

# ESG Litigation Risk

## Climate Lawsuits Dominate, but Scope Is Widening

'The primary risks to issuers facing ESG litigation may not be financial, but reputational and operational. A judgement in the plaintiff's favour could mean costly changes to business-as-usual for a company.'

Nneka Chike-Obi, Sustainable Fitch

As investors have called for more sustainability data in recent years, regulators in major markets have introduced mandatory reporting requirements for certain types of entities. These rules, combined with existing legislation, have intensified ESG-related litigation risk for reporting entities. A growing number of lawsuits on the basis of ESG statements in securities filings, including bond offering documents, have been filed against corporations and governments.

### Regulatory Developments Raise ESG Litigation Risks

The US provides the most scope for investors to sue based on information in securities documentation, but legal developments in several countries have increased the amount of litigation taking place in other markets. The rise in both ESG-focused financing and ESG information in corporate reporting has created more opportunities to identify potential harm to investors, where information is alleged to be misleading, omitted, or deceptive, all of which can form a basis for a lawsuit. The main risks to issuers from the rising incidence of climate-related, or more broadly ESG-related, litigation are not financial but strategic and operational, as many ESG lawsuits seek structural changes in business practice rather than financial restitution.

Litigation is one of the main transmission mechanisms of ESG issues to credit risk. Its rising prominence is therefore of potentially high relevance and materiality for issuers in many sectors.

### Climate Litigation Targets Governments, Fossil Fuel Sectors

There have been more than 1,800 climate-related lawsuits filed worldwide, three-quarters of which are in the US, according to the Grantham Institute and the Sabin Center for Climate Change Law. Most suits involve groups suing government entities over their enforcement of climate change policy. Sectors with sizeable emissions impacts, such as oil and gas, utilities and vehicles, are frequent targets of corporate climate litigation. Among securities lawsuits, judges have not consistently agreed with investors that financial losses due to climate-related issues were intentional or avoidable by the plaintiffs – although cases seeking policy changes rather than compensation, or those with corresponding criminal/regulatory enforcement actions have been more successful.

### ESG Trends Point to Litigation Priorities

While there has been a heavy focus on environmental-related litigation, the development of the sustainable finance field is likely to determine which ESG issues feature in lawsuits. Societal trends and major events like the Covid-19 pandemic are reflected in pending cases. Growing importance of social factors within corporate sustainability frameworks may create new areas where investors or consumers identify gaps between disclosures and practices.

#### Related Research

[Climate Legislation to Hasten Business Model Changes, Affecting Credit Profiles Over Time \(March 2021\)](#)

[Enhanced Climate-Risk Disclosure Will Challenge Some US Corporates \(October 2021\)](#)

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## ESG Disclosures Can Form the Legal Basis for Civil Litigation

### Legal Framework in Key Markets

A stakeholder's right to pursue civil remedies varies depending on jurisdiction, but the scope of information that can form the basis of a lawsuit is expanding with greater inclusion of ESG. In the credit market, this includes sustainable finance frameworks, sustainable bond documentation and any other sustainability information contained in material related to the solicitation of investment.

Historically, regulatory filings or annual reports have included financial, operational and strategic data. ESG emerged as a new framework before financial regulators could fully consider how it fits alongside traditional reporting.

A potential liability occurs when sustainability disclosures are false, misleading, or cannot be substantiated, causing financial harm to an investor. The negative financial impact is the basis of a civil claim under securities law. Companies that engage in so-called greenwashing in securities documentation are therefore at heightened risk of investor-related litigation.

**Greenwashing:** An activity undertaken by a company that misleads investors or customers into believing it is more environmentally sustainable than it is.

The US Securities Act of 1933 governs all securities issued federally and has two components of particular relevance to ESG litigation:

1. the requirement for a prospectus to include accurate and truthful information about the securities and issuer; and
2. civil liability for the issuer that can be pursued by any investor that purchased securities based on misleading statements.

The Securities Exchange Act of 1934 created the Securities and Exchange Commission (SEC) and placed an additional liability on misleading information filed with the agency.

This legislation has made the US a hub for investor-led lawsuits. While most corporate litigation occurs in US courts, the size of its financial market means that non-US entities can be subject to litigation in the US, including those that do not have a physical presence in the country. Several securities class action lawsuits have been on behalf of investors holding American Depositary Receipts (ADR) in foreign companies.

Australia is the second-largest jurisdiction for corporate class actions after the US, with 20% of global cases related to shareholder claims, according to data from Allens law firm. A 1992 amendment to the Federal Court of Australia Act introduced "representative proceedings", another term for class actions. As a common law jurisdiction, case law is the main driver of legal change. For example, in *Sharma v Minister for the Environment (2021)* about a coal mine project, the Federal Court of Australia established a new duty of care for the ministry – the avoidance of causing personal harm to children. This creates a precedent for suits related to negative environmental impacts on young people.

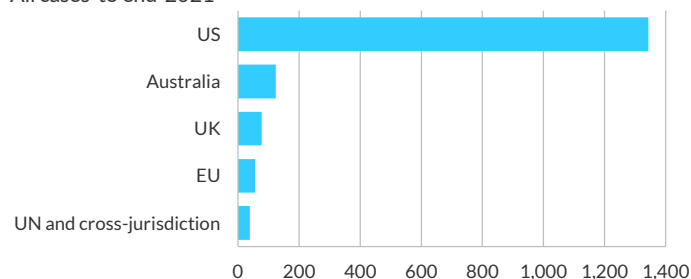
The UK could become a venue for more ESG-related lawsuits due to recent legal developments. In 2015, limits on the use of collective or representative actions (equivalent of US class actions) were loosened for violations of competition law, leading to an increase in these types of cases. There has also been a rise in filings of actions unrelated to competition by parties seeking to establish precedence for similar treatment of harm related to corporate activity.

Under Section 90A of the 2006 Financial Services and Markets Act, issuers can be liable to investors who have suffered a loss due to misleading statements or dishonest omissions in securities documentation. The first shareholder action trial under the regulation (*SL Claimants v Tesco Plc*) was scheduled in October 2020, but the parties settled just before reaching court.

The EU approved the Representative Actions Directive in November 2020, which allows some groups to pursue claims similar to a class action. Only qualified entities are able to file suits; they must be non-profit independent organisations with "a legitimate interest in consumer protection". In its current form, the law would not apply to investments, but could be used to bring a claim of consumer harm related to environmental or social risk factors.

### Climate Change Litigations Filed by Geography

All cases to end-2021



Source: Fitch Ratings, LSE, Columbia University

Government-imposed ESG disclosure rules expose companies to several specific litigation risks. For companies subject to investor protection laws, a requirement to include ESG information in formal filings or documentation broadens the company's liability to shareholders and bondholders. Under a regime that allows class actions, customers, communities, NGOs and other stakeholders could also have standing to file suit on the basis of ESG information reported to investors, even if they are not investors themselves.

While both of these risks already exist, we expect that an increase in sustainability data and disclosures available to the public following a disclosure regulation would create more scope for lawsuits. The 2023 introduction of mandatory ESG disclosures under the EU's Corporate Sustainability Reporting Directive will apply to about 50,000 companies operating in the region regardless of their main domicile.

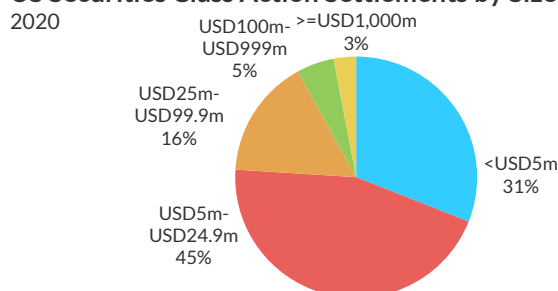
### Implications for Credit Issuers

An important consideration is the plaintiffs' intended purpose in filing ESG lawsuits. In many cases, the aim is to change the defendant's behaviour, rather than to be granted a financial award. Examples include suing for a change in company or government policy, discovery of internal documents, or inclusion of activist shareholder proposals in regulatory filings.

This means that the primary risks to issuers facing ESG litigation may not be financial, but reputational and operational.

A settlement or judgement in the plaintiff's favour could mean costly changes to business-as-usual for a company. Nonetheless financial settlements can be sizeable; US cases with institutional investors or pension plans as lead plaintiffs, or those where the SEC also takes enforcement action, are associated with larger settlements and financial judgements.<sup>1</sup>

### US Securities Class Action Settlements by Size



Source: Fitch Ratings, Cornerstone Research

The rapid growth in the sustainable bond market means that a much larger number of issuers have securities documentation that includes ESG information. Issuers are responsible (and therefore potentially liable) for every statement made within a bond prospectus or sustainable financing framework, and these could become the subject of securities litigation.

Issuers can mitigate exposure to litigation risk from sustainable bonds issuance by aligning instruments to international best practices such as the ICMA principles, and using reputable external reviewers for pre-issuance evaluation.

Banks could also be affected; an English court ruled that arranging banks have a duty of care with regard to new securities issuances and can be liable for investor losses due to execution errors.<sup>2</sup>

Some of the key ratings factors in Fitch Ratings' [Corporate Rating Criteria](#) could be affected by an ESG lawsuit. Under Corporate Governance, Fitch defines financial transparency as "how easy it is for investors to be in a position to assess an issuer's financial condition and fundamental risks". A claim that a company obfuscated its exposure to environmental risks could require re-evaluation of the its performance in this area. Credit ratings are sensitive to analysts' forward-looking opinions on industry risk (e.g. long-term growth prospects) and financial risk (e.g. impact of operational developments on issuer's financial profile). Fitch includes litigation risk as a [sector-specific key factor](#) for several industries, including tobacco, insurance broking/services and medical devices, where there is a history of large settlements and regulatory changes that have affected how those industries operate.

<sup>1</sup>"Securities Class Action Settlements – 2020 Review and Analysis," Cornerstone Research

### SEC Climate Change Disclosure Consultation

In March 2021, the SEC requested comments on the introduction of climate change disclosures and received about 550 formal responses. Many called for climate change reporting to be included in SEC filings and audited financial statements, among them a global investor group coordinated by NGO Ceres representing USD2.7 trillion in assets under management. Inclusion in regulatory filings, such as Form 10-K, would create a clear litigation risk under the Exchange Act.

Others acknowledged the importance of climate change information but preferred it to be in furnished disclosures, which are not subject to the same legal liability as filings. Commenters suggesting a limit or "safe harbour" on civil liability and SEC enforcement associated with forward-looking climate change disclosures include the International Capital Markets Association (ICMA), the Institute of International Finance, the National Association of Bond Lawyers (NABL) and the Sustainability Accounting Standards Board.

Some respondents addressed the specific challenges that could face bond market participants. The NABL and the Credit Roundtable, which represents US-based asset managers, highlighted that many bond issuers are privately-held companies, small market cap public companies, and municipalities that have various limitations on their ability to deliver comprehensive climate-related data in the short term.

The SEC plans to announce its climate reporting policy in early 2022.

## Climate-Focused Litigation Is an Emerging Risk

Most climate lawsuits fall into one of three categories:

1. Suing a government over climate change policies; seeking damages or a change in law;
2. Suing a corporation for contributing to climate change; seeking damages or a change in its operations, practices, or strategy; and
3. Suing an entity over misleading climate claims in securities documentation; seeking damages or a change in its operations, practices, strategy, or law.

About 1,800 climate change lawsuits have been filed to date, and most cases have a government as defendant – about 75% of all cases in Australia and the UK, and 88% of US cases in 2020 and 2021.<sup>3</sup> Most cases are brought by NGOs on behalf of a community, on the basis that a government has failed to mitigate climate change. Lawsuits against governments in Colombia, France, Ireland, Mexico, Nepal, the Netherlands and Spain have been decided in favour of environmental groups and resulted in policy changes on emissions, national climate plans and renewable energy.

<sup>2</sup> *Golden Belt v BNP Paribas*, 2017

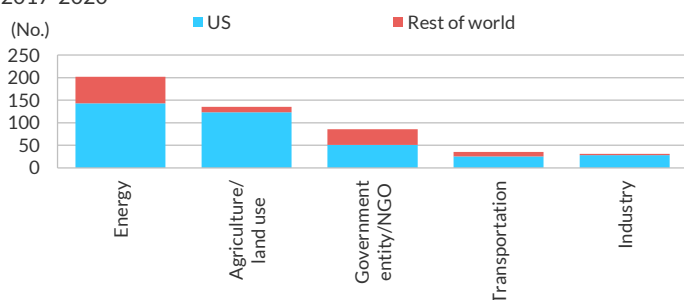
<sup>3</sup> Grantham Research Institute, Sabin Center for Climate Change Law

There are also suits from industry seeking to amend climate policy. The American Petroleum Institute, which represents oil companies, has repeatedly sued the US Environmental Protection Agency over emissions rules and fuel standards, and has been successful in overturning some regulations.

Within corporate litigation, climate change is a small but growing subject, and the energy sector is a major target due to its significant contribution to greenhouse gas emissions. In 2021, Dutch courts ruled against **Royal Dutch Shell plc** (AA/Stable) in a landmark class action suit (*Milieudefensie et. al. v Royal Dutch Shell plc*), requiring the company to reduce its Scope 1, 2, and 3 emissions by 45% by 2030. Shell has filed an appeal. There are several active cases by US state and local governments against oil and gas companies that have yet to be decided or are under appeal. A notable example is City of Baltimore’s lawsuit against 26 fossil fuel companies over physical climate risk because it is “particularly vulnerable to sea level rise and flooding”.<sup>4</sup>

### Climate Litigation Cases, Top Defendant Sectors

2017-2020



Source: Fitch Ratings, LSE, Columbia Law School

Among climate-related securities lawsuits, some cases seeking a change in corporate climate strategy have been successful for plaintiffs. The New York City Employees’ Retirement System sued aerospace manufacturer TransDigm Inc. in 2017 for failing to include its shareholder proposal on climate change in proxy materials. The settlement required the defendant to develop a comprehensive emissions policy. In *McVeigh v Retail Employees Superannuation Trust* (Australia 2020), the pension fund agreed to incorporate climate risks and set a 2050 net zero target. A similar Australian shareholder case against the Commonwealth Bank of Australia (CBA; A+/Stable) in 2017 also led to a settlement requiring CBA to institute a climate change policy.

There is more of a mixed picture in securities cases pursuing financial remedies to investment losses. Holders of employee pension plans at three American fossil fuel companies – Arch Resources, Inc., Peabody Energy and ExxonMobil Corporation – filed suits in 2015 and 2016 arguing that continuing to purchase the company’s own shares was a breach of fiduciary duty, given the negative effect of climate regulation on the coal and oil sector’s financial outlooks. All three cases were dismissed because courts concluded that a company’s declining financial performance is not in itself a reason for employee pension funds to divest its shares, even though Arch and Peabody filed for bankruptcy in 2016.

Lawsuits associated with high-profile incidents involving criminal and regulatory penalties have been more likely to end in a financial

settlement or judgement in the plaintiff’s favour, such as the **diesel emissions scandal** in the mid-2010s involving automotive manufacturers. In 2019, Fiat Chrysler (now Stellantis N.V.; BBB-/Positive) settled two lawsuits over the issue, paying USD307.5 million to vehicle owners and USD110 million to investors who purchased shares between 2014 and 2017. Volkswagen AG (BBB+/Positive) agreed a settlement with US ADR investors for USD48 million in 2019, while cases brought by German shareholders and American bondholders have yet to be decided; by 2020, it had also agreed settlements to car owners of more than USD1 billion worldwide.

Many cases that could set precedence in the area of climate litigation have yet to be decided. Cases to watch with relevance to the credit market include:

*York County v Rambo* (US 2019): Bond investors claim utility PG&E Corporation made misleading statements about climate change and wildfire resilience in offering documents for USD4 billion of bonds. The company filed for **bankruptcy** following catastrophic fires in 2017 and 2018.

*O’Donnell v Commonwealth* (Australia 2020): Class action suit against the Australian government for failing to disclose material climate change risks to retail sovereign bond investors.

*ClientEarth v Belgian National Bank* (2021): environmental NGO claims that the National Bank of Belgium violated EU law on climate, the environment, and human rights by purchasing fossil fuel company bonds under the ECB’s Corporate Sector Purchase Program (CSPP) launched in 2016. ClientEarth has also asked the European Court of Justice to evaluate the legality of the CSPP.

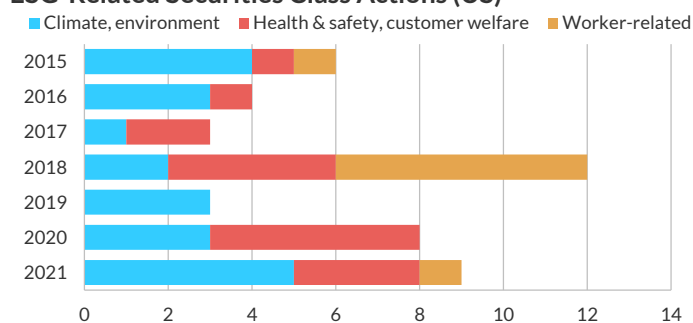
In our view, the main consequences of climate lawsuits against governments are regulatory and policy changes that could significantly alter the operating environment for carbon intensive industries. We do not see a direct link between climate lawsuits and credit risk impact for sovereign or public finance issuers themselves at this time. For lawsuits against companies, a ruling leading to a change in business strategy or operations would have a greater effect on medium- to long-term credit profiles than financial settlements or fines.

### Litigation Priorities to Widen Based on ESG Trends

As sustainable finance priorities expand beyond climate change, there are several other ESG topics where litigation could become more common. Regulations targeting **modern slavery**, **deforestation**, **labour conditions** and **supply chain due diligence** will increase the amount of reporting on these subjects. There has also been growth in social and sustainability bond issuance from corporates and financial institutions in recent years. While most ESG-related securities class action lawsuits have a climate or environmental basis, societal trends can influence year-to-year swings in certain areas – for example, six cases in the US related to workplace discrimination, harassment, or abuse in 2018 following the emergence of the #MeToo movement in the previous year.

<sup>4</sup> *Mayor and City Council of Baltimore v. BP plc et. al.*, 2018

### ESG-Related Securities Class Actions (US)



Source: Fitch Ratings, Stanford Law School

We anticipate the following topics will gain momentum within ESG litigation.

#### Greenwashing

Consumer class actions filed in 2021, such as *Hanscom v Reynolds Consumer Products*, *Dwyer v Allbirds, Inc.*, and *Vegetarian Society of Denmark v Danish Crown (Corporation)*, point to marketing claims about environmental and social practices (e.g. recyclability, animal welfare) that are potentially misleading. Two US investor class actions filed in 2021 – involving a food and beverage company (Oatly Group AB) and a biotechnology manufacturer (Danimer Scientific) – specifically mention greenwashing.

#### Data Privacy

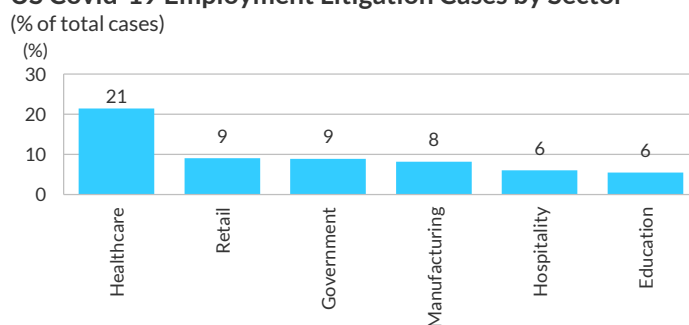
Targeted legislation like the EU's [General Data Privacy Regulation \(GDPR\)](#), and similar laws in Australia and parts of the US have raised the importance of data privacy management for corporates.

Companies that handle large amounts of consumer data have been subject to securities class action lawsuits over disclosures about their data privacy practices. There is ongoing litigation involving Nielsen Holdings plc, Snap Inc., Didi Global Inc., and Zoom Video Communications, Inc.

#### Health and Safety, Labour-Related Issues

The pandemic has contributed to greater awareness of health risks for employees and customers. There have been more than 4,200 Covid-19-related employment lawsuits in the US since January 2020, the largest share coming from the healthcare sector.<sup>5</sup> There are a small number of securities lawsuits based on how companies communicated the health and safety impact of the pandemic on their operations to investors. These include cases against cruise operators (Royal Caribbean Cruises, Norwegian Cruise Line, Carnival Corporation) and a REIT that manages detention and residential treatment facilities (The Geo Group, Inc.).

#### US Covid-19 Employment Litigation Cases by Sector



Source: Fitch Ratings, Fisher & Phillips LLP

<sup>5</sup> Fisher & Phillips LLP

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