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CLIMATE CHANGE LAW. CURRENT PERSPECTIVES.

Climate Change and Directors' Duties: Part 1

Climate Change and Directors' Duties: Part 2

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Introduction

Company directors must exercise reasonable care, skill and diligence (Companies Act 2006 s.174). They must act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole (s.172). In doing so, they must have regard to the impact of the company's operations on the community and the environment (s.172(d)).

What do these duties mean in the context of the potential impact of a company's activities upon climate change? Whereas there was oncea general consensus that this obligation lacked teeth, the recent mushrooming of significant regulatory requirements, 'soft law' instruments and voluntary commitments suggests that this consensus is no more. Moreover, the debate looks set to enter the English courts, thanks to a legal action by ClientEarth against Shell currently in its pre-action phase.

In this article, we survey the current guidance as to the climate-related duties of a company director. How onerous are they really? What are the underlying themes and potential areas of dispute?

Underlying Themes

We flag six key overarching questions at the outset:

(1) The "soft law" question. What is the relevance of 'soft law'? Will the courts look to statements of principle or best practice such as the Recommendations of the Taskforce on Climate-related Financial Disclosures ("**TCFD**") in order to inform their determination as to the content of the statutory duties, when they come to consider whether a director has acted in breach of the Act?

(2) The "standard of review" question. What standard of review will the courts bring to bear when scrutinising boardroom decisions?

(3) The "time frame" question. In conditions of uncertainty, how should a court give appropriate weight to medium- and long-term impacts of climate change when assessing what it is reasonable for a company director to do today?

(4) The "process vs substantive outcomes" divide. Where is the dividing line between the Court's supervision of "process" and substantive outcomes?

(5) The "enforcement" question. How, if at all, can directors' duties practically be enforced? What are the prospects of activist minority shareholders satisfying the Court that permission should be granted to continue a derivative claim?

(6) The "profit" question? Does long-term profitability trump all? Or are the interests of the company to be interpreted more broadly as encompassing other interests and values, such that even a profitable decision may breach the statutory duties?

Underlying Principle

The underlying principle may be simply stated.

- Directors must "promote the long-term sustainable success of the company" (FRC, Principle A).
- They must therefore identify and competently handle risk.
- Climate change imposes (i) physical risks, (ii) transition risks (i.e. those arising from the process of adjustment towards a low-carbon economy) and (iii) litigation risk.
- Those risks differ from those previously experienced by most businesses, in their breadth, magnitude, time horizons, foreseeability and dependence on short-term actions (Bank of England, 2018). Pre-existing risk management structures are therefore unlikely to suffice.

To put this in more concrete terms, it may be a breach of directors' duties for a board of directors to decide to construct a coal-fired power plant, where the board has not assessed the impacts of rising carbon prices, increased competition from cheaper renewable sources, and the likely future removal of subsidies. This was the claim made (in Poland) in ClientEarth v Enea SA. The claim succeeded, but without any determination of the breach of duty issue (since the Court found that the board resolution approving the power plant was in any event technically invalid).

Soft Law Workings Out of the Underlying Principle

A competent response to climate change risks is likely (in a substantial company) to require action in the fields of governance, strategy, risk management, metrics and targets (TCFD, 2017). In other words, directors must (a) properly inform themselves, (b) ensure that decision-making within their company gives appropriate weight to climate change risks and opportunities, (c) honestly and appropriately disclose climate change risks and impacts to investors, regulators and the public at large, and of course (d) endeavour to develop the company's business in directions which minimise exposure to climate risks and maximise its ability to benefit from the transition to a low-carbon economy.

These basic ideas have been worked out in a number of influential policy documents, the substantive content of which overlaps. They include:

- TCFD, Recommendations of the Task Force on Climate-related Financial Disclosures, 2017 (and subsequent implementing publications as summarised here).
- World Economic Forum, How to Set Up Effective Climate Governance on Corporate Boards, Guiding principles and questions (January 2019).
- Joint statement on climate change by Bank of England, FCA, FRC & Pensions Regulator (2019).
- IFRS, 'Effects of climate-related matters on financial statements', (20 November 2020)
- Principles on Climate Obligations of Enterprises (2nd ed, 2021) by Prof. Jaap Spier and an international group of legal experts.

Also relevant in this context are guidance, regulations and voluntary initiatives adopted by and for financial institutions, including the Equator Principles (project finance), the Bank of England Prudential Regulation Authority's Supervisory Statement 3/19 (banks & insurers), and recent FCA Policy Statements and final rules mandating climate disclosure by large companies. These statements are of course relevant even to unlisted non-finance companies because, increasingly, they affect the availability and price of finance.

These (mostly) 'soft law' statements of principle are not necessarily co-extensive with the duty to exercise reasonable care, skill and diligence under s.174 of the Companies Act 2006. But it can be expected that they will inform the courts' assessment of what is 'reasonable', and that departures from these principles may require justification (Lord Sales, 2019). A 2021 Australian legal opinion expressed the view that the TCFD disclosure recommendations had *"transitioned from "best practice" to industry standard"*. This is likely also to be the direction

of travel in England.

In our companion article, **Climate Change and Directors' Duties: Part 2**, we analyse what in practice is likely to be required of directors in order to discharge their statutory duties in relation to climate change risks.

Enforcement of Directors' Duties

Directors owe their duties to the company, and it is (in general) the company which must seek to hold them responsible. Since (absent a shareholder revolt or change in control) the directors control the company, there is provision in s.260 of the Companies Act 2006 for an individual minority shareholder to bring a *"derivative claim"* on the company's behalf.

Such a claimant requires permission from the court under s.261 and s.263. The court will refuse permission if it is a claim that no reasonable director would bring: *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch), [2010] B.C.C. 420. If that hurdle is met then the court conducts a balancing exercise as to whether it is in the interests of the company for the claim to continue (a decision informed in part by the court's necessarily provisional view on the prospects of success).

One problem that activist shareholder litigants will face is that the court must refuse permission where the company has authorised or ratified the impugned act or omission (s.263(2)). It remains to be seen whether companies – for example Shell in the action threatened by ClientEarth – will look to defeat claims by this means: a decision to ratify the directors' impugned conduct must be made by way of shareholders' resolution (s.239(2)), and directors may prefer not to open themselves up to scrutiny by their shareholders in this way.

Even if shareholder derivative claims are not defeated in this way (i.e. by authorisation / ratification), the permission stage of a derivative action is likely to be a significant hurdle for minority shareholders to overcome.

Conclusion

There has been a sea-change over the last 6-7 years in what is expected of company boards in relation to climate change. The obligations to exercise reasonable care, skill and diligence and to promote the company's success are, or are likely to be, recognised as entailing specific duties of information, evaluation, governance, strategy and disclosure. We analyse the likely practical content of those duties in our companion article, **Climate Change and Directors' Duties: Part 2**.

While the duties may be 'procedural', their substantive effect is likely to be profound. In particular, the increasing volume and specificity of climate-related disclosures is likely to lead to litigation about the validity of the statements made in those disclosures; and companies' increasing publication of data, impact assessments and climate strategies means that there will be a much greater body of material by reference to which the rationality or reasonableness of particular board decisions can be scrutinised.

At the same time, the capacity of individual shareholders to bring claims against directors for breach of duty will remain limited because of the difficulties in obtaining permission to bring a derivative claim. This will not necessarily eliminate the willingness of activist litigants to bring such claims, or of corporate boards to avoid them.

Climate Change and Directors' Duties: Part 2

Introduction

In Climate Change and Directors' Duties: Part 1, we described the 'sea-change' that has taken place over the last 6-7 years in thinking about directors' obligations in the context of climate change. We identified some of the key 'soft law' statements of principle in this area, and outlined 6 key overarching questions which we consider likely to play out in caselaw over the next few years.

In this article, we examine in greater detail what – in practice – is likely required of a board of directors of a substantial company, in order for its members to discharge their statutory duties. We break that topic up into 4 headings, corresponding to the basic categories of (i) knowledge, (ii) thought, (iii) communication and (iv) action.

Four Aspects of Directors' Statutory Duties

1: Duty to inform oneself

It is self-evident that a director cannot discharge their s.174 duty of care and skill without being adequately informed about material risks. The question is how far in practice that duty extends. Clearly, it must extend far enough to enable attainment of the obligations as to disclosure and decision-making described below.

Relevant statements of principle from the World Economic Forum's ("**WEF**") 'Guiding principles' include:

- **Principle 2, Command of the Subject:** *"The board should ensure that its composition is sufficiently diverse in knowledge, skills, experience and background to effectively debate and take decisions informed by an awareness and understanding of climate-related threats and opportunities."*
- **Principle 4, Material risk and opportunity assessment:** *"The board should ensure that management assesses the short-, medium- and long-term materiality of climate-related risks and opportunities for the company on an ongoing basis..."*
- **Principle 8, Exchange:** *"The Board should maintain regular exchanges and dialogues with peers, policy-makers, investors and other stakeholders to encourage the sharing of methodologies and to stay informed about the latest climate-relevant risks, regulatory requirements etc."*

Claims for breach solely of this aspect of a director's duties are unlikely to succeed; but, where it is possible to establish that a board lacks relevant expertise of its own and has failed to take appropriate external advice, that may add support to claims brought on further grounds.

Companies are likely, also, to be under a duty to assess the environmental impact of their operations generally and of new substantial investments in particular. (Financiers complying with the Equator Principles will require such an impact assessment.) That assessment may not necessarily take place at board level.

2: Duty to embed climate-conscious decision-making

Not surprisingly, this aspect features heavily in soft-law guidance, given that it goes to the core of how a board of directors can impact corporate management and activities. WEF's relevant statements of principle include:

- **Principle 3, Board structure:** *"The board should determine the most effective way to integrate climate considerations into its structure and committees."*
- **Principle 5, Strategic and organizational integration:** *"The board should ensure that climate systemically informs strategic investment planning and decision-making processes and is embedded into the management of risk and opportunities across the organization."*
- **Principle 6, Incentivization:** *"The board should ensure that executive incentives are aligned to promote the long-term prosperity of the company"*, e.g. by way of including climate-related targets and indicators in executive incentive schemes.

The Bank of England Prudential Regulation Authority ("**PRA**") has issued a *"Supervisory Statement"* to banks, insurers and investment firms, in which the PRA's *"expectations"* are set out in greater detail. Such firms are expected to carry out stress and scenario testing over short and long time horizons (the latter, *"in the order of decades"*). They are also expected to identify, measure, monitor and manage climate change risk as part of their overall risk management.

One way that companies already embed climate considerations into decision-making is by setting an internal effective carbon price, and using that price to assess the financial viability of investments and activities. This was litigated in the New York Supreme Court in People of New York v Exxon Mobil, where it was alleged that Exxon had made materially false and misleading representations concerning the proxy cost of carbon dioxide that it claimed to use to simulate the impact of future climate change regulations. The claim was dismissed in 2019 after a 12-day trial, with Ostrager J finding that the New York Attorney General had *"failed to prove by a preponderance of the evidence that ExxonMobil made any material misrepresentations that "would have been viewed by a reasonable investor as having significantly altered the 'total mix' of information made available.""*

While there have been few cases in this area to date, it is an area to watch.

3: Duty to disclose

There are two different duties here: first, a duty to provide information ("**transparency**"), and second a duty to ensure that any statements made on behalf of the company are made honestly on reasonable grounds and comply with any applicable consumer protection or other standards ("**accuracy**").

The first of these duties (transparency) differs from the previous duties, since it might be thought not self-evidently in a company's own interest to be transparent (compare e.g. the duty to inform oneself, considered above). However, there is a consensus that long-term successful companies are necessarily transparent (in order to gain the trust of shareholders, regulators, customers and stakeholders). And, in any case, climate-related disclosure is now increasingly mandated by regulators. For financial years starting on or after 6 April 2022, most large UK companies (i.e. those with more than 500 employees) are now required by law to make climate-related financial disclosures in their annual reports in accordance with the TCFD's 11 recommendations.

A critique by ClientEarth of the adequacy of UK-companies' climate-change reporting in the 2019-2020 financial year is available here. The findings included that "*Around 50% of companies mention some form of 'Paris-alignment' or 'net-zero' target, but many provide limited details – raising concerns of greenwash.*" This illustrates the second aspect of the duty of disclosure: climate-related disclosures and related statements and advertising must not be misleading or made without reasonable basis Certainly, this is an area in which litigation is discernibly on the increase (albeit not yet in the UK):

- Re Exxon Mobil Corp (filed 2019, Texas)
- Beyond Pesticides v Exxon Mobil Corp (filed 2020, District of Columbia)
- State v BP America Inc. (filed 2020, Delaware)
- Earth Island Institute v Coca-Cola Co (filed 2021, District of Columbia)
- Perri v Croskrey (filed 2021, Delaware)
- Greenpeace France v TotalEnergies SE (filed 2022, Court of Paris)

The Competition and Markets Authority ("**CMA**") recently published guidance on how consumer protection law applies to environmental or green claims made by businesses on their goods and services. That includes claims made about the business as a whole, and would therefore embrace misleading 'net zero' claims. Businesses have been put on notice that enforcement action will be taken against misleading green claims.

The remedies sought in these claims tend to be declaratory (the court stating that there has been a breach of the relevant legal rules) and injunctive (the court ordering the defendant to cease its misleading practices and publish the court's judgment). However, in some jurisdictions, fines can be imposed, and consumers may be entitled to damages (see e.g. The Consumer Protection from Unfair Trading Regulations 2008, ss.13 and 27J). There are likely to be debates about whether and if so how individual claimants can establish 'loss'; the Volkswagen 'Dieselgate' litigation may turn out to be instructive.

4: Duties to Act

Most of the obligations considered above have been 'procedural' rather than 'substantive', in the sense that they have considered the process by which a board or management of a company take decisions rather than the outcome of that decision.

The courts are understandably warier of impugning substantive decisions on account of the principle that Courts should not second-guess boardroom decisions. But it is clear in principle that the courts are entitled to do so where appropriate. As to this, with reference to the two statutory duties under consideration:

- The test for a breach of s.172 (duty to promote success of the company) is *"whether the director honestly believed that his act or omission was in the interests of the company" (Southern Counties Fresh Foods Ltd v RWM* [2008] EWHC 2810, [53]). The test is subjective, and so raises a high bar. The court does not consider there to have been a breach of s.172 simply because, in the court's opinion, the act or omission was not in the interests of the company (unless no reasonable director could have considered it so). However, the Court can vary the 'intensity' of review, having regard to the subject matter in question. The intensity applied by the Court is a flexible standard, which will have regard to the context and issues before it.
- The test for a breach of s.174 (duty to exercise reasonable care, skill and diligence) is an objective standard. The court will ask whether the director acted with the care, skill and diligence that would be exercised by *"a reasonably diligent person with— (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that the director has"* (s.174). This may in some cases be a matter for expert evidence, but that is not necessarily the case: *Bishopsgate Contracting Solutions Limited v O'Sullivan* [2021] EWHC 2103 (QB) at [194] per Linden J. The 'soft law' statements of principle considered in these articles may well be informative as to generally accepted standards of diligence.

In principle, therefore, directors' statutory duties may require them to cause the company to take or refrain from specific actions / activities in order to reduce greenhouse gas emissions. Whether that is so in any particular case will of course depend on all the circumstances of that case.

Relevance of Non-Financial Effects of Decisions

There is, however, one point of potential general application, which concerns what we described in our first article as the "profit question", i.e. whether a long-term profitable decision is capable of breaching a directors' duties because of adverse non-financial outcomes.

If not taking action to reduce the company's contribution to climate change is likely to lead to financial loss to shareholders, then – while there may be difficulties of proof or questions about the relevant time horizon – there is no conceptual difficulty in principle in establishing that the directors are breaching their duties to the company. ClientEarth v Enea SA (the Polish coal power station case) is an example.

The more controversial question is whether it could be a breach of duty to act in such a way as contributes 'unreasonably' towards greenhouse gas ("**GHG**") emissions without obviously damaging the financial

interests of shareholders. In principle, the answer is clearly 'yes'; but the contours of the relevant duty to have regard to non-financial interests are still being worked out.

In more detail:

(i) **Long-term profitability.** One response would be to say that it is of only theoretical interest, on the basis that litigation and regulation can be expected to 'catch up' to a point where polluters indeed pay. On that hypothesis, shareholders' long-term financial interests are threatened even if their short-term financial interests may seem unaffected. In other words, on this view, market and economic forces will eventually render the business decision a breach of the 'profit' principle; and the courts should be entitled (and indeed required) to take account of that long-term horizon in assessing the directors' conduct.

(ii) **Critique.** The problem with the foregoing view is that there is obvious scope for disagreement as to whether regulation and litigation will perfectly 'catch up' in this way. These are not questions the courts can fairly or practically adjudicate.

(iii) **Established Non-Financial Duty.** It is clear from the scheme of the Companies Act 2006 that directors should not be looking solely to shareholders' financial returns. This follows from the various duties in s.172(1) of the Act, including in particular the duty in s.172(1)(d) to have regard to *"the impact of the company's operations on the community and the environment"*. That duty is mandatory. *Faulkner v Vollin Holdings Ltd* [2021] EWHC 787 (Ch), [428]-[429] suggests that a company director must have *"**proper** regard"* to (and so cannot simply disregard, or pay token consideration to) the factors listed in s.172 (emphasis added). The scheme of the Act is therefore that it would be a breach of duty for a director to have regard exclusively to the financial interests of shareholders.

(iv) **Content of the 'duty to have regard'?** Process duties of this nature are well established in common law (particularly in the context of administrative law). In another context (the public sector equality duty) there is high authority that such a duty must be exercised *"in substance, with rigour, and with an open mind"* (per Aikens LJ in *R (Brown) v Secretary of State for Work and Pensions (Equality and Human Rights Commission intervening)* [2008] EWHC 3158 (Admin), [2009] PTSR 1506 at [92]. The similarity in statutory language, and the wider context (affording respect to the views of the primary decision-maker), strongly point towards a similar approach here.

(v) **Duties of Result?** For a strong statement of the duties of companies (and, therefore, the duties of directors) to achieve specific emissions reductions targets and to take all cost-effective means available to them to reduce emissions, see principles 2 and 7-13 of the Principles on Climate Obligations of Enterprises. These go further than the existing established requirements of s.172 and s.174; but the case can certainly be made that a board having proper *"regard"* to the company's environmental impact will indeed seek to (e.g.) *"reduce its GHG emissions from its activities performed in the relevant country that incur additional costs if the costs will, beyond reasonable doubt, be offset by future financial savings or financial gains within a reasonable time period"* (principle 8). At any rate, these principles may be a useful cross-check, and a company whose policies are not in line with them may in due course have to justify its directors' compliance with the s.172(d) duty.

Conclusion

There is clearly scope for debate, both about the existing content of directors' duties (in particular the extent to which these may entail obligations to achieve particular results in terms of e.g. GHG-emission reductions), and as to whether those duties should be strengthened by Parliament. It is certain that there will be judicial consideration of these questions in the near term.

Meanwhile, we would respectfully agree with Lord Sales' (extrajudicial) conclusions that *"...the basic direction of travel... seems clear. With respect to the legislative scheme, environmental considerations may and, increasingly, must be taken into account by directors... It is clear that the very traditional view of the undemanding nature of directors' duties is now outmoded"*.

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