loyalty. As part of the duty of loyalty, boards of directors also have what are often referred to as "Caremark" duties, named for the seminal 1996 case *In re Caremark International Inc. Derivative Litigation*.[58] In *Caremark*, the Delaware Chancery Court articulated the oversight and monitoring responsibilities of a corporation's boards of directors under Delaware law. Under *Caremark*, a corporation's board has a fiduciary obligation to assure itself that:

> [I]nformation and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance. . . .[T]he level of detail that is appropriate for such an information system is a question of business judgment.[59]

Directors who fail to fulfill their *Caremark* duties breach their duty of loyalty to the corporation. The legal standard for imposing liability on directors for oversight failures is a demanding one. It requires bad faith, in the form of an "intentional dereliction of duty," "conscious disregard for

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58 *See In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).

59 *Id*. at 969-70.

one's responsibilities," or actions taken "with the intent to violate applicable positive law."[60] Because of the difficulty of proving bad faith, the Delaware courts have stated that a *Caremark* claim is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[61]

In spite of this, shareholders have brought *Caremark* claims alleging oversight failures with respect to issues ranging from executive compensation to risk and legal compliance, and extending to ESG issues. In a case involving the board's oversight of environmental practices at Duke Energy Corporation brought in the wake of a major coal ash spill, the Chief Justice of the Delaware Supreme Court, in a noteworthy dissent from the court's dismissal of *Caremark* claims against the company's directors, criticized what he viewed as conduct that was inconsistent with the directors' fiduciary duties:

> I find that . . . it was the business strategy of Duke Energy, accepted and supported by its board of directors, to run the company in a manner that purposely skirted, and in many ways consciously violated, important environmental laws. Being skilled at running an energy company whose conduct presented environmental hazards, but whose operations provided an important source of employment, Duke's executives, advisors, and directors used all the tools in their large box to cause Duke to flout its environmental responsibilities, therefore reduce its costs of operations, and by that means, increase its profitability. This, fiduciaries of a Delaware corporation, may not do.[62]

The Supreme Court of Delaware affirmed dismissal of the claims against the directors because it found that the board exercised oversight by receiving management presentations on environmental problems at the company and on actions management was taking to address them. Accordingly, the board had not consciously disregarded its oversight responsibility.

Expectations of what directors should be doing to satisfy their oversight responsibilities, and the scope of what falls under the umbrella of the board's oversight role, have evolved over time. In recent years, this has been particularly apparent in shareholder derivative suits seeking to hold directors responsible for oversight failures in the wake of high-profile cybersecurity breaches at

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60 *City of Birmingham Retirement and Relief Sys. v. Good*, 2017 WL 6397490 (Del. Dec. 15, 2017).

61 *Id*. (citations omitted)

62 *Id.* at *65 (Strine, J., dissenting).

their companies. These suits—which have been brought against Target Corporation, Wyndham Worldwide Corporation, The Home Depot, Inc. and The Wendy's Company—have generally not been successful. The Target, Wyndham and Home Depot suits were dismissed. The Home Depot suit subsequently settled while an appeal of the dismissal was pending, and the Wendy's suit settled, in each case in exchange for the adoption of certain governance reforms. These governance "reforms" included:

- establishing a board-level technology committee with a written charter and oversight responsibility for cybersecurity and information technology matters (Wendy's);
- receiving reports from management at least annually (or more frequently if requested by the committee) on the company's cybersecurity program and material cybersecurity risks (Wendy's);
- having authority to retain outside experts to assist in oversight of cybersecurity (Wendy's and Home Depot);
- having the enterprise risk management team continue to meet on a regular basis, and continue to discuss and evaluate potential risks to the company, including cyber risks (Wendy's);
- having authority to meet with the Chief Information Officer in executive session as the Technology Committee deems appropriate (Wendy's);
- documenting the duties and responsibilities of the Chief Information Security Officer (Home Depot);
- maintaining an executive-level committee focused on data security (Home Depot); and
- receiving periodic reports from management about the information technology and cybersecurity budget (Home Depot).

IV. Steps Companies and Boards Can Take to Mitigate the Legal Risk of ESG Disclosures

The risks associated with ESG disclosures are real and should not be underestimated. However, there are steps that companies can take to reduce the potential legal exposure created by these disclosures.

A. Include Disclaimers

Companies should consider accompanying ESG disclosures with disclaimers. The disclaimers can note that the standards or goals invoked in the ESG disclosures are not guarantees or promises. It also may be appropriate to note that the standards of measurement and performance for ESG issues are developing or are based on assumptions. The inclusion of disclaimers is particularly important on website postings of ESG statements if a company plans on including a cross-reference or link to the website in its proxy statement or other SEC filings. Where ESG disclosures are included in actual SEC filings, the forward-looking statement disclosure statement in that filing should be updated to reflect the nuances of the ESG disclosures, and other disclaimers may be appropriate as well. Generally, the disclaimers should be located near the pertinent ESG disclosures, to avoid risks of investors or consumers asserting that they did not see the disclaimers when reading and relying on the disclosures.

B. Check the Facts

As with any other public statement, companies should confirm the accuracy of ESG disclosures before they are released to the public. ESG disclosures should be reviewed for overstatements, misstatements, or concrete statements about initiatives that might be rendered misleading or untrue by an adverse supplier or other event. Companies should be wary of publishing commitments to achieve specific ESG goals or targets by certain dates, as they may face litigation alleging misrepresentations to consumers if those goals or targets are not met. As part of this review, companies should confirm they have adequate diligence procedures in place to accurately measure progress on ESG goals and should consider whether internal or external auditors are needed to help verify or attest to the concrete facts and numbers included in ESG disclosures.

C. Use Aspirational Language and Estimates

Companies should consider keeping ESG disclosures aspirational. When discussing ESG initiatives or codes of conduct, this means using words like “should,” “expect,” or “strive,” as opposed to making falsifiable assertions that the company, its employees, or its suppliers “do” comply, “are” in compliance, “must” be in compliance, or “will” be in compliance with applicable laws and standards. Companies can also minimize litigation risk when measuring progress on ESG goals by talking about “estimates” or “approximations”—as opposed to relying on concrete measurements. This also means setting process-based or soft goals, rather than objective, clearly measurable targets (*e.g.*, reduction of a specific amount by a specific date).

D. Understand that Location Matters

The more prominently displayed an ESG disclosure is, the more likely it becomes that a court will find the disclosure material to investors or consumers. Including detailed ESG disclosures in SEC filings or on product packaging may increase the risk of litigation, as it may be easier for plaintiffs to show that they saw the disclosure and reasonably relied on it in making their decision. ESG statements on websites can also present heightened risks, particularly if products are sold through websites. Companies should consider only using language suggesting that ESG initiatives and disclosures are material to the company, investors, or consumers, if in fact they truly are. Fluffy assertions of materiality may simply aid plaintiffs attempting to prove reasonable reliance in litigation while providing little upside to the company.

E. Educate Internally on Litigation and Related Trends

Companies should educate employees responsible for updating and preparing ESG statements and supporting documentation on the growing risk of lawsuits based on alleged misrepresentations in these statements. Employees should also understand that ESG statements need to be consistent with descriptions of the company's business and material trends and risks in SEC filings. ESG statements and SEC filings should be reviewed for consistency before being released. Even if ESG materials are not currently required or included in SEC filings, companies should consider that they may face pressure to incorporate them in the future.

Companies also should monitor related developments in ESG reporting. For example, in May 2018, the Delaware House approved legislation called "The Certification of Adoption of Sustainability and Transparency Standards Act," which would establish a voluntary disclosure regime to encourage dialogue on sustainability and responsibility among participating Delaware business entities and their various stakeholders.[63] The Act would not require business entities to use specific standards or criteria. Instead, the governing body of an entity seeking certification under the Act would need to adopt standards or criteria, based on or derived from a third party not controlled by the entity "that is engaged to provide professional consulting services or advice to assist . . . in measuring, managing or reporting the impact of their business and operations on issues of social and environmental impact." Qualifying entities could then

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[63] *See* H.R. 310, 149th Gen. Assembly., Reg. Sess. (Del. 2018) (approved May 8, 2018), http://legis.delaware.gov/BillDetail/26304.

obtain from the Secretary of State of the State of Delaware a Certificate of Adoption, although the Secretary of State would not judge the quality of the disclosures. Importantly, the Act would not impose fines or penalties on entities that do not seek to be certified or that fail to satisfy their own performance standards once certified. Moreover, the Act would provide that the decision not to seek certification or the failure to meet the specified sustainability standards will not create a right of action or otherwise give rise to a claim for breach of fiduciary or similar duty.

F. Encourage Appropriate Internal Collaboration

Requiring collaboration and review among the different teams involved in drafting, reviewing and publishing ESG disclosures can integrate the differing priorities and perspectives of sustainability teams, investor relations and corporate secretaries. Breaking down silos between these teams will both minimize mistakes and promote dialogue about the appropriate level of risk to take with the company's ESG disclosures.

G. Improve Board Practices

The legal principles defining the oversight responsibilities of boards of directors suggest that there are steps boards can take to provide for effective oversight of ESG issues, including a company's disclosures and other public statements about various aspects of its ESG practices. This can help minimize the risk that the board, and the company, will face litigation and potential liability.

Board Oversight: Although the governance "reforms" that emerged from the Home Depot and Wendy's cases were developed in the cybersecurity context, they have broader application. In this regard, they are instructive about the types of actions that boards should consider, to perform effective oversight of ESG issues. Themes pertinent to board oversight of ESG matters include: (i) regular reporting from management, including with respect to material risks; (ii) empowerment of senior management with clearly defined responsibilities and a direct line of communication to the board or relevant committees; and (iii) regular consideration of ESG risks, at the board and senior management level, as part of the company's enterprise risk management program. All of these practices can facilitate a board's understanding of the ESG issues that are core to the company's business operations and enable the board to see that the company's regular enterprise risk management processes are applied to these issues.

Setting the Risk Appetite and Establishing Controls and Procedures: There is also a potential role for the board with respect to ESG disclosures. As a threshold matter, a board should be comfortable that the company has appropriate controls and procedures for seeing that the company's disclosures are accurate and relevant, and do not create undue legal exposure for the company. Boards should understand that there is a continuum of legal risk associated with ESG disclosures—and that some types of disclosures may pose greater risk than others—and boards and senior management should reach consensus about levels of risk their companies are willing to accept. Controls and procedures that boards should consider may include policies about providing disclaimers making clear that ESG disclosures are not guarantees or promises, and diligence procedures for fact-checking statements and reviewing them for overstatements or statements that create the potential for misrepresentations. Boards also should endeavor to understand who at their companies signs off on ESG disclosures, and consider what role, if any, directors and senior management have in the review and preparation of ESG disclosures.

Escalation Processes: Finally, boards should evaluate protocols in place to escalate ESG matters to the board before public statements are made. This may be appropriate where statements involve policy matters, or changes in policy, that normally would require board involvement. For example, before a company makes a public commitment to achieving gender pay equity by a specific deadline, or to "go green" in a major line of business, consideration should be given to whether informing the board, or providing for board review or approval, is appropriate. Without appropriate board input, a subsequent failure to execute on these types of commitments could result in exposure for the company and the board. Regular reporting to the board on core ESG issues and how they relate to the company's strategy, operations and risk management can reduce the potential for disconnect between a company's practices and its public statements.

Annex A

A number of laws and regulations also govern and may trigger ESG disclosures. For example:

1. The UK Modern Slavery Act, U.K. 2015 c. 30, requires that any "commercial organization" that carries on business or part of a business in the UK and has an annual after-tax revenue of at least £36 million must prepare, and in some cases, issue, a yearly statement detailing the steps it and its subsidiaries have taken to ensure that neither slavery nor human trafficking are taking place in its supply chain.

2. The California Transparency in Supply Chains Act, California Civil Code § 1714.43, requires "[e]very retail seller and manufacturer doing business in [California] and having annual worldwide gross receipts that exceed one hundred million dollars ($100,000,000)" to "disclose . . . its efforts to eradicate slavery and human trafficking from its direct supply chain for tangible goods offered for sale" in a statement meeting certain specified minimum requirements. The California law has served as a model for several bills introduced in both houses of Congress in recent years that would mandate that public companies disclose measures taken to address forced labor conditions to the SEC. *See, e.g.*, the Business Supply Chain Transparency on Trafficking and Slavery Act, H.R. 4842 of 2014 (113th Congress) (seeking to amend Section 13 of the Exchange Act).

3. The SEC's Conflict Minerals Disclosure Rule, Exchange Act Rule 13p-1, requires that "[e]very registrant that files reports with the Commission under Sections 13(a) . . . or 15(d) . . . of the Exchange Act, having conflict minerals that are necessary to the functionality or production of a product manufactured or contracted by that registrant to be manufactured, shall file a report on Form SD" in the manner and time specified by that form.

4. The SEC has also issued guidance noting that Items 101, 103, 303, and 503(c) of Regulation S-K can sometimes require disclosure of risks and costs posed by climate change, environmental regulation, and environmental litigation. Commission Guidance Regarding Disclosure Related to Climate Change, SEC Release Nos. 33-9106; 34-61469; FR-82 (Feb. 8, 2010).

5. The United Kingdom implemented for financial years beginning on or after January 1, 2017, the EU Non-Financial Reporting Directive, which requires certain companies to publish annual reports containing information regarding environmental, social, employee information, human rights, and anti-corruption and bribery matters. See The Companies, Partnerships, and Groups (Accounts and Non-Financial Reporting) Regulations 2016. This is similar to general European Union law that requires large companies to disclose certain information concerning the way they operate and manage social and environmental challenges. *See* Directive 2014/95/EU, *amending* 2013/34/EU.

6. The SEC adopted its much-anticipated Pay-Ratio Disclosure Rule on August 5, 2015. SEC Release Nos. 33-9877; 34-75610; File No. S7-07-13 (Aug. 5, 2015). The Rule implements Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act to require disclosure of the median of the annual total compensation of all employees of a registrant (excluding the chief executive officer), the annual total compensation of that registrant's chief executive officer, and the ratio of the median of the annual total compensation of all employees to the annual total compensation of the chief executive officer.

7. Many jurisdictions have adopted guidelines requiring certain companies to disclose statistics regarding the diversity of the composition of boards and executive officer positions. *See, e.g.*, European Union's Directive 2014/95/EU (requiring large public-interest companies with more than 500 employees to disclose information on their diversity policy, covering age, gender, geographical diversity, and educational and professional background); France Loi numéro 2011-103 (requiring certain French companies to increase to 40% the number of women serving on boards).

8. Many jurisdictions in Europe have begun to require companies to disclose gender pay gaps. *See* Germany's 2016 Remuneration Transparency Act (requiring employers with more than 500 employees to publish status reports on gender equality and equal pay); United Kingdom's Equality Act of 2010 (mandating all companies with at least 250 employees in Great Britain to report gender pay gap to the Government Equalities Office). There have been similar attempts in the United States to mandate public disclosure of gender pay gaps, but most of these have been at the state level, and some have failed to gain traction. For example, the

California legislature passed a bill in 2017, AB 1209, which would have required companies to submit pay data categorized by gender, race, and ethnicity, but Governor Jerry Brown vetoed the bill. Also in 2017, Governor Andrew Cuomo of New York issued an executive order requiring state contractors with prime contracts having value in excess of $25,000 ($100,000 for construction contracts) to disclose in their work utilization reports the salaries of each employee. *See* E.O. No. 162, Ensuring Pay Equity by State Contractors (Jan. 2017).

9. Environmental issues remain an important area for mandatory disclosure, not just in the United States, but also in Europe. *See, e.g.*, European Union's 2013 Accounting Directive (requiring disclosure by EU-registered oil, gas, mining and logging companies of payments to governments for access to natural resources); 2015 French Energy Transition Law (requiring that public companies disclose risks associated with the effects of climate change).