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The Duty of UK Company Directors to Consider Relevant ESG Factors

Commissioned by:

PRI Principles for Responsible Investment

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The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and, ultimately, of the environment and society as a whole.

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The Duty of UK Company Directors to Consider Relevant ESG Factors

Directors[1] of UK[2] companies, including any non-executive directors nominated by a private equity firm to sit on a portfolio company board, are (among other things[3]) required to comply with the duties set out in the Companies Act 2006 (the "Act"). These duties modify, clarify and confirm various aspects of the common law that previously applied to directors of UK companies, and the case law that shaped those common law duties remains relevant in interpreting the duties now laid out in the Act.[4]

This memorandum focuses on two particular duties[5] – the fiduciary duty to promote a company's success[6] and the duty to exercise reasonable care, skill and diligence[7] – as they apply to directors of English, solvent,[8] private, unquoted, commercial companies. It specifically addresses the extent to which environmental, social and governance ("ESG") factors should be taken into account in decision-making by those directors, whether they are acting individually or collectively as a board of directors, although ESG risks and opportunities are, in principle, no different from other risks that are material to a given company. In the corporate context, ESG issues may be addressed by a wide variety of different policies, procedures and corporate governance mechanisms, including enterprise risk management (ERM) tools, health, safety and environmental (HS&E) policies, strategic planning, due diligence and corporate social responsibility statements.

Directors' duties are owed separately by each director, each of whom has a separate duty to exercise independent judgment,[9] and each director could be pursued separately for breach of duty even when taking part in a collective decision-making process. Moreover, it is the individual acting as a director who owes the duties, not any shareholder or private equity firm who appointed the director, and it is that individual director's judgment that must be brought to bear in decision-making.[10]

1. A "director" of a UK company includes "any person occupying the position of director, by whatever name called" and therefore can include people not properly appointed (so called *de facto* directors) – see Companies Act 2006 ("CA 2006"), Section 250. In addition, duties can apply to those who are categorised as "shadow directors" pursuant to CA 2006, Section 251 – see CA 2006, Section 170(5).
2. This memorandum reflects the law in England and Wales. Although the law in Scotland and Northern Ireland is similar in most respects, this memorandum does not consider the position in other parts of the United Kingdom to the extent that the law is different.
3. The CA 2006 duties are not the only duties applicable to UK company directors. In addition to these and various other common law duties, directors should also be aware that there are many criminal and civil law responsibilities that apply to them individually. This memorandum does not purport to be a comprehensive review of those responsibilities and should not be relied upon as such.
4. CA 2006, Sections 170(3) and (4).
5. For a private equity-nominated director, the duties to avoid and disclose conflicts of interest (including those in CA 2006, Sections 175-177) are particularly important. They are not directly relevant to the subject matter of this note – namely, the extent of a director's duty to consider ESG factors – and are therefore not considered further.
6. CA 2006, Section 172.
7. CA 2006, Section 174.
8. This memorandum does not specifically consider the position of a company that is facing any risk of insolvency, when creditors' interests may become relevant – see CA 2006, Section 172(3). For a recent review of the creditor-regarding aspects of a director's duty when a company faces insolvency risk, see *BTI v Sequana* ([2019] EWCA Civ 112). Further, this memorandum does not consider any aspects of the law, including the Insolvency Act 1986, that may be applicable to a director of a company facing a risk of insolvency.
9. CA 2006, Section 173: "A director of a company must exercise independent judgment". Note that this duty is not infringed if a director acts "in a way authorised by the company's constitution" (Section 173(2)(b)), although there are probably limits on the ability of a company's constitution to permit directors to follow instructions given that Section 232 explicitly renders void any provision that excludes or limits liability for breach of duty. In any case, Section 173(2)(b) only applies to Section 173, and it is also clear that the duty to promote success in Section 172 also requires a director to exercise his or her own judgment.
10. For a fuller discussion on this subject, including alternative approaches to the law, see Ahern, Deirdre M., *Nominee Directors' Duty to Promote the Success of the Company: Commercial Pragmatism and Legal Orthodoxy* (2011, 127 Law Quarterly Review, 118-146).

The fiduciary duty of loyalty

The most fundamental duty that a UK company director owes to the company of which he or she is a director is to act in the way that the director considers, in good faith, would be most likely to promote the success of the company for the benefit of its shareholders as a whole.[11]

In the absence of any other indication in the company's constitution,[12] the success of the company is usually taken to mean its long-term[13] financial success or "increase in value",[14] although the directors, acting in good faith and in the absence of specific instruction from shareholders, have some latitude to define "success" for their particular company[15] and, even more so, to determine how that success may be achieved. Directors may take the view that being a "responsible citizen", and taking into account the interests of all relevant stakeholders, should be an integral part of their strategy to achieve financial success for the benefit of shareholders, and such a commercial judgment would be entirely consistent with their legal duty.

> *"It is clear that directors should have regard to any relevant ESG factors when seeking to promote the company's success"*

Indeed, the Act adopts this "enlightened shareholder value" approach,[16] specifically requiring directors to "have regard" to a non-exhaustive list of considerations when taking decisions in pursuit of the success of the company including "the interests of the company's employees", "the impact of the company's operations on the community and the environment" and "the desirability of the company maintaining a reputation for high standards of business conduct". Furthermore, it is clear that directors should have regard to all relevant factors, including any relevant ESG factors, when seeking to promote the company's success, and not only those listed in the Act.[17] Company law mandates this process, but does not mandate any particular outcome. It is for each director to balance the various factors and come to his or her own conclusion as to the appropriate decision, measured against the yardstick of long-term shareholder value.[18]

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11. CA 2006, Section 172. The Act uses the term "members", but, in the context of a company with a share capital, the members are the shareholders.
12. CA 2006, Section 172(2) contemplates the possibility that a company's constitution may provide otherwise: "Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes". See further page 6 below.
13. Megarry J in *Gaiman v National Association for Mental Health* ([1970] 2 All ER 362), in applying the duty of directors to exercise powers in the best interests of the company, equated the company's interests with those of "both present and future members... as a whole". Textbook writers generally concur that the common law required, or at least permitted, directors to look beyond the interests of the present shareholders, at least outside of the context of a takeover offer. See, for example, David Kershaw, Company Law in Context, 2012, OUP at page 337: "Most sensibly, it suggests that the board must not only have regard to the interests of the current value of the company's shares but also the long-term value of the company". Davies et al., Principles of Modern Company Law, 2016 conclude (at 16-46) that the better view is that directors "must take into account both the long- and the short-term interests of the shareholders and strike a balance between them". CA 2006, Section 172(1) now specifically requires directors to "have regard" to "the likely consequences of any decision in the long term".
14. See Hood, Parker, *Directors' Duties under the Companies Act 2006: Clarity or Confusion?* (2013, Journal of Corporate Law Studies, 13-1, 1-48) at page 17 and references cited therein, including Ministerial Statements made while the CA 2006 was being debated by Parliament.
15. The CA 2006 Explanatory Notes to Section 172 say: "The decision as to what will promote the success of the company, and what constitutes such success, is one for the director's good faith judgment." This seems to be an overstatement of a director's latitude, however, since it is principally the shareholders who hold the power to define what constitutes "success" for the company (for example, by making specific provision in the constitution); the directors will, no doubt, have wide discretion in determining what will promote it.
16. See CA 2006 Explanatory Notes to Section 172.
17. Section 172(1) specifically states that the listed "have regard to" factors are to be considered "amongst other matters". See also paragraph 326 of the CA 2006 Explanatory Notes to Section 172, which states, "This list is not exhaustive".
18. Unless some other purpose has been specified, in which case that would be the yardstick – see further page 6 below.

Therefore, if a director is of the opinion that any particular regulatory risk or likely change in the business environment, including one that is related to an ESG factor, poses a risk to, or provides an opportunity for, the company's future financial success, that director ought to take account of that factor when exercising power on behalf of the company. The time horizon over which that factor might affect the company's financial success might be the short, medium or long term; and the decision could be about a future course of action or could be a decision not to take action.[19]

> *"In order for it to be a relevant factor in decision-making, directors would only have to be convinced that the risk is a material one that the company should seek to avoid."*

As with any risks, in order to be relevant to decision-making, directors would not have to be convinced that an ESG risk or a change in the business environment will affect the company, only that the risk that it might do so is a material risk that the company should seek to avoid. It is for the directors to weigh the likelihood of the risk and the damage that could be done to the firm if it comes to pass and to act accordingly. A risk that would have significant consequences if it were to materialise could be a reason to act (or not to act) in a particular way, even if the directors did not believe that the risk was very likely to materialise.

Directors should consider "externalities" – that is, factors that do not currently directly affect the company itself – if those factors may have a material impact on the company's future success. For example, an activity that is likely to be outlawed in the future, or that may give rise to reputational damage if generally known outside of the company, could be a relevant factor for directors to take into account.

The duty of loyalty is generally a subjective duty,[20] meaning that a breach would require that the director did not believe that his or her actions were most likely to promote success.[21] That means that a director would not be in breach of this duty[22] if he or she considered the matter and came to an erroneous conclusion. However, if the director did not consider the company's interests at all, the court can then apply an objective assessment and ask itself: Could "an intelligent and honest man in the position of director… have reasonably believed" that the action was for the benefit of the company?[23] If not, the director would be in breach of duty.

19. It is outside the scope of this memorandum to consider which ESG risks may pose a material financial risk to private equity-backed companies, and this analysis will of course vary from company to company. However, by way of example, climate change is now regarded as a material financial risk for many companies, as well as creating significant opportunities – see further *Directors' Liability and Climate Risk: United Kingdom Country Paper, April 2018, Commonwealth Climate and Law Initiative* at pages 6-10.

20. The CA 2006 uses the phrase "he considers, in good faith" to delineate the scope of the duty. This is consistent with the approach taken by the common law: see, for example, *Smith v Fawcett* ([1942] Ch, 304), where Lord Greene says (at page 306): "[Directors] must exercise their discretion bona fide in what they consider – not what a court may consider – is in the interests of the company". Note that there are circumstances in which the courts will apply some level of objectivity where they do not regard it as plausible that the directors did actually believe that a particular course of action was in the company's interests: see *Regentcrest v Cohen* ([2001] 2 BCLC 80) and David Kershaw, Company Law in Context, 2012, OUP at pages 339-345.

21. The courts are reluctant to interfere with honest business judgments because they are concerned with hindsight bias and the chilling effect it could have on considered risk-taking – see, for example, comments of Jonathan Parker J in *Regentcrest v Cohen* ([2001] 2 BCLC 80) at paragraphs 127 and 147.

22. He or she could not be in breach of the Section 172 duty but could be in breach of the duty to act with due care, skill and diligence – see footnote 29 below and accompanying text.

23. *Charterbridge Corp v Lloyds Bank* ([1970] Ch 62) at page 74, and see also *Secretary of State for Business, Innovation & Skills v Pawson* ([2015] EWHC 2626 (Ch)). Some commentators argue that a complete failure to consider the company's interests should automatically amount to a breach of duty – see Joffe et al., Minority Shareholders, Law, Practice and Procedure, 2015, at 1.23, and the recent case of *Bhullar v Bhullar* ([2017] EWCH 407 (Ch) at paragraphs 122-123, where the judge appears to assume that a failure to consider the interests of the company amounted to a breach of fiduciary duty.

Conversely, a director is not permitted to take action that would – in the director's good faith judgment or, in the absence of evidence that the director considered the company's interests, on the basis of the objective test referred to above – damage the financial success of the company.[24] That means that ESG factors should be used to justify a decision or the use of company resources only if such factors are relevant to long-term shareholder value (including because they pose a material risk to long-term value) or, at best, if taking them into account is neutral as regards shareholder value.[25]

> *"It is possible that a private equity firm could specifically modify a portfolio company's purpose to include purposes in addition to financial return for shareholders."*

Finally, as mentioned above,[26] the Act specifically allows a company to specify that its purposes "consist of or include purposes other than the benefit of its [shareholders[27]]", but few commercial companies do so. It is possible that a private equity firm could specifically modify a portfolio company's purpose to include purposes other than, or as well as, financial return for shareholders. If so, that modification would alter the definition of success for the purposes of the directors' Section 172 duty.[28]

The duty of care

The 2006 Act also restated another common law duty applicable to the directors of a UK company: the duty to exercise "reasonable care, skill and diligence".[29]

The Act specifies a two-tier test for this duty: "the care, skill and diligence that would be exercised by a reasonably diligent person with (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that the director has". In other words, the court will set an objectively reasonable minimum standard by reference to the role that the director takes on in relation to the particular company, taking account of its size and complexity. It may then raise (but not lower) that threshold if the director has knowledge, skill and experience that exceeds that objectively defined level.[30]

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24. See, for example, *Secretary of State for Business, Innovation & Skills v Pawson* ([2015] EWHC 2626 (Ch)), a case brought under the Company Directors Disqualification Act 1986. Here the judge took the view that the director had not given any consideration to the company's interests and applied the objective test. The judge concluded that the director was in breach of his duty under Section 172 on that basis.
25. Use of corporate resources would not be justified unless the directors took the view that doing so was justified in order to enhance or protect future value. That means giving money to charity, for example, would be duty-compliant if the directors believed that it could enhance the company's standing in the eyes of some or all of its stakeholders – for example, by building loyalty from employees – and therefore contribute to long-term value. If the directors were not of the view that a particular charitable gift would (or could) enhance shareholder value, it would not be duty-compliant.
26. See above at footnote 12.
27. The CA 2006 uses the term "members", but, in the context of a company with a share capital, the members are the shareholders.
28. That would be the position while the company is solvent; once the directors owe duties to creditors, when the company is insolvent or approaching insolvency, the effect of such an amended purpose is less clear.
29. CA 2006, Section 174. The duty of care is not a fiduciary duty, now confirmed by CA 2006, Section 178(2).
30. The duty of care had evolved under the common law from the largely subjective test espoused by Romer J in *City Equitable Fire Insurance Co, Re* ([1925] Ch. 407) to the objective approach adopted by Hoffman LJ in *D'Jan of London Ltd, Re* ([1994] 1 B.C.L.C. 561). The CA 2006 largely adopted the approach taken in that latter case.

For a private equity-appointed director acting as a non-executive, who will frequently have particular skills and experience, it will not always be easy to define the level of care, skill and diligence that will be expected by a court and, indeed, those expectations are likely to change over time in line with developing business practices and industry and societal norms.[31] It is clear that the courts expect directors to maintain sufficient knowledge and understanding of the company's business to enable them to discharge their duties. For a company affected by an ESG issue, this would suggest that the directors ought to have – or, at least, have access to – information about that issue and its likely consequences for the company.[32] In many cases, private equity-appointed directors will, in fact, have deep knowledge and experience of the sector in which the company operates and the business plan and operational activities of the company itself. Directors are required by the law to bring any such knowledge, skills and experience to bear in the decision-making process.[33] Furthermore, although directors can delegate authority to deal with a particular issue, in appropriate cases they must put in place systems to oversee the discharge of that delegated authority.[34]

The duty of care therefore requires all directors to follow an appropriate process when making decisions and to use their expertise to ensure that all relevant factors – including any relevant ESG factors – have been properly taken into account. It is for the directors to decide which factors are taken into account and what weight to give them, using the default yardstick set by the duty to promote success: long-term shareholder value. However, in extreme cases, failure to ask the right questions or to consider a factor which clearly could have an adverse impact on value for a particular company, such as (if relevant and material) climate risk or the risk of corruption or forced labour in the supply chain, could form the basis of a claim for breach of duty.[35] That is particularly true for a failure to consider the factors specifically listed in Section 172 – including the interests of employees, the need to foster business relationships with suppliers and customers, the impact on the community and environment, and the need for a reputation for high standards of business conduct – but would apply to any other risk or opportunity that the company was facing which the court believes ought reasonably to have been considered by the board as part of its decision-making process.

> *"The duty of care therefore requires all directors to follow an appropriate process when taking decisions and to use their expertise to ensure that any relevant ESG factors have been properly taken into account."*

31. In *Equitable Life Assurance Society v Bowley and Others* [2003] EWHC 2263 (Comm) at para 41 (per Langley J), "the extent to which a non-executive director may reasonably rely on the executive directors and other professionals to perform their duties is one in which the law can fairly be said to be developing and is plainly 'fact sensitive'. It is plainly arguable, I think, that a company may reasonably at least look to non-executive directors for independence of judgment and supervision of the executive management".
32. "Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors. Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions". *Re Barings plc and others (No 5), Secretary of State for Trade and Industry v Baker and other* ([1999] 1 BCLC 433) at page 489.
33. CA 2006, Section 174(2)(b).
34. See footnote 32 above.
35. See, for example, *Brumder v Motornet Service and Repairs Ltd* ([2013) EWCA Civ 195), where a sole director and shareholder was in breach of duty because he "had paid no attention whatsoever to health and safety issues, and has abrogated his responsibilities as owner and director of the company for them". In *Weavering Capital v Dabhia* ([2015] BCC 741), a director was held to be in breach when he failed to probe information provided by another director. Climate risk is an example of a risk that is now so well-established and well-known that a court would probably expect a company affected by it to take account of it in decision-making.

Enforcement of duties

In the United Kingdom, the duty to promote a company's success lays down the law's expectations for directors, but it is not an easy duty to enforce.[36] There are at least three important reasons why it would be difficult to sustain a claim against a director for breach of this duty, even if there is evidence of loss to the company: the difficulties of proving bad faith or a subjective belief that an action would not promote the company's success;[37] the fact that the duty is owed to the company and not to outsiders;[38] and the significant substantive and procedural barriers to bringing a derivative claim under the Act,[39] especially in cases where the majority shareholders are willing to ratify a purported breach.[40]

Nevertheless, given the significant increase in disclosure and transparency requirements for UK companies – and the scrutiny that is now routinely applied to the actions of directors of companies that have failed,[41] or that cause significant harm to outsiders – private equity-appointed directors would be well-advised to be aware of the standard of expectations laid down by the law. That is particularly the case given recent changes to UK law that will increase the focus on the Section 172 duty and the "have regard to" factors. For example, for any UK company that does not qualify as an SME,[42] there is a new requirement for the company's strategic report to include a statement explaining how the directors of the company have complied with their duty to have regard to the factors set out in Section 172 when making decisions.[43]

A claimant seeking to enforce the duty to exercise care, skill and diligence faces some of the same challenges: namely, that only the company can bring a claim, and there are significant obstacles for a minority shareholder wishing to bring a derivative claim. However, as described above, the test to be applied by the court is objective, and there is no "business judgment rule" built into the statutory duty of care. Therefore, it is at least theoretically possible for a claim to be brought for breach of duty when there is evidence that insufficient consideration was given to an ESG factor and it can be shown that this failure led to a poor decision that, in turn, resulted in damage to the company.[44] However, successful claims have generally arisen in cases of "extreme" or "total" failures.[45]

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36. See, for example, Keay, Andrew, *The duty to promote the success of the company: is it fit for purpose in a post-financial crisis world?*, in J. Loughrey (ed), Directors' Duties and Shareholder Litigation in the Wake of the Financial Crisis, Edward Elgar, 2012, pp. 50-97, who says (at page 95): "It [Section 172] might well be seen as a general statement of principle, hopefully encouraging directors to aim for the long-term success of the company and to demonstrate enlightenment, but there is certainly an enforcement problem with the provision".
37. See footnote 23 above for a description of the test to be applied where there is no evidence that any consideration was given to a decision. However, this remains a relatively high barrier to a successful claim given the need to prove that "an intelligent and honest man in the position of the director" could not "have reasonably believed" the action to be in the interests of the company.
38. See CA 2006, Section 170(1).
39. The statutory procedure that enables a shareholder to bring a derivative claim is set out in Part 11 of CA 2006. It includes many safeguards, which means that such claims are relatively rare in practice; see Keay, Andrew, *Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006*, 2016, Journal of Corporate Law Studies, 39-68 and Armour, John, *Derivative actions: a framework for decisions,* 2019, 135 Law Quarterly Review, 412-436. Liquidators can cause the company to bring a claim for breach of duty, although, for cost reasons, they may be reluctant to do so.
40. See CA 2006, Sections 263(2)(b) and (c) and Sections 263(3)(c) and (d). Note that shareholders are not able to authorise or ratify the breach when the company is insolvent – see Tolley's Company Law, Issue 164, D 3033 and *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250.
41. For example, Section 7A of the Company Directors Disqualification Act 1986 obliges the office holder of an insolvent company to prepare a report on the conduct of the directors and submit that to the UK government, which may then consider whether to seek a disqualification order.
42. CA 2006, Section 414CZA(2) provides that the requirement for a "section 172(1) statement" does not apply if the company qualifies as medium-sized in relation to that financial year. Section 465 of the Act sets out the conditions to qualify as "medium-sized": to satisfy two or more of the following requirements: 1. Turnover not more than £36 million; 2. Balance sheet total not more than £18 million; 3. Number of employees not more than 250.
43. The Companies (Miscellaneous Reporting) Regulations 2018 inserted a new Section 414CZA into CA 2006, which provides that "A strategic report for a financial year of a company must include a statement (a "section 172(1) statement") which describes how the directors have had regard to the matters set out in section 172(1)(a) to (f) when performing their duty under section 172". These Regulations also introduce mandatory requirements for some companies to report on employee and stakeholder engagement, the ratio of CEO pay to the average pay of the UK workforce and corporate governance arrangements.
44. Note that the duties are cumulative, and it is possible for a single act or omission to be the subject of a breach of more than one duty – see CA 2006, Section 179.
45. See, for example, David Kershaw, The Foundations of Anglo-American Corporate Fiduciary Law, 2018, CUP, who says (at page 280): "These cases tell us that where directors follow basic procedural steps, such as contacting parties affected by a decision or seeking expert advice, the probability of breach is low".

In conclusion

To avoid legal and reputational risks, boards would be well-advised to conduct a thorough analysis of all risks and opportunities faced by their particular company – including those arising from ESG factors – taking expert advice if needed. They should establish robust processes to ensure that these risks and opportunities are adequately taken into account in decision-making and are reviewed, managed and mitigated using an appropriate compliance management system. An increased societal focus on certain ESG issues, and more onerous disclosure requirements, makes this all the more important.

The duty to promote the success of the company may be described as relatively forgiving, given its subjective nature and the court's reluctance to interfere with good faith business judgments, and that allows directors to take account of such factors as they consider appropriate, including ESG factors, when they make decisions. The duty of care is more demanding, given that establishing a breach does not require evidence of any particular subjective state of mind, and mandates that relevant material factors must be considered by directors.

There is, of course, a link between these duties: the directors must decide which factors, potentially including ESG factors, are relevant in promoting the company's success and must exercise their duty of care, skill and diligence in selecting those as well as in making sure that, once selected, they are properly taken into account.

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