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ESG REPORTING ISSUES AND SECURITIES LITIGATION RISK

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Investors are increasingly considering the Environmental, Social and Governance (ESG) credentials of publicly listed issuers when making investments. This has put ESG disclosures (including climate change-related disclosures) in annual reports and prospectuses under intense scrutiny, meaning issuers are at risk of investor and activist claims if those disclosures are inaccurate.

Experience from other jurisdictions (in particular the US) shows that investors are willing to pursue large-scale group claims against companies for inaccurately representing their ESG credentials, and given the growth in the UK securities litigation market more generally, we anticipate that investors in this jurisdiction are likely to follow suit.

What is ESG investing?

ESG investing (also known as sustainable or socially responsible investing) considers environmental, social and governance factors, alongside financial factors, in the investment decision making process.

The growth of ESG investing in recent years has been dramatic – as traditional investors have increased their focus on ESG factors, and new funds with specific ESG mandates have come into the market. Investment in ESG-friendly assets grew to over $30.7 trillion globally in 2019, an increase of over 70% since 2015. Sustainable investment funds, which only invest in companies with strong ESG credentials, have grown even more rapidly: at the end of 2019, assets held in European sustainable investment funds reached €668 billion, up 56% on the previous year.

ESG reporting in the UK

The relevant statutory framework is principally contained in the amendments to the Companies Act 2006 introduced by the Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016 (implementing the EU Non-Financial Reporting Directive). This requires companies to publish information relating to certain ESG matters in their annual reports such as the impact of activity relating to environmental issues, employee welfare, and respect for human rights. Additional specific disclosure obligations are contained in the Climate Change Act 2008 and the Modern Slavery Act 2015. For financial years starting after 1 January 2019, large companies are required to describe in their strategic reports how directors have had regard to the Companies Act 2006 directors' duty factors, which include the impact of the company's operations on the community and the environment and the company's reputation. The UK Corporate Governance Code 2018 seeks for companies to go one step further and describe how these factors have been considered in board discussions and decision-making. Clifford Chance's briefing with practical guidance on these issues is available **here**.

The statutory framework is supplemented by guidance published by the London Stock Exchange (the *"Guidance for issuers on the integration of ESG into investor reporting and communication"*), which adopts the recommendations published by the Task Force on Climate-related Financial Disclosures (TCFD). This guidance identifies eight priorities for climate risk-related reporting, which include reporting on how a company's core business models and strategies may be impacted by climate trends (strategic relevance), identifying, by way of a materiality assessment, the issues that will influence stakeholders and should be reported (investor materiality) and providing timely, accurate, comparable and consistent data (investment grade, 'decision useful' data) to investors. The EU's Taxonomy Regulation requires certain financial market participants to disclose the alignment of their investments with the detailed environmental sustainability (and 'social' – labour, human rights etc) criteria in the Regulation – Clifford Chance's briefing on the Regulation is **here**.

The FCA is due to publish a consultation paper later this year in which it aims to clarify ESG disclosure obligations for companies and to ensure that the existing rules align with the TCFD's recommendations (albeit this consultation has been extended due to delays caused by Covid-19). The FCA has noted that, at present, there is a lack of consistency in the approach taken by issuers to their ESG disclosures, which is impeding investors in appraising and comparing the ESG credentials of companies (see its Discussion Paper on Climate Change and Green Finance (DP18/8)).

Shareholder activism

In tandem with the growth of ESG investing, sustainability-focused shareholder activism has also increased. Shareholder activism has acted as a catalyst for companies to take ESG seriously (particularly in the oil and gas sector and, increasingly, the finance sector), and ensure that policies are in place to make certain that the company's strategy is in line with wider societal environmental goals.

For example, at BP's 2019 AGM, two special resolutions in relation to climate change issues were requisitioned by shareholder groups coordinated by Climate Action 100+ and Follow This. One of these resolutions sought that BP include in its annual report from 2019 onwards a progress report describing how its business strategy is consistent with the objectives of the Paris Agreement, supported by information relating to relevant capital expenditure, metrics and targets. This resolution was passed at the AGM with the support of 99% of shareholders, demonstrating the importance to investors of ESG credentials and their disclosure.

Given that investors are already taking active steps to ensure that companies comply with their obligations to disclose adequately their ESG credentials, we anticipate that activists and investors will also focus on holding companies to account (in particular through shareholder group claims) where those disclosures are inaccurate.

Securities litigation risk

Where a company's disclosures are revealed to the market to be incorrect, often through a high-profile scandal or regulatory intervention, it may cause the share price of the company to fall rapidly (known as a "stock drop"). Shareholders may bring claims to recover losses suffered as a result of the drop.

There has been a marked uptick in these types of claim (known as "securities litigation") in recent years, both globally and in the UK. In this jurisdiction, the growth of this sector is due to a number of factors, namely: readily available third-party litigation funding and 'After the Event' insurance, the use of group litigation orders, and the rise of claimant law firms/claims management companies which actively seek out potential claims. These factors have removed the barriers which previously faced these claims.

As the growth of ESG investing has led to increased scrutiny of ESG disclosures in annual reports, and investors increasingly rely on this information when deciding whether or not to invest in a particular company, the risk of securities litigation as a result of inaccurate ESG disclosures is particularly acute. Other factors that may serve to foster such claims include the predicted market and regulatory volatility surrounding ESG and climate change issues creating the conditions for a stock drop, and the risk of developing terms and concepts being used in disclosures without proper subsequent implementation in practice.

Securities litigation: the statutory framework

Section 90A FSMA provides the basis of liability where an issuer makes an untrue or misleading statement or omission in published information (other than listing particulars or prospectuses), such as annual reports and accounts.

Under s90A, claimants must prove that they acquired, continued to hold or disposed of shares in reliance on the published information and suffered loss as a consequence of the misstatement or omission and in circumstances where such reliance was reasonable.

No claims under s90A have reached judgement, so this is still a developing area of law. A key area of uncertainty under s90A is that claimants must have relied on the published information. This is likely to be a significant (and often insurmountable) hurdle for investors in most cases.

The statute is clear that claimants need to have acquired, continued to hold or disposed of shares in reliance on published information. In the case against Tesco, where profits were overstated in an annual report, the claimants were ordered to provide particulars of their respective reliance specifically on the incorrect statement, which is a difficult element to analyse when investment decisions are usually made on the contents of the report holistically, with no particular dependent elements.

However, in relation to ESG-based claims, the reliance requirement may be more easily established, removing a significant barrier to a successful claim. This is because compliance with particular ESG goals is often a documented threshold requirement for ESG-conscious investors, such that they will not invest in a particular company unless it has strong ESG credentials. For example, a sustainable fund, in order to comply with its investment mandate, may only be permitted to invest in companies which predominantly consume renewable energy, and so they are likely to be able to establish that they relied on any statement to that effect in a company's annual report. If that statement is revealed to be incorrect, causing a stock drop, investors may well be able to successfully bring a claim against the company for their losses.

ESG-related litigation in other jurisdictions

Around 1700 climate change cases have been filed in over 30 jurisdictions globally, over 1150 of which were brought in the USA. Thirty seven of the cases filed in the USA were securities litigation claims based on inaccurate ESG disclosures in SEC filings.

Examples of ESG-related claims include those against Yum! Brands Inc., Darigold, Inc., Walmart Inc., BP PLC and ExxonMobil. For a detailed analysis of the ExxonMobil shareholder litigation, and securities-based climate litigation in the US more generally, see Clifford Chance's briefing **here**.

We anticipate that the US experience may be replicated in the UK in due course.

Clifford Chance and securities litigation

Clifford Chance is at the forefront of this developing market and we are uniquely placed to guide issuers and others through the evolving landscapes of UK securities litigation, as well as having a deep understanding of the ESG and climate change issues that may form the basis of future securities litigation. For further information, visit our Climate, Sustainability, Green Finance and Renewables Thought Leadership hub **here**.

As well as extensive experience in the UK, our US litigation practice has over 30 years of experience of US class actions – and so we are able to leverage that expertise in order to anticipate the direction of travel in this expanding area of the law.

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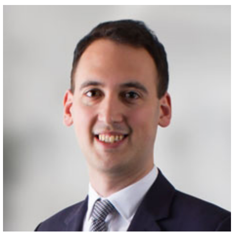

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