

# The Limits of Reporting on Sustainability Impacts in Changing Corporate Behaviour

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## Abstract

Standards for sustainability have moved from this being an initiative of voluntary bodies like the Global Reporting Initiative and the Sustainability Accounting Standards Board to standards being developed by governments, such as the EU's Corporate Sustainability Reporting Directive, and private sector initiatives whose standards have received government support, such as the IFRS Foundation's International Sustainability Standards Board. Within the standard setting process a heated debate exists about whether these standards should be based simply on financial materiality (e.g., what matters to shareholders), so-called "single materiality," or also impact materiality (e.g., the positive and negative externalities the company is creating in the world), so-called "double materiality." This debate is an important one, but we think too much emphasis is being placed on the extent to which companies reporting on their sustainability performance according to a set of standards can make the world a better place. Reporting transparency is simply the first step in a seven-step hierarchy of ways in which corporate behavior can be influenced. At the top of this hierarchy is corporate form as codified in company law, although changes in corporate behavior are still influenced by the intervening steps.

## Keywords

Corporate reporting, directors' duties, corporate sustainability reporting, climate related disclosures, financial materiality, impact materiality, governance, company law, transition plans

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## Introduction

2023 has been a very significant one in the world of setting standards for sustainability reporting. On June 26 2023, the IFRS Foundation issued the first two standards from the International Sustainability Standards Board (ISSB), “IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information,” and “IFRS S2: Climate-related Disclosures<sup>1</sup>.” One month later, on July 31, the European Commission adopted the 12 European Sustainability Reporting Standards (ESRS) developed by the European Financial Reporting Advisory Group’s (EFRAG) Sustainability Reporting Board (SRB)<sup>2</sup>.

While the difference in the number of issued standards is striking, a more fundamental issue is that the ISSB’s standards are based on single (i.e., financial) materiality and EFRAG’s are based on double (i.e., both financial and impact) materiality. Financial materiality is about how a company’s performance on material sustainability issues matters to investors because of its effect, both positive and negative, on financial performance. Impact materiality is about how a company affects society and the environment. Impact materiality is about positive and negative externalities regardless of whether they influence investors’ decisions and even if the company is strictly operating within the bounds of established laws and regulations.

The single vs. double materiality debate has been heated for quite some time. It was a central issue when the IFRS Foundation issued its 2020 Consultation regarding the establishment of the ISSB. Some even challenged the name of the ISSB, calling it the I?SB because it did not adopt double materiality.<sup>3</sup> In October 2023 ISSB Chair Emmanuel Faber, writing in *Le Monde* and reported by *Responsible Investor*, issued a defense of the ISSB’s single materiality approach.<sup>4</sup>

While this debate is an important, and no doubt eternal one, our thesis is that we may be expecting too much from what reporting can do to make companies solve the

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<sup>1</sup> International Sustainability Standards Board, *ISSB Issues Inaugural Global Sustainability Disclosure Standards*, <https://www.ifrs.org/news-and-events/news/2023/06/issb-issues-ifrs-s1-ifrs-s2/> (23 June 2023).

<sup>2</sup> European Commission, *Sustainable Finance: Commission adopts the European Sustainability Reporting Standards*, [https://ec.europa.eu/commission/presscorner/detail/en/mex\\_23\\_4044](https://ec.europa.eu/commission/presscorner/detail/en/mex_23_4044) (31 July 2023). The European Sustainability Reporting Standards were adopted by the EU institutions on 23 October 2023, following the end of the co-legislators’ scrutiny period. See EFRAG, *EFRAG Welcomes the Final Adoption of the ESRS by the European Institutions*, <https://www.efrag.org/News/Public-453/EFrag-welcomes-the-final-adoption-of-the-ESRS-by-the-European-Institut?AspxAutoDetectCookieSupport=1> (23 October 2023).

<sup>3</sup> Robert G. Eccles, *A Personal Message to the Cantankerous Critics of the International Sustainability Standards Board*, <https://www.forbes.com/sites/bobeccles/2022/02/19/a-personal-message-to-the-cantankerous-critics-of-the-international-sustainability-standards-board/?sh=155d5fc95054> (19 February 2022).

<sup>4</sup> Fiona McNally, *ISSB’s Faber Questions ‘Simplistic’ Push for Double Materiality*, [https://www.responsible-investor.com/issbs-faber-questions-simplistic-push-for-double-materiality/?utm\\_source=newsletter-in-the-loop&utm\\_medium=email&utm\\_campaign=ri-in-the-loop-subscriber&utm\\_content=20-10-2023](https://www.responsible-investor.com/issbs-faber-questions-simplistic-push-for-double-materiality/?utm_source=newsletter-in-the-loop&utm_medium=email&utm_campaign=ri-in-the-loop-subscriber&utm_content=20-10-2023) (11 October 2023).

environmental and social problems in the world. The theory of change for the Corporate Sustainability Reporting Directive (CSRD)<sup>5</sup>, the enabling legislation for ESRS, is that reporting on impact materiality will be a significant contribution to enable Europe to accomplish its “Green Deal” objective of making the EU carbon neutral by 2050 and obtain competitive advantage in doing so.

While we do not deny that reporting on impact materiality can help reduce negative externalities, we think it needs to be placed in a broader perspective. It is necessary but not sufficient, other levers must also be pulled to enable and require companies to contribute to the achievement of net zero by 2050. Towards that end, we have developed a hierarchy for what can be done to change corporate behavior to make it more conducive to increasing positive externalities and reducing negative ones. We argue that reporting on external impacts is simply the first of a series of actions that can be taken by the company. In this hierarchy, one action can build on the ones below it. For example, transparency about impact can give stakeholders information to put pressure on companies which can, in turn, lead to the emergence of norms that can then become voluntary standards for corporate behavior. These can, in turn again, lead to laws and regulations. At the extreme, a fundamental repurposing of business can be contemplated to truly align corporate behavior with wider stakeholder interests.

This paper is organized in four parts. Part 1 discusses single vs. double materiality. Part 2 posits a seven-step hierarchy of actions which influence corporate behavior. Part 3 examines the implications of new reporting regimes on directors’ duties under current company law in the UK. Part 4 concludes.

## 1. Single vs. Double Materiality in Sustainability Reporting

On June 26, 2023, the IFRS Foundation issued the first two standards from the ISSB, “IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information,” and “IFRS S2: Climate-related Disclosures.” A month later, on July 31, 2023, the European Commission adopted the 12 European Sustainability Reporting Standards (ESRS) developed by the SRB.

It is instructive to consider how these standards have respectively embedded a financial materiality, and an impact materiality lens. It is also instructive to explore the role of incremental actions on the lines of those described in Part 2, and how leveraging the information disclosed in accordance with these standards, these can drive change in corporate behavior.

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<sup>5</sup> Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting (16 December 2022) OJ L 322 15-80.

### 1.1. IFRS S1

The objective of IFRS S1 “is to require an entity to disclose information about its sustainability-related risks and opportunities that is useful to *primary users of general purpose reports* in making decisions relating to providing resources to the entity.” Hence, like the International Accounting Standards Board (IASB), the ISSB is focused on financial materiality. The same is true for Climate Disclosure Standards Board (CDSB), International Integrated Reporting Council (IIRC), Sustainability Accounting Standards Board (SASB), and Taskforce on Climate-related Financial Disclosures (TCFD), all of which have merged into the IFRS Foundation.

As explained in “IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information,” “This standard requires an entity to disclose information about all sustainability-related risks and opportunities that could reasonably be expected to affect the entity’s cash flows, its access to finance or cost of capital over the short, medium, and long term. For the purpose of this Standard, these risks and opportunities are collectively referred to as ‘sustainability-related risk and opportunities that could reasonably be expected to affect the entity’s prospects’.” The intended audience for ISSB’s disclosures are primarily the reporting entity’s existing and potential investors, lenders and other creditors and sustainability disclosures should be included in the entity’s general purpose financial reports.

IFRS S1 defines the financial materiality lens as:

“An entity shall disclose material information about the sustainability-related risks and opportunities that could reasonably be expected to affect the entity’s prospects.

In the context of sustainability-related financial disclosures, information is material if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that primary users of general purpose financial reports make or on the basis of those reports, which include financial statements and sustainability-related financial disclosures and which provide information about a specific reporting entity.” (p. 8)

This definition builds on the one given in “Definition of Material Amendments to IAS 1 and IAS 8”: “Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.”

IFRS S1 also notes that “Materiality judgements are specific to an entity. Consequently, this Standard does not specify any thresholds for materiality or predetermine what would be material in a particular situation.” In terms of sources of guidance, IFRS S1 cites SASB, the “CDSB Framework Application Guidance for Water-related Disclosures” and the “CDSB Framework Application Guidance for Biodiversity-related Disclosures.”

And while the ISSB is focused on financial materiality, it further notes that an entity’s ability to generate cash flows over the short, medium, and long term “is inextricably linked to the interactions between the entity and its stakeholders, society, the economy and the natural environment throughout the entity’s *value chain*.” It notes

how the entity and its value chain “form an interdependent system in which the entity operates.” As a consequence of this, the entity has a dependence on these relationships and resources and “its impacts on those resources and relationships give rise to sustainability-related risks and opportunities for the entity.”

Thus, while IFRS S1 clearly notes the existence of impacts, thereby expanding the boundary of a corporation’s responsibility, they are only important to the extent they create sustainability risks and opportunities which can affect the entity’s cash flows. Impacts, whether positive or negative, the entity has are not relevant if they do not affect financial performance over whatever time frame.

## 1.2. *ESRS 1*

Unlike the ISSB’s standards, those of EFRAG’s SRB are based on a law. “The objective of European Sustainability Reporting Standards (ESRS) is to specify the sustainability information that an undertaking shall disclose in accordance with Directive 2013/34/EU of the European Parliament and of the Council as amended by Directive (EU) 2022/2464 of the European Parliament and of the Council.” The reporting entity is the same one as under the financial statements and the sustainability performance information is to be presented in a dedicated section of the “management report.” Like IFRS S1, connectivity is important. Users of the information should be able “to assess the connections between various information about impacts, risks and opportunities in these statements and related information in other parts of its corporate reporting.”

ESRS 1 is firmly grounded in double materiality and notes that “Impact materiality and financial materiality assessments are inter-related and the interdependencies between these two dimensions shall be considered.” It defines financial materiality in essentially the same way as does IFRS S1. But ESRS 1 clearly makes impact materiality a higher priority. “In general, the starting point is the assessment of impacts.” And while it notes that “a sustainability impact may be financially material from inception or become financially material when it becomes investor relevant,” it emphasizes that “Impacts are captured by the impact materiality perspective irrespective of whether or not they are financially material.”

ESRS 1 defines impact materiality as:

“A sustainability matter is material from an impact perspective when it pertains to the undertaking’s material actual or potential, positive or negative impacts on people or the environment over the short-, medium- or long-term. Impacts include those connected with the undertaking’s own operations and upstream and downstream value chain including through its products and services as well as through its business relationships. Business relationships include those in the undertaking’s upstream and downstream value chain and are not limited to direct contractual relationships.”

By giving priority to impact materiality and extending it to beyond “direct contractual relationships” (not further explained) the boundaries of corporate responsibility are expanded even more than in IFRS S1.

But this boundary extension goes much further than this, since it raises the question of how a company should handle the situation where addressing negative impact

materiality would impinge on the company's financial performance over some defined period of time. ESRS 1 states that the usefulness of performance metrics should be considered by reference to whether they provide insight into "how effective its [the undertaking's] practices are in reducing negative outcomes and/or increasing positive outcomes for people and the environment (for impact)" and/or "the likelihood that its practices result in financial effects on the undertaking (for risks and opportunities). At the same time, ESRS 1 does discuss the potential that "actions to address certain impacts or risks, or to benefit from certain opportunities in relation to a sustainability matter, might have material negative impacts or cause material risks in relation to one or several other sustainability matters."

The question of how a company balances financial performance for shareholders with making the world a better place for stakeholders is not addressed. Implicit in this is the view that companies exist to make the world a better place for stakeholders. This is not the same as what is referred to today as "stakeholder capitalism" which argues that doing good by key stakeholders on material issues is doing well for the firm's shareholders, at least over the long term. This debate will no doubt continue for years to come.

What is important to note here is that the CSRD appears to be starting to redefine the role of the corporation in society through impact materiality reporting. The primacy of impact is clear in two ways.

First, like IFRS S1, the TCFD framework is used to structure the disclosures. This is described in more detail in "ESRS 2 General Disclosures." But a notable difference is that "risks and opportunities" is called "impact, risk and opportunity management." There are also some differences in how ESRS 1 and 2 describe these elements. For example, for governance it asks for "the composition and diversity of the administrative, management and supervisory bodies." For strategy it asks for revenues of fossil fuel-related industries "as defined in Article 2, point (62), of Regulation EU No 2018/1999 of the European Parliament and Council, of chemicals production (i.e., under Division 20.2 of Annex I to Regulation (EC) No 1893/2006, controversial weapons, and the cultivation and production of tobacco."

This is much more prescriptive and through a clear values lens. It also asks for disclosure on how the interests and views of the company's stakeholders have been taken into account in determining strategy and business model. And while it asks for disclosure of the financial effects of material risks and opportunities, it does not ask for the financial effects of addressing material negative or positive impacts. (In contrast, under strategy, IFRS S1 has an extensive discussion about "financial position, financial performance and cash flows.") For impact, risk, and opportunity management there is a large emphasis on policies and actions adopted to manage material sustainability matters with the clear message that companies need to have plans and the necessary resources to address impact matters.

Second, there is an extensive discussion of stakeholders in regard to determining impact materiality. Whereas IFRS S1 mentions stakeholders twice, ESRS S1 mentions them 22 times. Consistent with its focus on impact materiality, it notes, in this order, two types of stakeholders. The first is "affected stakeholders" which are "individuals

or groups whose interests are affected or could be affected – positively or negatively – by the undertakings activities and its direct and indirect business relationships across the value chain.” The second is “users of sustainability statements.” These include the same group identified by IFRS S1 (financial institutions of various kinds) but extended to include other users such as “business partners, trade unions and social partners, civil society and non-governmental organisations, governments, analysts and academics.” This is a much more extensive list.

Going further, ESRS 1 states that “Engagement with affected stakeholders is central to the undertaking’s on-going due diligence process (see chapter 4 *Sustainability due diligence*) and sustainability materiality assessment” in order “to identify the material impacts for the purposes of sustainability reporting.” The purpose of the sustainability due diligence process is to “identify, prevent, mitigate and account for how they [the undertaking] address the actual and potential negative impacts on the environment and people connected with their business.” This process is to be informed by the afore-mentioned “international instruments of the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises.” As noted in Part 2, these principles, are intended to be broad guardrails within which companies should operate and until now have influenced national regulation to only a limited extent around the world.

This is essentially an attempt to extend the boundaries of corporate responsibility through transparency. By starting with and emphasizing impact materiality, the CSRD through ESRS hopes that companies will give a priority to reducing negative externalities and increasing positive ones. It is, however, not clear how companies can do this, given their constraints to create value for shareholders and these constraints remain the dominant ones. As long as a company is adhering to all appropriate laws and regulations, simply reporting on negative externalities does not mean the company will have sufficient incentive to reduce them, whatever pressures they may be feeling from civil society. Of course, if investors are pressuring them to reduce their negative externalities, they will pay attention to this. But most investors will only be doing this if they think this is value enhancing. This is where the other actions in the hierarchy described in Part 2 come into play.

Not only is it unclear in the CSRD and ESRS how tradeoffs between reducing negative externalities and financial performance should be navigated, it is equally unclear how a company should treat tradeoffs between different negative externalities. There are 10 ESRS standards for various environmental and social topics. It is highly unlikely that a company can be making improvement on all of them at the same time. For example, an automobile company might reduce the carbon emissions of its products by producing electric cars, but potentially at the cost of eliminating jobs, particularly in its supply chain.

We are not arguing that reporting on impact materiality will have zero impact. We are simply arguing that the effectiveness of transparency in relation to a company’s external impacts will depend on other factors, such as those in the hierarchy described in Part 2. The constraints of extant company law and of how business culture understands that law are likely to be a limiting factor. So, one way of increasing the effect

of transparency on corporate behavior would be to consider making changes to corporate purpose under company law.

## 2. A Hierarchy of Actions: Moving beyond Disclosure Alone

Fundamental to the debate is the question of how far transparency over companies' environmental or social impacts can be expected to encourage changes in corporate behaviour – especially given the constraints, in company law, to create value for shareholders.

Identification and transparency of external impacts is an important starting point. But where a company's external impacts cannot be tracked through to its bottom line, other, more direct, mechanisms may be necessary to drive change in line with sustainability-related public policy goals.

Building from a baseline of transparency, we can plot a stylised hierarchy of the various channels or mechanisms by which corporate behaviour may be influenced (Figure 1). Each incremental step in the hierarchy carries with it a stronger incentive for the company to take direct action to manage its external environmental or social impacts.

The lower points in the hierarchy ((2) – (4)) capture the dynamic process by which a company's reported external sustainability impacts can become financially material. Initially these steps are often incremental, such as the recognition given by companies to voluntary initiatives such as the UN Guiding Principles on Business and Human Rights in the period following their launch, which often involved little more than a public statement acknowledging the principles with little change to corporate activity or responsibilities. Importantly, these mechanisms all operate via corporate decisions taken within the frame of existing company law, and in accordance with the primacy of shareholders' interests.

Steps (2) to (4) are broadly consistent with recent research on the determinants of financial materiality.<sup>6</sup> Frieberg et al. (2020) demonstrate how financial effects may arise for some or all companies in an industry when a sustainability-related issue comes to light. The authors trace a stylised path through a series of stages: first the matter comes under closer scrutiny by affected stakeholders (e.g., communities, consumers, NGOs); the company (or companies) under scrutiny may then take actions in response, seeking to rebuild trust and acceptance, and new norms emerge for the entire industry, and NGOs, including the prospect of regulatory change or competitive disruption. In our hierarchy, we elaborate on how these norms can become voluntary standards and the channels by which shareholders put pressure on companies to follow these standards. The company's response in this step may be an accumulation of pressures arising under any or all of the prior steps.

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<sup>6</sup> David Frieberg, Jean Rogers and George Serafeim, *How ESG Issues become Financially Material to Corporations and their Investors*, Harvard Business School Working Paper 20-056 (2020).



Figure 1. Drivers of corporate behavioral change: a hierarchy of actions

Steps (5) and (6) involve a more sophisticated understanding of (or accounting for) natural, human, and social capital. In some cases, this may be captured more directly via signals from tax or subsidy measures (5), or legal/regulatory intervention including application of accounting standards (6). In these steps, institutional or public policy actions may over-ride shareholder interests.

As we move towards the top of the hierarchy, changes in corporate behaviour arise from more direct structural changes to corporate form or purpose through fundamental changes in company law (7).

In the remainder of this section, we explore each of these measures and consider their likely effectiveness.

### 2.1. Step (2): Stakeholder Pressure Creates Norms

The public voice, the media, civil society, and the broad network of a company’s stakeholder relationships can all be important conduits for raising awareness of sustainability-related concerns and using reputational – and in some cases legal – mechanisms to drive behavioural change.

One argument is that since each company needs a ‘social licence to operate’, most external impacts will ultimately have financial effects – at least over a sufficiently long time horizon. The term ‘social licence to operate’ was originally used in the late 1990s in the context of mining and exploration projects. It is now used more broadly to refer to the standards and norms a company must adhere to in order to maintain acceptance, trust, and legitimacy among those affected by its activities – e.g., workers, suppliers, communities, and those impacted by degradation of the natural environment.

Failure to maintain a social licence can materially affect a company’s prospects if it erodes the human, social, and natural capital on which it depends. This links firmly to the recognition in IFRS S1 that an entity operates in an interdependent system and relies on a variety of “resources and relationships” to create value. However, the risk

to social licence is not predictable and can depend on a range of external factors, such as levels of public interest, effectiveness of enforcement mechanisms, access to legal remedies, and the materiality of any adverse consequences.

This implies that many external sustainability impacts will be priced discontinuously, rather than smoothly over time. So, even if it were the case that most external impacts were *potentially* financially material, they may be discounted heavily and may fail to be factored routinely into corporate decision-making.

## 2.2. Step (3). Translating Norms to Voluntary Standards

Through a variety of mechanisms, predominantly through multilateral institutions, environmental and social norms in business are underpinned by international agreements. These include the 2015 Sustainable Development Goals (SDGs),<sup>7</sup> the 2015 Paris Agreement<sup>8</sup> the 2022 Kunming-Montreal Global Biodiversity Framework,<sup>9</sup> and the 1948 Universal Declaration of Human Rights.<sup>10</sup>

In some cases, these agreements have been translated into national law or regulation to some degree, often creating binding sustainability-related obligations for businesses (see Step (6)). In others, they are reflected in voluntary guidelines promulgated by multilateral bodies. These guidelines are typically voluntary frameworks, whose use by companies will vary and should involve some consideration of how they fit with the duties of directors and other obligations enshrined in company law – including to act in the interests of shareholders. Examples include UN and OECD principles and guidelines, both of which are explicitly referenced in ESRS 1 (see Part I):

- The United Nations Guiding Principles on Business and Human Rights (UNGPs)<sup>11</sup> are described by the UN Office of the High Commissioner on Human Rights as the “global standard for preventing and addressing the risk of adverse human rights involving business activity”.<sup>12</sup> The Guiding Principles do not themselves have legal status in international law, but they do provide the global standard by which businesses can navigate their obligations under relevant international human rights treaties.
- The OECD Guidelines for Multinational Enterprises on Responsible Business Conduct, initially adopted in 1976 and amended most recently in 2023, have

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<sup>7</sup> United Nations General Assembly, *Transforming Our World: The 2030 Agenda for Sustainable Development*, A/RES/70/1 (2015).

<sup>8</sup> United Nations Framework Convention on Climate Change, *Report of the Conference of the Parties on its Twenty-first Session, held in Paris from 30 November to 13 December 2015* (2016).

<sup>9</sup> United Nations Environment Programme, *Decision Adopted by the Conference of the Parties to the Convention on Biological Diversity* (2022).

<sup>10</sup> United Nations General Assembly, *Universal Declaration of Human Rights*, 217 A (III) (1948).

<sup>11</sup> United Nations, *Guiding Principles on Business and Human Rights* (2011).

<sup>12</sup> See United Nations Office of the High Commissioner for Human Rights, *OHCHR and Business and Human Rights*, <https://www.ohchr.org/en/business-and-human-rights> (accessed 22 November 2023).

been adopted by the OECD Council at the ministerial level.<sup>13</sup> The Guidelines set expectations in a wide range of areas with the aim of encouraging corporate behaviour that maximises positive environmental and social impacts, and minimises adverse impacts. The Guidelines also include implementation procedures for businesses.

Similar considerations guide the activities of multilateral development banks (MDBs). At the United Nations Framework Convention on Climate Change Conference of the Parties in 2023, the MDBs reaffirmed their commitment to “socially inclusive, gender responsive and nature positive climate and development action”<sup>14</sup>, giving effect to these commitments through a range of activities and programmes. On climate change, the MDBs’ actions are underpinned by a set of common principles to ensure the alignment of investments with the goals of the Paris Agreement.<sup>15</sup> And, individually, the MDBs have each established dedicated environmental and social policies.<sup>16</sup>

Another vehicle for embedding corporate behavioral norms are industry standards developed by national standards institutions, and their international counterpart, the International Organization for Standardization (ISO). These institutions set voluntary parameters within which companies may choose to operate – but again within the bounds of prevailing company law (unless they are incorporated into national law or technical regulation).

These – often technical, and sometimes niche – standards are developed by industry practitioners and consensus driven. Among ISO’s standards, there are a large number that provide technical specifications, solutions and operating guidelines relevant to minimizing environmental and social impacts. As such, they set norms for companies operating in this area – but again, always solutions, within the frame of existing legal and regulatory frameworks. To demonstrate the role industry standards can play, ISO has set out how its standards contribute to the SDGs.<sup>17</sup>

As corporate behavioural norms become widely accepted and as companies start to publicly endorse or align to them, they become a benchmark for stakeholders to

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<sup>13</sup> Organisation for Economic Cooperation and Development, *OECD Guidelines for Multinational Enterprises on Responsible Business Conduct* (2023). The Guidelines are very clear that they are voluntary and are to be applied within the parameters of existing international and national legal frameworks. They do include a non-judicial complaint mechanism, which can sometimes be a preliminary step towards civil litigation.

<sup>14</sup> Multilateral Development Banks, *COP28 Multilateral Development Banks (MDB) Joint Statement* (2023).

<sup>15</sup> Multilateral Development Banks, *The MDBs’ Alignment Approach to the Objectives of the Paris Agreement: Working Together to Catalyse Low-Emissions and Climate-Resilient Development* (2023).

<sup>16</sup> The World Bank, for instance, issued its Environmental and Social Framework in 2016. See The World Bank, *Environmental and Social Framework*, <https://www.worldbank.org/en/projects-operations/environmental-and-social-framework> (accessed 22 November 2023). Other MDBs have taken – or are taking – similar steps to update their policy and standards and frameworks.

<sup>17</sup> International Organization for Standardization, *Contributing to the Sustainable Development Goals with ISO Standards* (2018). ISO has also mapped its standards to each of the SDGs, plotting the number of standards that contribute to each goal at <https://www.iso.org/sdgs.html>.

scrutinize the performance of those companies to which they are exposed, and they may give risk to litigation risk associated with the public statements the companies have made. This can increase the pressure in Step (2).

### 2.3. *Step (4). Shareholder Pressure/Investor Demands*

With greater transparency of companies' impacts and dependencies, and with reference to societal expectations and the norms of corporate behaviour (as reflected in the steps set out above), investors may influence their portfolio companies both through their capital allocation decisions and their investor stewardship.

We need to acknowledge that the responsiveness of investors to new information will depend on a variety of factors, e.g., their own sustainability commitments, the particular needs and preferences of their clients and consumers, their investment horizons and strategies, and their assessments of sustainability-related risks and opportunities. There may be a wide spectrum of views represented within a company's shareholder base.

Universal owners, in particular, may be especially affected by whole-of-market environmental and social risks, opportunities, and impacts.<sup>18</sup> Since a universal owner has exposures across the entire economy, the costs of externalities generated by any one portfolio company are likely to be borne somewhere else in its portfolio. So, taking a 'systems' view, it may be in a universal owner's best interests to encourage portfolio companies to internalise these externalities.

Stewardship can be a powerful vehicle to exert influence. The recommendations of both the sector neutral Disclosure Framework developed by the Transition Plan Taskforce (TPT)<sup>19</sup> and the Glasgow Financial Alliance for Net Zero (GFANZ)<sup>20</sup> emphasise the role of influence through engagement.

Engagement may occur at many levels, across asset classes, and at varying intensity.<sup>21</sup> The UK Stewardship Code 2020 (the Code) emphasises engagement to 'maintain and enhance the value of assets', also highlighting the value of collaborative engagement and escalation as mechanisms to influence issuers.<sup>22</sup> Principle 7 of the Code explicitly references material environmental, social and governance issues, while Principle 4 encourages signatories to 'identify and respond to market-wide and systemic risks to promote a well-functioning financial system'. Institutional investors

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<sup>18</sup> United Nations Environment Programme Finance Initiative and United Nations Principles for Responsible Investment, *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors* (2011).

<sup>19</sup> Transition Plan Taskforce (TPT), *Disclosure Framework* (2023).

<sup>20</sup> Glasgow Financial Alliance for Net Zero (GFANZ), *Towards a Global Baseline for Net-zero Transition Planning* (2022).

<sup>21</sup> For example, the Institutional Investors Group on Climate Change (IIGCC) launched a Net Zero Engagement Initiative in March 2023 (see IIGCC, *Net Zero Engagement Initiative*, <https://www.iigcc.org/net-zero-engagement-initiative> (accessed 22 November 2023)). See also IIGCC, *Net Zero Bondholder Stewardship Guidance – Engaging with Corporate Debt Issuers* (2023).

<sup>22</sup> Financial Reporting Council, *The UK Stewardship Code 2020* (2020).

have organised global collaborative initiatives to engage companies on key sustainability issues.<sup>23</sup>

Even beyond universal owners, there has been a more general trend towards institutional investors' increasingly taking sustainability-related considerations into account in their investment decisions. Thus, sustainability-related issues may come under closer scrutiny, and investors may become more responsive to new sustainability-related information. This could begin to close the wedge between the financial materiality and double materiality perspectives.<sup>24</sup>

We also see evidence of investors making more direct demands on companies, for instance through the frameworks attached to use-of-proceeds and sustainability-linked debt instruments, the inclusion of environmental or social conditions attached to non-equity financing arrangements (e.g., debt covenants), and the terms of private equity investments.<sup>25</sup>

#### 2.4. Step (5). Pricing and/or Taxing Externalities

If companies' external impacts were routinely fully and fairly priced and accounted for in *monetary* terms in their financial statements, companies would face a direct financial incentive to manage these impacts.

And if human, social, and natural capital were fully and fairly valued in monetary terms, a company's impacts and dependencies on stakeholders, society, the natural environment, and the economy would be reflected sooner and more systematically in corporate value – and hence in corporate decision-making.

The World Business Council for Sustainable Development (WBCSD) has for some time encouraged closer integration between sustainability-related and financial practice. As far back as 2011, the WBCSD promoted the concept of corporate ecosystem valuation (CEV) as a way to help businesses “better reflect the full value of the ecosystems they impact and depend on”.<sup>26</sup> More recently, the WBCSD has developed a primer on integrating sustainability factors in the models that generate investment valuation.<sup>27</sup>

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<sup>23</sup> For example, Climate Action 100+ was launched in 2017 as a global collaborative initiative to accelerate action on climate change (see Climate Action 100+ *About Climate Action 100+* <https://www.climateaction100.org/about/> (accessed 22 November 2023)). At the time of writing, 171 companies were targeted, and more than 700 investors, representing over \$68 trillion in assets, were involved in the initiative.

<sup>24</sup> See Global Sustainable Investment Alliance, *Global Sustainable Investment Review 2022* (2023). The report observes that \$30.3 trillion is invested globally in sustainable investing assets, and calculates that investment in these assets in non-US markets increased by 20% between 2020 and 2022.

<sup>25</sup> See, for example, International Capital Market Association *The Principles, Guidelines and Handbooks* <https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks> (accessed 22 November 2023) and Climate Bonds Initiative *Climate Bonds Standard* (Version 4.0, 2023).

<sup>26</sup> World Business Council for Sustainable Development (WBCSD), *Guide to Corporate Ecosystem Valuation* (2011).

<sup>27</sup> WBCSD, *Guiding the Integration of Sustainability In Valuation* (2023). This primer describes

The purest form of pricing externalities comes from laws and regulations. In the meantime, groups are working to develop methodologies that could be used on a voluntary basis by companies and investors to estimate the price of an externality being created by a company. For instance, the International Foundation for Valuing Impacts (IFVI), which was founded in 2022 as an evolution of the Harvard Business School's Impact-Weighted Accounts Project, has developed a system of accounting that can measure and monetise positive and negative environmental and social impacts and bring them into the financial statements. Their work aims to do this by developing methodologies to adjust core accounting measures, e.g, adjusting staff costs in the income statement for any externalities on workers, or adjusting the cost of goods sold for environmental impacts. Partnering with industry, including via the Value Balancing Alliance, IFVI aims to bring impact accounting into the mainstream of corporate decision-making.<sup>28</sup> Several other initiatives are similarly active in this area.<sup>29</sup>

Internal carbon pricing is one area in which external impacts are translated to monetary values today in order to support the organization's decision-making. That said, according to the World Bank, of the 8,402 companies reporting under CDP in 2022, only 15% reported that they had implemented an internal carbon price.<sup>30</sup> The World Bank reports that driving low-carbon investment and energy efficiency are the main motivations for implementing internal carbon pricing, but changing internal behavior is also cited.

Carbon taxation and 'cap-and-trade' (and similar) emissions trading schemes can, in theory, help to accentuate the impact of carbon prices on financial decision making by directly hitting the company's bottom line.<sup>31</sup> As of April 2023, there were 73 carbon taxes or emissions trading schemes in operation, covering around 23% of global GHG emissions.<sup>32</sup>

The effectiveness of such measures has, however, been called into question. For instance, the carbon price resulting from such schemes may be more a reflection of the design of the scheme, than a fair monetary value of the externality. In its report, the World Bank concludes that less than 5% of global GHG emissions are covered

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a framework for Sustainability in Intrinsic Valuation (SiiV). It identifies six "points of contact" for sustainability factors in investment valuation models: sustainability context and exposures, management strategy and response, influencing factors, key value drivers, accountable elements, and model-related assumptions.

<sup>28</sup> See International Foundation for Valuing Impacts and Value Balancing Alliance, *General Methodology 1: Conceptual Framework for Impact Accounting* (2023).

<sup>29</sup> See, for example, the Capitals Coalition, *The Capitals Approach*, <https://capitalscoalition.org/capitals-approach/> (accessed 22 November 2023).

<sup>30</sup> World Bank, *State and Trends of Carbon Pricing 2023* (2023) at 22.

<sup>31</sup> International Organization of Securities Commissions, *Compliance Carbon Markets* (2023). Chapter 1 provides an overview of the carbon markets ecosystem, including a description of the different types of compliance and voluntary carbon markets and the different emissions trading mechanisms they apply.

<sup>32</sup> World Bank, *State and Trends of Carbon Pricing* (2023), at 22.

by a carbon price that is at the level necessary to limit global warming to below 2°C.<sup>33</sup> If these schemes generated a carbon price that better reflected the externality, they could better inform internal carbon prices and influence financial decision making.

### 2.5. Step (6). Legal/Regulatory Requirements

If corporate incentives to manage external impacts arising from disclosure, emerging norms, pricing, valuation, and market discipline are insufficient, legal and regulatory change may be necessary to enforce a change in behaviour aligned with public policy goals.

A wide range of environmental and social standards are already embedded in laws and regulation, and more are in train, requiring companies to take certain actions to minimise their external impacts – including in their value chains. Examples include laws and accompanying regulations around pollution prevention and control,<sup>34</sup> environmental protection and waste and resource efficiency,<sup>35</sup> worker safety, anti-discrimination,<sup>36</sup> privacy,<sup>37</sup> and modern slavery.<sup>38</sup>

We are also starting to see new expectations emerging for corporate governance and corporate due diligence. These have the potential substantially to alter decision-making at the highest levels within companies, irrespective of commercial incentives.

Some emerging requirements in these areas, while suggestive of a public policy direction, remain largely disclosure-based in practice. For instance, one of the Principles underpinning the UK's Corporate Governance Code<sup>39</sup> is that a “successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders *and contributing to wider society*” [emphasis added].

Some due diligence obligations also remain disclosure based. For instance, the Modern Slavery Act in the UK obliges companies to produce an annual statement setting out the actions they have taken to address human trafficking and modern slavery in their supply chains.

However, the EU has proposed a more direct approach in its draft Corporate Sustainability Due Diligence Directive (CSDDD).<sup>40</sup> A provisional deal was reached by

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<sup>33</sup> Ibid, at 20. According to the High-Level Commission on Carbon Prices in 2017, direct carbon price levels would have to be more than US\$61 (in 2023 terms) by 2030.

<sup>34</sup> See for example, the UK Control of Pollution Act 1974.

<sup>35</sup> See for example, the UK Environment Act 2021.

<sup>36</sup> See for example, the UK Equality Act 2010.

<sup>37</sup> See for example, the UK Data Protection Act 2018.

<sup>38</sup> See for example, the UK Modern Slavery Act 2015.

<sup>39</sup> Financial Reporting Council, *The UK Corporate Governance Code* (2018). The Code applies on a ‘comply or explain’ basis to companies with a premium listing on the London Stock Exchange and was updated in 2018.

<sup>40</sup> See European Commission, *Corporate Sustainability Due Diligence: Council and Parliament strike deal to protect environment and human rights*, <https://www.consilium.europa.eu/en/press/press-releases/2023/12/14/corporate-sustainability-due-diligence-council-and-parliament-strike-deal-to-protect-environment-and-human-rights/> (accessed 25 January 2024).

the Council and European Parliament in December 2023, paving the way for the introduction of obligations on large EU companies (and certain non-EU companies) to carry out due diligence in respect of “actual and potential adverse impacts on the environment and human rights for their business chain of activities which covers the upstream business partners of the company and partially the downstream activities, such as distribution or recycling.” The same provisional agreement also requires “companies to adopt a plan ensuring that their business model and strategy are compatible with the Paris agreement on climate change”.

If adopted, these requirements will be far-reaching and will set new parameters within which in-scope companies *must* operate, irrespective of the implications for financial performance and for shareholders. The CSDDD is a much more direct intervention than disclosure-based measures, since it aims directly to modify corporate behaviour without relying on transparency to catalyze pressure from stakeholders.

Of course, there are limitations to attempts to drive change through legal and regulatory measures. They require adequate enforcement mechanisms or a litigation landscape sufficient to incentivize whole-hearted adoption. Such measures also risk a *compliance first* approach to sustainable development. This is at odds with the growing belief that sustainability challenges demand a fundamental re-think of business and finance.

### 2.6. *Step (7). Structural Repurposing of Business*

While corporate sustainability disclosure requirements are evolving rapidly around the world,<sup>41</sup> core company law remains slower to change. Perhaps the scale of the task at hand is so great that it will not be enough to leave the decision to take positive environmental or social actions to either commercial imperative or legal obligation. This takes us to the final step in the hierarchy: corporate law reform, that leads to a structural repurposing of business. This is the subject of Part 3.

## 3. **Company Law, Directors’ and Trustee Duties and Sustainability Disclosure**

The rules on directors’ duties have not been harmonized in the EU (though as mentioned earlier there is a proposal to do so in relation to the human and environmental impacts of directors’ decision making under the draft CSDDD) and directors’ duties are currently defined under the law of the relevant Member State.

We have therefore used English company law as an example to test the relationship between directors’ duties, disclosure in respect of sustainability matters, and corporate responsibility. We do so given its longevity and international influence and also

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<sup>41</sup> The Carrots and Sticks database tracks the development of sustainability-related policy measures worldwide. See Carrot & Sticks, *About Carrots & Sticks*, <https://www.carrotsandsticks.net/about-carrots-sticks/> (accessed 22 November 2023).

because the relationship between climate transition related disclosure and directors duties was raised during consultation and considered by the TPT prior to publication of the final TPT Disclosure Rramework.<sup>42</sup>

### 3.1. *English Company Law*

Most current English company law is codified in the Companies Act 2006 (“CA2006”), with provisions governing formation, the constitution of a company, and the responsibilities of its directors and members. The CA2006 allows for companies to choose to include in their articles of association the pursuit of wider purposes beyond those of promoting the success of the company for the benefits of its members (for example, as required to receive B Corp certification). The CA2006 is also one of the primary pieces of legislation applicable to companies limited by guaranty and community interest companies, which are social enterprises structured as companies with a statutory asset lock. However, companies adopting any of these approaches remain the exception rather than the rule, and consequently the focus of this section is on the responsibilities of directors of companies with conventional articles of association focused on the interests of the shareholders as a whole.

The CA2006 codified for the first time and updated the articulation of directors’ duties, introducing into these the concept of “enlightened shareholder value”. This was one of many changes proposed in a fundamental review of company law initiated in 1998 at the request of the UK Government’s Department of Trade and Industry and undertaken by an independent company law review steering group.<sup>43</sup>

The two key provisions of CA2006 relevant to directors’ duties are section 172 and section 174. Under section 172(1) a director of a company 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, and in doing so have regard (amongst other matters) to –

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

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<sup>42</sup> See TPT *Legal Considerations for Transition Plan Preparers Using the TPT Disclosure Framework* (October 2023).

<sup>43</sup> See the UK Companies Act 2006, Explanatory Notes.

The duty is subjectively framed and focuses on promotion of the success of the company for the benefit of all its shareholders, having regard to various factors including those listed. It is open to directors to attach more or less weight to each relevant factor, subject to satisfying the overarching duty. Section 172(2) allows more latitude to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, for example where the shareholders have amended the articles of association to require consideration of environmental or social impacts. In those instances, the reference in section 172(1) to promoting the success of the company for the benefit of its members is applied to achieving those purposes in addition or in substitution depending on the constitution of the company concerned. However, this is only relevant to companies who take a form or adopt articles designed to address specific purposes, such as a wider consideration of stakeholders and not just the members of the company.

Section 174 CA2006 sets out the standard of care, skill, and diligence that is required of a company's directors. This is the care, skill, and diligence that would be exercised by (a) a reasonably diligent person with 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. It is therefore both an objective and subjective test.

### *3.2. Potential Implications of Disclosure Regimes*

The development of climate and sustainability disclosure regimes such as TCFD, ISSB, CSRD, and the recently published and currently voluntary TPT Disclosure Framework has raised questions as to the relationship of these with the duties of company directors. This is especially true for the CSRD's ESRS given that it is grounded in impact materiality. In essence, the challenge is whether a normative purpose can be inferred into these regimes that could modify directors' duties or their performance. Concern was expressed in the TPT consultation that the TPT Framework might prioritise or compel action focused on economy-wide transition over that of the company's success, or encourage directors to prioritise certain of the factors listed in section 172(1) over other factors in a manner that may not fit with the overarching duty expressed under section 172. Further, directors of multinational groups, parts of whose group may be caught by different climate and sustainability focused disclosure requirements (for example, those of both the UK and the EU), might face a more complex regulatory landscape if the exercise of their duties as directors is governed by rules of another jurisdiction (for example the State of Delaware).

This is an interesting shaping of the debate. Logically, climate change and other sustainability risks, impacts, and opportunities can be characterised as part of the natural and economic landscape in which companies operate. Like other issues such as cyber crime, geopolitical risk, and supply chain dependencies that are recent hot topics on the board agenda, they are part of the context or fact pattern within which companies operate and directors take decisions.

In the case of the TPT Framework these issues have been expressly addressed by inclusion of framing language that makes clear that the Framework does not purport to alter or affect legal rights or obligations,<sup>44</sup> nor does it compel action (as opposed to disclosure). But the legal position at its base is straightforward. Disclosure should align with and not over-reach the strategy decided upon. What is required is disclosure of the entity's approach to transition, the adequacy of which is left to be assessed through the operation of market discipline. This is consistent with the wider "comply or explain" approach in the UK to governance. Within the EU, a similar approach has been taken in the CSRD and ESRS, the emphasis is on disclosure of the company's approach, the priorities and targets it has set, and levers it has available to deliver these rather than dictating action. The difference is the specificity of disclosure required to be made pursuant to the ESRS.

It may be, as can be inferred from the TPT Framework, that it will often be in a company's best interests to set itself ambitious objectives and priorities to contribute to an "economy-wide transition". However, this will require conscious decision making by boards in respect of the boundaries of its strategy and related disclosure addressing transition or sustainability matters. For companies operating in or exposed to very high emitting sectors, decision making on transition strategy may be particularly challenging. Directors of some companies may decide, acting by reference to their duties, that divergence from or inaction in relation to a global or national transition pathway is appropriate in whole or in part depending on the circumstances at the time the matter is considered. Assuming TPT disclosure is mandated in the UK, and CSRD begins to apply in Europe, the requirements for specific disclosure will drive a clearer and more detailed articulation of a company's approach than has been required to date.

### 3.3. *Lawsuits and Director Discretion*

Recent English caselaw has reinforced the extent of the discretion left to directors in the exercise of their duties under the Companies Act and the limits on scope for challenge on that basis. In *Client Earth -v- Shell plc and others*<sup>45</sup> the legal NGO applied to the High Court in its capacity as a shareholder in Shell for permission to bring a derivative action on behalf of the company against current Shell directors for breach of their directors' duties. The argument was that they had failed to adopt and implement an appropriate climate change risk management strategy and failed to implement the decision of the Dutch Court in May 2021 against Royal Dutch Shell in the case brought by MilieuDefensie.<sup>46</sup> Mr. Justice Trower rejected the application in a decision

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<sup>44</sup> See TPT, *Disclosure Framework* (October 2023), at page 7 where TPT states: "Nothing in the Disclosure Framework is intended to override, substitute, or alter existing legal or regulatory requirements...".

<sup>45</sup> *ClientEarth v Shell plc & others* [2023] EWHC 1897.

<sup>46</sup> *Milieudefensie et al v. Royal Dutch Shell plc*, Hague District Court, Rechtbank Den Haag (26 May 2021), C/09/571932 / HA ZA 19-379.

that has made clear how difficult it is currently for activist minority shareholders to bring a successful challenge against directors under UK company law.

The court noted that the management of a business of the size and complexity of Shell requires the directors to take into account a range of competing considerations, the proper balancing of which is a directors' decision, which the court is ill-equipped to interfere with. In addition, the test for breach of section 172 is a subjective one and requires proof of conduct other than in good faith.<sup>47</sup> The court also mentioned several discretionary factors that were relevant to an application of this kind.

One of these, under section 263(3)(a) CA 2006, is whether the shareholder is acting in good faith in seeking to continue the claims. The court here noted that ClientEarth had another motive as regards the promotion of its own policy agenda. And under section 263(4) CA2006 another relevant factor was the view of other members of the company with no personal interest in the matter. The court noted the level of support for Shell's energy transition strategy, which was the subject of an advisory vote at Shell's 2021 and 2022 AGMs and received, respectively, 88.4% and 80% of votes cast.

In essence, this case reinforces the previous understanding of the Companies Act provisions applicable to directors' duties and the case law on derivative actions. It is up to directors to determine in good faith what actions are appropriate to promote "the success of the company" and to the company's shareholders to decide whether they agree with the actions settled upon and the definition of success. ClientEarth subsequently applied for leave to appeal to the Court of Appeal but this was refused in November 2023.

As a result, activist litigation seems less likely to focus on direct challenges to directors' duties as a mechanism to effect change in the common law world. It is more likely to continue to use other routes against companies. Litigants may be more inclined to ground actions in any mismatch between statements made by the company and actual performance or to challenge the treatment of sustainability issues in the published accounts of the company. Other potential causes of action may arise from physical damage or personal injury that is asserted to arise from the actions or omissions of the company in circumstances in which a duty of care, breach of the duty, and causation can all be asserted. .

In the main, these are likely to be risks primarily for the company rather than its directors. Civil liability of directors under English law for any untrue or misleading statement in, or omission from, the strategic report, the directors' report, the directors' remuneration report, or any separate corporate governance statement is limited to some extent under section 463 CA2006. Any such liability is owed to the company and arises only if the director knew the relevant statements were untrue or misleading and took no action to try to correct it, or if they knew that the relevant omission was a dishonest concealment of a material fact. Active engagement by directors on these issues and of ensuring competence within the board is clearly necessary and of growing importance.

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<sup>47</sup> *ClientEarth v Shell* at [29].

### 3.4. *The Risk from Unfulfilled Ambitions Driven by Reporting Regimes*

The area of risk for companies is likely to be the relationship between their stated ambitions and ability or willingness to deliver on these. As externalities within the sustainability sphere become more evidently material (both as regards impact and financial materiality), disclosure regimes and market expectations are driving more granular disclosure as to implementation. Recent frameworks (the EU Taxonomy regime, ESRS, TCFD, ISSB and TPT) all push companies to make public disclosure as to how they are achieving or intend to achieve their objectives, even if the TCFD and ISSB standards apply at a less detailed level than ESRS, Taxonomy, or the TPT Framework. And this regulatory framework is reinforced by the stewardship activities and engagement of many institutional investors particularly those based in Europe.

These new disclosures are likely to create a crunch point for companies. Over the past 20 years, an enthusiasm for adopting norms and making statements about their sustainability priorities has not always been consistently matched by equivalent focus on integrating these into strategy, capital allocation decisions, and business-as-usual. Indeed, directors and senior management may sometimes be unaware of their company's alignment to soft law principles (for example, the UN Guidelines on Business and Human Rights, or the OECD Guidelines for Multinational Enterprises) or the implications of that alignment. That culture is starting to change, as governance expectations grow in relation to climate change the energy transition, and wider sustainability factors.

Over the next couple of years, increased disclosure requirements will drive companies to decide and then disclose whether, how, and by when they plan to meet, dilute, or walk away from previously stated ambitions. The extent to which these ambitions are converted into strategy and implementation plans and delivered on and how risks are assessed and reflected in annual reports and accounts will all depend on decisions made by directors exercising their duties (in English law primarily under section 172 and 174 CA2006). This will bite initially in relation to any net-zero ambition they have communicated, but also increasingly to other environmental and social risks and impacts.

We should not expect this to be straightforward. It is likely to require directors to build on existing knowledge of salient sustainability issues, and to demand the balancing of a wide range of factors, uncertainties, and dependencies, including investor expectations, current climate science applied to their business, the policy and economic landscape in key markets, and the extent to which commercial counterparties are embedding transition plan analysis in relationship management. More disclosure creates an opportunity to inform and update stakeholders. The incoming requirements will make it much harder to disclose ambition untethered to corporate strategy or performance.

It also creates risks in respect of misstatement or of damages claims predicated on reliance on earlier communications (though the ability to demonstrate loss and causation will depend on the facts and may be challenging). We should expect disclosure to become more detailed, heavily qualified, and market sensitive, and for the

underlying work to demand increasing amounts of board and management time before the process normalises. It is also reasonable to expect that reported progress against targets and plans will ebb and flow as all the challenges, tradeoffs, and opportunities of transition become real to companies and those in their value chains.

Against that backdrop and given the importance of investor expectations in this process, it is also worth noting that a legal debate has been rumbling on in the UK for at least the last 18 years as to how far pension trustees and other fiduciaries may take into account factors that go beyond immediate financial returns, such as social and environmental impacts. This has resulted in two reports by the law firm Freshfields Bruckfield Deringer and two reports by the Law Commission<sup>48</sup> which discuss the boundaries for consideration of sustainability factors in investment decision making.

The 2021 Freshfields report had looked at the rules in 11 key markets during 2020/21 and concluded that, “while there are differences across the jurisdictions and investor groups analysed, where sustainability impact approaches can be effective in achieving an investor’s financial goals, the investor will likely be required to consider using them and act accordingly. Cases where investors can pursue sustainability goals for their own sake in parallel with financial goals are more limited”.

In the UK, an application to bring a derivative action that asserted breach of fiduciary duties by directors of a trustee company limited by guaranty (i.e., without shareholders) brought this time at common law has also failed.<sup>49</sup> This case was grounded in a complaint that the pension fund was continuing to invest in fossil fuels without an adequate divestment strategy. Permission to bring a case against directors of the Universities Superannuation Scheme was denied at first instance and then on appeal. The judgment draws out the differences that exist between directors and other fiduciaries and the derivative action remedies available (for directors under statute, and for trustees under the common law). As a general matter it reinforces the impression of difficulty in bringing any cases of this nature.

A further review by the Financial Markets and Law Committee was commissioned by the UK government and published its review in early 2024. The aim of this was to inform trustees and to provide clarity on their fiduciary duty in the context of the transition to net zero.<sup>50</sup> It is in response to a concern that advisers to pension fund trustees may tend to conservatism in their advice, and this can result in focusing exclusively on financial returns, particularly short-term ones. It makes clear the Committee's view that climate and other sustainability issues should be categorised as financial factors on the basis that they can impact risk and return.

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<sup>48</sup> Freshfields Bruckhaus Deringer LLP, *A Legal Framework for Impact: Sustainability Impact in Investment Decision Making* (2021), Freshfields Bruckhaus Deringer LLP, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* (2005), UK Law Commission, *Pension Funds and Social Investment* (2017), UK Law Commission *Fiduciary Duties of Investment Intermediaries* (2014). See also Professor John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making* (2012).

<sup>49</sup> *McGaughey & Anor v Universities Superannuation Scheme Limited* [2023] EWCA Civ 873.

<sup>50</sup> HM Government, *Mobilising Green Investment: 2023 Green Finance Strategy*, <https://www.gov.uk/government/publications/green-finance-strategy/mobilising-green-investment-2023-green-finance-strategy> (updated 11 April 2023).

#### 4. Concluding Remarks

Experience over the past 30 years suggests that market interpretations of shareholder value maximization, enhanced shareholder value, and fiduciary duty have focused increasingly on the short term, losing some of the subtleties expressed in the original economic theory or caselaw.

Like many turning points, the article written by Milton Friedman<sup>51</sup> articulating the Friedman Doctrine was expressed in a more nuanced form than is now remembered. It includes an acknowledgement that decisions taken by a company, for example to support a community on which that company relies for its workforce, may be framed as an activity of corporate social responsibility and be necessary to secure the ongoing operation of the business and delivery of profits to shareholders. This does not seem so far from the UK Companies Act articulation set out in section 172. Understanding of the law on the duties of trustees is also often communicated in simplified form. Over the last 30 years, as these nuances have become less obvious, other mechanisms have come into play that operate to promote short-term thinking. For example, the average longevity of CEOs in post has reduced, executive incentive structures have focused on short time periods, and the popularity of returning capital to shareholders has increased.

Companies' dependencies on a social licence to operate, i.e., their reliance upon the continued acceptance of their activity by consumers, employees, counterparties, and the communities that surround their operations has had to be painfully relearnt on a regular and individualized basis. Even then, many organizations do not experience the reality of this dependency unless an issue attracts regulatory, judicial, or media attention. Consequently, the dependency on actors beyond the investor base can be underestimated by those directors, executives, and advisors who have not yet experienced the reality of a full-blown crisis.

In 2015 in a speech on the Tragedy of the Horizon<sup>52</sup>, Mark Carney noted that the catastrophic impacts of climate change have an obvious capacity to damage financial resilience and prosperity, when combined with the dynamics of the global financial system. However, he also observed that these would be felt beyond the traditional horizons of most actors—imposing a cost on future generations that the current generation has no direct incentive to fix. As part of the solution, he proposed the creation of the body that became the TCFD to improve disclosure such that investors could assess risks and express their views in the market. Although this strategy has proved highly successful as regards the roll out of disclosure obligations, the jury is out though as to whether market discipline will work in a controlled way. It is notable

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<sup>51</sup> Milton Friedman, *A Friedman Doctrine – The Social Responsibility of Business Is to Increase Its Profits*, <https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html> (13 September 1970).

<sup>52</sup> Bank of England, *Breaking the Tragedy of the Horizon – Climate Change and Financial Stability* (Speech given by Mark Carney at Lloyd's of London), <https://www.bankofengland.co.uk/-/media/boe/files/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability.pdf> (29 September 2015).

that Carney also diagnosed the need for policy responses from governments and technological developments from business in addition to advocating improved disclosure.

Since 2015, our dependency on nature and a viable climate, and the limits to growth inherent in our planetary boundaries, have started to be more widely discussed, and the damage already done has grown more obvious. This has become particularly evident during 2023<sup>53</sup> and it is now less likely that the impacts of current actions will be only felt beyond the horizon of those taking the decisions. However, there remains a global failure to implement public policy and economics that acknowledge, price, and respond to these risks, even as the scientific view of their severity and immediacy has solidified. Many decision makers in the private and public sectors remain relatively unaware and uneducated on these matters. For example, the climate scenarios developed several years ago under the supervision of central banks for use in TCFD reporting have come under criticism<sup>54</sup> for failing to reflect the materiality of the climate-related financial risks that financial institutions and markets face. If the scenarios that financial institutions and companies have been asked to use for regulatory purposes to assess climate-related financial risk generate data that suggests no material impact in most cases, it may not be that surprising if the market fails to respond.

To achieve the changes required to contain climate change related harm and loss of biodiversity within the necessary timeframe, all effective actions within the hierarchy will need to be deployed by governments and markets – and at speed. Disclosure by companies is necessary, but unlikely to be sufficient on its own to drive rapid transformation of a global economic system that has evolved to focus on short-term returns on investment, and to ignore the dependence of our civilization on nature and a habitable planet.

Steps are already being taken beyond disclosure towards changing corporate behaviour. We have seen MDBs and multilateral organisations revisiting frameworks and guidelines. National governments are pursuing targeted environmental and social legislation that is biting, to varying degrees, on corporate behaviour. And in the EU, we are seeing an ambitious attempt in the CSDDD towards a repurposing of business. If we are to complement disclosure-based regulation with more direct means of influence on corporate behaviour, reigniting the debate on corporate form and purpose is welcome. But this debate won't be resolved quickly, and time is of the essence, so we should not lose time in rolling out more directly effective industrial regulation, incentives, taxes, and market-based policies which, if adequately enforced- will work coherently with the corporate system we currently have.

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<sup>53</sup> William J Ripple, Christopher Wolf, Jillian W Gregg, Johan Rockstrom, Thomas M Newsome, Beverly E Law, Luiz Marques, Timothy M Lenton, Chi Xu, Saleemul Huq, Leon Simons, and Sir David King, *The 2023 State of the Climate Report: Entering Unchartered Territory* 73 *BioScience* 841 (2023).

<sup>54</sup> Sandy Trust, Sanjay Joshi, Tim Lenton, and Jack Oliver *The Emperor's New Climate Scenarios* (Institute and Faculty of Actuaries, 2023). In November 2023 the Network for Greening the Financial system published their fourth vintage of scenarios that start to address the issues identified in this article. This includes two new scenarios, the "Too little too late" Fragmented World scenario and the "orderly" low demand scenario.