ESG and Directors' Duty - Externalities and the Limits of the Business Judgment Rule -

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ESG and directors' duties

- Are directors permitted to take stakeholders' interests into their consideration?
  - Yes, if it advances shareholders' interest, and directors have a wide discretion how to promote the firm value under the business judgment rule (Bebchuk & Tallarita 2020, Rock 2020, UKCA Art.172)
  - Yes, if it is supported by the majority of shareholders support (Hart & Zingales 2017)
  - Yes, if it decreases negative externalities from the corporation's business (Elhauge 2005)
- Can directors be held liable against their corporation for not considering stakeholders' interests beyond legal requirements?

Directors' liability for not considering stakeholders' interests beyond legal requirements?

- Traditional approach: No, directors have wide discretion under BJR
  - ClientEarth v. Shell [2023] EWHC 1137
  - Tiong v. HC Surgical [2020] SGHC201
  - Bainbridge (2022), Lan & Wan (2023)

- New developments in the US and Japan
  - Expanding the Caremark duty of oversight
    - Marchand v. Barnhill (Del. 2019), In re Boeing Derivative Litigation (Del. Ch. 2021)
    - Armour & Gordon (2014), Strine et al. (2021), Shapira (2022)
  - In re TEPCO shareholders' derivative suit, Tokyo District Court, July 13, 2022

Essential role of the business judgment rule (or the discretion of directors)

- The new developments in the US and Japan might be welcomed as a step toward ESG and sustainability
- However, BJR is one of the principles of corporate law essential for optimal risk-taking and for the growth of corporations and the economy
  - Jurisdictions that do not have “BJR” also grant wide discretion to directors
- Possible chilling effect by unclarity of when and why BJR will be denied
  - Tokyo District Court is not so clear on these points
  - Views of the commentators supporting the expansion of the Caremark duty are also diverse on their grounds and could have different scopes

Tokyo District Court, Civil 8th Div., July 13th, 2022 *In re* TEPCO Shareholders' Derivative Suit

- Meltdown at Fukushima 1st Nuclear Power Plant of Tokyo Electric Power Company (TEPCO) after the Eastern Japan Great Earthquake on March 11, 2011
  - Tsunami flooded Fukushima 1st's vital facilities, resulting in the loss of all electricity necessary for cooling reactors
- Plaintiff SHs: Anti-nuclear power activist (citizens' group)
- Defendants: Five former directors of TEPCO (chairman, president, and directors in charge of nuclear power branch)
- TEPCO joined to assist the defendants
- Four of the defendants held jointly liable for 13.3 trillion JPY (ca. 70billion GBP or 88billion USD)
  - As damages caused to TEPCO by Fukushima 1st incident (ie. compensation to victims and decommissioning/decontamination cost paid so far)
  - For breach of their duty of care for not taking appropriate preventive measures against a huge tsunami, disregarding the significance of a report by a scientific government council noting its possibility
  - Causation was a major issue (the Supreme Court denied it in a different suit against the Japanese government), but will not be discussed today
- Both sides appealed to Tokyo High Court

Plaintiffs

https://toyokeizai.net/articles/-/609049

Tokyo District Court's logic (1)

- Operators of nuclear power plants (NPP) have a duty to society and the general public to prevent by any chance a severe incident (meltdown causing massive emission of radioactive substance) based on up-to-date scientific knowledge.
- Relevant regulations and the Nuclear Damage Compensation Act are based on the premise that operators of NPP bear the primary responsibility to secure its safety.
- Therefore, when there is a risk of a severe incident caused by a tsunami that can be expected based on up-to-date scientific knowledge, a company operating an NPP clearly owes a duty to its neighbors and those who could suffer damage to their life, body and property to take necessary measures to prevent such an incident, and its directors owe a duty of care to the company to order such measures.

Tokyo District Court's logic (2)

- Also, as the Nuclear Damage Compensation Act imposes strict liability for damages caused by NPP, a company operating an NPP would face an existential crisis by enormous liability once a severe incident occurs. Therefore, directors of the company owe a duty of care to the company to order measures necessary to prevent severe incidents by a tsunami that can be expected based on up-to-date scientific knowledge so that the company would not bear such liability.

Tokyo District Court's logic (3)

- From above, if the defendants who were directors of TEPCO had recognized or had been able to recognize the possibility of the occurrence of a severe incident at Fukushima 1st Power Plant due to a huge tsunami, predictable by up-to-date scientific knowledge, but had failed to order taking measures necessary to avoid such an incident, such directors shall be deemed to have violated their duties of care against TEPCO regardless of whether such failure constitutes a violation of a particular law/regulation.

How can the Tokyo District Court's decision be explained?

- At face value, Tokyo District Court seems to have excluded the application of BJR because of the risk of an enormous negative externality, even though TEPCO and its directors did not violate the requirements of laws and regulations
- If this is what the court really means, this could be a radical departure from traditional corporate law theory toward ESG
- No sufficiently clear explanation by the court

Was TEPCO in violation of regulatory guidance?

- Tokyo District Court explicitly stated that TEPCO's directors were in breach of their duties "regardless of whether their failure constituted a violation of a particular law/regulation"
- However, some findings of the court suggest that TEPCO did not respect some regulatory guidance
  - Likelihood of an earthquake causing a huge tsunami around Fukushima: 6% within 30yrs, 9% within 50yrs (Earthquake Research Promotion HQ (2002), Long Term Evaluation of Earthquakes off the Coast from Sanriku to Boso)
  - Permissible likelihood of severe incidents set by Japanese Nuclear Security Committee following IAEA: 1/1million per year
  - Japanese Nuclear Safety Agency specifically requested TEPCO to consider the possibility of a huge tsunami exceeding its assumption upon reviewing earthquake-proofness of nuclear power plants based on JNSC's new standard (adopted in 2006) that required taking very rare but possible earthquakes into consideration
- An easy case with an obiter dictum?

Did TEPCO directors negligently overlook a red flag for a very rare, but enormous risk?

- TEPCO's employees reported to its director in charge of nuclear power plants that according to their calculation based on the "Long-term Evaluation", the waves of a huge tsunami caused by an earthquake could be high enough to flood the vital facilities of Fukushima 1st and suggested to take measures such as the construction of seawalls immediately
- However, the director dismissed this proposal by downplaying the significance of the "Long-term Evaluation", arguing that its view was still scientifically disputed, and ordered to seek a second opinion from other scientists who were closer to TEPCO
- Tokyo District Court condemned this response, holding that the "Long-term Evaluation" was scientifically reliable enough to oblige TEPCO's directors to take necessary measures against possible tsunami

TEPCO and Caremark

- TEPCO decision seems to correspond with recent Delaware case law expanding the Caremark duty of oversight beyond regulatory compliance (eg. Marchand v. Barnhill (2019))
- Still, some questions arise
  - Was it clear to TEPCO's directors how they should act? Don't directors have discretion on how to evaluate and respond to risk information? Isn't this a hindsight bias that BJR sought to avoid?
  - How the exclusion of BJR is justified would affect its extent and thus its clarity to directors
    - Tokyo District Court is not clear as its first point emphasizes public interest while the second one focuses on the interest of TEPCO and its shareholders

Divergence among pro-Caremark expansion views

- Expansion for public interest
  - Strine et al. 2021
  - Cf. Pollman 2019, Arlen 2023: duty of obedience/oversight for public interest, but limited to regulatory compliance
- Expansion for shareholders' interest
  - Shapira 2022: oversight of "mission-critical" ESG risks to avoid reputational damage to the company
  - Gadinis & Miazad 2020: duty to gather information regarding social risks of the company's operation from stakeholders to avoid loss to the company
  - Cf. Tokyo District Court 2022: oversight of meltdown risk to avoid TEPCO being heavily indebted by tort liability
  - Armour & Gordon 2014: oversight of risk of systemic externalities from the business of the company, in particular banks, to avoid market-wide loss to diversified investors' portfolio
- Expansion for the interest of tort claimants of a bankrupt company?

Divergence of the scope of expansion and different types of ESG risks

- Risk of systemic externality causing portfolio-wide loss (Armour & Gordon)
  - Nuclear power plants are different from banks as tort liability might control externality (A&G)
- Mission-critical ESG risk (Shapira)
- Risk of enormous tort liability
- How about climate change?
  - Likely to cause market-wide loss, but the contribution of and damage to a particular corporation is unclear
  - Is it “mission critical” for corporations other than oil majors?

How much respect is given to BJR?

- BJR simply denied in limited scope
  - Armour & Gordon: Negligence standard instead for systemic firms
- BJR and the board's discretion respected to some extent
  - Shapira: "What judges do is focus on the process, and interfere only in cases where directors failed to even consider a critical factor"
  - Gadinis & Miazad: "Board is free to reach its own judgment, provided that it receives adequate information and shows due care in considering it"
  - Even under these standards, TEPCO's directors could be held liable
- Do such standards provide a clear-enough code of conduct for directors to avoid chilling effect?
  - ESG is important, but so is BJR
  - Depends on the clarity and width of the scope of the expansion of directors' duty

Conclusion

- Tokyo District Court held directors of TEPCO liable arguably for failing to consider a risk of enormous externality beyond the requirements of laws and regulations
  - Overlaps with recent case laws in Delaware, but too early to judge whether it is a trend in Japan
- Expansion of the directors' duty of oversight to cover ESG risks seems to be gaining traction, but the views of the supporters of this idea are diverse which calls for a more detailed and focused discussion
- Relevant factors include
  - How much weight to give to the BJR, clarity to directors, and the necessity to avoid chilling effect
  - How to justify the expansion, for public interest or for shareholders' interest?
  - Types of ESG risks covered