Corporate Counsel

How Public Companies Can Minimize Risks Resulting From a Post-COVID-19 Focus on ESG Issues: Part II

In Part I, we discussed securities law claims that may arise from a company's failure to meet its own ESG-related standards. Here, in Part II, we focus on potential claims that a company's ESG disclosures mask poor financial performance, as well as other legal risks associated with ESG.

By **Todd G. Cosenza and William J. Stellmach** | May 19, 2020

In Part I of this article, we introduced the litigation risks that may arise from a company's focus on environmental, social, and governance ("ESG") issues, which appear to be receiving heightened attention amid the COVID-19 pandemic. In Part I, we discussed securities law claims that may arise from a company's failure to meet its own ESG-related standards. Here, in Part II, we focus on potential claims that a company's ESG disclosures mask poor financial performance, as well as other legal risks associated with ESG.

Securities Law Claims Relating to Financial Performance As discussed above, shareholder plaintiffs may challenge ESG disclosures to the extent that a company fails to live up to its own touted standards. Additionally, ESG disclosures may expose a company to very different, but equally troublesome, claims that the company has promoted ESG factors in order to mask poor financial performance.

Notwithstanding certain shareholders' increased appetite for socially conscious investments, many investors continue to adhere to the traditional view that a corporation's principal goal is to maximize shareholder value. This approach was most notably synthesized by economist Milton Friedman, who, in response to the notion that corporate executives have "social responsibilities," explained, "in his capacity as a corporate executive, the manager is the agent of the individuals who own the corporation or establish the eleemosynary institution, and his primary responsibility is to them."

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

Putting aside the philosophical debate regarding what a corporation's "primary responsibility" should be, companies should consider the real consequences of a modern approach that relegates shareholder value to a position of lesser importance. Investors already have, and undoubtedly will continue to, claim that the elevation of ESG factors "can allow executives to set their own criteria for success and let them off the hook for poor financial performance." Andrew Hill, The Limits of the Pursuit of Profit, FINANCIAL TIMES (Sept. 23, 2019) (describing "[o]ne of the main criticisms of the stakeholder approach").

The recent failed IPO of WeWork exemplifies the pitfalls of the elevation of ESG factors over traditional financial performance metrics. In valuing itself, WeWork relied on its own "community-adjusted EBITDA" calculation, which accounted for several ESG factors, as well as other non-GAAP financial measures. The use of these figures drew skepticism and criticism from both potential investors and regulators. As one analyst commented, "companies invent these measures to take numbers they don't love, but are required to report, and turn them into results that look more attractive in their earnings releases." Alison Griswold, Get Ready for Some Creative Accounting in WeWork's IPO Filing, Quartz (Aug. 13, 2019). Shortly before WeWork canceled its IPO, the SEC provided negative feedback regarding the company's use of non-GAAP financial metrics in its draft prospectus. Jean Eaglesham & Eliot Brown, WeWork Was Wrestling With SEC Over Key Financial Metric Just Before It Scrapped IPO, WALL STREET JOURNAL (Nov. 10, 2019).

To minimize the risk of liability based on the use of nontraditional performance metrics, companies should strive to keep ESG disclosures separate from descriptions of financial performance. At the very least, any use of ESG-adjusted financial metrics should be accompanied by conspicuous disclaimers.

Additional ESG Risks

As discussed above and in Part I, ESG disclosures present a host of risks in the context of federal securities laws. To be clear, such disclosures also give rise to litigation and enforcement risks in other areas, which warrant brief discussion.

Although the disclosures which expose a company to liability in private securities litigation present similar risks of federal government action, the current administration has not shown an appetite to pursue enforcement or civil actions based on companies' failures to meet ESG goals. This could change, particularly under future presidential administrations, and particularly in the area of environmental issues.

In contrast, certain state and local governments have aggressively pursued investigations and lawsuits against companies relating to climate change and other environmental issues. These investigations and lawsuits may very well expand into other issues as ESG gains more prominence. For example, the COVID-19 pandemic could give rise to a number of such actions (relating to, e.g., the furloughing of employees and reduction in employees' pay, on the one hand, or the decision to resume certain business operations earlier than recommended by public health authorities, on the other hand).

For the most part, claims that corporate directors and officers breached fiduciary duties or duties of loyalty by failing to prioritize ESG factors have not been successful. Notably, however, there has been appetite to approach these claims differently. Chief Justice Strine (whose advocacy of ESG in the wake of the COVID-19 pandemic is quoted in Part I) dissented from a decision in which the Delaware Supreme Court dismissed Caremark claims against the board of Duke Energy Corporation brought in the wake of a coal ash spill. Chief Justice Strine wrote: 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 cost of operations, and by that means, increase its profitability. This, fiduciaries of a Delaware corporation, may not do. City of Birmingham Ret. & Relief Sys., 2017 WL 6397490 (Del. Dec. 15, 2017) (Strine, C.J., dissenting).

Conversely, just as a company's reliance on ESG factors may expose it to claims that it has misrepresented its true financial performance in violation of the federal securities laws, a company's diversion of resources for ESG purposes may give rise to derivative claims against the company's officers and directors. For example, if a corporate executive decides to provide the company's employees with additional paid time off in response to the COVID-19 pandemic, shareholders may claim, derivatively on behalf of the company, that the executive breached a duty by failing to manage the company's costs at a time when revenue is declining rapidly.

Conclusion

In response to increasing pressure from activists, government authorities, and, most importantly, investors, a growing number of companies are embracing ESG issues. The COVID-19 pandemic appears to be hastening the growth of this new outlook on corporate responsibility. As companies begin to prioritize issues such as climate change, workplace misconduct, safety, and social justice, it is important to anticipate the risks that arise from a commitment to ESG issues and to minimize those risks through the use of carefully drafted disclosures.

*The authors wish to thank Willkie associate **John L. Brennan** for his contributions to the article.*

***Todd Cosenza** is a partner in the Litigation Department and Vice-Chair of the Securities Litigation Practice Group at Willkie Farr & Gallagher LLP in New York, where he focuses on complex financial litigation. **Bill Stellmach**, former head of the Fraud Section of the U.S. Department of Justice's Criminal Division, is a partner in Willkie's Litigation Department in Washington and Co-Chair of the firm's White-Collar Defense Group. His practice focuses on representing companies, financial institutions and their boards and senior officers in internal and government-facing investigations and enforcement actions, and enhancing compliance programs.*

WILLKIE

WILLKIE FARR & GALLAGHER LLP