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ACCOUNTING FOR SUSTAINABILITY

European Union Centre on Shared Complex Challenges

International Legal Symposium

Climate Change Risk and Corporate Governance
Directors' Duties and Liability Exposures in a post-Paris World

29-30 August 2016, University of Melbourne

Convened by the EU Centre for Shared Complex Challenges, University of Melbourne, and the Commonwealth Climate & Law Initiative (CCLI)

Symposium highlights

Note: the Symposium was convened under the Chatham House Rule, with the exception of the Keynote presentations. Comments should therefore be attributed to particular panellists or speakers, unless expressly indicated.

Opening Keynote: Ben Caldecott, Director, Sustainable Finance Program, Smith School of Enterprise & the Environment, University of Oxford

- 'Stranded asset' risks are a function of the 'creative destruction' (Schumpeter) process of innovation. This is not a new or controversial economic phenomenon.
- Climate risks include not only environmental changes (water stress, biodiversity loss) but regulation, technological developments, changing social norms and litigation risks.
- Climate risks are regularly mis-priced. Data is sparse, risks are non-linear. An interdisciplinary approach is required.
- "Straw man" arguments encourage inaction - led by major fossil fuel interests. These include claims that top-down, coordinated international action to limit warning to well below 2°C will not happen (which does not account for the technological risks), that markets already price the risks in (which does not account for the fact that markets are notorious for mis-pricing risk, as occurred in the GFC).
- There is an emergent focus on disclosure requirements and duties of fiduciaries (corporates and investors) and increasing involvement of the insurance sector.

Session One: The financial and business implications of climate change

- Climate science – IPCC 2014 Synthesis Report demonstrates some physical impacts are now irreversible.
- Important concepts as science and economics converge:
  - *Cumulative emissions*. Developed countries must take the lead- carbon budgets.
  - "*Chain of Evidence*"- human caused- linking impacts to companies- leads to liabilities. A chain of clear and direct liability linking cumulative emissions and temperature rise to companies.
  - *Liability chain*: end–to-end attribution.
  - *Loss events*- e.g. loss of low lying land due to storm surges and increased sea levels. Adaptation challenges globally for low lying infrastructure and development.
  - *2 degree threshold*- based on the UNFCCC framework – to define a dangerous threshold. Important to understand that this is an ethical, social, economic, legal construct agreed upon at COP 15 (Copenhagen). Followed up at the Paris COP 21 meeting – with the 1.5 aspirational target.
- Five key theses on the climate change implications for investor risk:
  - climate change is now disconnected from broader ESG (environmental social governance) issues.
  - there is a key role for investors following the Paris Agreement.
  - more disclosure initiatives are being developed to increase transparency.
  - investment products and strategies are maturing in their ability to capture climate risk/opportunities
  - private investors now have to deal with the impacts of their investments on the climate.

- 'Carbon budget' for global emissions to stay below 2°C threshold means that a significant proportion of proven fossil fuel reserves will need to remain unburnt: by some estimates 80% of coal, 30% of oil and gas.

- Re-pricing of assets is inevitable, but the challenge lies in predicting the timing – when will these take effect and how can investors take this into account in their investment decision making? Look to tools, indexes, balanced portfolios, and low carbon strategies. E.g. successes in fixed income green bonds. Stress-testing and scenario planning are well-recognised tools for the management of risk in the face of uncertainty.

- Risk is about probabilities and likelihood using the best available information, observation and predictions. Given the complexity and unknowns, "perfect has become the enemy of good" – lack of perfection is not an excuse for inaction.

- Effective communication of risk management approach is critical - e.g. ANU "social responsibility" vs. HESTA/LGS "reducing exposure to long term risk" messaging.

Session Two: Company Directors' Duties and Climate Risk Governance

- Importance of reflection by directors on their approach to governance in the context of sections 180 and 181 of the *Corporations Act 2001* (Cth).

- Central concepts of Section 181- acting in *good faith* and in the *best interests of the corporation*. Climate change, and the physical, regulatory and technological risks associated with it, has evolved from a purely 'ethical' issue to one which is materially financial, and thus having regard to it is wholly consistent with corporate best interests.

- Section 180 (1) - Boards – due *care* and *diligence* of a *reasonable* director sets the standard of competence. The role of board director is a professional one - requiring the ability to manage risk and strategy. This calls for robust processes (as opposed to prescribed outcomes). The four "Es" of due care and due diligence are proposed:
    1. Educate (a director needs to keep themselves abreast of issues relevant to company operations, financial position and regulatory environment – 'alarm bell' knowledge)
    2. Enquire (a positive obligation to proactively ask questions of experts)
    3. Examine (oversee and consider advice)
    4. Evaluate (critically evaluate, form , form independent judgements)

- The *Business Judgement Rule* as set out in 180(2) tries to balance the tension of making a commercial judgement whilst holding directors to account for the absence of robust process. It may excuse directors who make educated judgment calls, but not uninformed decisions or failures to consider an issue.

- Applying the principles of the conduct of a *"reasonable person"*, in the consideration of the impacts of climate change, common reasons for inaction on climate change may not hold e.g. denial, honest ignorance, assumption, uncertainty/complexity paralysis, default to peer or regulatory baseline.

- Note growing international litigation "frontiers"– e.g. failure to manage economic transition risks (Missouri), misleading disclosure of climate risks in annual reports (New York AG, UK FRC).

- Existing corporate laws and litigation frameworks are well able to handle a failure to govern for climate-related risks. However, cases brought against directors are complex, hard fought and costly (regardless of the outcome). Litigation funders have emerged as key players.

- Possible actions: shareholders bringing action against company directors or trustees of super funds, personal liability for misleading conduct – annual reports or continuous disclosure obligations.

- Not all breaches of the law by a company comprise a breach of duty by its directors, particularly where their actions have not exposed the company to clear jeopardy. However, issues relating to the governance and disclosure of climate risks will often fall within the scope of directors' direct responsibility / control.

- Parallels around misleading disclosure may be drawn to investor class actions against the directors of BP (Deepwater Horizon) and BHP (Samarco dam collapse).

Keynote: Dr John Purcell, CPA Australia - Change Risk Disclosure – Law and Accounting

- There remains robust debate over the relative merits of mandatory vs voluntary climate risk disclosure regimes.

- Voluntary reporting remains sensitive to factors such as variable public policy, firm size, geographic scope of operations and peer influences.

- Although regulation aims to mitigate problems outlined in agency theory there are still issues with disclosure and its authenticity. For instance – where it may be in the self-interest of managers to suppress information.

- Voluntary disclosures made by companies are taken as a proxy for good corporate governance, supporting legitimacy and stakeholder theories. Arguments exist for and against sustainability disclosure. Increased mandatory disclosure, although imperfect, may be an alternative. It is important to note that mandatory disclosure need not imply clumsy, one-size-fits-all prescriptions.

Session Three: Misleading Disclosure and Reporting

- Pressure from international investors for improved climate risk disclosure has increased since the Paris Agreement in December 2015. Boilerplate disclosures are no longer considered adequate to present a true and fair view of the relevant risks.

- The current Australian regulatory regime is well able to require robust climate risk disclosures, but its application and enforcement is wanting. Lack of understanding of the scope of the financial risks associated with climate change, and issues around assurance of forward-looking disclosures, remains key issues. Better regulatory guidance on application of prevailing requirements would assist.

- Going forwards, Australian regulators are likely to be influenced by international developments. The outcomes of the Bloomberg Task Force on Climate-related Financial Disclosures (TCFD) established by the G20's Financial Stability Board will be important in setting disclosure expectations for companies in providing information to investors, lenders, insurers, and other stakeholders. Other leading disclosure instruments include Article 173 of the French Energy Transition Law, the climate risk disclosure questionnaires issued by the Commissioner for Insurance California, and the World Federation of Exchanges ESG disclosure guidance (Sustainable Stock Exchange initiative).

Keynote: Helga Birgden, Global Head of Responsible Investment, Mercer - The Future Makers

- In investor boardrooms there is at best confusion, and at worst ignorance, on the risks to their portfolios associated with climate change, and how these can be managed.

- Framing of climate risk: a two dimensional view of deterministic vs. uncertainty, needs to be broadened to recognise that the risk and reward agenda is a much broader spectrum.

- The WEF Global Risks annual report can help here, understanding intangible assets, and where risks converge and interact. There is a need to move from a quantitative approach to incorporate the qualitative.

- Mercer Report '*Investing in a Time of Climate Change*' (2015) concludes that:
  1. Climate change will have an impact on portfolios regardless of the temperature increase scenario
  2. Potential sector impacts are the most meaningful, particularly over the next 10-25 years
  3. Asset class impacts can also be material, and vary by climate scenario
  4. A 2°C climate scenario need not harm portfolio value out to 2050, if managed.

- Institutional investors remain significantly exposed to climate risks. For example, bonds typically represent 68% of portfolio investments, 53% of which are corporate bonds. 29% of corporate bonds are energy utility bonds.

Session Four: Duties of Investors

- The climate risk issue is closely related to the broader disconnect between long-term investment decisions and short-termism in markets (Mark Carney's 'tragedy of the horizon').

- A more robust regulatory and supervisory environment is appropriate for superannuation as the trustees have control of other people's retirement savings that they cannot access. Accordingly, trustee directors of registrable superannuation (pension) funds in Australia have additional duties to those imposed on company directors under the *Corporations Act*, under the *SIS Act*. Duties are owed to the beneficiary directly (as well as the trustee corporation), and the standard of conduct is held to that of a prudent professional trustee director.

- The Bank of England Prudential Regulation Authority categorises the risks associated with climate change as being physical, transitional (ie economic/market responses to climate change, including regulatory and technological responses) and liability.

- Trustee directors often fall into a polarising debate around climate change 'ethics' and political ideology on a 'carbon tax'. In doing so, they fail to account for risks beyond environmental impacts – reputational, technological, stranded assets, regulatory reform. Processes should be put in place to measure and properly price such risks.

- Disclosure/breach of duty claim parallels may be drawn to litigation emerging in the US against trustee directors of the Peabody Coal and Arch Coal employer-sponsored pension funds.

- The risk management approaches applied by prudential regulators and life insurers may be instructive on how best to deal with climate risks in Australia. Prudential regulation demands capital (net assets buffer), risk management and governance. In a climate risk context, this could be translated as a requirement for 'climate solvency' (with a positive long-term contribution to the 'community's climate balance sheet', with a margin for risk), a risk management strategy for climate risks to the community (beyond the business), and its governance as a board responsibility. Such requirements would also be positive from an investment perspective, with investors taking comfort from the fact of prudential regulation.

- Any business that passes on an external cost to the broader community faces the inherent risk that society will require these costs to be internalised. In this regard, climate change is analogous to the situation 100 years ago when companies threw their waste into rivers.

Session Five: Implications for Insurers' Financial Lines

- Far beyond physical impacts insured under property casualty policies, litigation against companies and/or their directors who fail to manage risks associated with climate change may present a significant tail risks for insurers. Industry consideration of the impacts on financial lines (including Directors' & Officers' insurance, Professional Indemnity, and speciality products such as reputational risk and supply chain) is at an emergent stage.

- Corporate culture around governance and disclosure will be important to being able to secure optimal coverage.

- Parallels may be drawn to the emergence of cyber and bribery/corruption coverage issues in recent years, although climate-related risk insurance is not yet front of mind.

- Taking D&O policies as an example, long-standing policy wording may not be equipped to cover climate-related exposures – from definitions, to the scope of coverage and exclusions (eg pollution, property damage, prior known matters).

- Litigation funding is now an integral part of the class actions landscape in Australia – particularly where investor loss is demonstrable. Disclosure-based claims for loss are most likely to arise where company reports refer only to existing regulatory exposures, rather than direction of travel / forward-looking risks. They commonly arise from changes in risk and regulation in an industry, which are not then adequately disclosed. Theory of harm (loosely): if investors had known about behaviour, they would have paid a lower price. Stock drop following corrective disclosure is a helpful indicator of what the price they would have paid may have been.

- Insurers seek to understand what is going to go wrong in an economy before it happens – eg a major insurer pulled coverage from Australian junior miners and mining services companies a few years ago as it foresaw the downturn in that industry.

- There is a big need for education around climate risk issues for those with fiduciary responsibilities. Litigation is effectively the stick for laggards that ultimately drives behavioural change.

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