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CLIMATE
Connecting Climate Change and the Law

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Climate Lawsuit Against Shell Directors Dismissed

May 16, 2023

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On May 12, 2023, the UK High Court dismissed a lawsuit filed by ClientEarth against Shell's Board of Directors, finding that ClientEarth failed to establish a *prima facie* case against the Board for its management of climate risks. The lawsuit asserted that the directors violated duties under the Companies Act, which creates a duty to promote the success of the company and to act with reasonable care, skill, and diligence. ClientEarth claimed that, among other things, Shell was required to adopt and implement an energy transition strategy consistent with the Paris Agreement in discharge of these obligations. Shell's "Energy Transition Strategy," according to the complaint, fails to align with the Paris Agreement because although it establishes a 2050 net-zero target, it excludes short- and medium-term targets to cut scope 3 emissions when such emissions account for 90% of the company's overall emissions and are calculated to be reduced by just 5% by 2030. ClientEarth sought an order compelling Shell to amend its plan to address these deficiencies.

The High Court disagreed, finding that the allegations were insufficient to state a violation of the Companies Act, explaining that "[t]he 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 court found that ClientEarth failed to establish that no reasonable director would have taken the same action as the Board with respect to climate risk. The court further noted that the climate-related duties asserted in the complaint were "vague" and could not establish "enforceable personal legal duties."

Taking the Temperature: Last month, we discussed the High Court's dismissal of another first-of-its-kind lawsuit asserting similar breach claims against the directors of the principal pension plan for UK higher education system employees. That case and the court's ruling here demonstrate that, as we have discussed, plaintiffs are likely to face an uphill battle in successfully bringing claims for supposed climate-related failures. As the High Court found here, directors generally maintain wide discretion to determine the course of action that, in their view, is in the best interests of the company as a whole. In the United States, courts in Delaware and many other jurisdictions will not second-guess directors' decisions or substitute their own judgment for that of the board so long as such decisions are made on an informed basis, in good faith, and in the best interests of the company and its stockholders. However, acting on an informed basis to make decisions that are best for the company on climate-related issues means that, in our

view, boards cannot and should not sit idly by without addressing the risks of climate change. As we have previously advised, boards and management should focus on climate-related governance (i.e., monitoring and assessing material risks and opportunities), data collection/assessment (including alignment with SBTi or other data standard setters) and disclosure (including necessary caveats or qualifications on articulated climate goals) to avoid litigation exposure.

MSCI Announces Changes to Its ESG Rating Methodology, Resulting in Downgrades for Most Funds

May 16, 2023

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MSCI has announced significant changes to its ESG investment fund ratings methodology that “aim to raise the requirements for a fund to be assessed as ‘AA’ or ‘AAA’ rated, improve stability in Fund ESG Ratings and add transparency through simpler attribution analysis.” However, these changes will result in downgrades to 31,000 of the funds currently rated by MSCI. MSCI also announced new coverage for 8,200 fixed income funds and a “new approach in rating funds with swap-based strategies” that “will rate swap-based ETFs based on the holdings of the replicated index instead of the fund’s collateral holdings.” According to MSCI, the methodology changes are based on client feedback, not regulatory developments in the EU or elsewhere.

MSCI’s main methodological change is now to derive the ESG Quality Score that underlies MSCI ESG Fund Ratings “from a simple weighted average of the ESG scores of the underlying holdings. [MSCI] will no longer apply adjustment factors.” That is because, according to MSCI, the adjustment factors by and large resulted in ratings upgrades because of how those factors were calculated. In particular, at the fund level, the adjustment factor rewards funds for holding companies that are both highly rated and improving their ESG rating. But companies across nearly every sector, “operating under a new environment of increased ESG scrutiny, have been improving and disclosing more of their E, S and G practices.” As a result, “many funds, including broad-market benchmark-replicating funds, are now highly rated by MSCI, in part driven by the momentum adjustment.” MSCI reports that as of December 2022, “approximately 73% of funds in [its] coverage universe (including ETFs, mutual funds and index funds) had a positive adjustment factor, meaning that these funds had greater exposure to companies with improving ESG Ratings than worsening ESG Ratings.” Accordingly, “the goal posts are shifting” in a “new era where improvement in ESG is the status quo,” such that “the threshold required to receive a top ‘AA’ or ‘AAA’ rating should be more rigorous and ambitious.” However, because the adjustment factor “had a mostly upward influence on funds’ ESG Ratings, removing it will lead to more downgrades than upgrades.” MSCI observes that this reflects “a one-time calibration of the entire universe of funds” and is “not indicative of more downgrades to come.”

Taking the Temperature: As we have reported, ESG ratings providers are being subject to scrutiny and potential regulation as a result of concerns regarding the transparency of their methodologies and the lack of consistency in ratings for the same company by different providers. The UK’s Financial Conduct Authority is in the midst of a public

consultation on a potential ESG ratings regulatory regime, which closes on June 30. The consultation states that "Treasury considers there is clear benefit to be gained from improving the transparency of methodologies, governance, and processes of ESG ratings providers. These outcomes could be brought about through regulation." The European Securities and Markets Authority's (ESMA) Securities and Markets Stakeholder Group (SMSG) earlier this year observed that, with respect to ratings providers, the "methodological choices are presently not always sufficiently disclosed," and "investors may not be in a position where they can make truly informed decisions, making it necessary for them to compare several ESG ratings and conduct their own research in parallel, often using raw ESG data." As SMSG observed, the market would benefit from improved "availability, integrity, and transparency of ESG ratings." The Securities and Exchange Board of India recently sought input into potential ESG ratings regulation, a call for regulation echoed by the International Organization of Securities Commissions.

Despite increased interest from regulators, the ESG ratings industry remains largely unregulated and we expect company ratings and the underlying methodology producing those ratings to remain controversial. We recently reported on the results of the Dow Jones Sustainability Indices Annual Review, which resulted in certain additions to and deletions from the Sustainability Index that provoked comment. We anticipate that calls for regulation will continue while ratings methodologies remain unclear, the sources of information supporting scores varies, and scores diverge among different providers.

EFRAG Heeds Call to Prioritize General ESRS Guidance Over New Sector-Specific Standards

May 16, 2023

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On March 29, the European Financial Reporting Advisory Group (EFRAG) announced that it would start to develop additional guidance for sector-agnostic European Sustainability Reporting Standards (ESRS). In making this announcement, EFRAG adjusted its planned publication schedule in response to comments from European Commissioner Mairead McGuiness, who publicly stated that companies across a range of sectors need further assistance on sustainability reporting.

EFRAG is a private association established in 2001 to, among other things, provide technical advice to the European Commission on sustainability reporting. The ESRS provides companies with guidance regarding climate-related and other ESG disclosures and audit obligations as part of the **EU Corporate Sustainability Reporting Directive (CSRD)**.

As we have **previously reported**, EFRAG approved **revised versions of the ESRS** in November. The November publications are sector-agnostic, and EFRAG has since been working on sector-specific standards (including for the textiles, mining, road transport, food and beverage, and energy and utilities sectors), as well as proposed standards for small- to medium-sized enterprises.

Acknowledging that compliance with the ESRS presents a significant challenge for companies, Commissioner McGuiness, whose areas of responsibility include the financial services sector, **publicly called on EFRAG** to prioritize developing additional guidance for the sector-agnostic ESRS over its work on the sector-specific standards.

In its March 29 statement, EFRAG announced that it would adjust its planned work in accordance with Commissioner McGuiness' request. In particular, EFRAG intends to develop "an ESRS implementation support function," which would potentially include the development of additional guidance, the deployment of a "comprehensive documentation hub," and the facilitation of educational resources. To meet these objectives, EFRAG is increasing staffing and dedicating additional resources, as well as "actively working" on the digitalization of the sector-agnostic ESRS.

The statement also noted that EFRAG would continue to work on the sector-specific standards, but on an altered timeline.

Taking the Temperature: EFRAG's shift in priorities and resourcing is notable for a few reasons.

First, we can expect that the reshuffling will mean some delay in the development, adoption and implementation of the sector-specific and SME reposting standards. How much of a delay remains unclear. Second, EFRAG's intention to develop a supportive framework that includes additional guidance as well as informational and educational resources reflects an acknowledgment that compliance with the CSRD is on the horizon, will impact a substantial number of companies and will present significant challenges for those companies.

As has been widely reported, the new CRSD obligations are estimated to apply to more than 50,000 EU public companies and large public companies headquartered outside the EU that do substantial business in the EU. This represents a more than four-fold increase in the number of companies currently covered by the existing Non-Financial Reporting Directive 2014/95/EU (NFRD). The compliance timeline under the CSRD contemplates that the largest of these companies will need to publish fiscal year 2024 sustainability reports in 2025, with other categories of companies coming online thereafter.

As Commissioner McGuiness acknowledged in her statement, meeting the new reporting and audit requirements is a looming challenge. A number of commentators have observed that preparing to collect, analyze and report on information in compliance with the CSRD will be a data- and resource-heavy undertaking for many organizations. Companies relatively new to ESG reporting will likely incur significant one-time costs in developing data gathering and reporting infrastructure, as well as ongoing costs tied to annual reporting.

As we reported recently, business leaders in the U.S. have expressed concern over the anticipated compliance cost, as well as the availability of sufficient human and technological resources, of meeting the SEC's proposed climate disclosure rule. Similar concerns exist regarding the CSRD. While additional EFRAG guidance will be welcomed and may well bear on compliance with the SEC's anticipated rule given the degree of overlap, companies should be (and as we have reported in large part are) planning ahead for incoming disclosure requirements. Specifically, we observe that the ESRS: (i) addresses many of the same subject areas as non-EU regulatory guidance, including the SEC's proposed climate change disclosure rule—an important step toward achieving regulatory and market consensus on climate-related disclosure; (ii) mandates disclosure of Scope 3 emissions and, consistent with related EU regulation, adopts a double materiality standard (i.e., issuer impact and external impact of issuer activities), which diverges from current U.S. guidance; and (iii) recognizes the need for companies to have sufficient time to comply, therefore adopting a gradual approach to implementation.

IIGCC Publishes Net Zero Standard for Oil and Gas Sector

May 16, 2023

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On April 18, 2023, the Institutional Investors Group on Climate Change (IIGCC) published a **"Net Zero Standard for Oil & Gas."** Development of the Standard follows a two-year collaborative process led by IIGCC with support from the Transition Pathway Initiative (TPI), Climate Action 100+ investors and other stakeholders. Net Zero Standards are sector-specific frameworks developed to help climate-focused investors (including groups such as **Climate Action 100+**) and other stakeholders assess corporate transition plans against the 1.5°C climate scenario set out in the **Paris Agreement**. The oil and gas Standard is the first of a series of "sector-specific frameworks" IIGCC will be helping to develop. IIGCC will apply the Standard to the operations and transition plans of major market participants and aims to publish public assessments in late 2023. Following the assessments, the framework will be reviewed again by IIGCC with the aim of making further refinements post-2023.

The Standard is designed to complement the Climate Action 100+ Net Zero Company Benchmark, which we have **previously discussed**. The metrics set out in the Standard are classified by type depending on whether they aim to capture climate-related disclosure or assess the alignment of disclosure against an existing benchmark. Disclosure metrics include an assessment of whether a company has set an ambition to achieve net zero greenhouse gas emissions by 2050 or sooner. The alignment metric evaluates whether reduction targets are in line with the relevant net zero pathway. Metrics relating to "climate solutions" (technologies and products that will enable the economy to decarbonize) are categorized and scored separately. The Standard asks a responding company to state the definitions it uses for categories including wind and solar electricity as well as low carbon fuels like hydrogen and biofuels. IIGCC has designed the metrics to provide investors with the "transparency they need to differentiate between companies that are genuinely transitioning and those that are not."

Provisional indicators were published in September 2021 and a pilot study was conducted on five major European **oil and gas companies**. IIGCC reports that while the pilot study showed "increasing transparency over decarbonization plans, including disclosures on the contribution of offsets to targets," it also showed a "need for continued improvement in alignment of all targets and plans with relevant 1.5°C scenario benchmarks." Adam Matthews, Chair of the process for the Oil & Gas Net Zero Standard, said: "This is intentionally a demanding yet practical Standard...[i]t levels the disclosure landscape." He further added that, "[w]e recognise it will not be easy to meet the Standard from day one, but we are inviting companies to unequivocally commit to disclose against the Standard and to set out a timeline to do so over the coming year."

Taking the Temperature: IIGCC recently launched the Net Zero Engagement Initiative (NZEI), which goes beyond the companies already engaged by Climate Action 100+ and will support investors to align more of their investment portfolio with the goals of the Paris Agreement. With the release of the Net Zero Standard for Oil & Gas, IIGCC is aiming to provide information to investors regarding corporate transition plans and, specifically, to better understand how to evaluate transition plans in economic sectors that have particular climate-related challenges.

As we have observed, investors are continuing to pressure companies on their net zero commitments, particularly in the financial services and oil and gas sectors. More broadly, at least certain studies indicate that many companies still lack credible and sufficiently detailed transitions plans to meet net zero goals by 2050.

At the same time, the politicization of climate-related action in the U.S. has also affected environmentally-focused investor initiatives like Climate Action 100+ and IIGCC. For instance, Republican members of the House Judiciary Committee launched an investigation into Climate Action 100+, claiming that it "seems to work like a cartel." That pressure seems to be having an impact, as significant members of key financial services or insurance industry net zero initiatives, such as the Net-Zero Insurance Alliance (NZIA), Net Zero Banking Alliance (NZBA) and Net Zero Asset Managers initiative (NZAM), have left the alliances due to antitrust concerns and/or certain of those organizations have amended membership requirements in the face of threatened withdrawals to ease net zero commitments. While these developments do not preclude individual company action on climate-related issues, the potential weakening of these industry collaborations threatens to deprive members of the benefits of appropriate cooperation and risks backlash from "pro-ESG" stakeholders, including potential challenges including in the form of litigation.