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Zeroing in

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The current case

In what is considered to be a "UK first", Shell shareholders have outlined their intention to bring a claim against Shell directors for failing to properly prepare the company for net zero. On 15 March 2022, ClientEarth, which had bought shares in Shell, sent a pre-action letter to Shell's board, claiming that the 13 executive and non-executive directors have failed to adopt and implement a strategy aligning with the Paris Agreement. It is the first case where a claimant has sought to hold company directors personally liable for failing to prepare for net zero.

The term net zero refers to a state in which greenhouse gases going into the atmosphere are balanced by removal out of the atmosphere. The Paris Agreement is a legally binding international treaty on climate change, which requires that countries reach net zero by 2050. The UK's Net Zero Strategy: Build Back Greener, published in October 2021, committed to decarbonising all sectors of the UK economy to meet a net zero target by 2050.

One of the grounds for the claim is the failure of the company to adequately respond to the ruling in Milieudefensie v Shell in May 2021, in which the Hague District Court in the Netherlands ordered Shell to reduce group-wide carbon emissions by net 45 per cent by the end of 2030 (compared with 2019 levels). Shell is currently appealing this decision, with the judgment branded "unreasonable" by directors. ClientEarth, has stated that they believe there are "sufficient grounds to assert that Shell's Board is mismanaging the material and foreseeable climate risk facing the company".

If proceedings are subsequently issued, ClientEarth will require the Court's permission to pursue them by way of derivative action on behalf of Shell.

The applicable law

ClientEarth, the shareholders' law firm, argues that the directors of Shell have failed to promote the success of the company for the benefit of its members, as required by section 172 of the UK Companies Act 2006 (**"Companies Act"**). Section 172 provides that a director must act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. In so doing, the director must have regard, amongst other things, to the impact of the company's operations on the community and the environment.

Furthermore, shareholders argue that Shell directors have breached their duties under section 174 to exercise "reasonable care, skill and diligence when discharging their duties". It is argued that Shell has failed to exercise reasonable skill and care in creating and committing to a climate strategy which adequately addresses the climate-related risks to its business.

The implications for net zero strategies in financial services

Failing to prepare a company for the net zero transition, despite being exposed to physical and transitional risks of climate change, brings with it the danger of litigation. Physical risks include acute and chronic meteorological or geographical phenomena whereas transition risks are those arising from adjustment towards a low-carbon economy, such as developments in public policy, technology, new legal authorities and changes to the interpretation of previous authorities.

In response to the UK's strategy for moving towards net zero, regulators in the UK have taken it upon themselves to implement rules on dealing with physical and transition climate risks. In October 2021, in a joint statement by the Financial Conduct Authority ("FCA"), Prudential Regulation Authority ("PRA"), The Pensions Regulator ("TPR") and the Financial Reporting Council ("FRC"), the Government's invitation to publish Climate Change Adaptation Reports was welcomed.

In the FCA's Climate Change Adaption Report, it states that its net zero commitments will be "backed up by appropriate governance". Similarly, in the PRA's Climate Change Adaption Report, there is a requirement to demonstrate a good understanding and management of climate-related financial risks on an ongoing basis and hold capital against material climate-related financial risks. The TPR's Climate Change Adaption Report highlights that its proposed new code of practice will include several climate change modules. Meanwhile, the Pension Schemes Act 2021 writes climate change into pensions law, with regulations under the Act adapting the recommendations for trustees from the Taskforce for Climate-related Financial Disclosures (**"TCFD"**). The FRC has, in its most recent year-end bulletin of key corporate reporting matters for companies, set out its focus for 2022, which is that premium listed companies will be required to disclose their compliance with the Taskforce for Climate-related Financial Disclosures (**"TCFD"**) recommendations on a comply-or-explain basis. The FRC also expects material climate change policies, risks and uncertainties to be included in narrative reporting and appropriately considered and reflected in a company's financial statements.

The success of the current claim will depend on whether the Court grants permission to bring a derivative claim on behalf of the company against the directors personally. Permission will be refused if the directors can show that Shell's strategy for net zero transition has either:

- been ratified by Shell or;
- a person acting in accordance with the duty to promote the success of Shell would not seek to proceed with the claim.

(section 263, Companies Act).

If ClientEarth is successful, the Court could force Shell's board to align its climate strategy with the goals of the Paris Agreement by way of a mandatory injunction. It could also declare that the Shell Board acted in breach of its statutory duties pursuant to the Companies Act.

Advice to provide senior managers and directors

Compliance officers and boards should therefore be aware that the Companies Act codifies the obligation on directors to have regard to (among other things) the impact of a company's operations on the environment. Like many requirements of the Companies Act, directors are exposed to a breach of duty claim if that requirement is not fulfilled in relation to decision making or activities with the potential to impact the climate.

For listed companies, there is a requirement (under the Listing Rules) to start publishing their climate-related disclosures in 2023 in respect of financial years beginning on or after 1 January 2022. We are also likely to see mandatory climate-related disclosures by the end of 2023 apply to most UK-registered companies. Companies should, therefore, "get their house in order" sooner rather than later and consider the environmental impact of their business operations.

In relation to any business dealing with consumers, the Competition and Markets Authority **("CMA")** Green Claims Code ensures that any environmental claims on goods and services do not mislead customers and can be substantiated. The rules are simple: claims must be truthful, accurate, clear and unambiguous. Greenwashing claims can also be brought under section 90 or 90A of the Financial Services and Markets Act 2000. These sections permit compensation to a person who has suffered loss as a result of "any true or misleading statement or dishonest omission" in relation to specific company documents.

Although there are procedural hurdles to bringing such a claim by way of shareholder derivative action, it remains a material risk.

The role of compliance within a financial institution's Net Zero transition

For now, compliance officers should mitigate their risks by ensuring that their companies:

- Understand and assess climate risks and address and oversee them within the entire business strategy;
- Identify, measure, monitor, manage and report on exposure to climate risks;
- Address a variety of outcomes relating to different transition paths to low-carbon solutions with both short- and longer-term assessments;
- Consider whether action needs to be taken to enhance transparency and consider that disclosure will be mandated in the near future.

There are numerous challenges in meeting these goals. Namely, data and tools to measure climate risks will require increasing scope, sophistication, accuracy, comprehensiveness and clarity. Where scientific data is not yet adequate for the accurate estimation or delineation of climate risks, companies should use reasonable proxies and assumptions. Furthermore, expanding awareness and knowledge across a company's workforce and agents, with a particular focus on senior managers, is also important.

Companies risk opening themselves up to regulatory or shareholder action where there are inconsistencies between a company's public position in relation to environmental issues and its internal activity.

Conclusions

The Shell litigation is indicative of what is to come, particularly in light of the rise of shareholder activism against Big Oil, in recent months. ClientEarth has argued that the board's strategy prioritises "near-term profit" at the cost of "enduring commercial viability".

Environmental charities and non-profit organisations are increasingly exploring new judicial routes to increase companies' environmental commitments. In May 2021 alone, Exxon had three of its directors replaced by "climate competent board members" nominated by activist hedge fund Engine No. 1, and Chevron's shareholders voted in favour of strict targets to drastically reduce its scope 3 ("from products it sells") emissions. But the Shell case has implications for all companies in financial services, and not just those in the "dirty energy" sector.

Companies should be alive to these issues and keep a close eye on legislation likely to come into force in 2023 requiring specific environmental disclosures, and plan ahead in the meantime.

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