

# Speakers

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# Enforcement and Litigation Risks Arising from ESG Disclosures

William J. Stellmach | Todd G. Cosenza

August 26, 2020

# The “Stakeholder” Approach

We believe that all investors, along with regulators, insurers, and the public, need a clearer picture of how companies are managing sustainability-related questions. This data should extend beyond climate to questions around how each company serves its full set of stakeholders, such as the diversity of its workforce, the sustainability of its supply chain, or how well it protects its customers' data. Each company's prospects for growth are inextricable from its ability to operate sustainably and serve its full set of stakeholders.

The importance of serving stakeholders and embracing purpose is becoming increasingly central to the way that companies understand their role in society. **As I have written in past letters, a company cannot achieve long-term profits without embracing purpose and considering the needs of a broad range of stakeholders.** A pharmaceutical company that hikes prices ruthlessly, a mining company that shortchanges safety, a bank that fails to respect its clients – these companies may maximize returns in the short term. But, as we have seen again and again, these actions that damage society will catch up with a company and destroy shareholder value. By contrast, a strong sense of purpose and a commitment to stakeholders helps a company connect more deeply to its customers and adjust to the changing demands of society. **Ultimately, purpose is the engine of long-term profitability.**



**BlackRock**

Larry Fink  
*Chairman and Chief Executive Officer*

# Agenda

- 1. Rising Prominence of ESG**
- 2. ESG v. Traditional Metrics**
- 3. Meeting Your ESG Standards**
- 4. Government Enforcement Risks**
- 5. Best Practices**

# Rising Prominence of ESG

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# Rising Prominence of ESG

## A solution to build back better: the circular economy

**Pascal Corfini**, Chair of the Committee on the Environment, Public Health and Food Safety, European Parliament

**Bruce Poole**, Secretary of State for Environment and Planning, Transport, Science

**Stirling Rodriguez**, Deputy Mayor for Environment and Energy, Greater London Authority

**Silence van Veldhoven**, Minister for the Environment, The Netherlands

**Luis Alvarez Sales Aguir de Henao**, Secretary of Environment Affairs, San Pedro City Hall

**Ron Della**, CEO, Amcor

**Alan Barfield**, Chair, Anup Group

**Sir Ian Cheesie**, Chairman, British Steel Ltd.

**Alfred Stern**, CEO, Suezalis

**Sir Alan Parker**, Chairman, Brunelwick Group

**Marco Schmitt**, CEO, Barmory

**Wolfgang Steig**, COO, Cordek Heat

**Emmanuel Faber**, Chairman and CEO, Danone

**Mika Roberts**, Group CEO, DS Group

**Carole Debra**, Internal CEO and CFO, Groupe Renault

**Helena Nelmes**, CEO, H&M Group

**Pablo Iba**, Executive Chairman, Inditex

**Carlo Masina**, CEO, Impek Suezalis Group

**Jean-Paul Agon**, Chairman and CEO, L'Oréal

**William McDonough**, Chief Executive, McDonough Innovations

**Mark Scheidel**, CEO, Nestlé

**Colin Barrett**, CEO, Nevenium

**Ramon L. Lopez**, Chairman and CEO, PepsiCo

**Frans van Houten**, CEO, Royal Philips Co-Chair, PACE

**Justin Mundy**, Co-Founder and Partner, S&P Partners Ltd.

**Dr. Uthman Kadi**, CEO, Solvay

**Stella McCartney**, Founder, Stella McCartney

**Mark Staudy**, Chief Executive and Managing Partner, SYSTEMIQ

**James Gilbey**, Chairman and CEO, The Coca-Cola Company

**Alan Jope**, CEO, Unilever

**Antoine Frirot**, Chairman and CEO, Veolia

**Mark Reed**, CEO, WIP

**Dr. Klaus Zemanek**, President, Deutsche Post Stiftung

**CEO America**, Deutsche Post DHL

**Diana Eick MacArthur**, Founder, Ellen MacArthur Foundation

**André Hoffmann**, President of Fondation Mérieux, Vice-Chairman of the Board, Roche Holding Ltd.

**Jeremy Oppenheim**, Global Director, Food and Land-Use Coalition

**Neelke Doorn**, CEO and Chairwoman, Global Environment Facility and Co-Chair, PACE

**Eric Kwon**, CEO, Global Fashion Agenda

**Par Heggem**, CEO, ISA Foundation

**Leslie Johnson**, CEO, Lantini Foundation

**Andrew Forrest**, Chairman, Windegar Foundation, Chairman, Suezalis Break Group

**Kristian Parker**, Vice-Chair of the Board of Trustees, Suezalis

**Annamiek Hoogenboom**, Co-Founder, Potlatch Luster

**Nikol Nesi**, CEO, Remond-Barilake

**Mark Bonabai**, Co-Chair, See The Future

**Wendy Schmidt**, President and Co-Founder, The Schmidt Family Foundation

**James Potlatch**, Co-Chair, UNEP International Business Panel

**Genardo Muñoz**, High-Level Climate Action Champion, UNFCCC COP26, Co-Founder and President, The Climate

**Nigel Topping**, High-Level Climate Action Champion, UNFCCC COP26

**Peter Salke**, President and CEO, WBCSD

**Dominic Waughy**, Managing Director, World Economic Forum

**Dr. Andrew Stans**, President and CEO, World Economic Forum

**Marcus Gowen**, CEO, WRAP

**Marco Lambertini**, Director General, WFP International

As we rise to the challenges caused by the coronavirus pandemic, the question is no longer should we build back better, but how.

Many have already called for a response to the devastating impacts of this pandemic that does not turn attention away from other global challenges such as climate change and pollution.

The circular economy offers a solution for how to do so. By designing out waste, keeping products and materials in use, and regenerating natural systems, it creates vital opportunities for economic growth that also restore the environment, create jobs, and benefit society.

Leading businesses and governments have already taken important steps towards building a circular economy. The fight against plastic pollution is one example. More than 850 organisations have united behind the Ellen MacArthur Foundation's vision of a circular economy for plastics and ambitious 2025 targets to achieve it. Now is the time to build on this momentum and do more, not less.

As the world faces unprecedented challenges, we\* are more committed than ever to accelerating the transition to a circular economy, creating solutions that combine economic opportunity with benefits to wider society and the environment.

For **plastics** we will eliminate what we don't need, innovate towards new business models and materials, and circulate all the plastic we do use – keeping it in the economy and out of the environment.

For **fashion** we will ensure clothes are used more, are made to be made again, and are made from safe and renewable materials.

For **food** we will redesign products and supply chains to regenerate nature, eliminate the concept of waste, and connect local production and consumption where appropriate.

For **finance** we will support companies in their transition to circular business models, and mobilise capital towards circular solutions.

And we will not stop there. We can do the same for other industries that have vital roles to play in this recovery, including healthcare, technology, mobility, electronics, chemicals, and the built environment.

We call on more businesses, governments, and financial institutions around the world to join us on the journey towards a circular economy, to invest in circular economy solutions, and to raise the ambition level of circular economy targets, while delivering faster against existing ones.

# Rising Prominence of ESG

**ESG INVESTING**  
VALERIE'S DIVERSITY METRICS

- Percentage of women on the board
- Percentage of directors with financial expertise
- Percentage of ethnically diverse directors
- Size of board committees

SOURCE: VALERIE GRANT, ALLIANCEBERNSTEIN SENIOR VP

**CNBC MARKET ALERT** | **STOCKS HIT SESSION HIGH ON FED BOND BUYING NEWS**

**CNBC**

The image is a screenshot of a CNBC Market Alert graphic. It features a dark blue background with a grid pattern. The text is primarily white and yellow. The main title 'ESG INVESTING' is in large yellow letters. Below it, 'VALERIE'S DIVERSITY METRICS' is in white. A bulleted list follows, with each item starting with a white circle. At the bottom left, there is a 'CNBC MARKET ALERT' logo. At the bottom center, a dark orange banner contains the text 'STOCKS HIT SESSION HIGH ON FED BOND BUYING NEWS' in white. At the bottom right, the 'CNBC' logo is displayed in white.

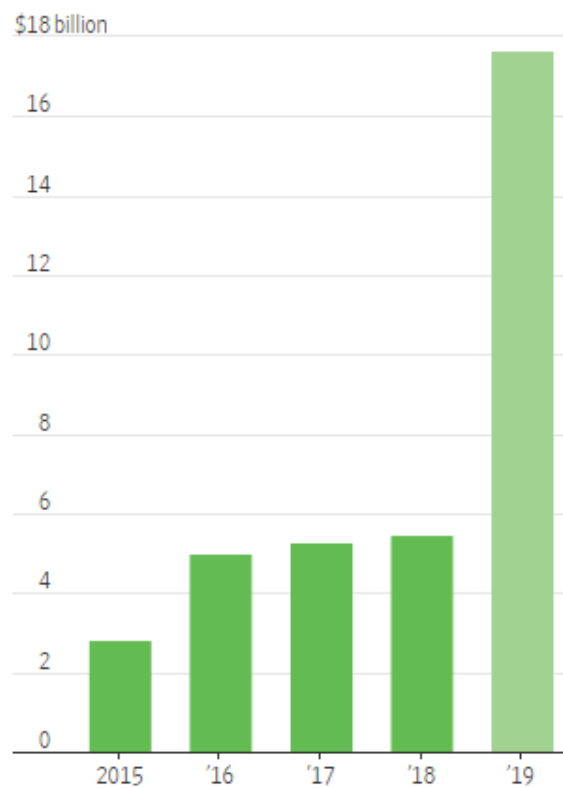


# Rising Prominence of ESG

## Breakout Move

Funds that focus on socially responsible investments have logged a record amount of inflows this year.

## Flows into sustainable funds by year



Note: Figure for 2019 is through the end of November.  
Source: Morningstar

Source: Juliet Chung & Dave Michaels, *ESG Funds Draw SEC Scrutiny*, Wall Street Journal (Dec. 16, 2019)

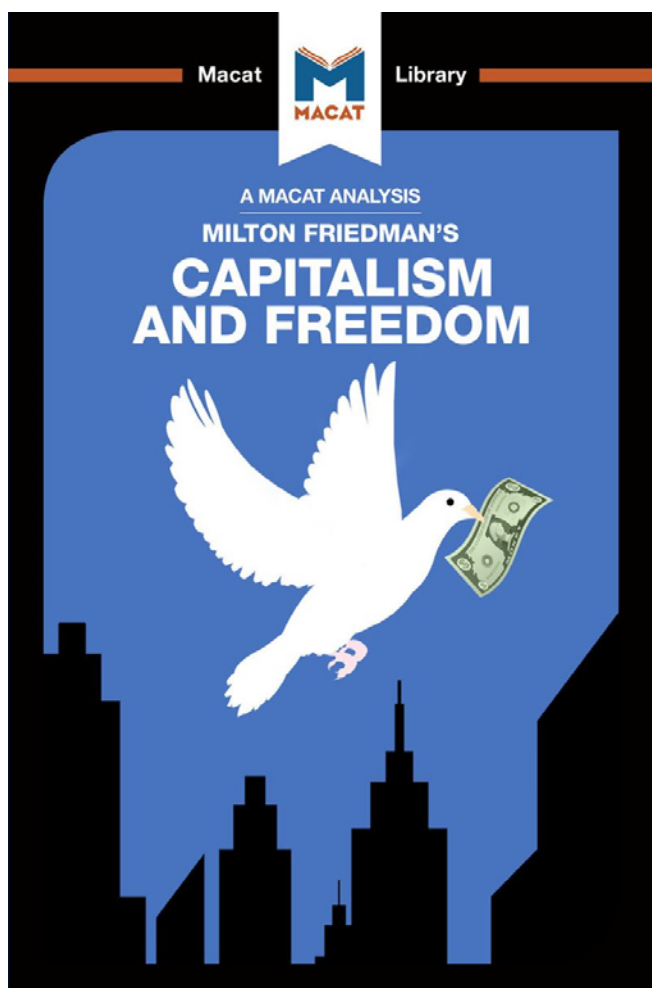
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# ESG v. Traditional Metrics

1. Rising Prominence of ESG
2. **ESG v. Traditional Metrics**
3. Meeting Your ESG Standards
4. Government Enforcement Risks
5. Best Practices

# Traditional View of Corporation's Role









“What does it mean to say that the corporate executive has a ‘social responsibility’ in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers. . . . In each of these cases, the corporate executive would be spending someone else’s money for a general social interest. Insofar as his actions in accord with his ‘social responsibility’ reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers’ money. Insofar as his actions lower the wages of some employees, he is spending their money.”

Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, THE NEW YORK TIMES (Sept. 13, 1970).

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# Reconciling ESG with Traditional Metrics?

Factor	Company	Event	Impact
<b>Environmental</b> 	<b>Peabody Energy</b>  Exxon Mobil BP	Publicly rejects climate science & action; funded groups that cast doubt on manmade climate change & opposed environmental regulations <sup>1</sup>	<b>99% drop</b> in share price from 2011-2016 <sup>2</sup> and <b>Chapter 11 filing</b> in 2016 <sup>3</sup> 
<b>Social</b> 	<b>Valeant Pharmaceuticals</b>  Wells Fargo Facebook	Increased price of prescription drugs by over 500%; received subpoenas from federal prosecutors over pricing strategy <sup>4</sup>	<b>80% drop</b> in stock price over the last year <sup>5</sup> and <b>Board voted to remove CEO</b> <sup>6</sup> 
<b>Governance</b> 	<b>Volkswagen</b>  Theranos Fiat	Intentionally programmed "clean diesel" vehicles to deceive EPA emissions tests <sup>7</sup>	<b>50% drop</b> in share price between March & September 2015 <sup>8</sup> and <b>Forced resignation of CEO</b> <sup>9</sup> 

Source: Mark McDivitt & Julian Lyne, *ESG Investing: Buzzwords or Better Investments*, NCPERS (May 2018)

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# ESG as a Driver of Shareholder Value

Over time, companies and countries that do not respond to stakeholders and address sustainability risks will encounter growing skepticism from the markets, and in turn, a higher cost of capital. Companies and countries that champion transparency and demonstrate their responsiveness to stakeholders, by contrast, will attract investment more effectively, including higher-quality, more patient capital.



It is also clear that those executives will have to win over vocal skeptics, including many in the investor community, on whether these stakeholder activities create value for companies. We believe they do. Strategies such as environmental, social, and governance (ESG), for example, how a company helps conserve the natural world (the “E”), builds relationships with its people and communities (the “S”), or governs in a responsible way (the “G”), create value—intrinsic value—through an emphasis on stakeholder interests. And, if companies are transparent to shareholders about efforts to address stakeholder priorities, market value will likely increase over time as well.



# Potential Claims

- Claims that a company's focus on ESG issues is detrimental to shareholder value
  - Derivative action for breach of fiduciary duty
- Claims that a company's ESG disclosures mask true financial performance, such as in the case of WeWork's "community-adjusted EBITDA," which deducted "building and community-level operating expenses"
  - Securities class action
  - SEC enforcement action

# Minimizing Litigation Risks

- Use clear disclosures
- Separate ESG disclosures from financial performance metrics
- Maintain focus on fiduciary duties to shareholders

# Meeting Your ESG Standards

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# ESG Constituency is Real and Growing



**USD 30 trillion**

wealth transfer from baby boomers to 75 million millennials to take place over the next few decades.<sup>16</sup>



**88%**

of high-net worth millennials are actively reviewing the ESG impact of their investment holdings.<sup>17</sup>



**89%**

of millennials expect their financial professional to do a deep dive into a company's ESG factors and history with ESG issues before recommending an investment opportunity.<sup>18</sup>



Source: MSCI ESG RESEARCH LLC, *Swipe to Invest: the Story Behind Millennials and ESG Investing* (March 2020)

**2X**

**57%**

of millennial investors have intentionally stopped investing or declined to invest in a company because of the impact that company's products or services have on people's health and well being.<sup>19</sup>



**95%**

of millennial investors were interested in sustainable investing as of 2019 up 9 percentage points from 2017.<sup>20</sup>



**85%**

of individual investors were interested in sustainable investing as of 2019 up 10 percentage points from 2017.<sup>21</sup>

# Meeting Your ESG Standards

- There has been a notable rise in “event-driven” securities actions in the past few years
- ESG disclosures that give rise to litigation risk:
  - Safety standards
  - Environmental consciousness
  - Commitment social justice, domestically and internationally
  - Intolerance of discrimination and harassment
- To minimize the risk of litigation, keep ESG disclosures forward-looking and aspirational, rather than concrete and retrospective

# Background Principals

- Before going into specific examples of these types of claims, a few general principles in the federal securities law context to understand and keep in mind:
  - “The securities laws were not designed to provide an umbrella cause of action for the review of management practices or to regulate ... internal corporate mismanagement.” *In re Citigroup, Inc. Sec. Litig.*, 330 F. Supp. 2d 367, 376-77 (S.D.N.Y. 2004).
  - “A corporation has no affirmative duty to speculate or disclose uncharged, unadjudicated wrongdoings or mismanagement, illegal internal policies, or violations of a company’s internal codes of conduct and legal policies.” *In re UBS AG Sec. Litig.*, 2012 WL 4471265, at \*31 (S.D.N.Y. Sept. 28, 2012), *aff’d sub nom.* 752 F.3d 173 (2d Cir. 2014).
  - “[F]ederal securities laws do not require a company to accuse itself of wrongdoing.” *In re Citigroup Sec. Litig.*, 330 F. Supp. 2d 367, 377 (S.D.N.Y. 2004).

# Successful Claims

- *In re BP PLC Sec. Litig.*, 2013 WL 6383968 (S.D. Tex. Dec. 5, 2013)
  - The court denied a motion to dismiss securities claims arising from the Deepwater Horizon incident because the plaintiffs adequately alleged that BP's disclosures about safety were sufficiently specific and detailed to be considered materially misleading.
  
- *Massey Energy Sec. Litig.*, 883 F. Supp. 2d 597 (S.D. W.Va. 2012)
  - The court denied a motion to dismiss securities claims arising from a coal mine fire and found that Massey's statement that it was an "industry leader," was actionable in light of the existing safety issues at the company.

# Unsuccessful Claims

- *Ong v. Chipotle Mexican Grill Inc.*, 294 F. Supp. 3d 199, 232 (S.D.N.Y. 2018)
  - The court held that Chipotle’s statements regarding food safety were “either not demonstrably false or inactionable puffery.”
- *Bondali v. Yum! Brands, Inc.*, 620 F. App’x 483 (6<sup>th</sup> Cir. 2015)
  - The court dismissed claims arising from Yum’s food safety incident because alleged misstatements were not actionable.
- *Construction Laborers Pension Trust for So. Cal. v. CBS Corp.*, 2020 WL 248729 (S.D.N.Y. Jan. 15, 2020)
  - The court held that statements in Business Conduct Statement were “far too general and aspirational to invite reasonable reliance.”

# Takeaways

- Spectrum of ESG-related disclosures:
  - *Higher Risk*: Concrete, specific statements that inaccurately represent a company's policies or actions
  - *Gray Area*: Less specific disclosures that might be deemed materially false or misleading in certain circumstances
  - *Lower Risk*: Aspirational statements regarding a company's "commitments" and "priorities," or the "intentions" and "design" of its policies

# ESG-Based Derivative Lawsuits

- *Ocegueda, derivatively on behalf of Facebook, Inc., v. Zuckerberg et al.*, No. 20-cv-4444 (N.D. Cal. 2020)
  - Allegations that Facebook has “failed to achieve real diversity on the Board and among the senior executive ranks.”
  - Asserts claims for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, abuse of control, unjust enrichment, and violation of Section 14(a) of the '34 Act.
- *Klein, derivatively on behalf of Oracle Corporation and Oracle America, Inc., v. Ellison et al.*, No. 20-cv-4439 (N.D. Cal. 2020).
  - Allegations that Oracle’s directors made misrepresentations in public statements claiming to have policies “designed to ensure diversity both at the management level and the Board itself.”
  - Same claims as in the Facebook action.



# Government Enforcement Risks

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# Government Enforcement Risks

- Past, present, and future sources of ESG enforcement:
  - Federal government
  - State and local governments
  - Foreign governments

# Federal Government Enforcement

- December 2016: “[S]tatements of investment policies [should] include proxy voting decisions as well as policies concerning economically targeted investments or incorporating environmental, social or governance (ESG) factors in investment policy statements or integrating ESG-related tools, metrics and analyses to evaluate an investment’s risk or return or choose among equivalent investments.”
- June 2020: Fiduciaries “must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision.”



# SEC Probes ESG Investment Claims

## THE WALL STREET JOURNAL.

MARKETS

### ESG Funds Draw SEC Scrutiny

Wall Street's growing foray into impact investing has regulators questioning investors' ESG criteria

By [Juliet Chung](#) and [Dave Michaels](#)

Updated Dec. 16, 2019 7:05 am ET

WILLKIE FARR & GALLAGHER<sub>LLP</sub>

# SEC Office of Compliance, Inspections and Examinations

- Adviser adherence to U.N. Principles of Responsible Investment
- What ESG investments have been made and why?
- Basis for ESG scoring – self-developed or third-party
- Proxy voting information regarding ESG matters
- Service providers assisting in ESG due diligence



# “Enabling Stakeholder Graft”...?

- Commissioner Hester Pierce:
  - “I think that should be party of the discussion, trying to figure out to what extent ESG might stand for ‘enabling stakeholder graft.’”
  - “Not only is it difficult to define what should be included in ESG, but, once you do, it is difficult to figure out how to measure success or failure.”
  - “As with the scarlet A, the ESG letters oversimplify complicated facts and thus may send companies scrambling to take actions that neither achieve the broader social goals of ESG proponents, nor serve their shareholders well.”



# SEC Proposed Rule: Talk the Talk, Then Walk the Walk

## **SECURITIES AND EXCHANGE COMMISSION**

**Release Nos. IC-33809; File No. S7-04-20**

**RIN 3235-AM72**

### **Request for Comments on Fund Names**

**AGENCY:** Securities and Exchange Commission

**ACTION:** Request for comment.

**SUMMARY:** The Securities and Exchange Commission is seeking public comment on the framework for addressing names of registered investment companies and business development companies that are likely to mislead investors about a fund's investments and risks pursuant to section 35(d) of the Investment Company Act of 1940, rule 35d-1 thereunder, and the antifraud provisions of the Federal securities laws. The Commission is seeking public comment particularly in light of market and other developments since the adoption of rule 35d-1 in 2001.

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# SEC Proposed Rule: Talk the Talk, Then Walk the Walk

1. Should the rule for naming funds apply to ESG or sustainable products?
2. Investors are relying on these terms to understand funds' strategies?
3. There should be specific requirements that funds must adhere to in order to call their investments ESG or sustainable?

# Pressure on SEC to Focus on ESG

## THE WALL STREET JOURNAL.

MARKETS | FINANCIAL REGULATION

### SEC Urged to Help Diversify Asset-Management Industry

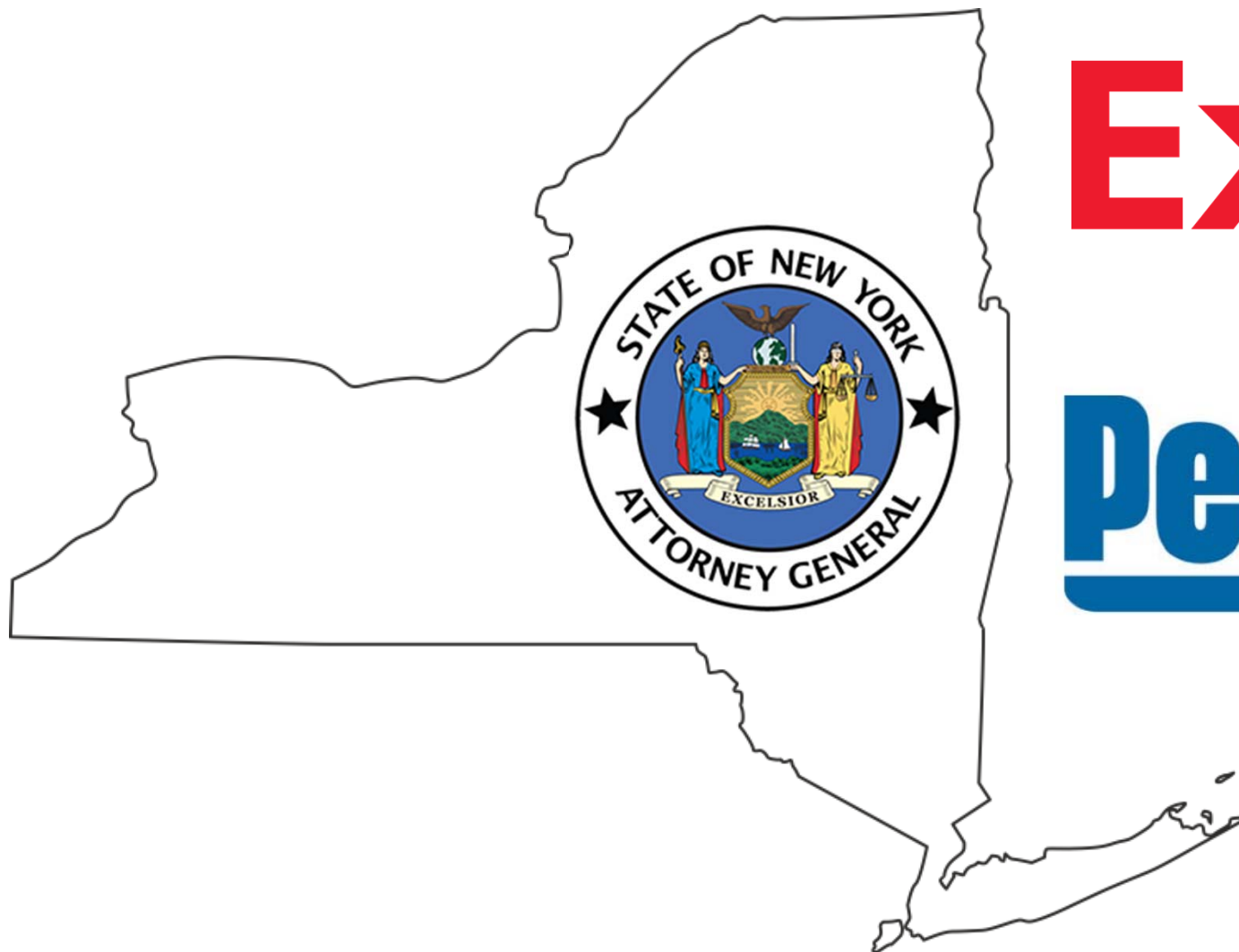
Investors recommended pushing for more disclosure of diversity policies and practices and investigating signs of discrimination

By [Dave Michaels](#)

Updated July 16, 2020 8:37 pm ET

WILLKIE FARR & GALLAGHER<sup>LLP</sup>

# New York State



**Exxon**

**Peabody**  
ENERGY

ELLKIE FARR & GALLAGHER LLP

# California Tort Nuisance Actions



# COVID-19

## BUSINESS INSIDER

**Nearly one third of people that have gone back to work after being laid off during the coronavirus pandemic have lost their jobs again, study finds**

Carmen Reinicke Aug 6, 2020, 12:57 PM



## The Detroit News

### Michigan issues \$33,400 in fines for workplaces violating COVID rules

**Beth LeBlanc** The Detroit News

Published 1:06 p.m. ET Aug. 21, 2020 | Updated 5:22 p.m. ET Aug. 21, 2020

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# Foreign Government Enforcement

- 2016 Paris Agreement:
  - Commitment to combat climate change and make finance flows consistent with climate-resilient development
- UN 2030 Agenda for Sustainable Development:
  - Targets for economic, social, and environmental aspects of sustainable development
- European Commission's Sustainable Finance Action Plan:
  - Examining integration of sustainability considerations into financial policy



# EU Disclosure Regulation: A Blueprint

- Pre-contract disclosures to investors on ESG issues, including integrating sustainability risks into investment-making decisions
- Ongoing disclosure obligations
- Currently limited to certain investment professionals
- Goes into effect March 2021





# Proposed Hypothetical

- A start-up athletic apparel company has gained rapid popularity and success, including the launch of an IPO, due, in part, to its stated commitment to social justice causes, embodied in:
  - the slogan “Clothing for a Better Tomorrow”;
  - its pledge to use sustainable materials;
  - its promotion of various social justice causes in a popular line of t-shirts;
  - its stated support of fair labor practices and professed dedication to the well being of its employees; and
  - sponsorship deals with athletes and celebrities who claim to use this company’s products specifically because of the company’s commitment to these issues.
- A *Wall Street Journal* report reveals that the company has for years made use of cheap labor in a factory in a foreign country, where the employees are paid less than \$0.50 per hour and are forced to work long hours, without breaks, in crowded, unsafe conditions.
- Within days of the report, the company’s stock price drops 25%, and a major sports league and retail chain withdraw from partnerships with the company.

# Proposed Hypothetical: Potential Claims

- Securities class action
- Shareholder derivative claims
- Class action on behalf of workers
- Class action on behalf of consumers
- Governmental investigations and enforcement
- Reaction from investment funds

# Best Practices

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# Best Practices

- Consider the audience
- Choose the right disclosures
- Explain ESG metrics clearly
- Disclosures should have an “owner”
- Disclosures should be aspirational and forward-looking
- Transparency regarding process and evaluation
- Maintain focus on fiduciary duties



## Questions

Please use the Q&A function in the Zoom taskbar to submit your question to the Panelists

# Speakers

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Co-Chair, White Collar Defense Group

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