ALLEN & OVERY

Risks for directors in the spotlight: Climate litigation

In this article we shine the spotlight on an emerging risk for directors – that of direct claims against them relating to acts or omissions addressing climate change. We briefly consider this fast developing area of litigation and examine some examples of the claims being made against directors. Against this backdrop, we then focus on the issues to be considered by directors and risk managers in seeking insurance protection against such risks.

Overview

In recent years claims relating to climate change have expanded. Companies, financial institutions and, increasingly, their directors and officers are finding themselves in the firing line.

In May 2021, the Court of the Hague delivered a landmark decision, ordering Shell to reduce its global CO2 emissions by 45% by 2030 (*Milieudefensie v Shell plc*). Similar claims were filed in Germany in 2021 against the car manufacturers BMW, Mercedes Benz and Volkswagen. In the U.S., ExxonMobil, its chairman, CEO, and other directors have been subject to a number of securities and financial regulation claims, relating to alleged failures to disclose climate risks properly (*Ramirez v ExxonMobil*).

To date, few climate actions have been filed in the UK against corporates or their directors. However, in March this year, NGO ClientEarth announced that it was taking the first step in commencing legal action in the UK against 13 of Shell's directors, alleging breaches of directors' duties for failure to prepare sufficiently for the transition risk for Shell to net zero. If the case proceeds, it will be the first UK case seeking to hold directors personally liable for failing to properly manage climate risk.

The legal theories being used to put directors directly in the firing line for climate risk vary from country to country. We set out below some of the typical arguments being used in the UK and elsewhere. We then set out the questions which need to be addressed to ensure that directors have the right insurance protections in place.

Directors’ Exposure

Directors’ Duties

Section 172 of the UK Companies Act 2006 requires directors to act in a way most likely to promote the success of the company. Directors are also required to have regard to the impact of the company’s operations on the community and the environment. In doing so, directors must exercise reasonable care, skill and diligence.

It is not sufficient to pay lip service to this duty; directors will need to take action to address environmental issues like climate change, or risk claims for breach of their duties. Claims against directors for breach of such duties must be brought by the company and for harm or loss caused to the company. It is, however, unlikely that a board will choose to sue itself and so these types of claims are more often brought by a company directed by a new board of directors against their predecessors or take the form of a derivative action (ie a claim by shareholders brought in the company’s name).

ClientEarth’s threatened claim against 13 of Shell’s board members, mentioned above, is a derivative action, alleging breach of directors’ duties under section 172 of the Companies Act. ClientEarth allege that Shell’s board has failed to implement sufficient policies to meet Shell’s net zero obligations, thereby jeopardising Shell’s long-term value and risks asset stranding.

Disclosure Liability : Task Force on Climate-Related Financial Disclosures (TCFD)

Directors also face liability in the UK arising from the new climate disclosure rules. The rules require the largest UK companies and financial institutions to disclose in their annual report how they are addressing climate related risks. These types of claims are common in other jurisdictions. In *Abrahams v Commonwealth Bank of Australia* shareholders sued the Commonwealth Bank of Australia alleging it violated the Australian Corporations Act by issuing an annual report which failed to disclose climate related business risks.

There are significant legal obstacles to bringing these types of claims in the UK. Even if misstatements regarding climate risk are made, that information would need to be directed to and relied on by a specific claimant for there to be a successful misrepresentation or negligence claim; this is unlikely in the case of general statements in, say, an annual report. Alternatively, a claimant could bring a claim in the UK under section 90A of the Financial Services and Markets Act 2000 (FSMA), which covers misinformation published to the market as a whole. However, s.90A claims can only be brought against an issuer and are limited to claims involving dishonesty or recklessness by those responsible for the publication as to whether information should be disclosed and, if so, the accuracy of that information.

Section 463 of the UK Companies Act 2006 provides a potential safe harbour for directors. Under this provision directors will only be liable to the company for information in the directors’ report, directors’ remuneration report, a strategic report or corporate governance statement, and only to the extent that he/she knew or was recklessness as to whether the statement was untrue or knew the omission was dishonest (ie the same standard as s.90A).

IPO or Rights Issue

There are greater risks for directors in relation to climate disclosure obligations in the context of companies with UK listed shares. Here claims are not limited to actions involving dishonesty or recklessness, and, unlike section 90A claims, can be brought against those responsible for the prospectus, including the directors. Claims could be brought against a company and its directors by investors who bought securities pursuant to misleading climate-related information in a prospectus (under section 90 of FSMA). So far as UK claims are concerned, however, HM Treasury has suggested amending the standard applied under section 90 of FSMA, from negligence to recklessness, in relation to forward looking information (which would capture climate risks). If this proposal is introduced it will be more difficult for a claimant to bring a successful claim against corporates and their directors for climate related breaches under s.90 FSMA.

Given the heightened public interest in climate change, it seems increasingly likely that allegations will be made that a company has misstated its climate impact which, once identified as mistatement, damages the company's share price and gives rise to s.90, s.90A or other types of "stock-drop" claims.

Liability for the company in these claims often turns on the extent of the director's knowledge of the underlying event, putting the directors' state of mind and conduct at the heart of these claims. This can make the defence of such claims highly fact intensive as well as requiring detailed expert evidence.

Regulatory enforcement – Greenwashing

New climate-related regulation, governing financial and consumer products in the UK, has been introduced, requiring (amongst other matters) more and accurate disclosure on products' environmental impacts.

Regulators in the UK and elsewhere in Europe have upheld greenwashing claims against fossil fuel companies for matters such as classifying natural gas as a clean fuel. The Italian Competition and Market Authority imposed a fine of EUR5 million against fossil fuel company Eni for labelling biofuels as 'green' diesel[1]. Similar complaints have been filed against Shell before the Advertising Standards Authority in the UK[2].

It is not only energy companies who are at risk. The German banking regulator, Bafin, recently launched an investigation in relation to an asset management company's claims regarding the sustainability of its investments which led to the CEO stepping down.

The increased regulatory landscape and growing appetite for climate litigation could see more corporates, financial institutions and their directors being subject to claims and regulatory findings.

1_Complaint by Transport and Environment against ENI before the CMA of Italy (2019)
2_Advertising Standard Authority UK complaint against Royal Dutch Shell (2020).

How are directors protected?

Indemnity from the company?

Many directors will have the benefit of an indemnity in their service contracts for certain types of liability. However, section 232 of the Companies Act 2006 prohibits a UK company from indemnifying a director against their liability for negligence, default, breach of duty or breach of trust in relation to the company or an associated company (subject to certain, limited, exceptions). Companies may pay directors' legal costs of defending civil proceedings but, if final judgment is given against the director, any such sums must be repaid. Similarly, a company is permitted to fund a director's defence costs in proceedings brought by a regulatory authority, but is not permitted to indemnify the director against the payment of any penalties levied by the regulatory authority.

Therefore there are significant gaps in the corporate protection from which directors may typically benefit. Insurance can be bought to fill these gaps but it is important to scrutinise the insurance cover closely to make sure it meets the director's and company's needs.

Will my Directors & Officers Insurance Policy respond?

Directors' & Officers' (**D&O**) policies insure individual directors (both executive and non-executive) and/or officers of a company against their liability for, and costs of defending, claims against them in that capacity. The cover provided is commonly extended to provide cover for some or all of the following:

(a) Investigations, including criminal, regulatory and, sometimes, internal investigations;

(b) Claims in relation to the listing or offering of securities;

(c) Extradition proceedings; and

(d) Corporate manslaughter charges.

> "A strength of the London insurance market is that it enables well advised and supported large corporates to negotiate bespoke cover in this increasingly important and potentially contentious area. The aim is to achieve clarity and transparency and thus avoid unnecessary satellite coverage disputes in the event of a claim."

Francis Kean, Partner, McGill

As we set out above, climate litigation against companies and their directors has to date typically involved novel uses of existing causes of action and procedures, such as breach of fiduciary and statutory duties, derivative actions, prospectus claims under section 90 of FSMA, and regulatory investigations. These types of claims are squarely within the types of causes of action and procedures for which D&O policies are designed to provide an indemnity, even if climate risk has not historically been an area of claims.

Tellingly, the recent Bank of England's Climate Biennial Exploratory Scenario exercise (CBES) recently concluded that D&O policies were the type of insurance most likely to be exposed and to respond to climate litigation, in particular to greenwashing claims and claims based on breach of fiduciary duties.[3] This reflects both that such policies could respond to climate litigation against individual directors and that the Bank of England is alert to the potential avalanche of claims. Policyholders need to be aware of the risk that, as an expanding area of risk for insurers, insurers may impose tighter terms with more exclusions and potentially lower limits available. In such a challenging market, it is all the more important for risk managers to develop good relations with their insurers and brokers and to have good conversations before each renewal on the nature of the risks faced by the entity, and the policy wordings available.

3_https://www.bankofengland.co.uk/speech/2022/june/anna-sweeney-speech-at-the-association-of-british-insurers-climate-change-summit-2022

Some D&O policies do provide bespoke extensions to cover for claims relating to pollution, or environmental mismanagement. This cover is typically focused on claims in relation to environmental damage, such as the release or discharge of pollutants, and may also provide cover for related clean-up costs. Depending on the individual policy wording, it may be possible to bring a claim relating to a company's cumulative impact on the climate – such as that threatened by ClientEarth against the directors of Shell – within the scope of these types of extensions to cover. We have also seen some policy wordings that provide bespoke cover for disclosure failures relating to global warming or climate change.

However, D&O policies will typically also contain various exclusions from cover that limit the types or risk insured. Common exclusions include:

(a) Liability for any bodily injury or damage to property;

(b) Claims in the courts of the United States and/or Canada. As the United States leads the way in climate litigation against directors and officers, whether your policy contains a geographic exclusion for North America may be critical to the effectiveness of your cover for climate risks.

(c) Claims alleging deliberate, wilful, and/or fraudulent acts or omissions of directors. This exclusion is intended to ensure that D&O policies provide cover for claims concerning innocent or negligent conduct by directors, but not deliberate or fraudulent conduct.

In the climate litigation context, omissions – and an individual directors' state of mind in relation to a particular omission – is an area where the application of this exclusion may prove contentious. Climate litigation often concerns an alleged failure to manage climate risk or make appropriate disclosures ie omissions rather than acts. If any such omission is negligent, then this type of exclusion would not apply. However, if insurers can show it was deliberate, the exclusion may well apply. Establishing an individual director and/or the board as a whole's state of knowledge and intentions, including whether they can be said to have "blind-eye" knowledge, may prove challenging and contentious.

In particular the centrality of the directors' state of mind and conduct to "stock-drop" claims may mean that insurers will seek to rely on these types of exclusions in relation to such claims. A successful s.90A claim – where fraud is a pre-requisite – would likely engage this type of exclusion.

It should also be noted that these exclusions typically operate as a clawback mechanism, such that the insurers pay the directors' defence costs until the point at which the director is found, or admits, to have acted in one of the excluded ways. If there is such a finding or admission, the insurer then has the right to reclaim all sums previously paid.

(d) Fines, whether criminal or civil.

D&O policies (unlike the company's indemnity) will of course specify a limit on insurers' liability, both for individual claims and overall for all claims. To date climate litigation has typically targeted boards as a whole, rather than individual directors, and therefore multiple individuals may be seeking cover at the same time for the same risk. It is also common for D&O policies also to provide cover for employees acting in a managerial or supervisory capacity and/or for certain specified roles below board level, such as general counsel. D&O polices are thus insuring a wide variety of individuals against a wide variety of claims.
The policy limits apply on a first come, first served basis (sometimes subject to some safeguards). Therefore there is a risk that, even if in principle the policy responds to a piece of climate litigation, the policy limits are inadequate, or already exhausted, so as not to provide sufficient protection.

Further information and a helpful checklist as to what to look for in a directors' and officers' liability policy can be found on our website, as can further information about the differences between the protection provided by company indemnities and D&O policies.

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