English ESG Litigation Against Directors

The salience of environmental, social and corporate governance (ESG) issues continues to rise. As it does, so too does the salience of litigation intended to influence corporate behaviour on these issues, including litigation personally targeting company directors. The potential for litigation against directors in relation to ESG issues has been trailed for some time by figures from the former Governor of the Bank of England Mark Carney, to the Supreme Court justice Lord Sales.

Yet despite that potential, ESG litigation targeting directors has had little success before the English Court. This article examines one avenue for such litigation - shareholder derivative claims - in the context of the recent high profile claim by climate NGO Client Earth against Shell's directors. It considers the reasons why this claim did not succeed – and the reasons why analogous claims are unlikely to succeed. And it concludes by exploring the alternative ESG claims that might be brought against directors in future; as well as how directors can help protect themselves from the risk of such litigation.

I. Derivative Claims

Concept

Shareholder derivative claims are claims brought (a) by shareholders of a company, (b) on behalf of that company, (c) against the directors of that company, (d) on the basis of those directors having breached the duties they owe to that company. Such claims operate as an exception to the rule that it is for the company - not individual shareholders - to determine whether or not to pursue a cause of action it holds (per *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189). The need for that exception is clear: if a company's directors have wronged the company, they are unlikely to begin proceedings against themselves.

Duties

Under the Companies Act 2006 (**CA 2006**), directors owe a variety of duties to their companies. Two key duties are the s172 duty to promote the success of the company, and the s174 duty to exercise reasonable care, skill and diligence.

The s172 duty requires that "*a director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole*". In doing so, the director must "*have regard*" to a number of factors, including the long term consequences of a decision, its impact on the environment and community, and its effect on the company's reputation.

Three elements of this duty bear further comment. First, the s172 test is *subjective*. Breaching s172 requires proof of conduct other than in good faith - irrationality on its own will not suffice (see [30], *Client Earth v Shell PLC & Ors* (2023) EWHC 1897 (Ch)). Second, the duty to "have regard" to other matters is precisely that - the director must consider these other matters, but he may decide that acting in the best interests of the company requires that he disregard them[1]. Third and relatedly, the duty to "have regard" to other matters, is to "have regard" to them insofar as they affect the success of the company - not to "have regard" to them in themselves[2]. These three elements each manifest the same underlying principle: that the Court will be reluctant to supplant the directors in the exercise of their duties, and attempt to weigh commercial considerations it is ill equipped to judge (see [85], *Iesini v Westrip Holdings Limited* [2009] EWHC 2526 (Ch)).

The s174 duty requires that "*a director of a company must exercise reasonable care, skill and diligence*", such as "*would be exercised by a reasonably diligent person*" with: (a) the knowledge, skill and experience that might reasonably be expected of a person carrying out that director's functions; and (b) the knowledge, skill and experience the director actually has.

This test has both objective and subjective elements. The standard of a reasonably diligent person, and traits "reasonably expected" of that person, are both to be judged objectively. The traits a director actually has, must be assessed subjectively.

Breach

Directors may breach their section 172 or 174 duties, in the context of ESG issues, should their (in)action on those issues expose their company to one or more of the following risks:

a) *Publicity Risk*: the risk of harm to the company's image.
b) *Regulatory Risk*: the risk that the company will fall foul of regulations (under an existing or future regulatory regime).
c) *Market Risk*: the risk that the company will be inadequately prepared for shifts in demand, e.g. from fossil fuels to renewables.
d) *Liability Risk*: the risk of being claimed against for the negative impacts of ESG (in)action.
e) *Physical Risk*: the risk of direct damage to a company's operations, from e.g. the physical impacts of climate change.

The Process / The Test

Shareholders may bring derivative claims against directors, for breach of these duties, under s260(1) CA 2006. Once such a claim has been issued, the claimants must apply for permission to continue it, before taking any further steps in the proceedings (per s261(1) CA 2006).

The Court will first determine whether to permit the claim to proceed "on the papers", without a hearing. If the court decides against the claimant on the paper, they can request an oral hearing to reconsider the matter, within seven days of being notified of the Court's decision (CPR 19.15(10)).

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1 Butterworths Corporate Law Service, LNUK, August 2023, CL[23.30]

2 Ibid, CL[25.165E]

The test for permission to proceed has two stages[3]. First, the Court must refuse permission if either: (a) the complained of act has been authorised or ratified by the company; or (b) a person acting in accordance with the s172 CA 2006 duty to promote the success of the company, would not seek to continue the claim (s263(2)(a) CA 2006).

Second, if neither of these conditions apply, the Court then has the discretion to permit the claim. In exercising that discretion, the Court must take account certain factors, notably: (a) whether the claimants are bringing the claim in good faith; (b) whether the claim promotes the success of the company; and (c) whether the company would be likely to ratify the complained of act (s263(3) CA 2006). Finally, the company must have "*particular regard*" to (any evidence of) the views of members of the company who have no personal interest in the claim (s263(4) CA 2006).

The claimant must show a *prima facie* case for giving permission to pursue the claim – if they do not, the court must dismiss the claim (s261(2)(a) CA 2006). This in turn requires the claimant to show a prima facie case (a) that the company has a good cause of action; and (b) that that cause of action arises from a directors breach of duty (see [78], *Iesini v Westrip Holdings Limited* [2009] EWHC 2526 (Ch)). Note that a *prima facie* case is a higher test than a seriously arguable case; and requires a case sufficient to entitle the claimant to judgment, in the absence of an answer from the defendant ([53] *Abouraya v Sigmund* [2015] BCC 503).

II. ClientEarth v Shell

ClientEarth is an environmental NGO. In 2023, it began a high profile derivative claim against Shell's directors, primarily on the basis that those directors had breached their duties to Shell, under sections 172 and 174 CA 2006. The High Court has now twice refused to permit ClientEarth's claim to proceed: on the basis of written submissions and an oral hearing. ClientEarth has now announced it will appeal the latest of these decisions to the Court of Appeal.

The Claim

ClientEarth's claim began with the proposition that Shell needs to transition away from fossil fuels, as failing to do so exposes the company to unacceptable risks. These risks encompass regulatory, market and social risks, from the transition to a net-zero economy; as well as physical risks, from direct damage to Shell's operations caused by climate change.

ClientEarth argued that these risks directly engaged directors' s172 and s174 duties. Further, they engaged (what ClientEarth argued were) certain "necessary incidents" of these duties. Those "necessary incidents" were said to arise for directors of companies like Shell, in the current climate context, and included: (a) a duty to appropriately weight climate risk; (b) a duty to implement reasonable measures to mitigate climate risk; (c) a duty to adopt strategies reasonably likely to meet

[3] Though in practice, factors relevant to the second stage are relevant to the first - and thus the Court is likely to consider both stages together ([60] *ClientEarth v Shell plc & Ors* [2023] EWHC 1137 (Ch))

Shell's climate targets; and (d) a duty to ensure Shell took reasonable steps to comply with its legal obligations.

On ClientEarth's case, Shell's directors mismanaged the above climate risks, in breach of the above duties. They did so by: (a) failing to set sufficiently ambitious emissions targets, (b) failing to set a reasonable climate risk strategy; and (c) failing to comply with an order given in separate Dutch proceedings (which required Shell to cut its greenhouse emissions by 45% by 2030 relative to 2019).

The relief sought by ClientEarth was: (a) a declaration that Shell's directors had breached their duties in the manner described by ClientEarth; and (b) a mandatory injunction requiring the directors to implement a strategy to manage climate risk in compliance with their duties, and to comply immediately with the order in the Dutch proceedings.

Transnational Strategy

The third "transnational" breach alleged by ClientEarth is notable, since the level of "judicial restraint" shown towards climate litigation is likely to vary from country to country.

ClientEarth therefore appears to have attempted a "transnational" strategy in this instance, leveraging the successful Dutch litigation against Shell, to argue that Shell's directors were under a duty to take reasonable steps to ensure court orders were obeyed, and that that in turn placed Shell's directors under a duty to ensure Shell obeyed the Dutch order.

In the event, the Court determined that "*there* [was] *no established English law duty separate…from the general duties owed by the Directors… which requires them to take reasonable steps to ensure that the order of a foreign court is obeyed*" ([24] *ClientEarth v Shell plc & Ors* [2023] EWHC 1137 (Ch)). As such, this avenue for progressing shareholder derivative claims appears significantly narrowed, if not closed.

III. Challenges for future claims

As noted, the High Court has now twice refused ClientEarth permission to continue their derivative claim[4]. It did so pursuant to the "first stage" of the test for permission described above: holding that a person acting in accordance with the s172 duty to promote the success of the company would <u>not</u> have sought to continue the claim. Notably, in reaching this "first stage" decision, the Court also had regard to the "second stage" factors.

The High Court based this decision on a number of flaws in ClientEarth's claim; many of which appear "fundamental" to derivative litigation of this kind. Accordingly, and unless these judgments are overturned at any appeal, serious doubt must be cast on the future of ESG derivative action – especially as brought by activist shareholders.

[4] By judgments dated 12 May 2023 and 24 July 2023 - the latter of which largely restated the former

Evidence

To begin with, the Court took issue with the supporting evidence adduced by ClientEarth. This chiefly took the form of a witness statement by Mr Benson, a lawyer for ClientEarth, setting out ClientEarth's case, alongside relevant background information.

It was held that "*the court* [could] *place very little weight on the opinions expressed by Mr Benson*" (([24] *ClientEarth v Shell plc & Ors* [2023] EWHC 1137 (Ch)). This was because (a) the matters dealt with by Mr Benson's statement - such as climate science, fuel price forecasting, macroeconomics, and so on - were of a kind that properly required expert evidence; however (b) neither Mr Benson, nor ClientEarth his employer, were experts on these matters. A similar issue arose in a derivative action in *McGaughey v Universities Superannuation Scheme* [2022] EWHC 1233 (Ch), where the Claimants' evidence was also a witness statement collating opinions expressed elsewhere. In that case, such evidence was considered insufficient to establish loss from the defendant Directors' decision not to divest from fossil fuels.

The need to adduce expert evidence imposes a practical burden on future climate related ESG litigation – especially given the complexity of the topic may demand expert evidence covering many independent and specialist fields (as was the implication in ClientEarth). However this is certainly a surmountable obstacle for such claims – and is probably the least "fundamental" difficulty with ESG derivative litigation, illustrated by the ClientEarth claim.

Remedies

The Court further took issue with the relief sought by ClientEarth; holding both that it was unsuitable, *and* that its unsuitability affected whether permission should be given for ClientEarth's claim to proceed ([55] *ClientEarth v Shell plc & Ors* [2023] EWHC 1137 (Ch)). This is a notable finding, in circumstances where the statutory test for permission to proceed does <u>not</u> make any explicit reference to the adequacy of the relief sought by the claimants.

Specifically, the Court held that ClientEarth's proposed mandatory injunction was too vague, and thus would have required "*constant supervision*" by the Court. Such injunctions are to be rejected on principle (per [14A-B] *Cooperative Insurance Society Ltd v Argyll Stores (Holdings) Ltd* [1998] 1 AC 1), and because they would generate disruptive disputes over compliance, which would not benefit the company. As regards ClientEarth's proposed declaratory relief, the Court considered it would "have no substantive effect and [would] fulfil no legally relevant purpose" ([83] *ClientEarth v Shell plc & Ors* [2023] EWHC 1137 (Ch)).

Theoretically, future ESG litigants can avoid this issue by crafting alternative, more purposeful and specific, relief. However the practical objectives sought by these litigants – such as reduction of greenhouse gas emissions - appear best achieved by mandatory injunctions. To the extent such injunctions are ambiguous, they risk being rejected for requiring "*constant supervision*". But to the extent they are specific, they risk being rejected for placing the Court in the role of commercial-decision maker – a role that more properly belongs to the directors.

Discretion

In this vein, the Court's ClientEarth judgments emphasised the reluctance of the Court to interfere with directors' decision making, which required the balancing of many competing factors. Accordingly, to establish a breach of directors' duties, it was not enough to show that directors should have considered a particular factor. Rather, the evidence must go beyond this, and establish that the directors' could not have reasonably balanced factors in the manner that they did / that the directors' decision went beyond the range of decisions reasonably available to them ([631] *Sharp v Blank and others* [2019] EWHC 3096 (Ch)).

This would appear a high bar for an ESG litigant to clear, given they necessarily lack the directors' knowledge and expertise. This bar will be yet more difficult to clear: (a) at the preliminary permission-granting stage of proceedings, before the claimants have the benefit of disclosure concerning the directors' decision making procedure; and (b) where decisions are being made in respect of highly uncertain, long term considerations (as must be reckoned with in any climate strategy).

Good Faith

A further problem with ESG derivative claims, as illustrated by ClientEarth v Shell, is that derivative actions brought for ESG purposes may struggle to establish that they are brought in good faith. Per s263(3)(a), the Court must take this into account in making its permission decision.

Crucially, where a claimant would not bring a derivative claim, but for a purpose besides promoting the success of the company, that claim will not be in good faith ([113] to [121], *Iesini v Westrip Holdings Limited* [2010] BCC 420). In ClientEarth, the Court considered that ClientEarth's very small (27 share) shareholding in Shell, gave rise "*to a very clear inference that its real interest is not in how best to promote the success of Shell*" ([93] *ClientEarth v Shell plc & Ors* [2023] EWHC 1137 (Ch)).

This appears a fundamentally difficult inference for activist ESG litigants to overcome, for two reasons. First, it would likely be prohibitively expensive for such litigants to establish large shareholdings in prominent corporations like Shell[5]. Second, activist ESG litigants are fundamentally likely to be bringing such litigation in service of a policy agenda, and not to ensure the success of the targeted company (which they likely consider responsible for serious environmental and social harms). ClientEarth is not a private equity house - it is a pressure group. The Court may struggle to look past that fact.

[5] This difficulty is compounded when one considers that: (a) activist ESG litigants will want to achieve the greatest possible social impact, and (b) larger companies will *ceteris paribus* have larger impacts, but (c) it will *ceteris paribus* be more difficult to establish substantial shareholders in larger companies.

Views of Members

A final and related difficulty for ESG derivative claims, as illustrated by ClientEarth v Shell, comes from the Court having to pay "*particular consideration*" to whether the claim is supported by shareholders without personal interest in the claim.

ClientEarth and its supporters' combined stake in Shell was less than 1%. By comparison, Shell's climate transition strategy had been supported by 80% of the votes cast by its members at the latest (2022) AGM. On this basis, the Court held that ClientEarth's claim had the support of only "*a very small proportion of the total shareholder constituency*" ([97] *ClientEarth v Shell plc & Ors* [2023] EWHC 1137 (Ch)). Accordingly, per s263(4) CA 2006, this "*would count strongly against the grant of permission*".

IV. Alternative Avenues

Given the difficulties identified above, and excepting a major upset in the Court of Appeal, shareholder derivative action is unlikely to prove a fruitful avenue for ESG related litigation in the medium term. As such, and since the profile of ESG issues can be expected to continue rising, it is worth canvassing alternative avenues for ESG litigation against directors.

Periodic Reporting Requirements

Periodic reporting requirements appear similarly unpromising as a potential avenue for director-targeting ESG litigation. In the human rights space, the Modern Slavery Act 2015 mandates that companies with turnover in excess of £36 million per year produce annual "slavery and human trafficking statements" detailing the steps the organisation has taken to prevent these practices in its supply chain or operations. However, the government has rejected recommendations that company directors be made liable for the quality of these statements.

As regards environmental concerns, quoted companies must report on their greenhouse gas emissions in their directors' reports[6]. Moreover, quoted companies *and* large unquoted companies must include in their directors' reports, further details on their emissions, energy consumption and energy efficiency[7]. Should a directors' report fail to comply with these requirements, directors may be liable for a fine, or even for the costs incurred by the company in preparing a compliant report (per sections 419(3) and 456 CA 2006). However, and importantly for practical purposes, these regulations are enforced by the Conduct Committee of the Financial Reporting Council (the FRC); and are *not* open to direct enforcement by an NGO such as ClientEarth. This significantly diminishes the pressure such regulations might otherwise place on regulated companies. Indeed, ClientEarth has repeatedly complained about the FRC's alleged laxity in enforcing these regulations, in addition to making formal complaints to the FRC regarding specific companies' reporting (to which the FRC has not responded).

[6] Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013

[7] Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018

S90 FSMA

S90 of the Financial Services and Markets Act 2000 (**FSMA**) represents a more plausible avenue for director-targeted ESG litigation. Specifically, s90 makes directors liable to pay compensation to any person who has acquired shares in their company, and suffered loss as a result of: (a) an untrue or misleading statement in that company's prospectus; or (b) the omission of information required to be included in that prospectus. Such liability is subject to various defences provided by Schedule 10 to FSMA; which relieve a director of liability where they e.g. reasonably believed that the relevant statement was true and not misleading, having made reasonable enquiries. Directors' liability under s90 could extend to liability for statements or omissions on ESG issues.

As investors place increasing emphasis on environmental credentials, attention has been drawn to the potential for issuers to make untrue or misleading claims about their products' green credentials (a practice known as "greenwashing"). In the UK, the CMA has been conducting an investigation into greenwashing since 2 November 2020[8]. Should investigations like this lead to revelations of false claims by issuers (and/or direct regulatory action), this may negatively impact their shares, and result in loss to investors. In turn, this may ground claims by those investors against the issuers.

Misrepresentation & Misstatement

A final category of potential director-targeted ESG claims arise from fraudulent misrepresentation and negligent misstatement[9]. A fraudulent misrepresentation arises where: (a) a defendant makes a false statement, (b) the defendant knows, or is reckless as to, the falsity of that statement, (c) the defendant intends that the claimant should act in reliance on the statement, and (d) the claimant enters a contract in reliance on the statement, and suffers loss as a consequence. A negligent misstatement requires that: (a) the defendant owes a duty of care to the claimant, (b) the defendant carelessly makes a false statement to the claimant, (c) the claimant relies on the statement, and (d) as a result, the claimant suffers loss.

Both of these claims may be engaged where a director makes a false statement on ESG matters; most obviously, where a false statement causes a shareholder to purchase shares, which then lose value when its falsity is revealed. In these instances, a director may be claimed against, so their knowledge can be attributed to – and a remedy sought from – their company. As regards remedies; the remedy for fraudulent misrepresentation is tortious damages, coupled with recission of the underlying contract; whilst the remedy for negligent misstatement is tortious damages.

The scope of these claims is significantly limited by two factors. First, such claims are only likely to be available to initial purchasers of shares. For fraudulent misrepresentation, that is because it will be difficult to prove that a director intended that their representations would influence secondary

[8] "CMA to examine if "eco-friendly" claims are misleading", Gov.uk Website, 2020.11.02, https://www.gov.uk/government/news/cma-to-examine-if-eco-friendly-claims-are-misleading , (accessed 2023.08.31)

[9] Negligent misrepresentation (under s2 of the Misrepresentation Act 1967) is unlikely to be relevant, since it would require a direct contractual relationship between the director and e.g. the shareholder.

purchasers of shares. For negligent misstatement, that is because it may be difficult to establish a duty of care between a director and a secondary purchaser (given it may be difficult to establish proximity and forseeability under the three-stage test in *Caparo Industries plc v Dickman* ([1990] 2 WLR 358)). The second limit on such claims arises from the difficulty of proving reliance. Without records showing that ESG statements were received and understood by claimants, and impacted their decision making, this may be a difficult evidential bar to clear. Finally, and in respect of fraudulent misrepresentation specifically, claimants may struggle to establish the necessary mental elements of the claim – including the knowledge and intention of directors.

V. Mitigating ESG Litigation Risks

To offset the risk of such claims, UK listed companies may wish to pursue the following steps:

Steps Regarding Derivative Actions

- Where ESG factors are relevant to directors' decisions, ensure that directors formally consider those factors, and maintain a clear record of that consideration. This can include implementing formal procedures to ensure consideration of these factors. This will assist in demonstrating directors' compliance with their CA 2006 duties.
- Educate and train directors on their duties under CA 2006, their need to give consideration to material ESG factors in their decision-making, and their potential personal liability for failures to give such consideration.
- Where the company faces material ESG related risks, develop a relevant ESG strategy, and have that strategy approved at the AGM. This will assist in demonstrating shareholder support for directors' ESG decisions.

Steps Regarding Statement / Disclosure Related Actions

- Properly qualify ESG disclosures, including by stating the assumptions made, and the methodologies used. Use cautionary language where appropriate, including estimates, ranges and aspirational statements. Use simple language that can easily be understood by non-professional investors.
- Clearly state whether advisers or experts are responsible for any element of ESG disclosures.
- Educate and train directors on their duties in reviewing and approving ESG disclosures, and their potential personal liability for false or misleading statements contained in those disclosures.
- Implement procedures to ensure the accuracy of all communications with shareholders. Ensure that the internal review system for disclosures is open and transparent, with sufficient oversight and accountability.

- Keep detailed records of all steps taken to verify ESG-related disclosures. This will assist in demonstrating directors' reasonable belief in said statements, in the event of claims from shareholders.

General Steps

- Maintain comprehensive insurance coverage, whether specifically for public offerings or more generally for directors and officers.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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