ESG DISPUTES AND REGULATORY RISKS
WHAT DO BUSINESSES AND GENERAL COUNSEL NEED TO KNOW?

Embedding sustainability into the concept of shareholder value is now a mainstream way of doing business. The circular economy or triple bottom line theory are common parlance with academics and there is an abundance of successful companies that focus on people, planet and profit. However, the relationship between sustainability and shareholder value is one that cuts both ways, because ESG sits at a confluence of commercial opportunity and risk. Whilst ESG credentials can spiral success upwards by helping businesses to access markets, reduce costs and increase productivity, it can just as easily trigger multiple risks or stigmatise a brand.

This article provides a snapshot of the wide variety of sources of ESG related commercial disputes or regulatory investigations under English law and how they interrelate to each other. It considers existing legislation, the role of regulators, carbon emissions and financial disclosure requirements, trends in ESG related litigation and where the boundaries of the law are most likely to be tested (liability in global supply chains and director duties). It is of interest to boards of directors, business owners, investors, FCA regulated firms, General Counsel or in-house legal teams and consultants advising on ESG matters.

ESG base camp

A raft of legislation which is capable of flying the ESG flag already exists, including the Corporate Manslaughter & Corporate Homicide Act 2007, Bribery Act 2010, Equality Act 2010, Consumer Rights Act 2015, Modern Slavery Act 2015, Sanctions & Anti-Money Laundering Act 2018 and the Environment Act 2021. All of this legislation is consistent with the United Nations Sustainable Development Goals, and considering its relevance to an organisation is a good starting point for supply chain due diligence or when contemplating a corporate transaction.

In practical terms, compliance with these standards manifests as reviewing or updating policies relating to health and safety practices, combatting corruption and financial crime, preventing discrimination, the responsible treatment of consumers, protection of workers in supply chains and preservation of the natural environment. Many website homepages contain direct links to the relevant policies.

It may be possible to incubate your business from ESG failures in the supply chain by negotiating terms which require compliance with relevant standards on an ongoing basis and permit termination in the event of breach, possibly with the benefit of a liquidated damages clause, or provisions that enable termination for a more sustainable supplier elsewhere.

Regulatory winds

In addition to legislative requirements, depending on what sectors your business is operating in it may also attract the attention of one or more regulators.

ESG DISPUTES AND REGULATORY RISKS
WHAT DO BUSINESSES AND GENERAL COUNSEL NEED TO KNOW?

The Financial Services Sector
In the light of the market capitalisation and assets under management of the businesses it regulates and the role of sustainable finance and insurance in the transition to net-zero, the Financial Conduct Authority (FCA) is possibly the most influential regulator in England when it comes to ESG – and it has stepped up its rules.

With effect from **30 June 2023** a general anti-greenwashing rule applies to all FCA regulated businesses, including those who approve financial promotions for unauthorised persons. This requires firms to ensure that any reference to the sustainability characteristics of a product or service in all client communications is consistent with the profile of that product or service and "clear, fair and not misleading". If the FCA considers that greenwashing has taken place, it has explicit authority to commence an investigation or take enforcement action. Further rules specific to the management and distribution of funds to retail investors are to take effect from 30 June 2024.

The FCA is also the authority responsible for enforcing compliance by listed companies with the UK Corporate Governance Code (also referred to further below). The requirements are further explained in a new specialist ESG sourcebook to the FCA Handbook.

In addition, FCA regulated firms investing and managing money on behalf of UK savers and pensioners who are voluntary signatories to the UK Stewardship Code are required to consider climate change and social factors as material issues in investment decisions and create long-term sustainable value for the economy, the environment and society.

The Competition and Markets Authority (CMA)
If a business is not regulated by the FCA, it will fall within the remit of the CMA which can instigate a criminal prosecution, halt trading, enforce compliance, order redress to be paid and impose civil penalties in relation to a breach of banned practices. The CMA has published a "Green Claims Code" focussing on six principles derived from existing consumer protection legislation (the Consumer Protection from Unfair Trading Regulations 2008). The thrust of the code is that green claims must not omit or hide important information and makes clear that in respect of any absolute claims, companies must consider the full life cycle of their product and services.

So far, the CMA has prioritised misleading acts or omissions in relation to the veracity of sustainable or eco claims in textiles & fashion, travel and transport and fast-moving consumer goods such as food and beverages and beauty or cleaning products. Green washing investigations into ASOS, Boohoo and Asda have all been publicly announced.

The Advertising Standards Agency (ASA)
The ASA has created rules about environmental claims, and it has the power to ban adverts, require that they be amended or refer cases to Trading Standards for prosecution. They have been active across multiple sectors in relation to: HSBC claiming to have provided $1m trillion globally to help their customers transition to net-zero; Ryanair's claim to be Europe's lowest emissions airline; Oatly's claim that it generates 73% less CO2 than milk; Innocent drinks' message that its recycling policy has a positive environmental impact which was not the case in the light of single-use plastic products; a claim that eating Quorn products would reduce a consumer's carbon footprint; a claim by Hyundai that one of its cars purifies the air as it goes; and a Shell campaign that filling up using the Shell Go+ App was driving carbon neutral.

Carbon & climate related financial reporting

Potential litigants and regulators may also latch onto the increasing levels of information which businesses are obliged to publish, working closely with accountants and auditors.

ESG DISPUTES AND REGULATORY RISKS WHAT DO BUSINESSES AND GENERAL COUNSEL NEED TO KNOW?

The Streamlined Energy and Carbon Reporting (SECR) requirements already apply to the annual accounts of almost 12,000 businesses which satisfy two of the following three criteria:

- a turnover exceeding £36m
- a balance sheet exceeding £18m
- more than 250 employees

SECR requires companies to publish an intensity ratio of their scope 1 and 2 carbon emissions from activities they are directly responsible for, their total energy consumption and measures taken to increase energy efficiency. Reporting on scope 3 emissions is entirely voluntary - being emissions connected with the activities of a business which it does not control such as travel by suppliers, commuting, the manufacture of materials and disposal of waste. Purpose led businesses whose brand or constitutional documents are inter-woven with sustainability will view the voluntary adoption of reporting on scope 3 emissions as a competitive edge, or the right thing to do. For everyone else, the direction of travel is clear.

Larger private companies with over £500m in turnover and 500 employees are required to make disclosures in line with recommendations from the Task Force on Climate-related Disclosure (TCFD), which is a framework for reporting financial information about the impact of climate change. The objective of the TCFD is to increase the amount of reliable information that is publicly available about the opportunities and exposure of businesses to climate-related risks across all sectors and jurisdictions on a consistent basis. The TCFD's recommendations are structured around governance, strategy, risk management, metrics and targets.

The largest listed companies and financial institutions are subject to the UK Corporate Governance Code which requires certain listed companies, asset managers, life insurers and pension providers to disclose against TCFD recommendations in their annual report on a "comply or explain" basis. They also have to explain how the business promotes sustainable success that contributes to wider society in accordance with the company's purpose and values. Public companies that do not satisfy market expectations are at risk of suffering depressed share prices and finding it more difficult or expensive to raise capital or incept insurance.

It is also worth noting that post-Brexit, the EU's Corporate Sustainability Reporting Directive will apply to EU subsidiaries which are ultimately owned by a UK parent, where (in broad terms) the subsidiary meets SECR thresholds, is listed or generates net turnover of more than €40m and the wider group derive in excess of €150m of net turnover in the EU. Specific advice should be sought prior to phased introduction of these rules from 1 January 2024 onwards.

The reach of global supply chains

Whilst a business may consider that its compliance with legislation, regulations and reporting requirements are all in order, a whistle-blower, investigative journalist or activist protest group may not. Their motivation is not necessarily to seek or leverage compensation (although it may be), but to draw public and media attention to aspects of corporate strategy, inequality, human rights abuses or green-washing. ESG related cases are being fought all over the planet relating to deforestation, human rights abuses, and the protection of indigenous people or threatened species.

Disputes which are already in the public domain relate to: human rights abuses and the certification of responsible gold by the London Bullion Market Association; the working and living conditions of Dyson's migrant workers in Malaysia; and the labour conditions and pay of Burmese workers at a Thai supplier of jeans to Tesco. Whilst these might seem distant in both geography and jurisdiction, ESG risks of this nature need to be on the radar of businesses operating in the food and drink, consumer goods, fashion, manufacturing and extractive sectors who utilise a global supply chain.

Once primary liability has been established in accordance with the laws of where any alleged wrongdoing has taken place, litigants searching for financial compensation can explore the boundaries of UK parent company liability for the acts of its overseas subsidiaries, agents or contractors in the supply chain.

ESG DISPUTES AND REGULATORY RISKS
WHAT DO BUSINESSES AND GENERAL COUNSEL NEED TO KNOW?

Such claims are based on whether the specific circumstances of each case support the imposition of a tortious duty of care in negligence between the ultimate parent company and victims of ESG failings. One can foresee disclosure and debate as to the extent to which a parent company has exercised control over its subsidiaries and the nature of its interactions with, or influence over, contractors and agents. A sitting Supreme Court Justice has commented that the extent to which directors, as the controlling mind of a company, comply with their duties (explored further below) is potentially relevant to a common law tortious claim against a parent company for negligence.

Indeed, the Supreme Court permitted residents of Nigeria to bring claims against Shell's ultimate UK domiciled parent company in relation to damages caused by an oil spill in Nigeria overseen by Shell's Nigerian subsidiary. The claims failed on time barring grounds, but not because their underlying legal basis was unarguable.

Litigating such claims on a multi-national company's "home turf" in England provides claimants with access to specialist class action or not-for-profit law firms, third party funding on a commercial or philanthropic basis, group litigation orders and an independent judiciary. It will also engage reputation management considerations.

Director duties v the climate crisis & communities

ESG is also well placed to stress the scope of statutory and common law fiduciary duties owed by directors to their company (or its creditors if insolvency is imminent) and test the risk appetite of directors and their D&O insurers.

The success of the company

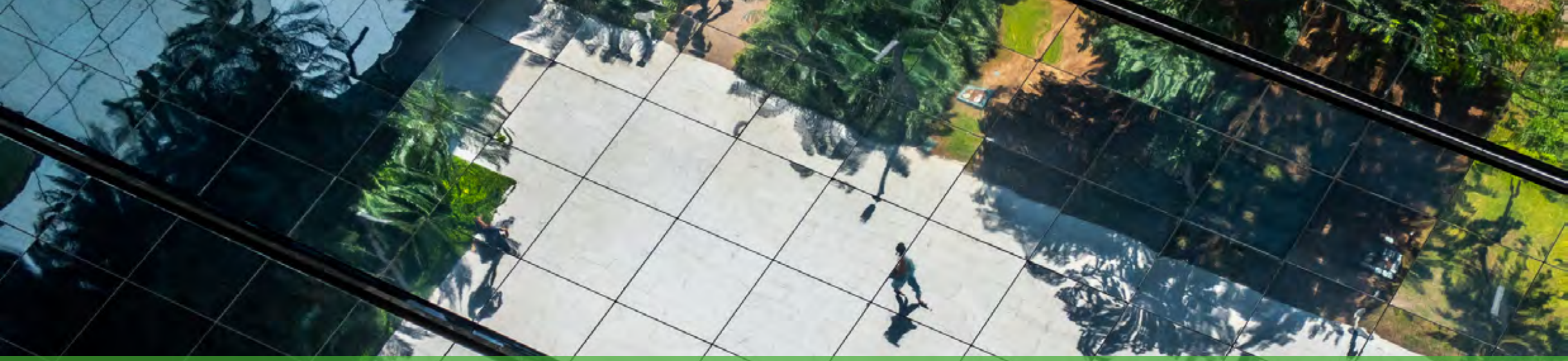
Section 172(1) of the Companies Act 2006 has provided that a director must promote the success of the company for the benefit of its members as a whole and, in doing so, have regard to (amongst other things) the likely consequences of any decision in the long term, the impact of the company's operations on the community and the environment, and maintaining a reputation for high standards of business conduct.

This has been understood to mean that the primary duty is to maximise the value of the shareholders' shares and that this is capable of outweighing other factors such as climate change considerations. However, within the current regime, it would be possible for directors to conclude that shareholders' interests would be so adversely impacted by climate change that discharging their duty requires the company to take action to reduce its contribution to the climate crisis. In addition, s.172(2) of the Companies Act 2006 provides that if a company's Articles of Association and other governing documents consist of environmental or social purposes then achieving those purposes will be construed as promoting the success of the company for the benefit of its members as a whole. Therefore, a legal mechanism requiring directors to treat people and planet on a par with profit already exists.

Businesses of this ilk, often with B-Corps status or some other independent certification, are proliferating along with downstream special purpose vehicles with sustainable purposes emanating from impact investment funds or foundations. In relation to corporate or entrepreneurial philanthropy, in April 2022 the English High Court held that the trustees of charities with approximately £64m of assets under management, which are part of the Sainsbury Family Charitable Trusts, were permitted to exclude investments that were not aligned with the Paris Agreement. The rationale being that such investments would conflict with the principal purposes of the charities to protect the environment and provide relief from poverty.

Exercising reasonable care, skill and due diligence

Section 174 of the Companies Act 2006 requires a director to exercise reasonable care, skill and due diligence with reference to the general knowledge, skill and experience that director actually has (which is subjective) and which a person carrying out their role may be expected to have (which is objective). Therefore, individual directors who have been given responsibility for specific ESG issues or baking ESG into their company's strategy will be judged not only by what they know, but also by what a reasonably competent director in that role ought to know.



ESG DISPUTES AND REGULATORY RISKS
WHAT DO BUSINESSES AND GENERAL COUNSEL NEED TO KNOW?

Modern businesses do increasingly acknowledge that they serve a much wider group of stakeholders including their workers, consumers and society at large and frequently do not pursue profit at the expense of the environment or social cohesion. The pivot to responsible business is consistent with the British Academy's "Principles for Purposeful Business" report which found that many UK companies are committed to purposeful and stakeholder-minded business, and provides a detailed framework to adopt purposeful business. This is an area that is ripe for scrutinising board strategy relating to ESG risks and opportunities, especially in a business where ESG is not a formal part of a company's purpose but woven into strategy by choice.

Directors & Officers Insurance

The availability of D&O cover may or may not be able to keep pace with allegations of climate or community related mismanagement. The withdrawal of cover entirely or the introduction of specific exclusions would severely curtail the commercial value of cover, which is put in place for precisely this type of personal risk for directors.

A more well-trodden path for insurers to manage their own risks (and tee up potential grounds to decline cover) would be to place burden on the company as policyholder, or its broker, to make accurate and specific climate and ESG related disclosures prior to policy inception or at renewal. For example, that the company has complied with all of its legislative obligations, financial reporting requirements and disclosed all shareholder claims or regulatory investigations or circumstances that might give rise to them. We predict that D&O insurance coverage disputes, or broker negligence, relating to climate and ESG risk will be a fertile area for satellite litigation, or arbitration, in conjunction with an underlying climate related regulatory or commercial dispute.

Also, D&O is only one line of insurance within a wider insurance industry which, taking a step back, faces unprecedented challenges regarding extreme weather related events and is in the process of re-engineering itself (coupled with green finance) to reward an ESG aligned way of business.

It is also worth noting that establishing a breach of a director duty can trigger other tortious claims against third parties such as inducing breach of contract, causing loss by unlawful means or conspiracy.

Shareholder remedies

Directors owe their statutory and fiduciary duties to the company, or its creditors in the event of insolvency, and not shareholders. Therefore, whilst directors can be held to account, if shareholders remain dissatisfied there are three established legal routes to obtain control of the company and/or seek redress:

- firstly, under sections 260-269 of the Companies Act 2006 shareholders can apply to Court for permission to bring a claim in the name of the company against its own board of directors for breaching their duties by mismanaging ESG risks. This is known as a derivative claim

- secondly, shareholders have a statutory right under s.994 Companies Act 2006 to petition the Court for relief on the ground that the company's affairs are being conducted in a manner that is both unfair and prejudicial to the interests of the members generally or a minority of the members. This right is typically exercised by shareholders of private rather than public companies

- thirdly, sections 90 and 90A of the Financial Services and Markets Act 2000 provide statutory causes of action for shareholders in listed companies who have received untrue or misleading information in a prospectus, annual report, accounts, interim results or market announcement. They can claim compensation from those responsible which would extend to the company itself and its directors. This route has previously been used to launch group actions against RBS and Tesco (and is not considered in further detail here)

Derivative claims

In February 2023, the not-for-profit law firm ClientEarth, having become a very small minority shareholder in Shell, sought permission to bring a derivative claim against all of Shell's 13 executive and non-executive directors for failing to implement a corporate strategy that aligns with the Paris Agreement. Shell's board were alleged to have mismanaged material and foreseeable physical and net-zero transition risks including vulnerability to stranded assets and the write down of fossil fuel assets.

Whilst obtaining the Court's permission to bring a derivative claim is an awkward procedural hurdle to overcome, the principle of open justice must have brought considerable pressure to bear on Shell. The prospect of a public hearing or participating in a detailed disclosure process as to how Shell arrived at and implements its strategy has high reputational stakes. ClientEarth might therefore, have expected engagement from Shell's board as to what strategic policy changes would represent a mutually agreeable alternative to litigation.

However, Shell fought the application and won with the Court concluding that on the face of it no specifically enforceable director duties relating to climate risk arose. Therefore, breaches of s.172 or s.174 Companies Act 2006 had not taken place and it remained for the directors to make commercial decisions about the business which the Court was not equipped to interfere with. To make out a successful case, the court would place more weight on independent expert evidence regarding climate risk, how the best interests of the members as a whole were impacted and how, applying a multi-factoral approach, no reasonable board could have adopted the strategy in question.

Unfair prejudice

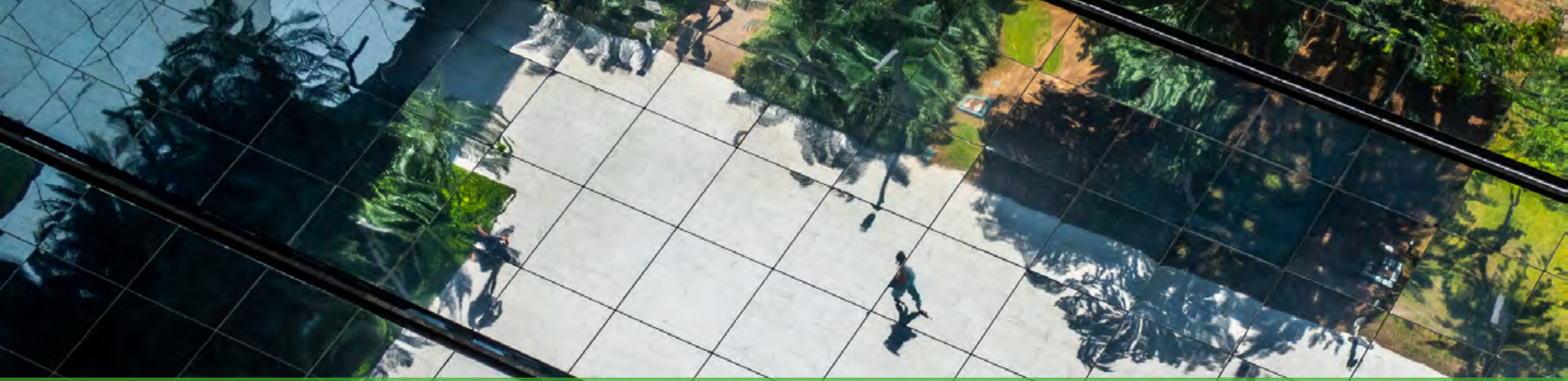
These types of claim usually entail an allegation of breach of a formal legal obligation, or failure to fulfil a legitimate expectation, coupled with a request that the Court awards damages and/or orders the sale of shares (where the basis of valuation is hotly contested) and/or regulates the conduct of the company including requiring the company (via its board) to carry out or refrain from carrying out specified acts. Such claims are often bolstered by an application for injunctive relief to "hold the ring" and prevent significant transactions occurring until the claim is finally resolved via negotiated settlement or trial.

These types of disputes are usually complicated, all-consuming and costly. There does not appear to be any publicly reported or binding legal precedent in relation to this cause of action in the context of mis-managing ESG risk. However, the broad scope and flexibility of the unfair prejudice regime, and its ability to de-rail a private business, means that it is well suited to shareholders looking to bring about change.

Any hint of a breach of director duty, breach of the terms of a Shareholders or Investment Agreement or abuse of the company's Articles can be used to threaten litigation and apply pressure. In addition, as explained above, larger private companies that are increasingly caught by obligations to disclose climate-related financial information on a mandatory basis can expect disgruntled shareholders to run the slide rule over their annual accounts and reports.

The conduct of litigation

When a dispute reaches litigation, there has been an increased take up and publicity of green litigation or arbitration protocols, with law firms and barristers' chambers pledging to print less paper, use more video conferencing, avoid unnecessary travel and use like-minded e-disclosure platform providers, translators, witness familiarisation or analytics companies who are similarly committed to lowering their carbon footprint. Such an approach has now received formal recognition by the judiciary.



ESG DISPUTES AND REGULATORY RISKS
WHAT DO BUSINESSES AND GENERAL COUNSEL NEED TO KNOW?

In November 2021, Mr Hugh Sims KC sitting in the Business and Property Courts handed down ***Judgment*** in relation to a £500m claim regarding the development of an "eco-town" comprising 1,000 acres of land and c.6,000 zero-carbon homes. In two postscripts to the Judgment, two comments were made regarding the conduct of claims:

1. In between 2008 when consultation for building the town commenced and the time of Judgment, the concentration of atmospheric CO_2 had increased by 27 parts per million (or 7%) and it was "not too late for the parties to co-operate to enable the project to proceed at a quicker pace than hitherto, to help contribute to a more sustainable housing stock, and reduce carbon emissions." The Judge here was quoting the Keeling Curve, a graph measuring the daily concentration of CO_2 in the earth's atmosphere from the Mauna Loa Observatory in Hawaii since 1958.

2. The trial proceeded remotely using video platform technology. Reference was made to the prediction of Sir Geoffrey Vos, Chancellor of the High Court, in November 2019 that climate change would be a factor in the future conduct of litigation with COVID-19 protocols accelerating the pace of change. In particular, the Court's duty to manage cases quickly and efficiently can include consideration of carbon reduction. The parties and their legal representatives were also commended for co-operating in this respect and enabling an "e-trial" to proceed.

Even parties who are adversaries in the cut and thrust of litigation can be expected to co-operate when comes to reducing carbon emissions.

APPENDIX

An overview of the Paris Agreement 2015 & the UK's Climate Change Act 2008
The Paris Agreement on Climate Change seeks to hold the increase in global average temperatures to 2C above pre-industrial levels, attempt to limit the increase to 1.5C and achieve "net zero" by 2050, where greenhouse gas emissions are reduced and at least balanced by sinks which remove carbon from the atmosphere.

It was ratified in 2016 and enshrined in UK law via amendments to The Climate Change Act 2008 which required the UK to ensure that its net carbon account for 2050 is at least 100% lower than the 1990 baseline. The Act prescribes that this is to be achieved by setting progressive net carbon budgets every five years and laying proposals and policies before Parliament for meeting both current and future budgets.

In October 2021, ***"Net Zero Strategy: Build Back Greener"*** set out Government policy to achieve the UK's carbon budgets, which made it amenable to judicial review by Client Earth, Friends of the Earth, The Good Law Project and environmental campaigner Joanna Wheatley. It has been successfully challenged on two grounds: (1) the Government's net zero strategy did not take into account known information about the estimated pace of reductions in emissions, or obtain reports explaining the numeric contributions of different policies; and (2) the arithmetic was inaccurate as it accounted for 95%, rather than 100%, of the reductions required.

The Government has published interim objectives to its climate strategy to reduce emissions by 2030 by at least 68%, and by 2035 by at least 78%, compared to 1990 levels.