The importance of people and planet

If directors fail to have regard for their ESG obligations, they are potentially in breach of their duties, writes **Vernon Dennis**

A company's social and environmental impact will have a wide range of consequences for its stakeholders, including customers, employees, investors, lenders and the community at large. The stance taken on this impact by the directors, the guiding mind of the company, should be influenced by the business's vision and purpose, and requires consideration of stakeholder interests, not just the interests of shareholders. It is far more than a matter of legal and regulatory compliance. Where directors have given insufficient regard, it will lead to an actionable breach of duty.

The acronym ESG – environmental, social and governance – was first coined more than 20 years ago. But when viewed solely as a panacea for environmental or social ills, such as preventing climate change and challenging social inequality, it can be easily misunderstood. This is to the point that, to some, ESG stands accused of subverting the profit motive of business.

ESG should instead be understood as part of the double materiality impact assessment process by which the directors of a company discharge their duty to promote the long-term success, or sustainability, of the company. This includes how the company's governance, reporting and review structures determine and implement a sustainable strategy, which manages and mitigates the company's environmental and social impacts. This strategy should secure the success of the business by analysis and determination as to the impact of such disruptive factors on the business.

ESG is not an opt-in or opt-out decision on specific issues according to what suits the business at the time. Indeed, huge reputational damage can arise from so-called virtue signalling or inauthentically promoting a particular agenda that has little, if anything, to do with the business's commercial activities. A business may also fall foul of regulations designed to clamp down on alleged greenwashing, rainbow washing or wellness washing. ▶

Unfortunately, virtue signalling and the overt association of ESG with only one, so-called 'progressive' side of any social and environmental debate, has led to the misuse and misunderstanding of ESG. It is a major reason why we have recently seen a backlash and weakening of ESG as an investment criterion. Shareholders are challenging ESG as non-financial 'woke' capitalism and a breach of the director's fiduciary duty to promote the shareholders' interests and produce a profit.

This anti-ESG sentiment requires a fresh perspective to be taken – non-political and non-ideological. ESG should be seen as an essential component in developing a sustainable business strategy, ensuring long-term success and profitability.

How is ESG relevant to insolvency?

The insolvency profession looks at business failure through the prism of financial loss and damage caused to the various impacted stakeholders. The Insolvency Act 1986 – which grants significant powers and rights of action to officeholders – looks at insolvency from a cash flow or balance sheet perspective. It is primarily a numbers game, where the underlying cause of business failure and director culpability are often secondary considerations after first establishing whether additional loss and damage have arisen past the point of insolvency. In instances of corporate failure, insolvency practitioners (IPs) will have been called upon to assess director conduct in relation to a business's ESG obligations, probably without even realising it.

In addition to Insolvency Act claims, IPs should have regard to the general duties owed to the company by the directors and which may form part of a claim pursuant to summary remedy afforded by the Insolvency Act s.212. This requires much deeper regard to the reasons for the business failure. Was a lack of consideration for the environmental or social impact of any action or inaction the cause of the company's demise? Was poor governance the reason the company did not appreciate and deal with the severity of the situation? These factors may go further back than the point of insolvency.

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A director's duty to promote the success of the company (Companies Act 2006 s.172) requires consideration of a variety of factors that fall squarely within the field of ESG, including the interests of employees, suppliers, customers, the community and the environment, all underpinned by governance and applicable standards of business conduct and ethics. Post-Sequana[1], it has been made clear that a director's duty to creditors is a modification of this general duty to the company. Accordingly, where a business has suffered loss or damage as a result of directors failing to have regard for ESG obligations, there is a potential breach of duty under s.172.

Failure to have regard for the company's impact on the environment or society (including employees, suppliers, customers and the community) could result in a claim that the directors are in breach of s.172. Nevertheless, it is more likely that environmental or societal harm caused by the company's operations will give rise to direct claims against the company as the tortfeasor. In such a scenario, it is possible that the company – through its shareholders or an insolvency office holder (if the company is insolvent) – could bring a claim against the directors under s.174 of the Companies Act 2006 (the directors' duty to exercise reasonable care, skill and diligence in managing the company). Directors may be held accountable for their failure to manage the company properly if it suffers losses or damages due to direct claims from injured third parties. They may also be held accountable if the company has failed to comply with legislative and/or regulatory environmental requirements resulting in liability or has experienced reputational damage and subsequent business loss.

An assessment of the reasonableness of the directors' conduct will consider compliance with industry standards, codes of conduct and regulation. The consideration of the regulatory regime specific to the company's industry or sector is something that an office holder may need to pay close attention to when determining whether there is a breach of s.174 by the directors.

Fresh perspective

While an argument can be made that ESG (as we have come to know it) is on the wane, instead it is time to look at ESG afresh. As part of the director's duty to promote the long-term success of the company. A duty to consider people, planet and the strategic disruptive factors impacted by, and impacting on, the business. The aim should be to avoid causing direct loss and damage to the company or loss to stakeholders that may cause indirect loss to the company. Failure to discharge these ESG obligations will be policed by the insolvency profession.

1. *BTI 2014 LLC v Sequana SA and others [2022] UKSC 25*

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