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ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) LITIGATION RISK FOR LENDERS

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A practice note on issues that lenders should be aware of when assessing whether the companies they are lending to are exposed to environmental, social or governance (ESG) litigation risk. Litigation on issues related to ESG is increasing so due diligence on the ESG risks considered in this note is becoming increasingly important.

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SCOPE OF THIS NOTE

Lenders have long been aware of the reputational risks of lending to companies with poor records of environmental, social or governance (ESG) policies. Recently, however, several companies have faced serious financial consequences for the negative effect that their actions have had on the environment, individuals or specific communities.

Given the potential financial impact of ESG litigation on a borrower and its ability to service and repay a loan, lenders are increasingly looking for ways to assess and minimise these risks. This note considers key ESG litigation risks that borrowers who are private companies may face and the claims that may be brought against them.

Claims against public authorities and other governmental bodies arising out of ESG concerns are outside the scope of this note. The focus of the note is on claims that could be brought against corporate borrowers. As such, criminal offences and regulatory disciplinary action are generally outside the scope of this note although are mentioned in passing in certain instances below.

WHAT IS ESG LITIGATION?

There is no ESG cause of action in English law. However, several existing English law causes of action provide a potential means for parties to pursue claims connected with ESG principles. Claims are therefore pursued under existing English legal causes of action such as in:

- Negligence.
- Nuisance.
- Unjust enrichment.
- Breach of statutes such as the *Companies Act 2006* (CA 2006) or the *Financial Services and Markets Act 2000* (FSMA).
- Fiduciary duties are also a developing area of law where ESG concerns are of potential relevance.

ESG claims for negligence

In a negligence claim, the claimant needs to show that:

- The alleged tortfeasor (the company) owed a duty of care to the person who suffered the damage.
- There was a breach of that duty.
- The claimant suffered loss or damage as a result of the breach.

For more information, see *Practice note, Claims in negligence: an overview*.

Claimants use the tort of negligence to pursue claims arising out of ESG concerns.

Lenders should be aware that certain borrowers may face negligence claims either based on negligence affecting the environment, harm to legal or natural persons and property or as a result of weak governance. It is evident from the facts that cases arising out of a company's weak governance overlap substantially with undesirable social consequences of a company's actions.

ESG claims for nuisance

The tort historically most associated with claims regarding environmental concerns is that of nuisance. There are two forms of common law nuisance: private nuisance and public nuisance. See *Practice notes, Common law nuisance* and *Statutory nuisance*.

The recent introduction of statutory protections has provided an alternative way of pursuing these claims but nuisance is still commonly pleaded in claims concerned with environmental issues.

ESG claims for unjust enrichment

Unjust enrichment is an area of law which straddles both common law and equitable principles and remedies. To assess whether an unjust enrichment claim is made out, the court asks the following:

- Has the defendant benefited (that is, been enriched)?
- Was the enrichment at the claimant's expense?
- Was the enrichment unjust?

- Are there any defences, (e.g. change of position, counter-restitution)?

In determining whether an enrichment was unjust, the court looks to see whether any "unjust factors" are established on the facts of the case before it. Those unjust factors are detailed further, along with a broader summary of the law of unjust enrichment including defences in *Practice note, Remedies: restitution.*

The unjust factors most likely to be relevant to an ESG claim pertain to governance concerns in respect of how companies obtain benefits from their contractual counterparties and other third parties. These include duress, undue influence and unconscionable bargains.

Section 172, Companies Act 2006 (CA 2006)

Section 172 of the CA 2006 provides that a director must act in a way that they consider, in good faith, is most likely to promote the success of the company for the benefit of its members as a whole. The non-exhaustive list of factors to which directors must have regard reflects an understanding that the benefit to members encompasses wider ESG concerns. The non-exhaustive list of factors to which directors must have regard are:

- The likely consequences of any decision in the long term.
- The interests of the company's employees.
- The need to foster the company's business relationships with suppliers, customers and others.
- The impact of the company's operations on the community and the environment.
- The desirability of the company maintaining a reputation for high standards of business conduct.
- The need to act fairly as between members of the company.

A range of remedies is potentially available for breach of the duties under section 172, see *Practice note, Directors' duties: directors' general duties under the Companies Act 2006: Consequences of breach*. However, the provision's greatest significance perhaps lies in its potential to prevent claims. One commentary notes that this provision potentially serves to protect directors who make long-term decisions over ones designed to obtain short-term financial gain (*Palmer's Company Law (Sweet and Maxwell, 2021), Vol 2: Part 8: Management and Administration: Chapter 8.26: Duty to Promote the Success of the Company: Companies Act 2006 s.17216*).

For more information on section 172, see Practice notes:

- *ESG horizon scanning: policy and legal measures.*
- *Directors' general duties under the Companies Act 2006.*

For financial years beginning on or after 1 January 2019, all public and private companies are required to prepare a strategic report, except those companies that qualify as medium-sized under *sections 465 to 467* of the CA 2006 in relation to the financial year, must include in that report a separate "section 172(1) statement" describing how the directors have had regard to the matters set out in section 172. Unquoted companies must publish their section 172(1) statement on a website (maintained by or on behalf of the company). For more information on:

- The strategic report, see *Practice note, Strategic report.*
- The section 172(1) statement, see *Practice note, Strategic report: section 172(1) statement.*

ESG claims for breach of fiduciary duties and breach of directors' duties

An area of debate among legal practitioners is the extent to which fiduciary or directors' duties may give rise to claims arising out of ESG concerns. The below are preliminary considerations in respect of an area of law which may give rise to further development.

In respect of fiduciary duties, the fiduciary has a duty to act in the interests of, and for the benefit of, their beneficiaries. The duties often include principles such as:

- The "no-conflict" principle: the rule that the fiduciary must not profit from their position at the expense of the beneficiary.

- The duty of undivided loyalty.
- The duty of confidentiality.

The focus of fiduciary duties has historically been on their financial ramifications. In other words, they are usually used to prevent fiduciaries from profiting at the expense of someone to whom they owe a duty. There is debate in the legal community about whether claims for breach of fiduciary duty may successfully be brought in respect of ESG concerns. For more information on fiduciary duties, see *Practice note, Fiduciary duties: Remedies.*

ENVIRONMENTAL CONCERNS

Has your borrower or its subsidiary negligently damaged the environment?

Claimants are pursuing claims in negligence arising out of alleged environmentally damaging activities. A recent trend is for claimants to pursue UK parent companies for actions taken by their foreign subsidiaries.

In *Okpabi v Royal Dutch Shell [2021] UKSC 3*, the Supreme Court held that there was a real issue to be tried in respect of whether the UK parent company owed a duty of care to persons living in the Niger Delta region of Nigeria because of the actions of its Nigerian subsidiary relating to oil spills and a failure to remediate them. Importantly, the court was not piercing the corporate veil but rather finding that there was a triable issue as to whether the parent company owed an independent duty of care in respect of the actions of its subsidiary.

The court explained the imposition of a duty of care of parent companies in relation to the actions of their subsidiaries is not a distinct category of liability in common law negligence and is determined by ordinary principles pertaining to the duty of care.

In the context of parent/subsidiary relationships, whether a duty of care arises depends on the extent to which, and the way in which, the parent availed itself of the opportunity to take over, intervene in, control, supervise or advise the management of the relevant operations (including land use) of the subsidiary (Lord Hamblen JSC, at paragraph 25). The court explained that a parent company's control of its subsidiary is just a starting point; it is also necessary to consider the extent to which the parent company engaged in de facto management of the subsidiary and held itself out as exercising supervision and control of its subsidiaries even if it did not in fact do so (*Lord Hamblen JSC, paragraph 147-148*).

(See *Legal update, Claim for pollution against holding company can proceed (Supreme Court)*.)

In this finding, the Supreme Court clarified an earlier decision, *Lungowe v Vedanta Resources [2019] UKSC 20*, which concerned a jurisdictional challenge in a claim brought by Zambian citizens against a UK parent company and its Zambian subsidiary. The claim alleged loss and damage due to pollution and environmental damage from emissions from a Zambian copper mine which was owned and operated by the Zambian subsidiary. The Supreme Court found that there was a real issue to be tried.

Group litigation orders may also pose a significant risk to polluting companies. *Jalla v Shell International Trading and Shipping Co Ltd [2021] EWCA Civ 1389* considered claims arising out of an oil spill in Nigeria in December 2011 which had damaged fishing, farming, a mangrove forest and the local water supply. The claims were for negligence, nuisance, breach of statutory duty, trespass, *Rylands v Fletcher (1865) 3 H&C 774* and breach of human rights under Nigerian law). The Court of Appeal:

- Held that the claims of 28,000 individuals and communities could not be pursued by two named individuals by way of a representative action under Civil Procedure Rule (CPR) 19.6(1) on the basis that it could not be shown that the two individuals had the same interest as the other persons.
- Noted alternative potential ways of bringing similar actions, including Group Litigation Orders, and for claimants to take actions in their own name and then for a representative sample to be taken by way of lead claimants (*paragraphs 49-50, 67*). The court also outlined the circumstances in which an action pursuant to CPR 19.6(1) in an environmental claim might be appropriate (*paragraph 55*).

(See *Legal update, Court of Appeal guidance on representative actions under CPR 19.6(1).*)

Is your borrower liable for a nuisance claim?

Public nuisance

Public nuisance is a crime which may give rise to tortious liability. Although precise definition of the tort is difficult, Lord Roger in *R v Rimmington [2006] 1 AC 459* adopted the following definition:

> "A person is guilty of a public nuisance ... , who (a) does an act not warranted by law, or (b) omits to discharge a legal duty, if the effect of the act or omission is to endanger the life, health, property, morals, or comfort of the public, or to obstruct the public in the exercise or enjoyment of rights common to all Her Majesty's subjects" (*paragraph 45*).

While criminal proceedings and an action for an injunction by the Attorney General are potentially available, private law actions can only be brought if a private person is injured in some way peculiar to themselves.

Damage may include general damage such as inconvenience and delay as well as personal injury and property damage.

So, for instance, the emission of noxious substances from a factory which damage personal property such as a motor car in the street is actionable in public nuisance by the owner of the motor car (*Halsey v Esso Petroleum [1961] 1 WLR 683*).

Private nuisance

Private nuisance aims to protect interests in land, so the right to sue is limited to those interested in the property affected. Claims for personal injury are in consequence excluded.

The interference must be unreasonable and a reasonably foreseeable consequence of the defendant's activity. The damage must also have been reasonably foreseeable.

Accordingly, private nuisance has been found where, for example, the defendant caused noxious fumes to pass on to a claimant's property such that trees on the claimant's land died or were damaged (*Wood v Conway Corporation [1914] 2 Ch 47*).

Statutory nuisance

While common law nuisance is still regularly pleaded, its significance has diminished as a result of statutory environmental protections.

For instance, Part III of the *Environmental Protection Act 1990* has created various statutory nuisances which do not, as such, give rise to civil liability, although the conviction of a criminal offence would potentially entitle a criminal court to make a compensation order.

The Environmental Protection Act requires local authorities to serve abatement notices in respect of statutory nuisances, failure to comply with which (without reasonable excuse) is a criminal offence.

This is often a less expensive way of addressing nuisance issues than by proceeding with a common law nuisance claim, meaning the significance of common law nuisance has diminished.

For a more general overview of statutory environmental protections, see Practice notes:

- *Environmental law: overview.*
- *EU Environmental Liability Directive 2004 and Environmental Damage regime in England and Wales.*

Does the borrower face claims under the Financial Services and Markets Act 2000 (FSMA) or for common law misrepresentation?

Companies may be subject to listing requirements pertaining to environmental issues (see *Practice note, TCFD recommendations: climate-related financial disclosures for premium listed and standard listed companies (LR 9.8.6R(8) and LR 14.3.27R)*). While this is yet to be tested, the above gives rise to the possibility of claims based on reporting or disclosure obligations pertaining to ESG matters. See in particular:

- *Section 90* of FSMA provides that a person responsible for listing particulars is liable to compensate a person who has acquired securities to which the particulars apply and suffered loss as a result of any untrue or misleading statement in that document.
- *Section 90A* of and *Schedule 10A* to FSMA provide that issuers may be liable in respect of published information (other than listing particulars) containing a misleading statement or dishonest omission in relation to securities. The claimant is required to prove it acquired, continued to hold or disposed of securities in reliance on the published information, and suffered loss.

The common law also provides for liability in respect of negligent misstatement.

This means that a borrower with undisclosed environmental liabilities could be liable for substantial damages to its investors.

Rule in Rylands v Fletcher

The rule in *Rylands v Fletcher* is now understood to be part of the law of common law nuisance. This imposes liability on a defendant for damage caused where a person brings onto or keeps on their land something that is likely to cause damage if it escapes. The defendant's activities must amount to a non-natural use of land and the damage must be reasonably foreseeable. See *Practice note, Common law nuisance: What is the rule in Rylands v Fletcher?.*

GOVERNANCE CONCERNS

Is your borrower liable to more people than just its employees?

Companies that have weak governance are at risk of negligence claims particularly in relation to the health and safety of their employees. Furthermore, cases are increasingly being brought in respect of people who are not employees of the borrower or indeed its subsidiary but whose health and safety has been compromised by the behaviour of a company. The outcome of these cases is of tremendous interest to lenders because it means that due diligence carried out on the borrower will not be complete unless it examines ESG risks and liabilities that may arise through the borrower's supply chain, its subsidiaries treatment of its employees, members of the public affected by a subsidiary's behaviour and in some cases purchasers of a company's assets.

It is well established that employers may be liable to their employees in respect of health and safety matters. The Court of Appeal decided in *Chandler v Cape plc [2012] EWCA Civ 525* that parent companies may also owe a duty of care to the employees of their subsidiaries in relation to health and safety matters (see *Legal update, Parent company: duty of care to employee of subsidiary (Court of Appeal)*).

Claimants have brought claims in respect of a broader range of persons than simply a company's employees. These cases are testing the circumstances in which companies can be liable in respect of governance concerns. For example, claims have been brought in respect of:

- Members of the public. In *Margereson and Hancock v JW Roberts Ltd [1996] Env LR 304*, the Court of Appeal held a company liable for mesothelioma suffered by members of the public, as opposed to employees, who as children had been exposed to asbestos dust which had escaped from the factory in significant quantities into a densely populated urban area.
- Workers employed by the buyer of an asset. In *Begum v Maran UK [2021] EWCA Civ 326*, the Court of Appeal upheld the judge's refusal to strike out parts of a claim. The claimant argued that a shipbroker who had negotiated the sale of an oil tanker to a cash buyer for the vessel to be broken up in a shipbreaking yard in

Bangladesh owed duties of care to workers demolishing the vessel. This was based on in part the shipbroker's awareness of unsafe working conditions in Bangladesh (see *Legal update, Negligence claim seeking to extend category of cases to which "creation of danger" principle applies is arguable (Court of Appeal)*).

- Farmers selling the company raw materials. In *Josiya v British American Tobacco [2021] EWHC 1743,* the court refused to strike out claims brought by 7,263 Malawian tobacco farmers against companies in the British American Tobacco group and the Imperial Tobacco group for negligence, conversion (of tobacco leaves) and unjust enrichment.

  The claims arose out of the alleged unlawful, exploitative and dangerous conditions in which the claimants produced tobacco leaves which were then alleged to have been bought by the tobacco companies. The strike-out application pertained to evidence of whether the tobacco companies in fact bought the tobacco leaves.

  The application to strike out failed with the court distinguishing between the evidence necessary to plead a claim and that required to prove it at trial (see *Legal update, Failed attempt to strike out group litigation elided information required to plead claim and evidence required to prove it (High Court)*).

Duress, undue influence and relief from unconscionable bargains

Claims for duress concern circumstances where the claimant has been conferred a benefit on the defendant in response to the defendant's (or a third party's) illegitimate pressure.

The categories of compulsion are not closed but are often said to consist of:

- Duress to the person.
- Duress of goods.
- The improper application of the legal process.
- Refusals by those in public authority to perform their duties.
- Economic duress.

For instance, if benefits are transferred under a contract procured by threats of murder, the contract is voidable (*Barton v Armstrong [1976] AC 104*) (this case refers to the contract being "void", although duress renders a contract voidable, not void (*Burrows, The Law of Restitution (Oxford University Press, 3rd ed, 2011), Chapter 10: Duress, page 263)*).

Economic duress is when a person obtains a benefit from another by exerting illegitimate economic or commercial pressure on them. What constitutes illegitimate pressure is a difficult question in circumstances where commercial negotiations often involve the exertion of pressure, such that economic duress should not be found lightly.

The Supreme Court in *Times Travel (UK) Ltd v Pakistan International Airline Corporation (Respondent) [2021] UKSC 40* recently clarified the law on when lawful acts may constitute illegitimate pressure for the purposes of establishing economic duress (see *Legal update, Scope of economic duress doctrine confined (Supreme Court)*). Times Travel concerned a claimant travel agency which was heavily dependent on the defendant airline for business and which was pressured by the defendant airline not to join a group seeking to recover sums due by way of commission. The defendant airline reduced the claimant's ticket allocation, as it was entitled to do, and terminated agency contracts. The court found that the defendant genuinely believed it was not liable for breach of contract such that its conduct was not reprehensible or unconscionable and the new contract it had entered into with the claimant (which included a waiver of the claim for unpaid commission) would not be rescinded.

In respect of undue influence, this is a long-standing equitable doctrine which most commonly arises where a person has given security for, or has guaranteed a loan to, another, and was induced to do so by the undue influence of the principal debtor. It has arisen in the context of matrimonial relationships and can result in the person who was subject to the undue influence establishing a defence in respect of the charge or guarantee which they entered into while subject to undue influence. This has obvious potential implications for lenders such as banks who provide securitised loans to, for instance, married couples. For further detail, including the steps lenders can take to protect themselves in the light of the doctrine of undue influence, see *Undue influence and the Etridge principles: toolkit.*

In respect of unconscionable bargains, where a party unconscionably exploits a specific weakness of another party (for instance, illiteracy or poor language skills) such as to shock or offend the conscience of the court, with the result that the contract is overreaching and oppressive, the court may also potentially intervene to rescind the resulting contract (*Adare Finance v Yellowstone Capital Management SA [2020] EWHC 2760 (Comm), paragraph 69*).

Illegality defence

The illegality defence can affect a range of causes of action including unjust enrichment. Broadly, English courts will not enforce a cause of action which arises as a consequence of illegality or is ex turpi causa. The law was recently restated and clarified in *Patel v Mirza [2017] AC 467* (see *Practice note, Contracts: invalidity*).

Equality legislation

Equality legislation may also have an impact of borrower companies. Equality legislation is an extensive area of law and is covered in more detail in Practice notes:

- *Equal pay: overview.*
- *Sex discrimination.*

Nonetheless, lenders should be aware it can open borrowers up to a range of potential claims.

By way of non-exhaustive example, *sections 64 to 80* of the Equality Act 2010 (EqA 2010) set out a series of provisions in respect of equality of work. *Section 66* provides that "sex equality" clauses are to be included in employment contracts. While these clauses are not limited to equal pay, in practice most claims concerned with this provision relate to equal pay. Further provisions in *sections 72 to 76* are directed to protecting pregnancy and maternity equality.

In a successful equal pay case, a court may:

- Make a declaration about the rights of parties in relation to the matters to which proceedings relate.
- Order an award by arrears of pay or damages in relation to the complainant.

(*Section 132, EqA 2010*.)

SOCIAL RESPONSIBILITIES: CRIMINAL CLAIMS

A range of statutory offences have been introduced that seek to address certain social concerns . While criminal sanctions are outside the scope of this note (which focuses on potential claims by private individuals arising out of ESG concerns) lenders should be aware of two of the most significant statutory offenses, the *Bribery Act 2010* (BA 2010) and the *Modern Slavery Act 2015* (MSA 2015). These two acts are designed to ensure that English companies face consequences if their suppliers or subsidiaries commit offenses under the Bribery or Modern Slavery acts.

Bribery Act 2010 (BA 2010)

The Bribery Act 2010, means that companies need to ensure that they and their employees do not:

- Offer, promise or give a bribe (*section 1*);
  - request agree to receive or accept a bribe (*section 2*); or
  - bribe a foreign public official to obtain or retain business (*section 6*).

In addition it is an offence for a commercial organisation to fail to prevent bribery by associated persons acting on their behalf (*section 7*).

Convictions carry significant penalties such as those visited on Sweett Group Plc for conviction under section 7, see *Legal update, Sweett Group plc sentenced for first conviction under section 7 of the Bribery Act 2010*.

The financial regulator has also issued significant penalties for breach of its provisions in respect of actions pertaining to bribery, see *Practice note, Bribery Act 2010: compliance and enforcement issues for financial institutions: FCA bribery and corruption role*.

For more information in respect of:

- The BA 2010 generally, see *Practice note, Bribery Act 2010.*
- Section 7, see *Practice note, Bribery Act 2010: application to commercial agreements.*
- Corporate liability, see *Practice notes, Bribery Act 2010: corporate criminal liability and Bribery Act 2010: compliance and enforcement issues for financial institutions.*

Modern Slavery Act 2015 (MSA 2015)

The MSA 2015 creates a range of offences in relation to human slavery and trafficking. Significantly *section 54* requires large businesses to produce a statement each year setting out the steps they have taken to ensure that their businesses and supply chains are slavery free, or that they have taken no steps to do this.

Home Office guidance provides that if a foreign subsidiary is part of a parent company's supply chain or own business, the parent company's statement should cover any actions taken in relation to that subsidiary to prevent modern slavery (*Home Office: Transparency in supply chains: a practical guide (updated 13 December 2021), paragraph 3.11*).

For more information on the Modern Slavery Act and potential penalties faced by companies for non-compliance, see Practice note, Modern Slavery Act 2015: slavery and human trafficking statement.