

A photograph of several large icebergs floating in the ocean. The icebergs are white and blue, with some showing signs of melting. The water is dark blue. The sky is a pale, hazy blue. The image is used as a background for the cover of a paper.

# Directors' Liability and Climate Risk: *Comparative Paper – Australia, Canada, South Africa, and the United Kingdom*

October 2019



SMITH SCHOOL OF ENTERPRISE  
AND THE ENVIRONMENT



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## About the Commonwealth Climate and Law Initiative

The Commonwealth Climate and Law Initiative (CCLI) a non-profit legal research, education and outreach project focused on the intersection of climate change and companies and securities laws. The CCLI leverages the interdisciplinary and cross-jurisdictional perspectives provided by its global experts from academia and the legal, accountancy, business and scientific communities. The CCLI examines the legal basis for directors, officers and trustees to take account of physical climate change risk and societal responses to climate change, under prevailing statutory and common laws. Building on the legal analysis, the CCLI provides corporate governance tools to assist boards and trustees to assess, manage and disclose the risks and opportunities arising from climate change. Originally focused on four common law countries in the Commonwealth – Australia, Canada, South Africa and the United Kingdom – the CCLI is expanding to common law countries in Asia, including India, Singapore and Hong Kong.

Despite only producing 5% of current annual global GHG emissions, Australia, Canada, South Africa, and the United Kingdom account for 15.6% of global coal reserves and 10% of global oil reserves. Their stock exchanges contain an even greater proportion of the world's listed fossil fuel reserves, and the benchmark index for the United Kingdom was considerably more exposed to fossil fuel reserve emissions than any other benchmark in the latest Carbon Scorecard published by S&P Global. They each have large and highly developed financial systems and account for 18% of the global pension assets and contain within the G20 the 16<sup>th</sup>, 9<sup>th</sup>, 17<sup>th</sup>, and 6<sup>th</sup> largest stock markets by market capitalisation respectively. The significant commonalities in the laws and legal systems of each of the four countries makes the initiative's work and outcomes readily transferable. They each operate a common law legal system. Their corporate governance laws are based on common fiduciary principles. Whilst their laws may differ at the margins, legal developments and judicial precedents are influential in each other jurisdiction.

The core research findings are contained in the national legal papers for the four jurisdictions. These have been complemented by conferences in the UK (Oxford, June 2016), Australia (Melbourne, August 2016), Canada (Vancouver and Toronto, October 2017) and South Africa (Johannesburg and Cape Town, January 2018). The national legal papers are organised by jurisdiction and follow a uniform structure to facilitate the creation of this comparative report. This report represents a high-level summary of the detailed legal analysis, with an overview of the material points of comparison and difference across the subject jurisdictions, in a plain-English format.

Annexed to this report is *The climate risk reporting journey – A corporate governance primer*. This actionable framework is designed to assist boards and their committees to integrate climate change issues into governance practice. It has been updated to reflect developments since it was originally published in November 2018.

### Commonwealth Climate and Law Initiative – October 2019

#### **Addendum**

This paper compares the law in force as at the date of completion of each subject country paper. The CCLI notes that a number of significant developments have occurred in the relevant jurisdictions since the publication of the country papers that are likely to reinforce rather than detract from the conclusions expressed in this paper. These include: updates to the Australian Securities and Investments Commission (ASIC) *Regulatory Guide 247: Effective disclosure in an operating and financial review* (August 2019); the joint publication by the Australian Accounting Standards Board (AASB) and Auditing and Assurance Standards Board (AuASB), *Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB Practice Statement 2* (December 2018); the Canadian Securities Administrators (CSA) publication, *CSA Staff Notice 51-358 Reporting of Climate Change-related Risks* (August 2019); the Bank of England Prudential Regulation Authority (PRA) supervisory statement, *SS3/19 Enhancing banks' and insurers' approaches to managing the financial risks from climate change* (April 2019); updates to UK pension scheme investment regulations requiring publication of the fund's policies on financially material considerations including climate change (effective October 2019); and the publication of the UK Government's *Green Finance Strategy* (July 2019).

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### ***Disclaimer***

The Commonwealth Climate and Law Initiative (CCLI), its founders, and partner organisations make no representations and provide no warranties in relation to any aspect of this publication, including regarding the advisability of investing in any particular company or investment fund or other vehicle. While we have obtained information believed to be reliable, we shall not be liable for any claims or losses of any nature in connection with information contained in this document, including but not limited to, lost profits or punitive or consequential damages.

# 1. Executive Summary

***The prevailing directors' duties regimes under Australian, Canadian, South African and UK laws are all conceptually capable of being applied to governance failures in the identification, assessment, oversight and disclosure of climate-related financial risks.***

## Climate risks and opportunities intersect with directors' duties and disclosure obligations

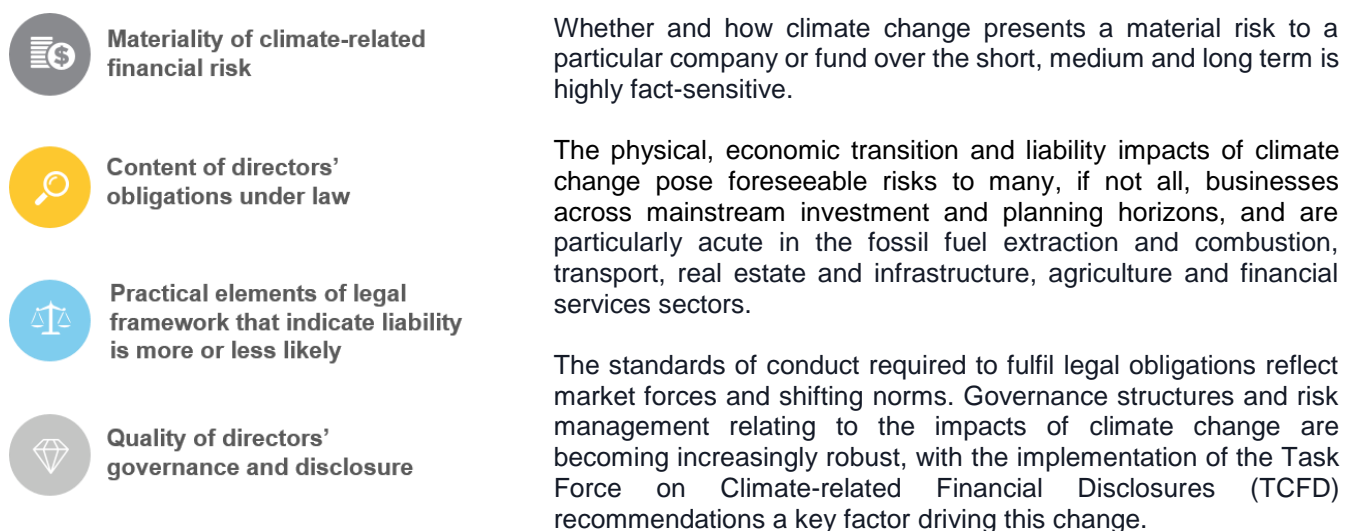
A director may breach their fiduciary duties of trust and loyalty where they consciously disregard, or wilfully ignore, material financial risks associated with climate change and their potential impact on corporate risk management and strategy, or where they adopt a course of action which no reasonable director could have rationally concluded was in the best interests of the company. A director may breach their duty of care and diligence where they totally fail to consider and govern for foreseeable and financially material climate risks, do so inadequately, or where they fail to monitor and oversee a robust corporate risk and reporting system that identifies and manages climate risks. The protection of the business judgment rule may not apply in this context.

Fiduciaries of pension or superannuation funds may breach their duties where a failure to consider climate risk in investment decisions results in lower returns or valuation losses in the long-term, particularly from asset stranding.

Directors' duties can be enforced through shareholder derivative actions, although the procedural barriers are high, or through the statutory oppression remedy. Some jurisdictions also allow for direct claims against directors by shareholders or derivative actions by non-shareholder stakeholders in certain circumstances. In Australia, directors' duties are also enforced by an independent regulator.

Directors may also face personal liability for breach of disclosure obligations to provide a true and fair view of corporate performance and prospects, particularly through securities class actions in Australia or Canada. Disclosures may be misleading where there is a failure to disclose the material economic transition risks or physical risks to a company's financial position, performance or prospects, a denial or material understatement of risk exposure or material overstatement of strategic preparedness or risk management, the material misstatement of balance sheet values, or the selective application of optimistic demand forecasts or assumptions.

## Assessment of liability exposure



**Figure 1: High level proxies to assess materiality of directors' liability exposure**

Australia is the jurisdiction where the liability risk to directors and fiduciaries is most material. This is not to say that the risk of liability is far-fetched in Canada, South Africa and the United Kingdom, and the risk is likely to increase in the future.

It is important not to overstate the practical likelihood of litigation. Procedural, evidentiary and cost-related barriers abound in the making of any claim against directors, particularly in the absence of evidence of bad faith. However, it would be ill-advised for company directors to dismiss the risk of personal liability as remote or theoretical, particularly directors of companies operating in sectors significantly exposed to physical or economic transition risks, or those with special expertise or responsibilities relating to risk oversight, such as the Chair or a member of risk or audit committees. While D&O insurance provides some financial protection in case of a claim, its application may be limited and it does not mitigate the reputational harm to directors.

## Implications for corporate governance and disclosure

**Directors and fiduciaries must now approach their governance of climate change in the same way as they would any other financial matter. The only safeguard against liability exposure will be a proactive, dynamic and considered approach to the impact of climate change on strategy, risk management oversight and reporting.**

**The climate risk reporting journey – A corporate governance primer** set out in the Annexure to this report is an actionable framework designed to assist boards and their committees to integrate the risks and opportunities of climate change into corporate governance and disclosure practice.



## 2. Introduction

This report represents a high-level summary in a plain-English format of the detailed legal analysis contained in four country papers produced by the CCLI on directors' duties and climate risk in Australia, Canada, South Africa and the UK.<sup>1</sup> The analysis is undertaken at a high level, focusing on areas of commonality, and does not purport to provide a comparative or exhaustive examination of the relevant laws in the four jurisdictions. It provides an overview of the conclusions that are substantively mirrored across each jurisdiction and identifies material divergences in *italics*. This paper does not consider directors' duties and climate change in the zone of insolvency and it is suggested this is worthy of separate and detailed consideration.

Annexed to this report is *The climate risk reporting journey – A corporate governance primer*, which serves as an actionable framework for directors in their integration of climate change issues into governance practice. Both this report and the primer are working documents that will continue to evolve in response to emerging practice. Accordingly, the CCLI welcomes comment from all users.

### ***The evolution of climate change to a foreseeable, and often material, financial risk issue***

Climate change has evolved from a non-financial, ethical and purely 'environmental' matter to one that presents foreseeable financial risks (and opportunities) within short, medium and long-term time horizons. Such risks include **physical risk** exposures from the direct and indirect impacts of both acute and incremental changes to the climate, spanning the increased frequency and intensity of extreme weather events such as storms, droughts and floods, to the gradual onset changes that compound over the medium to long term, such as increases in average temperature, changes in precipitation patterns and sea-level rise. Market and regulatory responses to climate-related issues present **economic transition risks**, including policy and regulatory reform, developments in technology in areas such as renewable energy and battery storage, and shifting market stakeholder expectations of investors and consumers. **Litigation risk** exposures arise from the attribution of climate change to a company's activities or a failure to manage either or both the physical or economic transition risks (A 5-6; C 6; SA 5-6; UK 6-8).

In the words of Australian Prudential Regulatory Authority Executive Board Member (and Chair of the international Sustainable Insurance Forum) Geoff Summerhayes, many of the risks of climate change are 'foreseeable, material and actionable now'.<sup>2</sup> Although climate-related financial risks pervade across almost all sectors of the economy, they are particularly acute in the high-risk sectors that include fossil fuel (coal, oil and gas) extraction and combustion, transport, real estate and infrastructure, agriculture and financial services. *The economies of Australia, South Africa and Canada are particularly exposed to economic transition risks due to the sectoral significance of fossil fuel extractive industries. Australia and the UK are also significantly exposed to economic transition risks due to the sectoral significance of financial services (A 7; C 5; SA 5; UK 8). The economies of South Africa and Australia also face substantial physical risks, including due to the sectoral significance of agriculture and other industries which are exposed to variations in precipitation and water stress. South Africa, northern Canada and Australia are already experiencing physical risk impacts well in excess of global averages (A 5; C 5; SA 5-6).*

### ***Directors are fiduciaries and owe duties to their company***

Companies are managed by boards of directors who are elected or appointed by shareholders. Shareholders have a proportional claim to the residual value of the company's assets after all debts and liabilities are paid out. While in practice, boards delegate day-to-day operational matters to executive management, they remain responsible for the oversight of corporate performance and risk management, monitoring and supervision of compliance, the

<sup>1</sup> Sarah Barker, CCLI, [Directors' Liability and Climate Risk: Australia – Country Paper](#); Prof. Cynthia Williams and Prof. Janis Sarra, CCLI, [Directors' Liability and Climate Risk: Canada – Country Paper](#); Christine Reddell, CCLI, [Directors' Liability and Climate Risk: South Africa – Country Paper](#); Alexia Staker and Alice Garton, CCLI, [Directors' Liability and Climate Risk: United Kingdom – Country Paper](#) (April 2018).

<sup>2</sup> Australian Prudential Regulation Authority (APRA), [Australia's New Horizon: Climate Change Challenges and Prudential Risk](#), speech by Executive Board Member Geoff Summerhayes to the Insurance Council of Australia Annual Forum 2017, Sydney, 17 February 2017.

approval of significant transactions, and, ultimately, corporate reporting. In fulfilling this role, directors are fiduciaries of their company, although not all their duties are fiduciary in nature. Broadly, whilst trust-related duties are considered fiduciary in nature, those relating to competence and attentiveness are not always classified as such. Directors' obligations are substantively similar (although not identical) across each of the four subject jurisdictions. They broadly fall within three categories:

- duties of trust and loyalty, including good faith, proper purposes and best interests, and avoidance of conflicts (fiduciary);
  - duties of competence and attentiveness (due care and diligence); and
  - obligations in relation to 'true and fair' corporate disclosure,
- (collectively for ease of reference, '**duties**') (A 8-9; C 6-8; SA 6-7; UK 10-11).

The particulars of conduct demanded by the duties in all four jurisdictions are flexible in response to changing norms. Their application to climate-related risks is heavily influenced by recent developments such as the Paris Agreement of December 2015, the recommendations of the G20 Financial Stability Board's Taskforce on Climate-related Financial Disclosures (**TCFD**) released in June 2017, the UNPRI/UNEPFI's Fiduciary Duty in the 21<sup>st</sup> Century work programme from 2015, and the emergent recognition of climate-related financial risks by central banks and market regulators (A 5-6; C 14; SA 10-11; UK 22-23). *The King Report on Corporate Governance has also been particularly influential in South Africa (SA 10, 15).*

The evolution of climate change to a foreseeable financial issue within mainstream investment and planning horizons renders moot any debate about whether its consideration is consistent with corporate best interests. Climate change triggers directors' governance duties in the same way as any other financial risk issue (A 56; C 13; SA 6; UK 15). *In addition, laws in the UK and South Africa expressly oblige, and in Canada permit, directors to have regard to the 'environment' in its own right in their pursuit of the best interests or success of the company (C 10; SA 11; UK 13). In Canada, this is framed as part of the requirement for directors to reflect on the interests of the corporation both as an economic actor and a 'good corporate citizen' (C 9).*

'Materiality' of risk is relevant to both the discharge of directors' duties and disclosure obligations. From a duties' perspective, directors are at a minimum duty bound to have regard to foreseeable financial risk issues in their pursuit of the best interests or success of the company and to exercise due care and diligence in relation to those risks (A 10-11, 17; C 10, 14; SA 10, 14; UK 14-15, 21). Whether a particular foreseeable risk has a material *impact* on a company will be a matter that can only be determined under a robust process of consideration. The relative significance of a given issue will be determinative of the degree of examination required and whether it must be disclosed. The greater the materiality, the more time and resources required to discharge duties in relation to risk management oversight of that risk (A 30; C 30; UK 35). Materiality in a disclosure context is subtly different, and is discussed further in Part 7 below.

### 3. Duties of trust and loyalty

In Australia, South Africa and the UK, compliance with (or breach of) duties of trust and loyalty generally turns on the subjective state of a director's mind, *although in Australia, consciousness of impropriety is not necessary to establish breach of the civil duties relating to conflicts of interest and proper purposes (A 10)*. The subjective nature of the test is also subject to an objective overlay where no reasonable director could have rationally concluded that a relevant act or omission was in the best interests of the company (A 10; SA 9, 11; UK 16). In these jurisdictions, it is conceivable that a director may breach their fiduciary duties of trust and loyalty, specifically, to exercise powers and discharge duties in good faith in the best interests of the company and for a proper purpose, or in the UK to promote the success of the company as a whole, where:

- the director **consciously disregards, or is wilfully ignorant of, material financial risks associated with climate change** and their potential impact on corporate risk management and strategy;



- **where, regardless of the director's subjective belief, no reasonable director could have rationally concluded the course of action was in the best interests of the company**, such as where directors of a company highly exposed to climate risk (for example, a carbon major) act to increase that exposure by purchasing additional carbon-intensive energy reserves without ensuring that the risk of asset stranding has been diligently and appropriately integrated into the commercial assessment process, and the company suffers loss as a result of the inability to monetise those assets; or
- the director's **ability to make an independent judgment** in the best interests or to promote the success of the company is **compromised by a material conflict of interest**, such as perverse remuneration incentives linked to stranded assets, or an allegiance to an external position or affiliation (A 11; SA 11; UK 15).

*Additionally, in the UK, a breach of the duty to promote the success of the company may arise due to a defect in the decision-making process where a director fails to have regard to mandatory factors set out in the statute, where those factors impact on the interests of the company. Factors relevant in the climate risk context include the likely consequences of the decision on long-term profitability and the impact of the company's operations on the community and the environment (UK 17).*

*In Canada, the statutory fiduciary duty requires directors and officers to act honestly and in good faith with a view to the best interests of the corporation.<sup>3</sup> The duty of loyalty requires fiduciaries to act in good faith in the interests of their beneficiaries (the company under corporate law and the pension beneficiaries of a pension fund), impartially balance the conflicting interests of different beneficiaries, avoid conflicts of interest, and not to act for the benefit of themselves or a third party. Directors and officers must respect the trust and confidence that have been reposed in them to manage the assets of the corporation in pursuit of the realisation of the objects of the corporation.<sup>4</sup> In executing its duty of loyalty to the corporation, the board of directors is required to reflect on the interests of the corporation both as an economic actor and as a 'good corporate citizen'.<sup>5</sup> These duties mean that they must engage with issues of climate-related physical and transition risks. Directors and officers should identify and develop a strategy to supervise and manage the transition that will address the specific risks and opportunities posed by climate change (C 9-11).<sup>6</sup>*

*In Australia, duties of trust and loyalty may be prosecuted criminally as well as civilly under the Corporations Act, where the director has acted recklessly or with intentional dishonesty (A 10). In South Africa and Canada, the 'business judgment rule' applies to the duties of trust and loyalty as well as duties of competence (C 10; SA 10,14,25).*

## 4. Duties of competence and attentiveness

The primary duty of competence and attentiveness across the four subject jurisdictions is to exercise due care and diligence. In Australia, South Africa and the United Kingdom, directors are held to the standard of conduct that would be exercised by a reasonable director (objective element) taking into account the characteristics of the company and, particularly where it would increase the objective standard, the actual knowledge, skills and experience of the director (subjective element) (A 12; SA 13; UK 19). *In Canada, the test is entirely objective (C 12).* Fulfilment of the duty requires robust and quality decision-making processes rather than the achievement of an optimal or even commercially advantageous financial outcome (A 15; C 12-13; SA 10,14; UK 20).

In a climate risk context, a director may risk breaching their duty of due care and diligence in circumstances where there is:

- **a total failure to consider and govern for foreseeable and financially material climate risks**, where a director fails to turn their mind to the issue of climate change (whether due to conscious disregard, wilful or

<sup>3</sup> Prof. Janis Sarra, [Fiduciary Obligations in Business and Investment: Implications of Climate Change](#) (April 2018) p 3.

<sup>4</sup> *Ibid*, p 5.

<sup>5</sup> *BCE Inc v 1976 Debentureholders*, 2008 SCC 69, para 66.

<sup>6</sup> Sarra, above n 3, p 15.

honest ignorance) in strategic planning and risk management in general or in relation to specific projects or acquisitions that require board oversight or approval;

- **inadequate consideration or governance of climate risk**, where a director briefly or superficially considers climate change, but fails to adequately inform themselves of the risks to the company arising from climate change, including the information that they ought to have known in relation to the material physical and economic transition risks, **especially a director of a company operating in high risk sectors**. This could include a **failure to make proactive reasonable inquiries, or to seek appropriately-qualified and independent advice where warranted**. ‘Soft law’ instruments such as the TCFD recommendations may be particularly influential in determining the standard of knowledge and inquiry attributable to a ‘reasonable’ director, which increasingly may extend to scenario planning and stress testing business plans and transactional outcomes against a range of potential climate futures, including ‘adverse’ scenarios, such as the 1.5°C or ‘well below’ 2°C global average temperature goals in the Paris Agreement;
- **a failure to critically evaluate advice**, where a director fails to consider, or through wilful neglect accepts, the conclusions of relevant delegates or experts on the impacts of climate change on the business without independent review or consideration;
- **a failure to monitor and oversee a robust corporate risk and reporting system that identifies and manages climate risks**, has mechanisms in place to respond rapidly to changes in the risk profile, and involves board supervision of delegates tasked with assessing and managing climate risk; or
- **a breach by the company of misleading disclosure laws** where a director causes, permits, or fails to take reasonable steps to prevent, the company from making a misleading disclosure in relation to the impacts of climate change on the company (A 12-14; C 14-15,25; SA 27; UK 21-21).

This is not to suggest that directors will be impugned for decisions made in good faith that the passage of time reveals to be sub-optimal. Courts are reluctant to second-guess the substantive wisdom of directors’ commercial judgment *per se*, so long as the process by which that decision was reached was robust. An express ‘**business judgment rule**’ (BJR) operates for the benefit of directors in Australia, Canada and South Africa. This rule provides that a director will not be held liable for a breach of the duty of due care and diligence where they have actively exercised their judgment (rather than having *omitted* to consider the relevant issue), otherwise acted honestly and free from material conflict of interest (or in South Africa, complied with the rules on conflicts of interest), were reasonably informed, and can demonstrate they held a rational belief that their conduct was in the best interests of the company (or in Canada, within a range of reasonable available options) (A 14; C 12, 15,23-24; SA 10, 14,25).

The BJR is unlikely to assist directors alleged to have breached their duty of due care and diligence in their climate risk governance where they are unable to discharge the threshold issue that they made a conscious judgment, such as where the course of action results from a total failure to consider foreseeable and financially material climate risks. Nor will the BJR assist if they are unable to further show that their judgment was based upon a robust informational basis, and that they rationally considered that the course of action was consistent with the best interests of the company or within a range of reasonable options.

*Although there is no express rule in the UK, there is in practice an ‘unofficial’ BJR as the courts are reluctant to intervene where a director has acted in good faith. However, this does not guarantee a defence. The objective aspects of certain duties arguably require courts to review directors’ decisions and recent UK case law indicates that many judges no longer decline to assess management decisions, particularly in relation to the duty of care, skill and diligence (UK 38).*

*In addition to the BJR, courts in the UK and South Africa have a general discretion to excuse a breach of the duty of care and diligence where a director acted honestly and reasonably, and it would be fair in all the circumstances to do so (SA 26; UK 39). In Canada, where the claim is for breach of the statutory duty of care, a defence is available if the director has relied in good faith on the financial statements represented by an officer or in a written report of the auditor to fairly reflect the financial condition of the corporation, or a report of a person whose profession lends credibility to a statement made by the professional.*

*In contrast, the protections afforded by principles of delegation and reliance on management and experts are more limited in Australia and courts have demonstrated they are prepared to hold directors to increasingly high standards of proactiveness and professionalism to discharge their duties of competence (A 56). There is limited case law interpreting duties of competence in the UK and South Africa. On the one hand, this makes it more difficult to ascertain the particulars of the duty in those jurisdictions. On the other, it leaves the door open for further judicial development in this area of law (SA 13,15). In the UK and Australia, courts have made clear that, despite the subjective element of the test, minimum standards of knowledge, proactive inquiry, oversight and independent evaluation apply (A 12; UK 19).*

## 5. Duties applicable to categories of directors or specific circumstances

### ***Pension fiduciaries and directors of corporate fiduciaries of pension, superannuation and other investment funds***

Fiduciaries of pension or superannuation funds could breach their fiduciary duty owed to beneficiaries of the fund, including the duty to act prudently, responsibly and honestly in making investments and the duty to act in the best interests of the fund and its beneficiaries. With the considerable overlap in the duties owed by directors to their company, pension fiduciaries' liability in relation to climate risk assessment and management could arise in similar circumstances to company directors discussed above, albeit from an investment perspective. Accordingly, liability may arise where failure to consider climate risk in investment decisions results in lower returns and valuation losses over the long term, particularly in relation to stranded assets. Pension fiduciaries must evaluate the market and regulatory risks that are likely to depress market prices or restrain fossil fuel production and consumption and adjust their investment strategies appropriately. Of particular salience to climate risk is the need to make investment strategy and asset allocation decisions based on a time frame commensurate with the fund's liabilities, taking into account the age of members of the fund. As such, pension fiduciaries must not simply maximise short term returns to the detriment of long term performance. Further, a duty of impartiality requires pension fiduciaries and fund managers to balance intergenerational interests in their investment practices, for example, the different investment horizons of older and younger members. In some jurisdictions, the pension fiduciary can be a company itself. *In Australia and the United Kingdom, a breach of these duties could in turn result in the individual directors of the corporate pension fiduciary breaching their duty to take reasonable steps to ensure the corporate pension fiduciary does not breach its duties owed to the trust. In Canada, the directors could be personally liable as accessories if they 'knowingly assisted' the corporate pension fiduciary in its breach (A 41-43; C 21-22; SA 21; UK 31).*

*In South Africa, as part of the fiduciary duty, pension fund boards are expressly required to give consideration to environmental, social and governance factors which may materially affect the sustainable long-term performance of the fund, such as physical risks from floods or transition risks in the fossil fuel extractive industries (SA 21). In Australia, directors of superannuation funds and officers of the responsible entity of a managed investment scheme (such as a trust-based managed investment fund, hedge fund or exchange traded fund) are subject to additional duties which apply more exacting standards of trust, loyalty and prudence than those applicable under the general duties of company directors (A 40-42). In Canada, pension fiduciaries in Ontario must disclose and explain whether and how they consider environmental, social and governance factors such as climate change in their investment strategy (C 21).*

It is also conceivable that where mismanagement of climate risk in breach of the duty to act prudently in making investments results in significant losses to pension funds, governments could seek to recoup any resultant public costs to national welfare systems (UK 31).

### ***Directors of banks***

Climate risk is relevant to banks not just in their investment and asset management capacity, but also in their financing function when lending to companies or projects that are materially exposed to the impacts of climate

change. *In the UK, the Senior Managers Regime and EU Capital Requirements Directive IV provide an additional source of risk management accountability and disclosure obligations for directors of banks, potentially increasing their exposure to liability in relation to climate risk management and disclosure, and specific regulatory expectations are set out in the PRA's Supervisory Statement 3/19 (UK 32-33). In South Africa, directors of banks owe additional duties to the bank to act bona fide for the benefit of the bank, and must possess and maintain the knowledge and skill 'as may be reasonably expected of a diligent person who holds the same appointment under similar circumstances' and must render financial services 'in the interests of clients and the integrity of the financial services industry'. This elevated standard of care is particularly relevant given the vulnerabilities of the financial sector to climate risk and systemic risks presented by climate change (SA 23-23).*

### **Directors of insurance companies**

Climate risk is relevant to insurance companies in their investment and underwriting capacities. *In the UK, the Senior Insurance Managers Regime and EU Solvency II Directive may create an additional avenue of liability for directors of insurance companies in relation to climate risk management and disclosure, and specific regulatory expectations are set out in the PRA's Supervisory Statement 3/19 (UK 33-34). The duty in South Africa to render financial services for the integrity of the financial services industry referred to above also applies to insurers (SA 22-23).*

### **Duty not to commit environmental offences**

*In South Africa, where a director's failure to recognise and take steps to mitigate the company's contribution to climate change results in the company committing the criminal offence of causing significant pollution or degradation to the environment or detrimentally affecting the environment, the director may be guilty of the same criminal offence as the company (SA 16).*

## **6. Enforcement of directors' duties**

### **Who can bring an action to enforce the duties?**

Directors' duties are generally owed to the company, rather than to individual shareholders or third parties. It is unsurprising that boards are typically reluctant to exercise their powers to commence proceedings by the company against themselves (or their former directorial colleagues) for a breach of duty. To overcome that barrier to a claim, in all four subject jurisdictions, directors may be subject to derivative shareholder actions for breach of directors' duties. A derivative action allows a shareholder to stand in the shoes of the company and commence enforcement proceedings on behalf of the company. Such claims can only proceed with leave of the court and the permission process is restrictive. Permission is generally dependent on the shareholder applicant being able to establish that the company has suffered loss caused by the breach, that the applicant is acting in good faith and that the proceeding is in the best interests of the company (assessed in the UK by whether a hypothetical director fulfilling their duty to promote the success of the company would bring the claim). This last factor suggests substantial loss to the company is required to justify the business disruption and cost of the proceedings. Accordingly, a derivative claim brought by activist shareholders for public interest or symbolic reasons only would be unlikely to pass this procedural hurdle (A 48; C 27; SA 28; UK 44-46).

*In Australia and South Africa, shareholder applicants may bring a derivative action for declaratory or injunctive relief (ie, restraining a breach) which does not require proof of loss (A 45-46; SA 30). Shareholders in South Africa also have an additional direct right of action against the directors for certain claims involving intention, fraud or gross negligence (SA 25,28). In the UK, derivative actions may be brought in respect of proposed acts or omissions. An applicant may seek to bring a derivative action relating to the proposed purchase of additional carbon-intensive assets by a carbon major that is already highly exposed to the risk of asset stranding and which would likely result in loss to the company (UK 45).*

In addition to the above procedural barriers to private enforcement of duties, there are also significant practical barriers for potential plaintiffs to a derivative claim. These include the potential for adverse costs orders against

the unsuccessful party to a derivative application (A 50). Another practical barrier is the numerous evidentiary hurdles that must be overcome for a successful claim. First, evidence is needed to establish that the loss is attributable to a foreseeable and material climate-related financial risk relevant to the company. This may be difficult for outsiders to assess, although the possibility of obtaining this evidence is more likely with the increasing sophistication of methodologies and tools such as asset-level data analysis by third parties. There is also the potential for insider ‘whistleblower’ evidence. Alternatively, it may be easiest to overcome this hurdle in a claim for breach of fiduciary duty of a pension fiduciary in preferring the interests of members with short rather than long term investment horizons, through the use of long term performance benchmarks to show disparity in performance. Second, evidence is needed to establish that the director breached their duties in relation to that risk. Evidence of directors’ decision-making processes are notoriously difficult for shareholders to access. Direct documentary records may not even exist, although the absence of discussion in the minutes of board meeting may itself be relevant to that point. Third, evidence is needed to show that the breach caused the loss complained of, which may be particularly difficult to show if the breach is an omission, such as a failure to consider climate risk. (UK 35-36) The first and third of these barriers may, however, be circumvented in an action for declaratory or injunctive relief and (in some jurisdictions) in an action commenced by an independent regulator, as discussed below. *In South Africa, claims for compensation for breach of the duty of care and diligence are assessed according to the common law relating to delict, which requires actual loss to the company and a causal connection between the breach and the loss (SA 7,14,24). In Australia, these procedural and practical barriers may be factors which have led to a reluctance of litigation funders to fund statutory derivative actions, compared with the proliferation of underwriting of securities class actions, discussed below (A 54).*

*In Australia, the duties may also be, and commonly are, enforced directly by the securities regulator, the Australia Securities and Investment Commission (ASIC), in either civil proceedings or (in relation to a breach of the duty to pursue the best interests of the company with dishonest intent) as a criminal prosecution in conjunction with the Director of Public Prosecutions. This circumvents the evidentiary barriers of proof of causation and loss (A 45,51). In addition, derivative claims for breach of duty in Canada and South Africa are open to non-shareholder stakeholders in certain limited circumstances, which could arguably be used to give standing to a local NGO that can show a legitimate interest in the company’s future sustainability, such as an NGO that represents a one-company or one-industry community (C 27; SA 14,29).*

While directors’ duties are owed to the company and can only be enforced by shareholders derivatively, in certain circumstances shareholders may bring an action for ‘unfair prejudice’ against a director on the basis of breach of the director’s duties to the company. This ‘oppression remedy’ avoids the strict permission process of a derivative action. While it is normally seen in relation to private companies, it is possible to make a claim in respect of a public company, *although in Australia it is extremely rare against directors of a public company, particularly where the company remains solvent.* The claim for unfair prejudice would be difficult to establish in relation to a breach of the duty of due care and diligence and it normally applies to cases of misconduct rather than mismanagement. *However, the enforcement of duties through the oppression remedy is most likely in Canada. The remedy protects the interests of a wide range of corporate stakeholders, including security holders, creditors, directors and officers. The remedy can result in the personal liability of directors where it is fair in all the circumstances, and while bad faith is an indicia of fairness, it is not necessary. It is actionable by non-shareholders complainants, although it would be difficult for NGOs to qualify (A 48, C 28-29, SA 30, UK 46-48).*

### **What are the time limits to enforce a breach of duty?**

Claims against directors and fiduciaries for breach of duty must be commenced within the statutory limitation period. In Australia, South Africa and the UK, this runs from the point in time when the cause of action accrues, which for some duties will likely be when the breach of duty occurs, and for others, when the loss is actually incurred. This compounds the evidential barriers discussed above, as information asymmetries mean shareholders may not become aware of the facts constituting the alleged breach within the limitation period. The limitation periods vary according to the jurisdiction and cause of action and can be extended or suspended in exceptional circumstances. *In Australia and the UK, a claim under company law legislation for breach of duty must be filed within six years, while in South Africa it is three years. In contrast, in Canada the limitation period varies from province to province but in most cases an action must be commenced within two years, and time begins to run when the cause of action is discovered by the claimant, which presents issues as to who is the claimant in a*

*derivative action for the purpose of the limitation period: the company, or the shareholder or other relevant stakeholder (A 54; SA 31; UK 51-52).*

## 7. Disclosure

Financial disclosure is critical for the functioning of efficient capital markets, where information is reflected in the price of a security and capital is allocated efficiently. As such, mandatory disclosure is a fundamental tenet of securities laws. Focusing on annual reporting obligations in particular, including financial statements and accompanying narrative reports, securities laws in each of the four subject jurisdictions essentially require that a ‘true and fair’ view be presented of both a company’s financial performance, position and prospects (A 26; C 17; SA 17-18; UK 25-26).<sup>7</sup>

Directors may be primarily liable for misleading disclosures made to the market in all of the four subject jurisdictions. *In Australia and South Africa, they may be accessorially liable for their involvement in the company’s misleading disclosure in breach of securities laws, or in the UK, be required to pay legal costs for the enforcement application against the company and the costs to rectify the revised accounts or reports (A 25; SA 18). In Canada, financial disclosure is made pursuant to provincial securities legislation and a series of national instruments that have been agreed on by the provincial and territorial securities regulators.<sup>8</sup> For example, the Ontario Securities Act specifies that a person is guilty of an offence if they: make a statement in information submitted to the Securities Commission that is misleading or untrue or does not state a fact that is required to be stated or is necessary to make the statement not misleading; or make a statement in any release, report, prospectus, financial statement required under securities law that, in a material respect and at the time and in the light of the circumstances under which it is made, is misleading.<sup>9</sup> Every director or officer of a company who authorises, permits or acquiesces in the commission of a disclosure offence, whether or not a charge has been laid or a finding of guilt has been made against the company in respect of the offence, is guilty of an offence.<sup>10</sup> Canadian corporations law also specifies that a person who makes or assists in making a report, return, notice or other document required by the corporate statute or regulations that contains an untrue statement of a material fact, or omits to state a material fact required therein or necessary to make a statement contained therein not misleading in the light of the circumstances in which it was made is guilty of an offence.<sup>11</sup>*

Misleading disclosure by a company may also be a ‘stepping stone’ to personal liability of directors in Australia and the UK. *In Australia, directors may breach their duty of care and diligence where they cause, permit or fail to take reasonable steps to prevent their company from making misleading statements to the market. In the UK, a successful shareholder action under the UK Financial Services and Markets Act 2000 against the company for compensation for misleading disclosure would be strong evidence of a breach of directors’ general duties (A 37, UK 28).*

All four jurisdictions impose either criminal liability or statutory sanction for misleading disclosure offences in certain circumstances. For example, in Australia, knowing or reckless involvement in a contravention by the company is a criminal offence. In Canada, directors may be liable to statutory offences and sanctions for failing to notify the audit committee and auditor after becoming aware of an error or mis-statement, or, after being informed by the auditor that such error or mis-statement is material, failing to inform shareholders or prepare revised financial statements (A 27; SA 18; UK 26).

Corporate disclosures can also indicate whether or not directors have complied with their directors’ duties, for example, by demonstrating whether and how thoroughly directors have assessed and managed climate risk in accordance with their fiduciary duties and duty of care and diligence discussed above. While disclosures are an imperfect proxy of board deliberations and risk management process, non-disclosure of climate risks, particularly

<sup>7</sup> In relation to the financial statements, the requirement to present a ‘true and fair’ must be considered in the context of requirements to comply with accounting standards. See further n 14 below.

<sup>8</sup> See for example, *National Instrument 51-102 Continuous Disclosure Obligations* and *National Instrument 51-101 Standards of Disclosure for Oil and Gas Activities*.

<sup>9</sup> *Ontario Securities Act, RS) 1990, c S 5, as amended, s 122(1).*

<sup>10</sup> *Ontario Securities Act, RS) 1990, c S 5, as amended, s 122(3).*

<sup>11</sup> *Canada Business Corporations Act, RSC 1985 c C-44, as amended, section 250(1).*

for companies operating in highly vulnerable sectors, may draw the attention of shareholders and other stakeholders concerned with the management of climate risk. The corollary is that disclosure of climate risks and opportunities may limit liability.<sup>12</sup>

None of the four jurisdictions currently have detailed legal rules regarding the particulars of climate-related financial risks that must be disclosed akin to the mandatory framework prevailing under Article 173 of France's Energy Transition for Green Growth Law,<sup>13</sup> although some jurisdictions require disclosure of specific climate information, such as greenhouse gas emissions. However, issuers in each jurisdiction are required to disclose material risks, which may include climate-related risks. Regulatory authorities in each of the four jurisdictions have expressed support for the TCFD recommendations as a useful framework for this climate-related risk disclosure. The UK Government expects large asset owners and listed companies to report in line with the TCFD recommendations by 2022 and has established a taskforce to consider whether to make TCFD disclosure mandatory. The Canadian Securities Administrators have published guidance to help issuers and their boards to identify, manage and disclose climate-related risks under existing reporting requirements to disclose material risks and, where practicable, their financial impacts. The Australian Prudential Regulatory Authority has referred to scenario analysis as 'the new standard for risk management' and encourages entities to conduct stress testing using climate risk scenarios, and the ASX Corporate Governance Principles and Recommendations encourage Australian listed entities to use the TCFD recommendations to consider whether they have a material exposure to climate risk and disclose accordingly. The TCFD recommendations are likely to become increasingly influential touchstones of 'true and fair' disclosure of climate-related financial risks as large institutional investors continue to call for their implementation, and mainstream companies adopt them in their reporting practice.

From a first principles perspective, only 'material' information must be disclosed. In each of the four jurisdictions, materiality in the disclosure context (as opposed to strategic or governance context) is not determined by reference to a bare quantitative calculation. Rather, it is a qualitative concept determined by the information that is likely to be decision-useful to a reasonable investor in their assessment of whether to purchase, sell or continue to hold the company's securities. There has been an extraordinary increase in mainstream regulatory and investor interest in the financial risks and opportunities associated with climate change in general, and TCFD-compliant disclosures in particular. For example, TCFD-compliant reporting has been endorsed by the world's two largest institutional investors, BlackRock and Vanguard, and the Climate Action 100+, a collective of institutional investors representing more than US\$33 trillion in assets under management. Given these shifts in the expectations of investors, it is increasingly plausible that regulators and courts would find that in the absence of meaningful discussion on climate-related risks and opportunities, the financial statements and accompanying narrative reports do not provide a true and fair view of corporate performance, position and prospects, or meet requirements to disclose material or principal business risks. Responding to investor statements on the importance of climate-related risks to their decision-making, the Australian Accounting Standards Board and Auditing and Assurance Standards Board have issued joint guidance on the application of accounting standards to the disclosure of climate-related risks in financial statements.

Forward-looking disclosures are subject to specific rules, but the inherent uncertainty in the scope, distribution and timing of the impacts of climate change is no defence for omissions or inadequate disclosure. High-level boilerplate disclosures, such as those used by some companies to describe their general exposure to stranded asset risk, are rarely decision-useful for investors and may present a misleading picture of the company's financial position. Investors increasingly demand disclosures that are specific to the financial performance indicator on which it may impact and to account for uncertainty via stress-testing across the range of plausible climate futures. To allay concerns that disclosure to avoid the risk of one liability creates a separate avenue to liability, appropriate language

<sup>12</sup> Alexia Staker, Alice Garton and Sarah Barker, CCLI, [Concerns misplaced: will compliance with the TCFD recommendations really expose companies and directors to liability risk?](#) (September 2017).

<sup>13</sup> However, various developments since the publication of the country papers have clarified the application of existing disclosure regimes under securities laws and accounting standards to climate-related financial risks. These include: Australian Securities and Investments Commission (ASIC) [Regulatory Guide 247: Effective disclosure in an operating and financial review](#) (August 2019) [247.66]; the joint publication by the Australian Accounting Standards Board (AASB) and Auditing and Assurance Standards Board (AuASB), [Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB Practice Statement 2](#) (December 2018; May 2019); the Canadian Securities Administrators (CSA) publication, [CSA Staff Notice 51-358 Reporting of Climate Change-related Risks](#) (August 2019); the Prudential Regulation Authority (PRA), Financial Conduct Authority (FCA), Financial Reporting Council (FRC) and The Pensions Regulator (TPR), [Joint Statement on Climate Change](#) (July 2019); FRC, [Statement on the Government's Green Finance Strategy](#) (July 2019).

adequately tailored to the particular disclosure can warn investors that there is a material risk that events and performance will in fact unfold differently to the descriptions in the scenario analysis.

There are a number of **disclosure omissions** that are amongst those most likely to present a risk of misleading disclosure in practice, particularly for companies in those sectors highly exposed to physical or economic transition risks associated with climate change within mainstream investment and planning horizons. These include:

- a **failure to disclose material economic transition risks or physical risks to a company's financial prospects, especially in the narrative portions of the annual report**, such as the Directors' Report (Australia and South Africa), Management Discussion & Analysis (Canada) and the Strategic Report (UK);
- the **denial or material understatement of risk exposure or material overstatement of strategic preparedness or risk management** of relevant climate-related financial risks, as expectations of the content of disclosures increase to mirror the evolving standards of directors to identify, assess and manage climate-related financial risks;
- the **material misstatement of balance sheet values**, from the over-estimation of assets to under-provisioning of liabilities, **particularly where assets are vulnerable to stranding** in the economic transition;<sup>14</sup>
- the **selective application of optimistic demand forecasts or assumptions** in support of statements or omissions that represent the company's asset valuations or prospects are unlikely to be materially impacted by climate-related financial risks;
- an **inconsistency between internal assessments on climate risk and external disclosures**, such as where internal reports from management and experts indicate the impact on the business of a proposed regulation to implement the goals of the Paris Agreement would be severe, but disclosures deny that the company is able to assess those impacts; and
- a **high-level boilerplate forward-looking risk statement about the predicted impacts (or lack of impacts) of climate change** on the company's operations and assets, including a statement of opinion or belief, that is **not supported on reasonable grounds or not accompanied by adequate, specific disclosures on the limitations or uncertainties** that materially impact on the achievement of the statement (*A 34-36; C 25-26; SA 18; UK 26-29*).

### ***Claims for misleading disclosure***

The barriers faced by shareholder litigants in pursuing claims for breach of directors' duties by way of derivative action means that shareholders of larger companies often see securities class actions for misleading disclosures as a more straightforward means of seeking redress. These are typically filed in circumstances where a company publishes a positive market announcement (good news) which is then followed by a negative market announcement (bad news), with a corresponding share price drop. Plaintiffs allege there was no reasonable basis for the good news or it should have been corrected sooner, such that the shareholders bought or continued to hold shares on the basis of misleading information at a higher price.

Where a company remains solvent, securities class actions are ordinarily filed against the company itself. Despite this, the potential for 'activist shareholder' claims against directors, where litigation is employed as a strategic tool

<sup>14</sup> The 'true and fair' requirement is a fundamental part of company law as it pertains to financial statements. There is a strong argument that it is an alternative way of expressing the requirement that financial statements must not be misleading or deceptive. However, the 'true and fair' requirement must be considered in the context of requirements for financial statements to comply with accounting standards. The interaction can be seen in debate over what is termed the 'true and fair override'. In the UK, a series of opinions sought by the FRC would seem to favour the 'true and fair override': see, eg FRC, *True and Fair* (June 2014). Whereas in Australia, legislation appears to give greater weight to adherence to accounting standards: *Corporations Act 2001* (Cth) ss 296, 297, note to 297. Relevant case law is limited, yet there is likely a close relationship between a failure to give a 'true and fair' view and a failure to comply with accounting standards: see, eg, the Australian case of *ASIC v Healey* [2011] FCA 717 [574] (Middleton J). On the application of the accounting standards to climate-related risk, see AASB and AuASB, [Climate-related and other emerging risks disclosure: assessing financial statement materiality using AASB/IASB Practice Statement 2](#) (April 2019).



to influence climate-related behaviour of directors (and their providers of Directors' & Officers' insurance), cannot be underestimated.

*The potential for a misleading disclosure claim to be filed against a director is relatively more pronounced in Australia and Canada than in the UK or South Africa, where plaintiffs must prove that a director knew or was reckless as to whether the statements were misleading in order to establish liability. Australia, in particular, is one of the most active jurisdictions for securities class actions, behind the United States, with commercial litigation funders commonly acting as significant underwriters. In addition, proof of knowledge, intent or recklessness is not a necessary element of breach of many disclosure-related laws and plaintiffs may be entitled to seek declaratory or injunctive relief, circumventing many of the evidentiary barriers associated with proving causation and loss. Further, 'dual-tracks' of enforcement are available, with both shareholders and the securities regulator, ASIC, empowered to commence proceedings, and in fact, shareholders commonly leverage a successful regulatory prosecution into a subsequent private damages claim.*

*Conversely, from a practical enforcement perspective, liability for misleading disclosures is less likely to accrue in the UK or South Africa, where plaintiffs must prove that a director knew or was reckless as to whether the statements were misleading in order to establish liability (SA 18; UK 26-28).*

## 8. D&O Insurance

Companies typically take out Directors' and Officers' (D&O) insurance on behalf of the board, which may shield directors from the monetary costs of litigation and compensation orders. However, a number of typical exclusions may operate to significantly limit the protections afforded by D&O insurance in relation to the assessment, management and disclosure of climate risk. In particular, coverage is generally unavailable for dishonest or intentional misconduct, misleading statements made in prospectuses (subject to specific policy extensions), 'prior known matters', and where there is a failure to take all reasonable precautionary measures to avoid or lessen the chance of a claim. Even where claims are ultimately settled prior to trial with D&O insurance proceeds, directors face the burden and reputational damage of 'ostensibly unsuccessful' litigation (A 47; C 25; SA 26-27; UK 40-41).

## 9. Conclusion

Significantly, the prevailing directors' duties regimes under Australian, Canadian, South Africa and UK laws are all conceptually capable of being applied to governance failures in the identification, assessment, oversight and disclosure of climate-related financial risks.

The form and substance of directors' governance activities that will satisfy or contravene their duties or disclosure obligations with regards to the impacts of climate change on their business will depend on the unique circumstances of the company and the decision-making context. **As a high-level proxy, relative liability exposure can be assessed as a function of:** (1) the materiality of the climate-related financial risk on the company in terms of the industry(s) in which it operates, its geographic location(s) and peer-relative exposures; (2) directors' obligations and defences under law; (3) the practical elements of the legal framework that indicate litigation is more or less likely in practice; and (4) the quality of the directors' governance and disclosure.

As to the first factor above, **whether and how climate change presents a material risk to a particular company over the short, medium and long term** will depend on the circumstances of the company. There are, however, indicators of the significance and relevance to business generally and to certain sectors and geographies specifically. The World Economic Forum's *Global Risk Report 2019* identifies extreme weather events, natural disasters, a failure of climate change mitigation and adaptation, and water crises in the top five global risks by likelihood or impact. While certain sectors and geographies are particularly vulnerable to transition or physical risks, such as the high-risk sectors identified by the TCFD, the Sustainability Accounting Standards Board identifies material financial impacts from climate change on US companies in 72 out of 79 industries. When considered with factors such as rapidly changing technologies, and the proposed and possible regulatory changes and shifting market dynamics to meet the commitments of the Paris Agreement, it is a prudent starting assumption that climate

change presents a risk of harm to many if not all businesses within mainstream planning and investment horizons, unless established otherwise under a robust process of due care and diligence.

To the second and third factors above, **directors' obligations and available defences under statutory and judge-made laws** mark the boundaries of both the expectations of directorial conduct and protections afforded to directors. Particularly salient factors which increase liability exposure include: legal requirements to take into account the environment and other stakeholders in considering the best interests of the company; where the law provides for breaches of fiduciary duty in the absence of subjective bad faith; where the law requires high standards of professionalism to fulfil the duty of care and diligence and which evolve to reflect industry norms and best practice; where the law limits the availability of the safe harbour afforded by the business judgment rule; and disclosure obligations which can be breached by honest but unreasonable disclosures in the absence of knowledge or intention.

**Procedural and evidentiary considerations can increase or decrease the practical likelihood of litigation.** Factors which decrease liability exposure include high thresholds for court permission for shareholder derivative actions, the potential for adverse costs orders, and difficulties in potential litigants obtaining sufficient evidence of breach and actual loss to support a claim. Factors which increase liability exposure include a well-established securities class actions landscape with active litigation funders, and where the duties and disclosure obligations are enforceable by an independent regulator.

Holding the **standard of governance conduct** equal (the fourth factor above), an assessment of the first three proxy factors suggests that Australia presents the most pronounced risk of director liability of the four subject jurisdictions. Individually, and taken together, the following factors indicate **Australian directors face the greatest potential for liability in relation to the impacts of climate change on their business**: a significant proportion of the Australian economy operates in the high-risk sectors; Australian law is relatively stringent in its expectations of director conduct; the duty of care and diligence can be breached in circumstances closest to 'mere' negligence and the business judgment rule defence is unsuccessful in nearly all cases; proof of dishonesty, intention or bad faith is not required for breaches of trust and loyalty and misleading disclosure obligations; corporate leadership in scenario analysis and stress testing by some listed companies is shifting market norms; requirements for actual loss can be avoided in claims for injunction or declaratory relief or enforcement action by the independent regulator, ASIC, which has made recent public statements about priorities on climate risk; and litigation funders regularly support securities class actions for misleading disclosures causing a significant stock loss.

**This is not to say that the risk of liability is far-fetched in Canada, South Africa and the United Kingdom, and in all jurisdictions, it is likely to increase in the future.** All three have economies and stock exchanges heavily skewed towards high-risk industries. The risk of litigation in Canada is increased by the potential for non-shareholders to bring a claim for breach of fiduciary duty. Notwithstanding, securities disclosure litigation is more likely in the short term, and the first wave of misleading disclosure claims against companies for climate-related financial disclosures could soon shift towards directors. In South Africa, the possibility of direct claims by shareholders and derivative actions by non-shareholders each increase the liability risk, but the three-year limitation period and requirement for actual loss (except for applications for injunctions) somewhat mitigates this risk. Director liability in the UK is less likely, based on the content of the duties, substantial procedural hurdles for a shareholder derivative action and absence of public enforcement by a regulator, but it is nonetheless conceivable, particularly in relation to the statutory duty of care and diligence.

**It is important not to overstate the practical likelihood of litigation.** Procedural, evidentiary and cost-related barriers abound in the making of any claim against directors, particularly in the absence of evidence of bad faith. **However, it would be ill-advised for company directors to dismiss the risk of personal liability as remote or theoretical**, particularly for those whose companies operate in those sectors significantly exposed to physical or economic transition risks associated with climate change, or those with special expertise or responsibilities relating to risk management, such as the Chair of the Board or a member of risk or audit committees. While D&O insurance provides some financial protection in case of a claim, its application will not be universal and it does not mitigate the reputational harm to directors.

The actions required to discharge a directors' obligations to govern climate-related risks and opportunities in the best interests of the company, with due care and diligence, and to ensure that corporate reports present a true

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and fair view of financial performance, position and prospects, will be unique in each case. In particular, additional interrogation and assurance may be warranted in sectors with significant climate-related exposures. Directors and fiduciaries must now approach their governance of climate change in the same way as they would any other foreseeable financial risk matter. **The only safeguard against liability exposure will be a proactive, dynamic and considered approach to the impact of climate change on strategy, risk management, oversight and reporting in the unique context of their company or fund.**

While this paper has focussed on liability risk, the story is not all negative. There are significant investment opportunities in climate change mitigation and adaptation and directors must be ready to embrace these opportunities if their businesses are to survive and thrive in a net-zero emissions global economy targeted under the Paris Agreement.

The ***Climate Risk Reporting Journey – A Corporate Governance Primer*** set out in the Annexure to this report provides a practical guide to assist directors to discharge their legal obligations to incorporate climate change risks and opportunities into corporate governance practice.



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# The climate risk reporting journey

## A corporate governance primer

October 2019

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**'Climate change is a foreseeable risk facing many listed companies ... in a range of different industries. Directors and officers ... need to understand and continually reassess existing and emerging risks (including climate risk) that may affect the company's business – for better or for worse.'**

ASIC Commissioner John Price, September 2018

Climate change has rapidly evolved from an 'environmental, non-financial' issue to a mainstream financial risk (and opportunity) impacting almost all sectors of the economy. Regulators and institutional investors now routinely refer to the recommendations of the Taskforce on Climate-related Financial Disclosures. However, many directors (and the executives on which they rely) are often ill-prepared to navigate the step-change in governance and disclosure expectations.

**'Carbon emissions have to decline by 45% from 2010 levels over the next decade in order to reach net zero by 2050. This requires a massive reallocation of capital. If some companies and industries fail to adjust to this new world, they will fail to exist.'**

Bank of England Governor Mark Carney, Banque du France Governor François Villeroy de Galhau and Chair of the Network for Greening the Financial System Frank Elderson, April 2019

The Commonwealth Climate and Law Initiative has teamed up with leading corporate governance experts from MinterEllison and the Centre for Policy Development to prepare this 2019 update to the Climate Risk Reporting Journey. This primer will assist boards embarking on their climate-related financial risk reporting journey, as well as those who are already well-advanced. It proposes key questions relevant to the assurance of a corporation's reporting on climate-related financial issues – and to the robust processes of governance and oversight on which those disclosures must be based.

## A threshold issue: why is climate change a financial risk (and opportunity) for my business?

Leading economic, regulatory and financial institutions – from securities regulators, central banks to institutional investors – have begun modifying their strategies to account for the scientific consensus on climate change, and associated risks to economic growth and financial market stability. *Physical impacts* (both acute catastrophic and gradual onset) such as sea level rise, species loss and extinction, increased ocean acidity, and an increase in the frequency and intensity of extreme weather events, create risks to health, livelihoods, food security, water supply, and human security – with consequences for productivity, supply chain integrity, and the costs and availability of finance and insurance.<sup>1</sup> *Transition risks* arise from the inexorable shift towards a net-zero emissions economy, and associated shifts in the regulatory, technological and stakeholder landscape within which business operates.

While these risks compound over the medium and long-term, they are increasingly relevant within shorter-term, mainstream investment horizons. Markets are already shifting at unprecedented rates, with strong signals on the potential for further disruption.

## A step-change in financial disclosure expectations

Since their release in June 2017, the recommendations of the G20 Financial Stability Board's *Taskforce on Climate-related Financial Disclosures (TCFD)* have emerged as the key benchmark against which to assess a company's strategic approach to the climate change mega-trend. The industry-led taskforce set out a framework to disclose the material impacts of climate change on a company's financial performance and prospects in a comparable and consistent form that is decision-useful for investors, lenders and insurance underwriters. A central requirement of the TCFD is forward-looking stress-testing and scenario analysis across the plausible range of climate futures (including a scenario involving an economic transition limiting emissions consistent with global average warming 'well below 2°C' and to strive for 1.5°C, as targeted by the 197 signatory countries to the Paris Agreement).



Even in those jurisdictions where the TCFD recommendations remain 'voluntary', investors, central banks, regulators and other stakeholders increasingly expect companies to use the TCFD recommendations to navigate the physical, economic transition and liability risk exposures relevant to their business. The TCFD recommendations are now expressly referenced in guidance from securities and prudential regulators, including the Bank of England Prudential Regulation Authority, the Australian Securities and Investments Commission, and the Canadian Securities Administrators. The Network for Greening the Financial System, a global coalition of central banks and supervisors, has called on policymakers to consider further actions to foster broader adoption of the TCFD recommendations.<sup>2</sup> The UK Government expects all listed companies and large asset owners to disclose in line with the TCFD recommendations by 2022, and has established a taskforce to explore whether to make the disclosure mandatory.<sup>3</sup> Reporting against the TCFD's governance and strategy indicators will be mandatory from 2020 for signatories of the UN Principles for Responsible Investment (the world's largest responsible investment industry body representing over US\$80AUM).<sup>4</sup>

Moving beyond narrative disclosures, recent Australian Accounting Standards Board and Auditing and Assurance Standards Board joint guidance<sup>5</sup> on the relevance of climate risks for financial statement accounting estimates is an unequivocal statement that climate change must be considered in the preparation and approval of the back-end of the annual report in Australia, and shows the direction of travel for the interpretation of IFRS accounting standards.

## Reporting and assurance

The board's approval of financial statements, and the accompanying narrative directors' report, is a primary source of assurance to shareholders. In turn, directors must exercise due care and diligence in assuring that the company's disclosures present a true, fair and balanced view of financial performance and prospects, and that they have been prepared on the basis of a robust process. This requires the board to both understand key risk areas, and to satisfy themselves that effective controls are in place.

**This primer proposes key questions to assist boards and their committees with the robust processes of governance, strategy and risk management oversight that underpin a corporation's reporting on climate-related financial issues and provide the basis for directors' assurance of those disclosures.**

Whilst recognising that the TCFD provides a framework for *reporting* rather than board governance *per se*, the primer seeks to place each query in context by indicating the category(s) of the TCFD recommendations to which it relates.

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***Company directors who consider climate change risks actively, disclose them properly and respond appropriately will reduce exposure to liability. But as time passes, the benchmark is rising.***

Australian commercial barristers Noel Hutley SC and Sebastian Hartford Davis (March 2019)<sup>11</sup>

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Of course, the actions required to discharge a director's obligations to govern climate-related risks (and opportunities) with due care and diligence, and to ensure that corporate reports present a true and fair view of financial position, performance and prospects, will be unique in each case. In particular, additional interrogation and assurance may be warranted in sectors with significant climate-related exposures (such as financial services, resources, energy, infrastructure, materials & manufacturing, transportation, agribusiness and real estate, amongst others). *Accordingly, this guide is high-level and general in nature only, and is not intended to provide or replace legal advice tailored to your specific jurisdiction and circumstances.*



The journey is broken down into a number of steps:







1

## Where do we need to go?

Governance foundations (developing board understanding of climate-related risks and opportunities, and mechanisms for evaluation and oversight)

TCFD RECOMMENDATION CATEGORY			
Governance	Strategy	Risk Management	Metrics & Targets

**Climate competence** Have the board and senior management (including legal, governance, finance and risk teams) been briefed on climate-related risks (and opportunities) to enable us to discharge our obligations in relation to governance, strategy and risk management oversight, and disclosure? In particular, do we understand the different drivers and potential financial consequences of physical climate impacts (increase in both acute catastrophic events and gradual onset changes) and economic transition-related risks (legal, technological and market, and policy and regulatory, including under the Paris Agreement)? Do we understand the difference between climate change mitigation and adaptation? Do we understand the role of stress-testing and scenario analysis in strategic governance, planning and risk management? Do we understand stranded asset risk?



**Experts and advisors** By whom are we being advised on these issues? How have we assured that their expertise is relevant and appropriate? What processes are in place to ensure that we remain informed of scientific, economic, technological, regulatory and legal developments in this dynamic and evolving area? Do we set aside sufficient time for deep-dive sessions with experts to explore these developments?



**Board responsibility** How are issues associated with climate change integrated into our strategic and oversight governance responsibilities? Is this issue clearly delineated within committee terms of reference and receiving adequate time and focus within the board and committee agendas? What mechanisms are in place to ensure that outputs from risk management and strategic analysis of climate risks, including scenario analysis of short-, medium- and long-term risks, are incorporated into our decision-making? How is accountability for climate risks and opportunities incorporated into internal and external evaluations of board performance?



**Operational and management responsibility** What part of each function or business unit has operational responsibility for the identification, assessment, management and monitoring of climate-related issues? Who is responsible and accountable for this issue within management? Should a climate risk committee be established, involving senior management from finance, operations, supply chains, sustainability and the heads of each business unit? Are we satisfied that relevant staff and any experts that they consult have the appropriate competence and resources? How is climate change integrated into our strategic reviews, capital and business planning, performance objectives, 'three lines of defence' and enterprise risk management framework, financial measurement and corporate reporting? How are relevant exposures and progress against metrics and targets, monitored and assessed by management and reported to the board or its committees, on both a regular and exceptions basis? (See Step 3 Dynamic Navigation - Risk Management Oversight)



**Conflicts** Have directors updated their standing declarations to identify extraneous interests that may compromise their ability to exercise independent judgment on climate-related governance issues in the best interests of the corporation?



**D&O insurances** Do climate change-related matters impact on our Directors' & Officers' insurances – from coverage exclusions and 'occurrences', to disclosure and notification considerations?





## 2 Route selection

Strategy, financial planning, capex and material risk management

TCFD RECOMMENDATION CATEGORY			
Governance	Strategy	Risk Management	Metrics & Targets

**Risk assessment** What foreseeable climate-related risks (and opportunities) are relevant to our sectors and geographic locations – not only within our business fence-lines, but upstream in our supply chain and downstream in our distribution chains? How are these risks interconnected? Are there any factors that compound or mitigate our enterprise risk exposures vis-à-vis other companies in our sectors and locations?



**Plausible climate futures** What plausible climate futures are relevant to our business model, such as the physical impact and economic transition frameworks and datasets from the IPCC and IEA, and the climate scenarios in prudential regulatory stress tests? Is at least one aligned with the Paris Agreement goals to keep average warming 'well below' 2°C, to strive for 1.5°C, and to reach net zero emissions in the second half of this century? How have the variables and assumptions been tailored to our sectors, locations, assets and operations? On what basis have these input parameters been selected as appropriate, especially assumptions on technology developments and demand and supply forecasts? On what basis do we believe these scenarios represent an adequate range of credible physical, economic transition and litigation risks (and opportunities) that could reasonably be expected to impact on our business performance or prospects? Does our approach accord with the views of our investors? Have we selected a scenario representing a delayed and abrupt policy shock such as the PRI's Inevitable Policy Response? *If not, why not - particularly if we are in a high risk sector?*



**Scenario analysis and stress testing** Undertaking forward-looking scenario analysis and immediate and delayed stress-testing against the selected plausible climate futures, what is our qualitative and quantitative exposure across short, medium and long-term time horizons relevant to our business and investment planning and useful asset life-cycles, across our geographic locations, and across our value chains? How do the outcomes and financial impacts vary under a range of different, albeit plausible, assumptions? How frequently should we repeat and update our scenario analysis and stress testing?



**Materiality assessment** Which of those risks present a *material* exposure to our corporate strategy or operations, in both absolute and relative terms? On what basis is the threshold of 'materiality' set? Over what time frames? For material exposures, has management undertaken financial modelling of the implications, including sensitivity analysis? *Note that different materiality thresholds may apply between this impact assessment context vs the disclosure (reporting) context (see Step 5 – Communicating Our Path).*



**Agile and flexible business model** What are the implications of identified material climate risks and opportunities for our business model? What strategic responses are open to us now and in the future to enable us to continue to thrive? *This should include both strategic responses to external drivers (eg. capitalise on new technologies or potential market shifts towards a circular economy), as well as operational responses to internal drivers (eg. real options for capital expenditure or diversification to increase asset and supply chain resilience to physical risks, or emissions reduction strategies as against science-based targets to lower exposure to transition risks).* How do those strategic responses themselves fare against a range of potential climate futures? What does it mean for our product or services offering, R&D investment, M&A, capital allocation and cost of finance? Is our strategy clearly articulated, and has it been reviewed and approved by the board and its committees?



**Corporate climate policy** What corporate policy do, and should, we have in place in relation to climate change and its impacts? Does this policy align with Paris Agreement goals and science-based emissions reduction targets? *Why/why not?* How is this policy reflected in our procurement and other contracting practices? Are we satisfied that our purpose and strategic objectives, and our risk strategy and risk appetite, remain fit-for-purpose as an increasing number of governments and other market stakeholders declare a 'climate emergency'?





## 3 Dynamic navigation

### Risk management oversight



## 4 When will we get there?

### Metrics and targets

TCFD RECOMMENDATION CATEGORY			
Governance	Strategy	Risk Management	Metrics & Targets
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**Early warning systems and signposts** What events or developments should trigger our reassessment of climate risks or a shift in strategic trajectory? What signposts do we monitor to gauge whether our central (and other) case assumptions require revision? What are the trigger points for our re-assessment of these issues? How, and how often, do we re-calibrate relevant signals?

**Developments** Have our variables, assumptions, parameters, benchmarks, datasets and methodologies been updated to reflect scientific, economic, financial and technological developments, as well as new data sources (eg, big data, artificial intelligence, spatial finance and asset level data analysis) (noting that it may be desirable to run parallel assessments that hold assumptions constant for the purposes of meaningful trend analysis)? What impact do these developments have for our strategy, risk management and disclosure?

**Prioritisation and dependencies** How does management determine the order of priority to be given to each relevant climate-related risk and opportunity? How does management assess interdependencies and positive and negative feedback loops between different climate risks, and between climate risk and other risks affecting our business?

**Contractual risk management allocation:** How does management ensure that insurances and key intra-group and external contractual arrangements appropriately allocate climate-related risks (such as an extreme weather event that would prevent contractual performance) and incentivise risk management behaviours within the business and by third party contractors? Has management commissioned a review of insurances, major contracts and template documents with a climate risk lens?

**Metrics and targets** What are the metrics and targets against which we measure our exposure to, and assess our progress in, managing climate-related risks? *These should include absolute emissions reduction targets, and may include sector-specific targets (eg, emissions intensity by unit of output, or 'scope 3' targets for indirect emissions in the value chain).* What time frames are relevant, and against which base year? How does scenario analysis inform the setting of these metrics and targets? Why are these parameters relevant and appropriate? What are our key performance indicators against those targets?

**Remuneration and perverse incentives** What assessments of remuneration structures have been conducted to ensure that no perverse incentives exist that may undermine our policies or progress (eg, that may favour capex/investment in assets at risk of being stranded)? Conversely, have we considered revision of our board and management remuneration policies to reflect progress against climate-related business objectives? How do we measure the effectiveness of these incentives ex post?

**Stakeholders and engagement** How do we engage with, or otherwise seek to influence, stakeholders such as employees, government, suppliers and customers on climate-related issues, and do we include information on our engagement in our disclosures? How do we engage with our debt and equity investors on climate change, and do we understand the importance of climate risks to their decision-making and over what time horizons? Have we considered whether our external associations, activities and engagements (such as membership of industry groups or government lobbying activities) may be perceived as inconsistent with our corporate climate change policy or disclosures?



# 5 Communicating our path

Are annual report disclosures (both front and back-end) complete, accurate and reliable?

**Reporting framework** Have our annual reports been prepared with regard to the TCFD or other recognised frameworks such as SASB, GRI/IR or CDSB?

*If not, why not – particularly if our industry is identified as one at 'high risk' by the TCFD? If so, what is the process by which our reports have been reconciled or assured against the relevant framework? Should we disclose our Scope 1, 2 and/or 3 emissions in line with GHG Protocol Methodology? If not, why not?*

**Assurance and audit – general** Can management provide a brief overview of how climate risk assessments and assumptions have been applied in the process of preparation and review of the financial statements, explanatory notes, directors' report in management commentary, and corporate governance statements? What has made management (and, separately, our external auditors) confident about the accuracy, integrity and completeness of our disclosures of the impacts of climate change on our performance and prospects? What were the key assumptions made, and metrics and statements requiring the most judgment? In what areas did our external auditor disagree with or challenge positions taken by management? Were any climate risk issues raised as key audit matters? How have we ensured there is consistency between our financial statements and narrative disclosures? *Directors may ask management or investigating accountants to provide a due diligence report that outlines the procedures followed, inquiries undertaken, verification information and conclusions reached.*

**Assurance and audit – financial measurement** How have relevant climate risk assumptions been factored into accounting estimates, from asset fair values, impairment calculations and changes in the useful life of assets, provisions for onerous contracts, contingent liabilities arising from fines and penalties, and changes in expected credit losses for loans and other financial assets, as well as revenues, expenditures and cash flows? Has any applicable regulatory guidance been considered (eg the AASB/AuASB joint guidance in Australia)? Are our methodologies reasonable and supportable? In particular, what methodology has been applied in impairment testing of significant assets and our assessment of stranded asset risks? Does that disclosure accurately convey the potential for materially different outcomes depending on key variables and assumptions? Is it consistent with our internal assessment of strategic direction and long-term value drivers? Have the assumptions been consistently applied across our financial statement accounting estimates? Is it appropriate to disclose the nature of material variables that may impact on the our reported performance and prospects ('modifying factors'), and a description of our methodologies? If there are no quantitative impacts on amounts recognised or disclosed in the financial statements, are disclosures of key assumptions and uncertainties still warranted, especially in light of investor expectations (*see further Materiality and evolving investor expectations, below*)?

**Omissions** What range of climate-related assumptions, scenarios and potential material financial impacts have been considered by management but not disclosed? On what basis has it been determined that they should not be disclosed? Are we proposing to disclose only favourable scenarios, or only potential financial impacts without disclosing the timing of such impacts?

**Forward-looking statements** What forward-looking statements in relation to climate risks and opportunities for our financial prospects are appropriate to disclose to the market, including in the management commentary? Are any such statements reasonable and supportable, and grounded in stress-testing and scenario analysis in relation to both physical and economic transition risks, over time-horizons consistent with our capital and financial planning cycles, as well as our reasonable expectations of the time horizons of our debt and equity investors? Have those forward-looking statements, and any explanatory text that accompanies them, been subject to legal review?

**Materiality and evolving investor expectations** Separate to internal management assessments of material climate-related impacts-- how do we determine materiality in a climate change *disclosure* context – ie. based on a contemporary understanding of information that a reasonable investor would consider decision-useful? Specifically, how have our disclosures evolved in response to regulatory developments, investor expectations, relevant litigation, and disclosures by our peers? Do, or should, we make other 'voluntary' disclosures to broader stakeholders on natural capital, the UN Sustainable Development Goals, or our company's impacts on the environment and climate change (eg. a separate sustainability report or response to a CDP questionnaire)? If so, how does management ensure that our annual reports and continuous disclosures are consistent with those voluntary disclosures? What steps have been taken in consultation with external auditors to address the challenges of assurance over these emerging forms of external reporting?

**Directors' assurance** On the basis of the above, are we satisfied that there are reasonable grounds to base our view that all potential material climate-related issues and risks to our position, performance and prospects have either been appropriately disclosed, or resolved as not material?

TCFD RECOMMENDATION CATEGORY			
Governance	Strategy	Risk Management	Metrics & Targets
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## About the Commonwealth Climate and Law Initiative

The Commonwealth Climate and Law Initiative (CCLI) is a research, education, and outreach project currently focused on four common law countries: Canada, Australia, South Africa and the United Kingdom. The CCLI examines the legal basis for directors, officers and trustees to take account of physical climate change risk and societal responses to climate change, under prevailing statutory and common laws. The CCLI leverages the inter-disciplinary and cross-jurisdictional perspectives provided by its global experts from academia and the legal, accountancy, business and scientific communities.

## About the lead authors

**Sarah Barker** is the Head of Climate Risk Governance at commercial law firm MinterEllison and one of the world's foremost experts on climate change governance, investment and liability. Her expertise is called upon by governments and institutions across the globe, from the Bank of England to the United Nations Principles for Responsible Investment, and she is the only lawyer represented on the Steering Committee of the Australian Sustainable Finance Initiative. Sarah is the Australian Convener for the CCLI, an academic visitor at the University of Oxford Smith School of Enterprise and the Environment, and teaches sustainability in corporate governance for Cambridge University's Institute for Sustainability Leadership. Sarah is an experienced non-executive director, with current board roles at Emergency Services & State Superannuation Fund and the Responsible Investment Association of Australasia, and has been an examiner, lecturer and course materials author for the Australian Institute of

Company Directors for more than fifteen years. In addition to tertiary qualifications in commerce and law, she has undertaken postgraduate studies at the London School of Economics, and holds a Masters degree from the University of Melbourne (awarded with Dean's Honours).

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