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Navigating the Landscape of ESG-Related Shareholder Litigation

By Bruce A. Ericson, Ari M. Berman, David Oliwenstein, Kimberly D. Jaimez and Roland C. Reimers*

The authors explain that, as the Securities and Exchange Commission continues to develop its environmental, social and governance ("ESG") agenda, a series of recent cases underscores the risks posed by ESG-related litigation.

Most of the recent environmental, social and governance ("ESG")-related headlines focus on the developing agenda of the Securities and Exchange Commission ("SEC") under the leadership of Chair Gary Gensler, but developments in private litigation also warrant close attention. While many of the first-generation lawsuits—which focused largely on corporate board diversity—have been dismissed for failure to state a claim, companies should remain vigilant. Indeed, as putative plaintiffs incorporate lessons learned from early defeats and expand the scope of ESG litigation, market participants should continue to be mindful of ESG disclosures.

THE CLIMATE CHANGE ROOTS OF ESG-RELATED LITIGATION

ESG lawsuits have long predated both the SEC's recent focus on ESG enforcement and rulemaking as well as the current wave of shareholder litigation focused on corporate diversity. Historically, high-profile ESG-related litigation often involved climate change actions against issuers in the natural resources industry.

One of the most influential climate change-related cases from this early period of ESG litigation was *Massachusetts v. Environmental Protection Agency*.[1] There, the U.S. Supreme Court held that the Environmental Protection Agency had the authority to regulate greenhouse gases ("GHGs") pursuant to the Clean Air Act. In so holding, the Supreme Court determined that climate change-

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[1] *Massachusetts v. Environmental Protection Agency*, 549 U.S. 497 (2007).

related harms, such as rising sea levels and damage to coastal land, constituted injuries sufficient to support Article III standing.

In more recent years, climate change-related litigation has shifted its focus to the adequacy of disclosures made by issuers under the securities laws. One high-profile example is *New York v. Exxon Mobil Corp.*, an action brought by the New York State Attorney General under the state's Martin Act, challenging Exxon's disclosures about the impact that climate change regulation could have on the company's assets and value. The trial court dismissed the action after determining that Exxon's disclosures were not materially misleading because no reasonable investor would make investment decisions based on "speculative assumptions of costs that may be incurred 20+ or 30+ years in the future with respect to unidentified future projects."

Because the case law concerning climate-related disclosures is relatively sparse, the *Exxon* case—and similar cases brought by state attorneys general against other natural resource companies—may play an important role in shaping future climate change and ESG-related litigation, alongside evolving disclosure regimes being developed by the SEC.[2]

IMPORTANT DEVELOPMENTS IN RECENT DIVERSITY-RELATED SHAREHOLDER LITIGATION

Following the *Massachusetts* and *Exxon* climate change-related cases, a new wave of ESG-related litigation has come to the forefront—including both securities lawsuits and derivative actions for breach of duty. As a general matter, these more recent cases have asserted claims against corporate defendants for alleged misrepresentations and omissions regarding the diversity of their board composition and hiring practices, as well as related breaches of fiduciary duty—essentially alleging that defendants failed to live up to their proclaimed commitments to diversity. Despite filing lengthy complaints, the private plaintiffs in these cases have, thus far, been largely unsuccessful. Examination of the bases for dismissal of those cases, however, sheds light on the avenues that shareholders may perceive as fruitful going forward.

One recent derivative action, *Lee v. Frost*,[3] filed against OPKO Health Inc. in the U.S. District Court for the Southern District of Florida, exemplifies how many courts have treated this first round of diversity-related shareholder litigation.

In *Lee*, plaintiffs alleged that OPKO Health's board had "falsely assur[ed] the investing public" that, among other things, OPKO Health "celebrates diversity

[2] https://www.sec.gov/news/public-statement/lee-climate-change-disclosures.

[3] *Lee v. Frost*, 1:21-cv-20885 (S.D. Fla.).

and prides itself on its diverse staff." Plaintiffs also alleged that OPKO Health failed to consider diversity factors in nominating corporate directors, and that, since at least April 2018, the company's board "consisted of zero Black or Latinx members" and that its management and leadership "have zero Black employees."

In late August 2021, the district court granted the defendants' motion to dismiss, concluding that the complaint was "replete with conclusory allegations" for which the plaintiffs had failed to present "particularized facts to animate these accusations." Such conclusory allegations, the *Lee* court held, had "no bearing on whether [OPKO Health's] directors discriminated against underrepresented minorities when nominating individuals to serve on [OPKO Health's] board or executive team." The court did, however, grant plaintiffs leave to file an amended complaint—which plaintiffs apparently declined to do.

Lee is one of the latest in a series of dismissals of shareholder derivative actions alleging diversity-related claims in which the allegations focused upon purportedly false and misleading disclosures regarding board diversity and alleging related breaches of fiduciary duties. For example, in *Elliemaria Toronto ESA v. NortonLifeLock Inc.,* the U.S. District Court for the Northern District of California dismissed the plaintiff's claims that NortonLifeLock "deceived stockholders and the market by claiming to have concrete and specific inclusion and diversity programs that are measurable and produce actionable tasks" because plaintiff's claim under Section 14(a) of the Securities Exchange Act of 1934 failed to allege demand futility or to state a claim, in part because the allegedly deficient disclosures constituted puffery.

In other cases, courts have not yet issued final rulings on the merits, but it appears unlikely that many plaintiffs will survive the early stages of litigation.[4]

Courts also have slowed plaintiffs' march by ensuring that ESG complaints adequately plead demand futility under Delaware law, which governs most major public companies. A shareholder seeking to commence a derivative action must allege either a pre-suit demand upon the board to commence a lawsuit on behalf of the corporation or that a demand upon the board to commence suit would be "futile." In *Falat v. Sacks*, the California district court held that plaintiffs failed to show that any director faced a "substantial risk of personal liability sufficient to excuse demand" and that, as a result, plaintiff "did not plead demand futility with particularity."

THE CONTINUED IMPORTANCE OF ESG RULEMAKING

Although private litigants have not had much, if any, success thus far, they undoubtedly will seek to adapt accordingly. Meanwhile, market participants

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4 *See, e.g.*, *City of Pontiac General Employees' Retirement Systems v. Bush*, 4:20-cv-06651) (N.D. Cal.).

should continue to monitor rulemaking from the SEC and self-regulatory organizations. For example, in August 2021, the SEC approved two board diversity proposals filed by the Nasdaq Stock Market. Collectively, those new rules are intended to promote various forms of diversity among the boards of directors of Nasdaq-listed companies and foster greater transparency in corporate decision-making with respect to diversity. Among other things, the newly approved rules require Nasdaq-listed companies to disclose information about the voluntary self-identified gender, underrepresented minority, and LGBTQ+ status of the company's board of directors, on an annual basis no later than the date a company files its proxy statement or information statement.

When implementing the newly promulgated rules, issuers should ensure that their disclosures are accurate and address exchange-mandated requirements. Doing so will be critical in the light of the fact that, as the SEC noted in its Nasdaq adopting release, "investors are increasingly demanding diverse boards and diversity-related information about public companies."[5]

BEST PRACTICES

In anticipation of the next wave in ESG-related litigation and the SEC's ongoing ESG focus (and the potential for enforcement actions), officers and directors should focus on ensuring the accuracy of ESG-related disclosures and developing robust policies and procedures regarding the evaluation of ESG-related issues. Companies should consider the following potential risk-mitigation measures:

- Closely examining investor communications related to ESG issues like board diversity and climate change—whether made in SEC filings, press releases, or other media—to ensure that they accurately reflect the actions that are being undertaken with respect to diversity initiatives, climate change disclosures and other ESG matters.
- Ensuring that governance and oversight committees focused on ESG-related topics work closely with directors and officers so that management and operational personnel remain well-informed about how these topics impact corporate decision-making.
- Reviewing existing policies and procedures regarding ESG-related topics on a regular basis and updating those policies and procedures as necessary in the light of regulatory rulemaking.
- Seeking the advice of counsel and auditors when considering the materiality of risks related to ESG-related issues, in the face of litigation

[5] https://www.sec.gov/news/public-statement/statement-nasdaq-diversity-080621.

trends and changing disclosure rules issued by exchanges and regulators.

TAKEAWAYS

- Although the courts have not been receptive to the most recent round of ESG-related lawsuits, future plaintiffs are unlikely to be deterred from filing additional securities and derivative actions.
- Companies should closely examine policies and procedures regarding ESG issues, including board diversity and climate change, and should ensure that their disclosures are complete and accurate.
- While the courts are deciding the contours of private ESG litigation, market participants should be mindful that ESG remains an enforcement and rulemaking priority for the SEC.