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Risks in sustainability-related disclosures – reflections on landmark climate litigation actions in the English courts

Last year, we wrote about ClientEarth's application to the High Court of England and Wales for permission to bring a judicial review claim, alleging that the UK Financial Conduct Authority (FCA) unlawfully approved the IPO prospectus of an energy company.[1] Following the High Court's dismissal of the application in April 2023, a renewal hearing was held on 13 December 2023, where the judge again refused permission to bring the judicial review claim.[2]

In this article, we draw out the key lessons from the FCA judicial review case for prospective issuers to bear in mind when including sustainability disclosures in a prospectus, in particular when interpreting and applying the disclosure requirements under Articles 6 and 16 of the UK Prospectus Regulation (EU) 2017/1129 (PR) and the ESMA Guidelines on Risk Factors under the PR. We anticipate that the requirement for, and focus on, sustainability disclosures in UK prospectuses will likely increase over time, including as a consequence of the prospectus reforms.

We also take this opportunity to bring to mind key lessons arising from another important climate litigation case, namely ClientEarth's claim against the directors of Shell plc ("*ClientEarth v Shell directors*").[3]

Background to the FCA judicial review case

ClientEarth alleged that the FCA's approval of the prospectus was unlawful, arguing that the energy company's prospectus did not meet disclosure requirements under the PR. ClientEarth argued that the energy company failed to adequately explain how the climate risks associated with its activities might affect its business and finances.

This case turned, in particular, on the interpretation of Article 16(1) PR, which makes provision for the prospectus to address risk factors affecting the issuer, including the following: *"The risk factors featured in a prospectus shall be limited to* ***risks which are specific to the issuer and/or to the securities and which are material for taking an informed investment decision****, as corroborated by the content of the registration document and the securities note.*

When drawing up the prospectus, the issuer, the offeror or the person asking for admission to trading on a regulated market ***shall assess the materiality of the risk factors based on the probability of their occurrence and the expected magnitude of their negative impact.***

Each risk factor shall be adequately described*, explaining how it affects the issuer or the securities being offered or to be admitted to trading. The assessment of the materiality of the risk factors provided for in the second subparagraph may also be disclosed by using a qualitative scale of low, medium or high…"* (emphasis added).

[1] https://www.allenovery.com/en-gb/global/blogs/investigations-insight/judicial-review-challenge-of-the-uk-fca-by-environmental-charity-spotlight-on-disclosure-risks
[2] (2023) EWHC 3301 (Admin).
[3] (2023) EWHC 1897 (Ch).

Key arguments and findings

– Disclosure of materiality assessment of climate risk factors

ClientEarth argued that Article 16 obliges the issuer to describe its assessment of the materiality of risk factors on the face of the prospectus, and that the energy company's prospectus was non-compliant because it *"only refers to climate change, the Paris Agreement and the net zero commitment in broad generic terms"*.

In interpreting Article 16, the judge held that Article 16 requires the disclosure of those risk factors that are material, but there is no separate requirement for the issuer to disclose its assessment of risk and materiality. No particular form of quantitative or qualitative analysis is required.

The judge noted that whether the requirements of Article 16(1) have been met *"requires an evaluative judgment which may admit of more than one view. In such a case, the court may not substitute its own view if the FCA's assessment is rational"* and *"the FCA's interpretation of Article 16(1) is plainly correct on a natural reading"*.

– Disclosure of specificity of climate-related risks

ClientEarth submitted that the specificity of the climate-related risks associated with the energy company's securities were not adequately disclosed and described in the prospectus. It argued that references in the prospectus (eg the possibility of climate activism negatively impacting the process of obtaining approval for further development, and the material adverse effect on the hydrocarbon industry and the group's business, financial condition and results of operation) were not specific enough and did not shed sufficient light on the energy company's particular situation as opposed to the situation of the industry in general.

The judge held that Article 16(1) provides that the risk factors be limited to risks that are specific to the issuer, and that each risk factor shall be adequately described, explaining how it affects the issuer or the securities being offered. However, beyond that, there is no separate requirement for the issuer to disclose its assessment of risk and specificity.

– Disclosure of impacts of the Paris Agreement under FCA TN801.2 and Article 6 PR

ClientEarth argued that, as the energy company's prospectus did not adequately deal with the potential impacts of the Paris Agreement on its business, the FCA's conclusion that the prospectus contained *"the necessary information which is material to an investor for making an informed assessment of* [the issuer's] *financial position and prospects"* (as required by Article 6 PR) was rationally unsustainable.

The judge noted that the Paris Agreement was identified as a material risk for the business in the prospectus, and the FCA had identified to the court the ways in which the prospectus did address risks to the energy company's business and securities arising out of climate-related factors. The judge held that although ClientEarth disagreed with the FCA's conclusion that the prospectus complied with Article 6, it did not come close to demonstrating that the FCA acted irrationally (which the court acknowledged is a high hurdle for claimants to overcome).

Overall, the judge deferred to the FCA's value judgment, noting that *"the prospectus plainly did address risks to* [the issuer's] *business and securities arising out of climate change factors, associated regulatory measures and changes in consumer use. The FCA considered that the risk factors were adequately described. The claimant disagrees with the FCA's evaluation but it has failed to demonstrate any arguable error of law in the approach taken by the FCA or its conclusion. The court will not substitute its view or that of the claimant for the considered judgment of the FCA"*.

Lessons from two landmark climate litigation cases in the English courts

☑ The FCA case supports the current market practice regarding IPO prospectus disclosures – but the scope and emphasis of disclosable information will likely change over time.

The latest judgment in the FCA judicial review case supports the level of granularity of climate-related disclosures in prospectuses required under Articles 6 and 16 of the PR, as interpreted by the FCA in this case.

However, disclosure is driven by what information is considered material to investment decisions and the detailed disclosure requirements in place at any point in time. As investor expectations evolve (as they are), this may necessitate more sustainability disclosures or changes in the nature of the sustainability disclosures (including, potentially, a greater level of detail).

Investor expectations and the reform of the detailed prospectus rules (and guidance) may also be influenced by the other new and emerging sustainability disclosure and reporting frameworks, such as the upcoming UK Sustainability Disclosure Standards (SDS, being the UK-endorsed versions of the ISSB's first two standards).[4] As part of the FCA's consultation (anticipated in the first half of 2024) on proposals to implement disclosure rules referencing the UK SDS for listed companies, the FCA will consider the interaction of that new regime with the proposed equity listing rule reforms.

☑ The High Court is reluctant to interfere in the FCA's value judgements in prospectus disclosures. This reluctance is reminiscent of the High Court's interpretation of directors' duties in the recent case of *ClientEarth v Shell directors*.

The latest judgment in the FCA judicial review case reflects the judge's deference to the FCA's value judgement in its capacity as an "expert regulator" on the contested issues. The judge's reluctance to interfere with the FCA's own judgement on whether the requirements of the PR were met is reminiscent of the High Court's approach to interpreting directors' duties under English law in the July 2023 judgment in *ClientEarth v Shell directors*.

In *ClientEarth v Shell directors*, the High Court found that *"while it is plain that there are fundamental disagreements between ClientEarth and the Directors as to the right way to achieve the NZ 2050 targets that Shell has set itself, **the law respects the autonomy of the decision making of the Directors on commercial issues and their judgments** as to how best to achieve results which are in the best interests of their members as a whole… the management of a business of the size and complexity of that of Shell will require the Directors to take into account a range of competing considerations, the proper balancing of which is **a classic management decision with which the court is ill-equipped to interfere**"* (emphasis added).[5]

Positively, these two cases demonstrate that the English courts will generally be reluctant to 'second guess' regulatory or commercial judgements. This is provided that regulatory decisions have a legal, rational, and procedurally proper/robust basis, and board decisions fall within the range of decisions reasonably available to the directors at the relevant time.

☑ Implications for boards, investors and sponsors

Given the focus on climate change, the continuing advancements in climate science as well as the ongoing evolution of stakeholder expectations and disclosure standards, the FCA may later revise its own interpretation of the PR (although, as explained above, the FCA presently supports current market practice). Over time, it is also possible that the judiciary could see the need to revise its interpretation of what it means for directors to act "reasonably" and "in good faith" when managing sustainability-related risks. Whilst the duties of a board are owed primarily to shareholders, the debate will continue over the weighting that ought to be given to matters to which the directors are required to have regard in board decision making, such as the impact of the company's operations on the community and the environment.

The latest judgment in the FCA judicial review case arises in the broader context of the review of the UK's public markets regime, which includes prospectus disclosure, and the need to recalibrate the relationship between boards and investors and investment risk. It is crucial to ensure a careful calibration that promotes useful and good disclosure which is not defensive in nature.

The case could have also influenced the scope of the UK sponsor regime which is currently under review. If the FCA were at greater risk of challenge, then it would be reasonable to consider that this might impact the reliance placed upon and comfort sought by the FCA from others, including sponsors. That, in turn, might place additional burden on those seeking listings or further capital, potentially impacting the availability of capital to those who need it to bring about change. It is important to be cognisant of the secondary effects of any such decisions.

[4] Please refer to our bulletin on the fast-evolving sustainability disclosure and reporting landscape at: https://www.allenovery.com/en-gb/global/news-and-insights/publications/issb-sustainability-disclosure-standards-challenges-in-global-regulatory-implementation-and-market-adoption

[5] The July 2023 judgment consolidates, and therefore repeats to a significant extent, the May 2023 judgment in that case. See our article at: https://www.allenovery.com/en-gb/global/news-and-insights/publications/first-of-its-kind-derivative-action-climate-case-falls-at-the-first-hurdle

☑ Continued risks of climate litigation and other avenues for climate activism

Businesses should remain alert to the risks of climate activism and take legal advice regarding interpreting and complying with the increasingly granular requirements under new and emerging sustainability reporting and disclosure frameworks.

- The High Court's refusal to grant permission to bring a derivative claim in *ClientEarth v Shell* directors (and characterising the claim as being primarily brought for an ulterior purpose) may prompt activists to advance their causes via other forums eg AGMs, informal lobbying and other means to shape the wider public discourse.
- The High Court's decision in the FCA judicial review case highlighted that claimants can only use public law grounds to challenge the FCA's decisions to approve prospectuses, and in this case, ClientEarth failed to overcome the "high hurdle" of demonstrating irrationality and to demonstrate arguable errors of law in the approach and conclusions of the FCA. Nonetheless, claimants may turn to use other legal bases to launch allegations of untrue or misleading statements in, or omissions of necessary information from, prospectuses and listing particulars (eg via section 90 FSMA).

Should you have questions regarding the above, please get in touch with the authors of this bulletin, comprising a multi-disciplinary team of equity capital markets, regulatory, disputes and investigations lawyers at Allen & Overy LLP.

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