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ESG disclosures and traps for the unwary — what's workable?

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On the topic of environmental, social, and governance (ESG), common questions from public companies run the gamut from "how can we disclose more and get credit for the good work we are doing?" to "how do we protect ourselves from 'greenwashing' claims and litigation risk?"

Public companies face a dizzying array of potential frameworks and channels for how they choose to report on ESG. With a lack of readily available scaffolding and conflicting information coming from regulators, companies face a real dilemma.

The stakes also are getting higher, with an activist hedge fund recently winning three board seats at a public company following an activism campaign based in part on "a strategic plan for sustainable value creation" that cited, among other matters, the company's lack of adherence to the Paris Agreement's goals in proxy filings made with the SEC.

New and notable trends in ESG disclosures

Based on pronouncements from the SEC and trends from shareholders and other stakeholders, we have identified three primary areas of focus for ESG-related disclosures: (i) climate change, (ii) human capital disclosures, and (iii) a movement toward potential standardization of public company ESG disclosure. And on June 11, the SEC released its Spring 2021 Regulatory Flexibility Agenda, which highlights "[d]isclosure relating to climate risk, [and] human capital, including workforce diversity and corporate board diversity," as the focus of key upcoming rulemaking.

Climate change. On the first point, the SEC recently announced that both the Division of Corporation Finance, which oversees public companies' compliance with the federal securities laws' disclosure requirements, and the Division of Enforcement, whose staff conducts investigations into possible violations of the federal securities laws, would be targeting companies' climate change–related disclosures.

In February 2021, Allison Herren Lee, then Acting Chair of the SEC, directed the Division of Corporation Finance to "enhance its focus on climate-related disclosure in public company filings," noting that "investors are considering climate-related issues when making their investment decisions."

Commissioner Lee's statement noted that this enhanced focus would include a review of the extent to which companies are addressing the topics identified in the SEC's 2010 interpretative release on climate change, as well as compliance with applicable disclosure obligations, and presumably will result in the issuance of comments to public companies on climate change–related disclosures. Commissioner Lee also indicated that the results of this effort would help inform an update to the 2010 interpretive release.

In March 2021, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement, to be tasked with developing initiatives to identify ESG-related misconduct. The Climate and ESG Task Force's initial focus will be to identify any material gaps or misstatements in issuers' disclosures of climate risks under existing rules.

As counsel to public company clients, we are seeing a clear broadening of the types of companies considering the adequacy and substance of their climate change–related disclosures. We expect that companies in a wide variety of industries will be reviewing their disclosures for potential climate change–related risks, including whether such risks and opportunities should be reflected in their descriptions of business, legal proceedings, risk factors, and management's discussions and analyses of financial condition and results of operations.

The SEC solicited public input on the adequacy of climate change disclosure, with comments due June 15. Comments received range from requests for mandatory, annual ESG disclosures in companies' annual reports on Form 10-K, to charges that climate change–related disclosures are politically charged and should be outside the scope of the SEC's purview.

Human capital management. During the first half of 2021, most public companies made their inaugural human capital management disclosures in their annual reports, driven by the SEC's amendments to Regulation S-K that added a requirement that companies describe their human capital resources, including the number of persons employed by them, and any human capital measures or objectives that they focus on in managing the businesses, to the extent material.

Despite pronouncements by then–SEC Chairman Jay Clayton at the time of the rule's adoption that he "expect[ed] to see meaningful qualitative and quantitative disclosure," many companies opted not to provide any quantitative information beyond the number of people employed (which was a legacy disclosure requirement).

We expect to see further pressures placed on companies to provide more detail on metrics that they consider in managing their workforces, such as diversity data, as well as specific information on how companies are focused on retaining their human capital.

Adoption of ESG standards. The current principles-based disclosure system applicable to U.S. publicly traded companies is rooted in materiality, with a disclosure framework overlay that is often highly prescriptive. Although the disclosure framework applies nearly uniformly to all public companies, disclosures are made on a continuum within this framework, with the ultimate outcome dependent on a company's size, stage in its life cycle, and industry. In other words, what Company A must disclose will not necessarily be what Company B must disclose.

In areas of disclosure outside of the prescriptive framework, which are largely based on management's assessment of materiality, companies retain a large amount of agency in determining what to disclose based on their own particular facts and circumstances, informed by feedback from shareholders and other stakeholders, as well as peer company practices.

ESG disclosures are no different in that they generally lack uniformity among different public companies. Even the new human capital management disclosure requirement (which is the most prescriptive ESG-specific regulation that the SEC has adopted) is broad-based and has resulted in divergent disclosure approaches.

In the case of broader ESG disclosures, such as sustainability goals or initiatives, the divide is even wider, leading to criticism that bemoans the lack of a standardized ESG framework and calls for greater ease of comparability among companies' disclosures. Commissioner Lee has been vocal in her support for a move toward more standard ESG disclosures, with SEC Chair Gary Gensler stating that the SEC wants to "bring some consistency and comparability" to how companies report on ESG.

Greenwashing claims and litigation risk arising from disclosure

Historically, "greenwashing" has been loosely defined as conveying a false impression about whether, or the extent to which, a given product or practice is environmentally friendly. Greenwashing has drawn the scrutiny of the Federal Trade Commission, through its authority to police truth in advertising, as well as many states with trade-practice and consumer-protection statutes. Today, greenwashing has drawn scrutiny at a corporate disclosure level as public companies interact with ESG-focused investors.

As noted by the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee in a May 14, 2020, Recommendation, "[t]he use of ESG-related disclosures has gone from a fringe concept to a mainstream, global investment and geopolitical priority."

Public companies are under increasing pressure to provide investors with ESG information and do so in varied forms, including annual filings and stand-alone reports such as CSR or sustainability reports, as well as through disclosure according to third-party standards such as GRI9, the Sustainability Accounting Standards Board, and the Task Force on Climate-Related Financial Disclosures. Finally, ESG data providers are inundating public companies with inquiries used to create scoring or rating systems for investors.

SEC Commissioner Elad L. Roisman discussed public company legal liability for disclosure in his July 7, 2020, Keynote Speech at the Society for Corporate Governance National Conference: "[o]ne thing that ESG disclosure proponents rarely mention is the liability that our public companies face for the disclosure they provide in SEC filings. U.S. public companies face greater litigation risk than companies listed in almost every other jurisdiction. U.S. public companies are not only subject to enforcement by the SEC and other federal agencies as well as state authorities for material misstatements and omissions, they also must draft disclosure with the awareness that the law provides a private right of action for misstatements and omissions in SEC filings."

Just as a material misstatement or omission can form the basis for an SEC civil action under Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, such misstatements or omissions in a public company's SEC filings and other public statements (such as earnings calls and press releases) can also be the subject of a private action. With the SEC's focus on ESG disclosure and issues of materiality, we expect additional scrutiny by private litigants, especially when such matters are exposed by regulators.

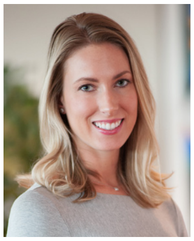
Given the current shift in focus to how companies report on ESG, after adverse environmental-related events that affect the price of publicly traded securities, we expect plaintiffs will more closely examine, and rely on as a basis for claims for violations of federal securities laws, ESG-related disclosures that could be characterized as overreaching or omitting material information.

Companies should closely review their public disclosures and statements to ensure consistency and accuracy. What in the past may have been viewed as marketing or mere puffery may now be characterized by litigants as material to an investing decision.

To the extent that companies are incorporating ESG disclosures into public offering documents, the possibility of Section 11 liability must also be an important consideration. Section 11 of the Securities Act of 1933 provides for a private right of action if a company's registration statement for a public offering either contains an untrue statement of a material fact or omits a material fact that renders a statement made misleading.

However, unlike section 10(b), which requires proof of reckless or intentional misconduct, Section 11 imposes strict liability against the issuer of the securities (and others) and does not require that a plaintiff allege or prove scienter. Consequently, Section 11 claims tend to be less susceptible to motions to dismiss at the pleadings stage and more burdensome and costly to litigate.

About the authors



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