Browne Jacobson

Directors and officers update (Summer 2023)

07 August 2023

ClientEarth v Shell

The High Court has refused permission for the environmental activist group, ClientEarth, to continue its derivative action against the directors of Shell in respect of the company's alleged mismanagement of the risks of climate change and its climate change commitments.

It had all gone rather quiet in the dispute between ClientEarth and Shell since the issue of the Claim Form earlier this year (you can read our previous report here). Since then, the court has been considering ClientEarth's application for permission to pursue the claim (required as a result of this being a shareholder derivative action). That decision has now been handed down by Mr Justice Trower who ruled that permission be refused.

There is much to consider in the 18-page judgment, which is worth reading in full for an understanding of the arguments put forward by either party, but the crux is that Mr Justice Trower was unimpressed with what he interpreted as ClientEarth's efforts to seek to impose absolute and specific duties on Shell's directors as to climate change which: "*cut across their general duty to have regard to the many competing considerations as to how to best promote the success of Shell for the benefit of its members as a whole*" – that general duty being what is required of the directors by section 172 of the Companies Act 2006.

The Judge also expressed concern about the "*collateral motive"* of ClientEarth – there was an inference that the real interest of ClientEarth was not to promote the interests of the shareholders as a whole but rather an effort to impose its views as to the correct strategy for dealing with the climate change risk. ClientEarth had not, in the court's view, done enough to counter that inference, particularly given that the level of support from shareholders generally was modest. Furthermore, Mr Justice Trower found that the court was not the forum for the resolution of these sorts of issues, which should more properly be decided by a vote of the shareholders in a general meeting.

ClientEarth was granted an oral hearing before Mr Justice Trower for the decision to be reconsidered and that was also dismissed. ClientEarth have indicated that intend to appeal that decision.

Considering the investment of time, energy and money to have progressed the claim even to this stage, as well as it being the first notable investor lawsuit against directors over the alleged failure to properly prepare for a shift from fossil fuels, it always seemed inevitable that we would see an airing of the parties respective positions in a court room. That being said, if ClientEarth's main objective was to shine a spotlight on the actions (or inactions) of Shell's board of directors and prompt greater scrutiny of their climate change strategy then ClientEarth may consider that, from the amount of public awareness raised by the derivative claim even being issued, that objective has already been largely achieved.

Emerging risks – ESG

Environmental, Social and Governance (ESG) issues are key sources of emerging liability for directors and officers (D&O), with companies facing constantly evolving regulations and disclosure requirements. Although it might seem that companies lagging behind on ESG initiatives would be a bad D&O risk, it is the companies that adopt a proactive position on ESG that potentially face liability.

Environmental, Social and Governance (ESG) standards were originally introduced as a way to encourage industries to consider their practices and policies and take a more positive approach to becoming more accountable and sustainable. ESG is now high on the boardroom agenda across almost every industry, having filtered down from large multi-national corporations to the mid-size companies that comprise large parts of global supply changes.

Over the last 15 years the main focus of D&O concerns, particularly in the financial services sector, have largely been driven by 'governance'. Following the global financial crisis of 2008 there was a significant rise in regulation leading to the creation (and separation) of the Financial Conduct Authority and the Prudential Regulation Authority.

The next wave that is now coming through focuses more on the 'E' and the 'S' of ESG. There is an increased awareness of the importance of sustainability and responsible business practices. As a result, there is greater scrutiny of whether a company is meeting those responsibilities and they are being held accountable if they are failing to do so. The Government and the FCA are increasing the obligations placed on companies to make disclosures as to their sustainability and their climate related risks and ensure that those disclosures are accurate and reliable.

Businesses that claim to have made significant sustainability efforts that turn out to be unsubstantiated, exaggerated or otherwise misleading are coming under scrutiny. Where companies set themselves an ambition – for example to be net zero by 2030 – they then become a target if the directors fall short of achieving that ambition and will face strong pushback from investors, consumers and regulators.

In the UK, increasingly higher reporting requirements allow for a greater ability to hold corporations to account. Disclosed data and zero emission plans can be scrutinised and compared against agreed international targets to see whether companies and their directors are meeting their own targets.

As a result, management is now finding it is caught between a rock and a hard place. If a company sets its targets too high and they are not met then they may face a backlash from the public, investors and other stakeholders that relied on those promises. Conversely, say too little and a company risks being accused of not doing enough to hold itself accountable on ESG issues or keep up with its competitors. It is a fine line to tread and insurers expect that it is only a matter of time before there is an increase in ESG claims activity. This will have a knock-on effect on the insurance industry and underwriters will want to see increased due diligence on any ESG-related claims that have been made and may start to offer improved D&O terms for firms that can show they are properly managing their ESG risks.

SVB – The D&O fallout

The fall of Silicon Valley Bank ("SVB") spread fears of a wholesale banking collapse across the globe. This was steadied by unprecedented governmental and regulatory intervention, with only a handful of US banks and Credit Suisse (which was plagued by issues far in advance of this) succumbing to recent fiscal pressures. There is no need to revisit the reasons for the capitulation of SVB here – this is a well-trodden topic, including within the April edition of Browne Jacobson's *ESG in 3D* – but what does this collapse mean for D&O and has SVB ushered in a wave of insurer caution?

Caution reigns

Over the weekend of 11-12 March 2023, insurers stared into the abyss of voluminous SVB claims and a potentially catastrophic domino effect – before the US government and HSBC (alongside interventions in other jurisdictions such as Canada) swooped in with eleventh-hour deals. As a result, the market is resorting to a period of caution and re-alignment.

Despite this scare, insurers are not rushing to re-draft the provisions of their D&O policies. Instead, more deliberate consideration of these policies is likely going forward. For example, in an era where a prudentially significant firm can collapse within the space of a few days, waiting for allegations of fraud or mismanagement - that might exclude coverage – to be proven may not be viable. Without a fuller consideration of the detailed wording of policies it is ultimately likely that insurers will instead redivert capital so that there are sufficient reserves to ensure they can weather previously safe risks on a prudential scale.

The D&O risks in the event of a bank's failure will vary depending on the cause of the downfall. However, SVB has made the market alive to risks on a considerable scale, although it is SVB's previously reputable nature that will strike deepest. The risks are particularly acute considering the finite nature of resources available to deal with any future government/regulatory intervention. The fallout has been relatively contained on this occasion but it is doubtful whether the required level of resources would be available if another significant institution suffered the same fate. For example, who would have thought in the first days of March 2023 that SVB's D&O cover would have been engaged to cover claims against the bank because of its failure, including those from its own shareholders.

A closer look

To match the market cooling, insurers will be re-aligning their underwriting guidelines to ensure they adequately value the risks from the institution itself, as well as its customers. SVB's reliance on small-medium and start-up companies in innovative and tech fields meant that their customer base was cash-hungry. This meant that when the fiscal winds changed, reserves were soon depleted, and the cash hungry customers ate into the foundations of the bank. It will be interesting to see how the market values these customers going forward – whether they are deemed as a high potential 'asset' for an insured, or a potential liability worthy of inflated premiums. One thing is for sure, more extensive due diligence of systems and controls to manage these risks during the underwriting process is likely to follow.

Dereliction of Duties

In the case of **Powers v. Greymountain Management Ltd [In Liquidation] [2022] (Ireland)** – the Irish High Court held that four directors were personally liable for the large-scale fraud committed by the company. Even though the court accepted that the two shadow directors were the 'controlling minds' of the fraud, the two Irish directors had abrogated their responsibility as directors to such a degree as to justify them being held personally responsible for the losses.

Greymountain Management Limited ("Greymountain") based in Ireland was managed by two Irish directors and two shadow directors based in Dubai. Greymountain took payments from investors that believed they were trading in binary options; however, it transpired that no legitimate trades were being made and the money was being transferred for the use of the shadow directors. A claim was made by 35 investors for losses totalling over $4m.

One of the Irish directors was a student that had been persuaded by his mother to take on the position to help pay his student fees. He had no role in the daily running of the company and received US$1,000 per month. The other was an experienced company director, having previously held directorships in over 400 companies. He claimed to have held an administrative role, akin to a company secretary, for which he received US$10,000 per month, though it was noted that he was responsible for signing pay processing agreements, transferring money and resolving complaints against Greymountain.

The Judge acknowledged that lifting the corporate veil should not be taking lightly but it was satisfied that where '*the sole purpose of Greymountain was to defraud unsuspecting individuals of their money*' it would be an '*affront to justice*' to allow the shadow directors to hide behind this protection when they were morally liable for causing the losses.

In respect of the Irish directors, the Judge acknowledged that the directors had been unknowingly involved in facilitating the fraud, but this was a result of their complete dereliction of duties as directors. Even though they may not have been aware of what was taking place, they had abrogated their responsibility as directors to the Dubai based shadow directors who took advantage of that opportunity to defraud investors who would likely have taken some comfort in the fact that this was an Irish company and therefore subject to EU regulation. The Irish directors were either ignorant of the law, which was not a defence, or chose not to acquire adequate knowledge of Greymountain to discharge their duties as directors. The Judge found that the impropriety was sufficiently serious to justify both Irish directors being held personally responsible.

This case is reminder to directors that although there are protections in place, these are not absolute and there will be circumstances which justify the corporate veil being lifted. Although these circumstances are rare – this case is a first for Ireland - directors must ensure that they are aware of their duties, have sufficient knowledge of the activities of their company and exercise proper control over those activities to ensure they will not be held responsible for the action of others.

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