

# Future Facing Disputes

## ESG risk and shareholder activism

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Shareholder activism is increasingly influencing corporate agendas. Shareholder activists are increasingly focusing on environmental, social and governance (“ESG”) issues to influence a company’s behaviour in light of climate change, the most significant challenge facing humanity today.

With COP26 (the 26th UN Climate Change Conference) having just taken place in Glasgow, the approach taken by businesses to climate change will be under increasing scrutiny as shareholder activists intensify their focus on ESG issues.

In this paper we look in more detail at the importance of shareholder activism in relation to ESG issues and how companies can deal effectively with an activist campaign. For more on the topic, please see our recent insight papers: Emergence of Climate Change Litigation (early 2020), Enforcing the Ethical Charter (July 2020) and Shareholder Activism and Director Risk (January 2021).



### Shareholder activism

Shareholder activism can have a positive impact on the value, performance and decision-making of a company. Increasingly, shareholder activism is based on an ethically driven agenda by proactive investors. There is an increasing trend for investors to view corporate attention to ESG criteria as closely linked with business resilience, competitive strength, and financial performance.



### Why is attention to ESG shareholder activism so important?

The driving force behind shareholder activism is often increasing the value of, or extracting value from the company, which, in the UK, aligns with the duties of directors to promote the success of a company for the benefit of its members as a whole.

ESG has the potential to unlock shareholder value and to make companies and markets more sustainable. Support for ESG issues from the world’s largest institutional investors and pension funds has given ESG investing and operating principles added legitimacy and credibility.

Shareholder activism in relation to ESG issues plays a crucial role in influencing governments to enact laws that aim to protect the environment, one of the key issues facing humanity today. Increasing pressure from shareholders and investors all contribute to the need for governments and companies to be ready to respond to the changing regulatory landscape. This pressure has resulted in policies for a rapid transition to ‘net zero’ and a focus on climate change risk mitigation to ensure a sustainable future for business.

Recent successes of shareholder activists against Big Oil, for example, Exxon, Chevron and Shell, are one of many signs of mounting and effective pressure from investors on public companies to enhance their performance and disclosures on ESG criteria.

Corporate disclosures on environmental and social issues can provide shareholder activists with a substantial amount of new material to use in their campaigns. Sustainability reports issued by companies over a course of several years will provide investors with an ability to compare ESG performance over time.

For companies that adapt to the ESG challenge, there are likely to be significant benefits. But the nature of many ESG risks means that, if they are not managed, they bring the potential for regulatory enforcement, civil claims and criminal sanctions. Increasingly, investigations and/or civil litigation run in parallel, or in close succession, and the risks arising from parallel proceedings will need to be managed very carefully.

Governments and corporations globally are increasingly being held accountable by litigants for their environmental impact, insufficient climate protection policies and non-implementation of international climate treaties. In the UK, courts are increasingly enforcing action against climate change. Climate change litigation covers a variety of different cases, including:

- Claims against companies for deceptive ‘greenwashing’ marketing campaigns or misleading environmental impact claims. As the focus on sustainability and ESG issues intensifies, businesses will be scrutinised on their policies, making environmental claims fertile ground for future litigation. In the UK, several consumer organisations and financial bodies have recently published guidance in relation to environmental impact claims such as the CMA and FCA.
- Cases brought to limit carbon-emitting behaviour (tort or nuisance claims).
- Cases relating to fossil fuel projects.
- Claims against businesses who do not disclose climate change risk in respect of investments.

The recent successes of shareholder activists against Big Oil are one of many signs of mounting and effective pressure from investors on public companies to enhance their performance and disclosures on ESG criteria:

- In the recent watershed case of ExxonMobil Corp, the shareholder activist approach was used and accepted. Investors were growing increasingly unhappy with the lack of corporate strategy to tackle climate change. Shareholders engaged in a proxy battle that resulted in the unseating of two directors from the board. This example reflects that investors may both achieve their social objectives and maximise financial return by monitoring and engaging with companies, rather than by divesting.
- In the case of Chevron, a large majority of Chevron shareholders voted for a resolution calling for the company to “substantially reduce” its scope 3 emissions, or those from the products it produces. This resulted in Chevron carefully considering the result and saying that it would increase production of hydrogen, renewable natural gas and liquid fuels for use in transport and that it would capture or offset 25m tonnes of carbon a year by 2030.
- Finally, in the recent landmark judgment against Royal Dutch Shell, for the first time in history a court held a large company directly responsible for causing dangerous climate change on the basis of a duty of care, flowing from international treaties, such as the 2016 Paris Climate Agreement and ordered Shell to lower its emissions by 45% by 2030 compared to 2019 levels – a much faster rate than the company had planned. This case was an historic turning point and catalyst for a potential wave of climate change litigation. Multinationals with high carbon footprints will now be forced to bring their policies in line with the Paris Agreement.



## Trending methods

While minority shareholders do not manage the daily operations of a company, there are several methods shareholder activists employ to force change and influence a company’s board of directors. Their methods include:

- Bringing about changes to board structure – such as proposing (or demanding) changes to the existing board of directors, changes to the remuneration policies or proposing a greater number of independent non-executive directors.
- Bringing civil claims against management, for example, unfair prejudice and derivative claims.

- Demanding that certain resolutions be voted on at AGMs, for example in respect of:
  - Operational and/or strategic changes
  - The share price of the company
  - Resolutions that relate to ESG issues
- Publicly calling for a company to undergo a transformational change to realise value, for example, by way of company reorganisation or M&A.
- Vote no campaigns
- Proxy fights
- Social media campaigns
- Stock-trading apps



## What can companies do to prepare for activist campaigns?

How a company deals with an activist campaign and handles the situation can affect the reputation of the company and the board of directors and there a number of actions a company can take to ensure the situation is handled well.

If the board becomes aware that an activist is targeting the company, it will need to consider the range of legal and regulatory tools at the activist's disposal. Many of these are contained in the Companies Act 2006 (CA 2006), for example, if the shareholder has sufficient stake or enough support, it could:

- Pose difficult questions at a general meeting
- Vote against/blocking resolutions
- Requisition a general meeting or a resolution at a GM
- Requisition the circulation of a statement
- Bring an action for unfair prejudice

There are a number of steps a company can take to minimise the risk of being targeted by activist shareholders and certain "red flags" that companies can look out for that may give an early indication that they may have become targets.



## To minimise the risk of being targeted by activist shareholders, generally companies should:

- maintain good relationships with major shareholders (including understanding and addressing their concerns on an ongoing basis). If a company is able to do this and effectively communicate its strategy and how it is maximising value for its shareholders, it will be less susceptible to challenge from an activist shareholder in the first place.
- maintain good relationships with analysts and key journalists, as well as consistently monitoring press, research reports and social media in respect of the company, its industry and peers. This enables companies to correct any misconceptions quickly and effectively. Companies should use publicity positively to engage with and talk about the issue the activist is concerned about.
- maintain good corporate governance standards (poor governance is a common ground for attack by activists). Prepare an action plan for the board that sets out the company's strategy for responding to questions from the activist shareholder (or others on the issues raised at a general meeting).
- monitor shareholder activist activity across the market to understand common avenues of attack and to ensure that the company is not vulnerable in these areas. This includes conducting regular strategic reviews to identify potential areas of challenge from activists.

- “Red flags” indicating an increased likelihood that the company may about to be targeted by shareholder activists include:
  - Poor financial or share performance
  - Increased levels of stock borrowing and lending activity in the company’s shares
  - Small holdings coming onto the register in the run up to general meetings
  - Unusual trading activity in the company’s shares more generally



## What companies can do when faced with shareholder activism based on ESG shortcomings:

1. Treat activist shareholders with ESG-themed inquiries and criticisms respectfully.
2. Assess and manage exposure to risks across all three limbs of ESG to understand potential risk areas, for example, the company could conduct an internal audit.
3. Address and mitigate risk areas by having a sustainable business model, carbon transition plan, by integrating ESG principles and standards and providing climate and ESG disclosures – and have legal counsel review ESG disclosures to ensure compliance.
4. Establish board management, oversight and data collection of ESG issues and good governance procedures to keep up with investor expectations and ESG-related targets.
5. Continuously improve ESG initiatives and integrate ESG concepts into company culture.
6. Anticipate and be prepared for regulatory change.

## Conclusion

There is increasing pressure on companies to deliver sustainable, long-term success in a socially responsible manner; together with greater emphasis on engagement with shareholders and employees to align their purpose, values and strategy with company culture.

The increased regulatory focus on ESG, a rise in ESG reporting obligations and continued increase in consumer and shareholder activism around ESG topics means that all businesses need to identify and manage their ESG risk.

Aside from ensuring compliance with legal obligations, commercial pressures and reputational risk, changes to corporate behaviour may be needed for companies to be truly ESG compliant.

If companies don’t listen, there is the potential for shareholder disputes and civil litigation.

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