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WHITE PAPER

July 2019

Managing Legal Risks From ESG Disclosures Under U.S. Law

Whether on their own initiative or in response to pressure from regulators, consumers, or activist shareholders, many issuers are disclosing more and more about their environmental, social, and governance ("ESG") practices. Issuers are publishing information about their accomplishments, current efforts, and future commitments in each of these areas, including in the U.S. Securities and Exchange Commission ("SEC") filings, webpages, printed materials, presentations to investors, etc. There is, as of now, no U.S. law compelling issuers to make ESG statements when they are not material. But recent U.S. case law underscores that ESG disclosures may be actionable if found to be materially false or misleading.

In this *White Paper*, we suggest some steps companies should consider as they seek to minimize the litigation risks that may arise from their increasing ESG disclosures.

ESG DISCLOSURES ARE VOLUNTARY UNDER U.S. LAW

At the moment, issuers are generally not required to make ESG disclosures in securities filings with the SEC unless the issuer determines such information would be material to investors. Materiality under U.S. securities laws is judged by whether the ESG disclosure would be viewed by a "reasonable investor" "as having significantly altered the 'total mix' of information made available." The current disclosure requirement for ESG issues under the U.S. securities laws thus hinges on whether the information would be material to a reasonable investor, such as whether it presents material risks to an issuer's business.[1] This raises two questions. Does an issuer make an item material by disclosing it in its SEC filings? And does disclosing the adoption of voluntary commitments that may have significant impacts on the business make them material? The answer to the first question is probably no, but the second question becomes much more difficult. Regardless, materiality is often a difficult standard to assess, and there is growing dissatisfaction in some quarters with the current SEC requirements.

TRADITIONAL AREAS OF EXPOSURE BASED ON ESG DISCLOSURES

As U.S. securities law and SEC regulations make issuer statements to investors—whether within securities filings or otherwise—potentially actionable, issuers may be open to significant liability in their ESG disclosures. Issuers may be liable under U.S. securities law for ESG disclosures if the disclosure includes a materially false or misleading statement. In addition, if such ESG disclosure is included within a quarterly or annual securities report, issuers could find their CEOs and CFOs open to liability as the individuals who "control" the issuer and are held responsible for any false or misleading statements. An issuer's directors could also be subject to liability based on ESG disclosure reflecting any disregard of the board's oversight responsibilities. ESG disclosures can also give rise to litigation under consumer protection and antifraud statutes. Issuers may also be subject to state and federal government investigations for ESG disclosures.

Perhaps the most important general principle from the case law is that if a statement is deemed vague or aspirational, then courts typically conclude that it cannot be false, misleading, or material to a reasonable investor, and is therefore not actionable. However, the context and timing of such statements are important to determining whether a statement, made in a code of conduct or elsewhere, is material or merely puffery. Thus, courts have refused to dismiss claims when statements were made in response to investors' concerns, particularly when those statements follow highly publicized incidents or were made "amidst contemporaneous questions regarding the company's ethics or investigations of the company's illicit activities." Moreover, U.S. courts have held that ESG disclosures may be material to a reasonable investor if they are sufficiently concrete or falsifiable.

LESSONS ON ESG DISCLOSURES FROM THE U.S. LEGAL LANDSCAPE

ESG disclosures foster goodwill with customers, investors, and the public by underscoring an issuer's positive influence in the community and commitment to good corporate citizenship. To minimize the "no good deed goes unpunished" trap, however, issuers should also consider the following when crafting, reviewing, and publishing their ESG statements:

Ensure There Is an Owner of the Company's ESG Statements

While the board and management bear ultimate responsibility for the company's financial statements and disclosures, it is important that there be an owner of the company's ESG statements and the process by which those statements are created, reviewed, and considered. This accountability is important for ensuring that the other suggestions discussed below are properly implemented and a consistent company narrative on its ESG practices is communicated to investors.

Know How You Will Measure Success Internally Before Disclosing Externally

ESG disclosures must be viewed as more than marketing tools. If the board and management have determined to disclose information about a company's safety record, climate policies, diversity goals, etc., then they must understand how they intend to view success and failure on those policies. This may require significant thought and present challenges because measuring success in many ESG areas is, putting it lightly, not straightforward. The board and management should also evaluate common ESG reporting guidelines from various organizations and initiatives, including the Sustainability Accounting Standards Board or the Global Reporting Initiative's Sustainability Reporting Standards, and whether these are standards for success in the company's ESG disclosure. As investors look to these sources for information or comparisons, it will be beneficial for a company to disclose whether its measures follow these guidelines or, if not, why such guidelines may not be appropriate for the company due to specific operations or other factors. The company may consider being upfront in its disclosures about how it measures success and it may be appropriate in some instances to admit that success is an evolving concept.

Develop Board Practices to Better Oversee the Development and Release of ESG Disclosures

A board of directors should study its company-specific ESG issues closely and consider in greater detail how ESG disclosures could impact the risks to the company. As part of their fiduciary duties and oversight responsibilities, directors should not only identify a company's material ESG risks, which could involve conducting a formal ESG assessment or engagement with key investors, customers and employees on ESG risks, but also the process by which such risks will be addressed and disclosed. There is increasing pressure on boards to form "climate committees" or take other action to elevate that particular ESG issue. Whether that is the right approach or not, boards need to exercise oversight on these issues as investors have emphasized a turn towards greater sustainability and transparency with no signs of relenting. As the board considers the process for addressing ESG risks and any related disclosure, it may be beneficial to adopt an overarching ESG disclosure policy to align board oversight, ownership, reliability, and verification of the disclosure, along with internal collaboration as some of the factors noted herein.

Evaluate and Apply the Same Level of Caution to All Public ESG Statements

ESG statements frequently appear in publications or investor materials that are later cross-referenced or incorporated into an issuer's proxy statement or other SEC filings. Where ESG disclosures are included in actual SEC filings, issuers may wish to consider updating the forward-looking disclosure to reflect the nuances of the ESG statements. But practically any ESG statement made in a public setting could subsequently form the basis of a lawsuit in the United States, regardless of whether it is incorporated into an official SEC filing. Additionally, the SEC has noted that it is "actively" comparing voluntary ESG information companies provide with ESG information disclosed in the company's SEC filings.[2] As a result, issuers may wish to consider applying the same level of caution to all public ESG statements and ensure that ESG statements and SEC filings are reviewed for consistency across all disclosure methods.

Encourage Appropriate Internal Collaboration

Issuers may wish to consider developing a system of collaboration and review among the different teams involved in gathering, drafting, reviewing, and publishing its ESG disclosures. To that end, issuers could form an internal audit subcommittee, correspond with sustainability disclosure experts, and report to the full board or specific directors. Such a system would allow for the board and management to consistently review the connection between a company's operations and ESG risks. A collaboration of this kind will need to break down organizational barriers to create cross-functional teams able to see the disclosures from all angles. This will enable stakeholders to better integrate their differing priorities, knowledge, and areas of expertise. In addition, this system will allow for the ESG reporting data collected to be vetted for relevance and for comparable periods, which investors will find useful in their push for more standardized or comparable ESG disclosure.

Verify the Accuracy of ESG Disclosures

Issuers may wish to consider implementing internal and external processes to evaluate the internal controls around ESG disclosure and measurement and to test the accuracy of ESG disclosures before they are released to the public. ESG disclosures present legal as well as reputational risks e.g., such as when a company's disclosed efforts to address climate change turn out to be publicly questioned and open the company up to charges of "greenwashing."[3] To help maintain accuracy around ESG disclosures, issuers could engage internal and external sustainability disclosure experts. Such internal and external auditors could review ESG disclosures for overstatements, misstatements, or concrete statements capable of becoming misleading or untrue by forces or circumstances outside of the issuers' control.

Educate Business, Shareholder Relations, and Public Relations Personnel Regarding Litigation Risks

Issuers should educate their personnel responsible for preparing ESG disclosures about the growing risk of U.S. and global scrutiny associated with these statements. Responsible individuals must understand that the issuers' ESG statements need to be consistent with descriptions of the company's business in SEC filings and elsewhere.

Use Aspirational Language or Approximations

From a litigation perspective, issuers should couch ESG statements in aspirational language. When discussing ESG initiatives or codes of conduct, issuers may wish to consider using words like "should," "expect," or "strive," as opposed to making falsifiable assertions that the company "does" comply, "is" in compliance, or "will" be in compliance with applicable laws and standards. Issuers can also minimize their litigation risk by styling their ESG goals as "estimates" or "approximations" toward specific big picture achievements. Commitments to concrete measurements or achievement by certain dates could also lead to a duty to update investors when such goals are not achieved. Where possible, issuers should not commit to concrete measurements and should avoid publishing commitments to achieve ESG goals by certain dates.

Hedge or Disclaim Where Possible

Issuers may also consider adding disclaimers or other hedging language stating that the standards or goals described in the ESG disclosures are not guarantees or promises. Where appropriate, they could indicate that metrics used to evaluate the progress or achievement of an ESG commitment are developing or are based on certain assumptions. To protect against a potential litigant asserting that it did not see or connect a disclaimer when reading or relying on an ESG disclosure, issuers could place the disclaimer near the related ESG disclosure.

Consider the Context

Issuers may wish to consider where they include or when they publish an ESG disclosure because the context around the disclosure matters. U.S. courts scrutinize more closely statements made in response to investors' concerns, particularly where those statements follow highly publicized incidents, such as an accident or a government investigation. A court is more likely to conclude that an ESG disclosure is material to an investor or customer if it is displayed prominently. Incorporating an ESG disclosure into SEC filings or displaying it on product packaging may increase the risk and potency of litigation, as it will be easier for a litigant to establish that it saw the ESG disclosure and relied on it in making an investment or purchase decision.

Consider Insurance Coverage

Issuers should consider whether director and officer ("D&O") or other insurance coverage can protect them as well as their directors, officers, and employees from potential liability related to ESG disclosures. Issuers can obtain three layers of D&O insurance coverage known as A-B-C coverage, which indemnifies directors and officers where the underlying claim against them is nonindemnifiable, reimburses the issuer for proper indemnification payments made to its directors and officers, and covers the issuer for claims against it, including securities law claims. Standard D&O coverage should protect against alleged misrepresentations or omissions in securities filings and other public statements, but issuers should investigate whether any special terms or conditions are necessary to ensure coverage for ESG misstatements or omissions claims.

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ENDNOTES

1 SEC Division of Corporate Finance Director William Hinman noted the SEC's materiality framework in a recent speech and advised companies to consider disclosure "on all emerging issues, including risks that may affect their long-term sustainability." Remarks of William Hinman, Director, Division of Corporation Finance of the SEC, at the 18th Annual Institute on Securities Regulation in Europe, March 15, 2019 (last visited July 9, 2019).

2 Remarks of William Hinman, Director, Division of Corporation Finance of the SEC, at the 18th Annual Institute on Securities Regulation in Europe, March 15, 2019 (last visited July 9, 2019).

3 For these purposes, greenwashing involves falsely conveying to investors or consumers that the company factors environmental responsibility into its governance.