Feature

KEY POINTS

- Litigation related to alleged inaccuracies in corporate disclosure about environmental, social and governance (ESG) issues is on the rise.
- The extent to which claimants must prove knowledge of inaccuracies differs depending on the nature of the claim pursued.
- Reliance by the claimant on any inaccuracy must be proven in any claim – and this raises particular challenges for claimants given the holistic nature of many investment decisions.
- Businesses can seek to minimise the risk of liability in various ways, most notably through precision and transparency in their reporting.

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Seeing the world differently: litigation arising from ESG-related disclosure

A proliferation in ESG-related disclosure requirements for companies – and public awareness of the same – is driving an increase in litigation. This article examines the reporting and disclosure obligations for companies in the UK, and then considers how shareholders or activists might litigate when firms are found to have given incorrect or misleading information. After concluding that there are potential difficulties with proving reliance and causation, the article suggests practical steps companies might consider to try to limit the risk of liability.

The rise of litigation related to environmental, social and governance (ESG) factors over recent years is well-documented, as is growing awareness of the potential consequences of irreversible climate change, and ever-growing regulatory responses to that. These latter developments have meant that the environmental element of the ESG umbrella continues to become of greater significance. As the regulatory regime proliferates, however, so too do the potential pitfalls for companies when discharging their reporting duties. With shareholders and consumers more environmentally conscious than ever, commercial entities face a potential wave of litigation concerned to try to keep them on what is perceived to be the environmental straight-and-narrow.

This article addresses some potential liabilities of companies incorporated and listed in the UK and their directors in relation to disclosure of ESG matters, including particularly environmental matters. After setting the scene and demonstrating the growing disclosure requirements imposed upon companies, the article turns to the methods by which corporate entities might be found civilly liable in relation to their duties to report.

A statement of the legal framework is followed by a discussion of what it means for corporate entities in terms of their legal exposure. Proposals for how those corporate entities might best manage the risk of such litigation will be set out by reference to the different routes to liability.

A GROWING BURDEN

Recent years have been marked by a growing list of reporting requirements for companies. These include yearly reports required under the Companies Act 2006 (CA 2006), such as, most importantly for present purposes, strategic reports and director reports, as well as statutory and regulatory listing requirements for publicly traded shares which offer further potential exposure for firms.

The government has also recently announced its intention to expand the corporate disclosure regime further still. In a recent policy paper, *Greening Finance: A Roadmap to Sustainable Investing*, HM Treasury laid out new proposals for additional environmental reporting standards for firms, investment products and funds.

The centrepiece of the new environmental framework is the impending introduction, through both primary legislation and FCA rules, of a new set of objectively assessed Sustainability Disclosure Requirements (SDRs). It is anticipated that SDRs will apply to companies, asset managers and owners, and the creators of investment products. It is also anticipated that new environmental reporting criteria, called the Green Taxonomy, will be introduced. The intent is that this new set of standards will go beyond those recommended by the International Sustainability Standards Board.

Under the SDR, companies will be required to disclose the percentage of their capital expenditure, operational expenditure and turnover that relates to activities aligned with the Green Taxonomy. Providers of investment products will then disclose the extent to which those products are aligned with the Green Taxonomy based on their constituent assets. This in turn will allow investors to identify aligned investment products.

Further, by tying each element of the Green Taxonomy to a series of "Technical Screening Criteria" (in essence ensuring that a company must take substantive action to be deemed as meeting elements of the Green Taxonomy), the government hopes to make environmental reporting by companies and asset managers more transparent and comprehensible by investors and consumers alike.

This framework is an ambitious step. It is likely to be implemented, at least to a large degree, through statute, and so the new requirements are not nugatory. However, the strictness of the SDR and the objective nature of the underlying Taxonomy and Technical Screening Criteria will have the effect of significantly widening firms' exposure to legal liability. It is to this which we now turn.

LEGAL LIABILITY

Increasingly onerous reporting requirements increase the scope for negative legal and commercial consequences if a firm is revealed to have made incorrect disclosures. Such a revelation through high-profile scandal, regulatory intervention or private legal action

may lead to a sharp drop in stock prices, which can itself lead shareholders to attempt to recover losses suffered as a result of that drop.

There is also a growing class of activist litigant which is not necessarily interested in the financial aspects of these revelations, but instead seeks to use litigation as a tool to enforce the environmental obligations of companies.

On both fronts, companies will be exposed to a range of potential legal liabilities. For UK-listed companies which fail to disclose climate-related risks, there are several potential angles of attack. These include:

- Sanctions imposed by the Financial Conduct Authority for breaches of listing rules, transparency rules or market abuse.
- Criminal liability for breach of various provisions of the Companies Act 2006.
- Civil liability of the company under statute or general tort principles.
- Civil liability of the directors to the company under the Companies Act 2006.

This article will focus on the latter two elements of the list above: the potential aspects of civil liability faced by firms and their directors who fail to make accurate environmental disclosures.

Civil liability of the company

If a company's disclosures are found to have been untrue or misleading, the company may find itself liable either on the basis of general principles of negligence (ie for negligent misstatement or negligent misrepresentation), or under statute.

The law of negligent misstatement and negligent misrepresentation will be relevant in any situation where a company has negligently reported, negligently made disclosures, or negligently misled investors. It will therefore be of the broadest application, since it is not limited by subject matter as with statute. The basic principles of these torts will be well-known to practitioners, but it is worth highlighting the importance of reliance and causation in both.

Damages will only be recoverable for negligent misstatement where the statement was reasonably relied upon by the claimant in the way intended by the defendant (*Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465). Similarly, in an action for negligent misrepresentation, the misrepresentation in question must have induced the representee to enter into the contract (see *Chitty on Contracts, 34th edn.*, 9-041). And, of course, in both cases, the recovery of damages is dependent upon proof of causation of loss.

Negligence remedies are of the broadest application. Moreover, statutory remedies are also available for false or misleading statements in particular contexts. For example, a false or misleading statement in listing particulars or share prospectuses will incur liability under s 90 of the Financial Services and Markets Act 2000 (FSMA 2000), while a false or misleading statement regarding those securities elsewhere will incur liability under s 90A (and Sch 10A) of the same Act.

There are circumstances in which a statutory claim will be preferable to a claim in negligence. For example, liability under s 90 FSMA 2000 expressly includes liability for omissions, which is a point of attraction for claims under s 90 FSMA 2000 when compared to a claim for negligence at common law. Claims under FSMA 2000 also face, however, their own particular challenges. These arise from the statutory defences available to such claims, and to the apparent current appetite of HM Treasury to narrow the scope of the FSMA 2000 provisions.

It will first be helpful to consider the two sections of FSMA 2000 in question.

Under s 90, liability is established when the claimant has suffered loss as a result of any "untrue or misleading statement"[1] which pertained to any security which is caught by the provisions of FSMA.

This is subject to a series of statutory defences, listed at Sch 10. The main defences are that the person responsible for the statement "reasonably believed" that it was true, or that the person allegedly liable both reasonably believed that the person responsible for the statement was an expert competent to make or to authorise the statement and consented to the statement's inclusion in the form and context in which it appeared. Other defences are available (eg for a statement which was corrected, or for a statement which the claimant was aware of prior to purchasing the securities in question) but these seem less likely to arise in the context under consideration.

It is important to note that liability under s 90 is therefore based on an untrue or misleading statement which the company did not reasonably believe to be true. This is almost identical to the formulation of negligent misrepresentation in s 2(1) of the Misrepresentation Act 1967. It is perhaps for this reason that this standard of liability has been called the "negligence standard".

Under s 90A, a similar liability applies to any statement published in relation to the securities, for example on the London Stock Exchange's Regulatory News Service, so long as the securities are admitted to a trading market in the UK. The person incurring the liability is the issuer of the security.

Under Sch 10A, para 6(1), a dishonest statement under s 90A is defined as one which is *both* regarded as dishonest by persons who regularly trade on the securities market in question, *and* which the person liable was aware was dishonest. This is of interest: unlike the prevailing objective standard of dishonesty used in the general law (eg *Ivey v Genting Casinos* [2017] UKSC 67 or *Royal Brunei Airlines v Tan* [1995] 2 AC 378), liability under s 90A is only established if both objective *and* subjective dishonesty are proven.

Another crucial difference between s 90 and s 90A lies in the standard of knowledge required for liability to be made out. As set out above, s 90 depends on the negligence standard: it arises when a company makes an untrue or misleading statement which it did not reasonably believe to be true. By contrast, under s 90A the issuer of the securities is liable only if the person discharging managerial liabilities within the issuer knew the statement to be untrue or misleading or was reckless as to whether the statement was untrue or misleading (FSMA 2000, Sch 10A, para 3(2)). This has been called the "recklessness standard" or the "fraud standard". The requirement to prove an active mental element makes it a higher bar to clear than the negligence standard.

There are therefore three particularly salient points for practitioners concerning ss 90 and 90A. First, it is harder to prove a s 90A claim: it is insufficient to show that the company lacked reasonable belief in the truth of the statement; rather the company must be shown to have known the statement was untrue, or to have been reckless as to its truth. Second, both claims require some kind of reliance on the statement and causation of loss to be proven in order to recover damages.[2] As explained further below, this is difficult for claimants in relation to overarching investment decisions. Third, the list of statutory defences in Sch 10 and Sch 10A of FSMA 2000 is in itself likely to make it harder to establish liability under statute than it is under negligence principles.

This conclusion is bolstered by recent developments concerning FSMA 2000. HM Treasury has recently consulted on amending the legislation so as to permit claims in respect of forward-looking information in share prospectuses (ie predictions as to future performance) to require recklessness to succeed. In effect, this means that to succeed on a claim in respect of misstatements in prospectuses concerning all but present statements a claimant would have to prove that the company knew or was reckless as to the accuracy of those statements. Considering it is this forward-looking information which is likely to be most material to investors in securities, any such amendment is likely to make it somewhat harder for investors to recover losses arising from merely predictive statements that turn out not to be true. This does, however, bring the position as regards forward-looking prospectus information in line with directors' reporting liabilities under s 463 CA 2006 and, of course, s 90A FSMA 2000. This proposed change appears to have been welcomed by respondents to the consultation.[3]

In terms of company liability for statements which turn out to be incorrect, then, the common law is likely to be the first port of call for activists or disgruntled shareholders. By its very nature, all that will be required is to prove "negligence" (rather than some greater level of knowledge or recklessness as to the accuracy of a statement), and a claim may lie in respect of statements in material other than listing particulars, prospectuses and other securities information. However, in claims centred on omissions, and in claims where proof of knowledge and reliance is trickier to establish, recourse to the statutory remedies (particularly s 90 FSMA 2000) is still likely to be sought.

Civil liability of the directors

Directors may also find themselves liable for inaccurate disclosures made negligently if the company decides to sue them to recoup their losses.

Under s 463 of the Companies Act 2006 (CA 2006), directors of a company are liable to compensate the company for any loss suffered as a result of an untrue or misleading statement included in the statutory director's report, strategic report, directors' remuneration report, or corporate governance report. Crucially, however, this liability is only imposed if the director in question knew that the relevant statement was untrue or misleading or was reckless as to whether it was untrue or misleading.

What are these reporting requirements? Directors are required under s 414C CA 2006 to publish a strategic report with the express purpose of informing shareholders of the performance of the company and how the directors have fulfilled their duties under s 172 CA 2006. Importantly s 414C requires the strategic report to include:

> "s. 414C(4): *'where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters'*
>
> s. 414C(7)(b): *'information about environmental matters (including the impact of the company's business on the environment)'*"

These requirements are supplemented by s 415 CA 2006, which requires directors to prepare a directors' report for each financial year.

Under Reg 7 of the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 (SI 2013/1970), listed companies must also give details of their greenhouse gas emissions in line with the requirements of s 85 of the Climate Change Act 2008.

The potential for liability in this sphere is, self-evidently, very broad. However, the drafters of the Companies Act and its many amendments have included saving provisions which will come to the rescue of directors who are accused of preparing untrue or misleading reports. As with the "recklessness" standard above for s 90A FSMA 2000, there is a requirement to prove that the directors knew or were reckless as to the untruth or misleadingness of the statement (or omission) (s 463(3) CA 2006). The difficulty of proving this will reduce the likelihood that the company will be able to obtain compensation from a delinquent director.

As set out above, the newer reporting requirement under s 414C CA 2006 was introduced with the express purpose of enabling shareholders to monitor a director's compliance with their duty under s 172 to promote the success of the company. Quite aside from the independent requirement to have regard to the environmental impact of business activity under s 172(1)(d), it can therefore further be inferred that a director who makes inaccurate environmental disclosures could be liable to the company under s 172. Such a view has begun to attract authoritative support: cases in Australia are beginning to move in this direction, and this development was extrajudicially recognised by Lord Sales as being of potential application in England.[4]

Conclusion

There are several ways in which firms can find themselves liable for incorrect environmental (and other ESG-related) statements. The key points to pay attention to are:

- the essential requirement in almost all cases to prove reliance and causation; and
- the need, in many cases, to demonstrate that those responsible for the untrue or misleading statements knew or were reckless to that fact. This will be an even more expansive requirement if the Treasury decides to proceed with its planned reform to forward-looking information in prospectuses and listing particulars.

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How might companies seek to protect themselves from liability in this way?

KEEPING OUT OF TROUBLE

So far, so troublesome. But there are various ways in which defendant companies can seek to reduce the risk of successful litigation against them.

Reliance

Claimants face an inherent difficulty in proving reliance. Investment decisions are frequently holistic ones rather than made on the basis of individual statements. And while there is no requirement that a particular statement be the sole matter relied upon by an investor or shareholder, it does need to have been material in the sense that, but for the statement, the claimant would not have purchased the securities (see eg *Edgington v Fitzmaurice* (1885) 29 Ch D 459).

This reasoning also applies at least to s 90A FSMA 2000: in a recent case surrounding incorrect accounting information disclosed by a major supermarket, reliance was held to be a key part of claims under s 90A FSMA (*SL Claimants v Tesco plc* [2020] Bus LR 250 at [91]) and was required to be particularised for each individual shareholder.

It is arguable that reliance in the ESG sphere is easier to demonstrate. ESG-conscious investors will likely treat adequate ESG disclosure as being a threshold issue for whether they invest. To this extent, they will be able to demonstrate some kind of documented reliance. However, not all claimants will be specifically ESG-focused, and documented reliance will not be available in all circumstances. Reliance stands to remain a key issue for litigants.

Negligence, knowledge or recklessness

The requirement, at the very least, that the defendant be shown to have acted negligently in making the false statement, or, at very most, that the defendant be shown to have acted with knowledge or recklessness, provides ample opportunity for firms to protect themselves from liability.

The bottom line is that transparency is likely to ward off litigation. Giving details about the methodology adopted or the assumptions made in the information published is likely to reduce the scope for liability, as is being clear that any figures given are merely directional or aspirational rather than predictive or on the basis of firm mathematical modelling. By being honest (and by suitably caveating any ESG-related claims), claimants will have a more difficult time establishing negligence, dishonesty or recklessness.

As a backstop, disclaimers might also be used. However, these should be deployed deliberately and with appropriate caution: disclaimers are likely to be construed restrictively by the courts, and so those which are unduly broad will probably not be specific enough to immunise a firm from liability. In the 2021 Shell case in the Netherlands, for example, broad boilerplate disclaimers were deemed by the court impermissibly to undermine the company's *prima facie* commitment to emissions reductions, itself a ground for finding that the company was disregarding its reduction obligations (*Case C/09/571932: Milieudefensie v Royal Dutch Shell*, at [4.5.2]). It is likely to be preferable to be transparent than to rely on disclaimers. Any such disclaimers should be carefully worded and as narrow as possible while still seeking to pursue the firm's goals.

CONCLUSION

The reporting requirements for firms are already broad, and are set to become broader still with the government's renewed focus on environmental disclosures. Within a decade, companies, asset managers and investment funds will be required to assess themselves according to the objective standards in the UK Green Taxonomy.

Through both general negligence principles and statute, it has been shown that the disclosure regime leaves companies open to litigation. It is reasonable to infer that this exposure to liability will only increase with a more objective environmental reporting framework. Companies may find themselves liable for general disclosures and reporting through the law of negligent misstatement or misrepresentation, while those which sell securities may find themselves further liable under the provisions of the Financial Services and Markets Act 2000.

Despite this, however, there is ample opportunity for firms to defend themselves against action. First, the government is likely to tighten up liability under FSMA 2000, making forward-looking information subject to a higher standard of knowledge whereby mere negligence is not enough to found liability. Second, claimants face difficulties proving "but-for" reliance or causation in relation to individual statements. Third, with the careful use of contextual information and disclaimers, companies will be better equipped to ward off liability.

While ESG factors grow in importance, it is important for firms to be aware how those factors can morph into litigation when things go wrong. If there is one watchword, however, it is likely to be transparency. There is no better preventative than to ensure that disclosures are accurate. But being clear about information and its provenance, and the assumptions underpinning it, will make firms' lives easier – and crucially, comply with the spirit of the reporting regimes in any event. ■

1 Liability under s 90 also extends to include omissions of any statement required under either statute.

2 Although note the persuasive view of the *Encyclopaedia of Financial Services Law* at 2A-189, which submits that claims under s 90 FSMA 2000 do not require proof of reliance.

3 UK Prospectus Regime Review Consultation: Summary of Responses, 16 December 2021.

4 Lord Sales, *'Directors' duties and climate change: keeping pace with environmental challenges'*, speech given to the Anglo-Australasian Law Society on 27 August 2019.

Further Reading:

- Climate-related disclosures: the new frontier? (2020) 9 JIBFL 615.
- Claims against ESG rating agencies: a hopeless task? (2021) 10 JIBFL 681.
- LexisPSL: Interactive toolkit: Banking & Finance: Sustainable business toolkit.