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Commonwealth Climate and Law Initiative - Climate Change and Legal Risk

Janis P. Sarra
Allard School of Law at the University of British Columbia

Cynthia Williams
Osgoode Hall Law School of York University, cwilliams@osgoode.yorku.ca

COMMONWEALTH Climate and Law Initiative

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Climate Change and Legal Risk

Janis Sarra and Cynthia Williams

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SUSTAINABLE FINANCE PROGRAMME UNIVERSITY OF OXFORD

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UBC PETER A. ALLARD SCHOOL OF LAW — The University of British Columbia

CCLI – Canada

Janis Sarra, *Fiduciary Obligations in Business and Investment: Implications of Climate Change*

Cynthia Williams, *Disclosure of Information Concerning Climate Change: Liability Risks and Opportunities*

Sarra and Williams, *Directors' Liability and Climate Risk: Canada - Country Paper: Commonwealth Climate and Law Initiative (CCLI)*

Canadian law as currently framed can be a driver for positive action on climate change

We acknowledge the generous support of the IVEY foundation

Overview of presentation

Janis

- Introduction
- Fiduciary obligations of directors on corporate boards
- Fiduciary obligations of pension fiduciaries

Cynthia

- Task Force on Climate-related Financial Disclosures
- Disclosure liability risks in Canada
- Current climate-related litigation

Introduction

Allocation of capital in business and investment have impact on and are impacted by climate change.

Climate change represents a significant financial risk that could substantially affect the valuation of many investment portfolios (World Economic Forum, 2017).

Climate change is increasing frequency and severity of extreme weather events, which now account for 77% of total economic losses, $2.2 trillion (UN Report, Oct 2018).

Why Canada is vulnerable

Canada’s economy is heavily dependent on the very resources that generate some of most egregious GHG emissions:

- fossil fuel sector generates 7.7% of Canada’s GDP
- oil and gas sector accounts for 26% of total GHG emissions.

Large growth in orphan wells (over 2,000 in 2018), due to low commodity prices, corporate failures in oil and gas sector.

- 80% increase in these stranded assets.
- $8-billion environmental cleanup of abandoned oil wells in Alberta alone.

Our capital markets are directly implicated in both the risk-generating activity and the potential to mitigate the risks.

Mark Carney: climate risk a "tragedy of the horizon" – the catastrophic impacts of climate change will be felt beyond timeframe of current business cycles (incentives) - imposing costs on future generations

Scientific evidence of responsibility improving

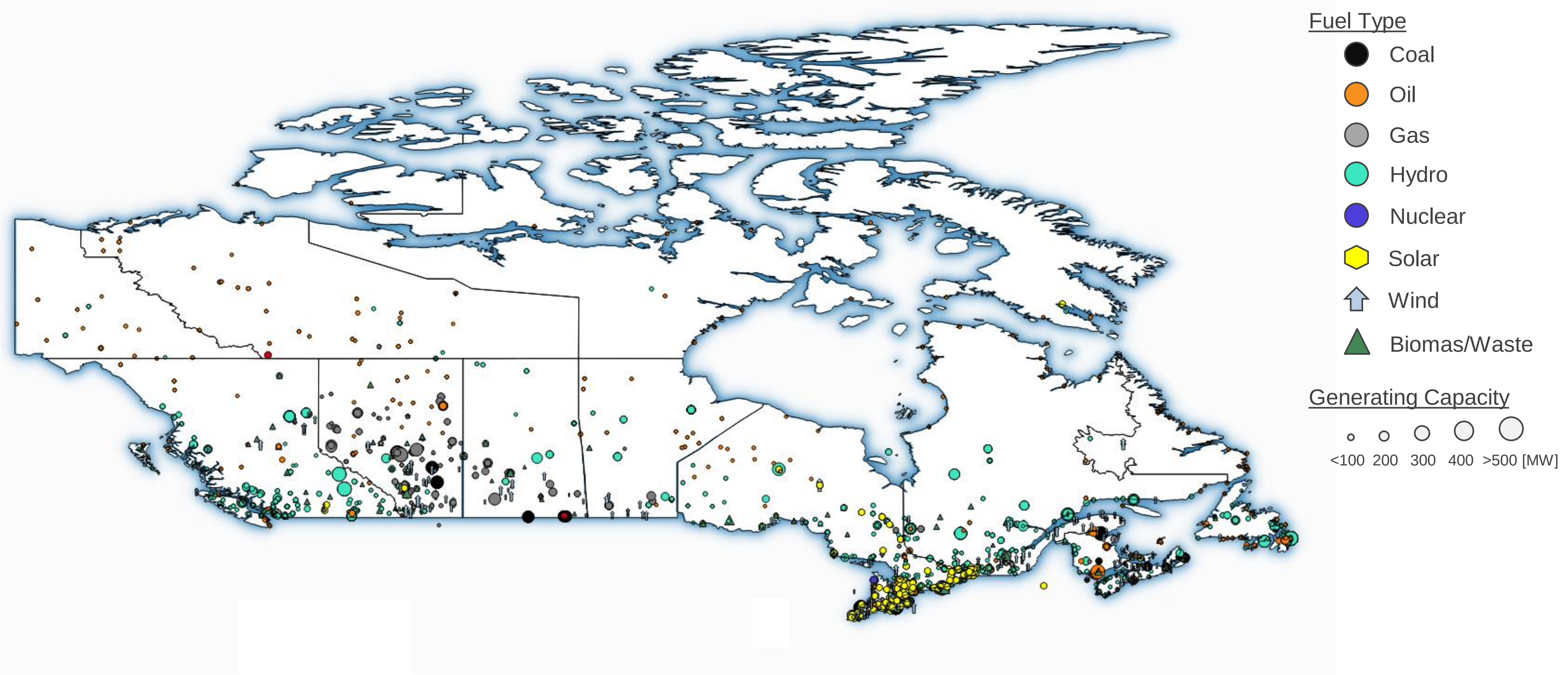
Frumhoff, Heede, & Oreskes, *The climate responsibilities of industrial carbon producers,* 2017 found:

Distinctive responsibilities of the major investor-owned producers of fossil fuels.

90 largest industrial carbon producers' products are responsible for 63% of all known industrial GHG emissions.

Specific attribution of emissions per company provides an evidentiary basis for claims against the companies, as evidenced by cases proliferating in the US.

ASSET-LEVEL DATA



Lucas Kruitwagen, Smith School of Business, Oxford

Canadian law is clear on fiduciary obligation of corporate directors

Corporate legislation in Canada has codified fiduciary duties, which operate in tandem with common law obligations.

Corporate statutes specify that directors and officers of corporations have a duty to act in the best interests of the corporation.

The corporate **statutory fiduciary duty** requires that corporate directors and officers "act honestly and in good faith with a view to the best interests of the corporation".

The statutory **duty of care** requires that directors and officers "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances".

The Supreme Court of Canada has been very clear on the scope of fiduciary obligations

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 (*Peoples)*

"Every director and officer of a corporation in exercising their powers and discharging their duties shall exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." (*Peoples, BCE)*

In executing its duty of loyalty to the corporation, the board of directors was required to reflect on the interests of the corporation both as an economic actor and as a "good corporate citizen" (*BCE)*

The Supreme Court of Canada has held:

It is legitimate, given all the circumstances of a given case, for the board of directors to consider the interests of shareholders, employees, creditors, consumers, governments and the environment (*Peoples, BCE*).

The fiduciary duty of the directors to the corporation is a broad, contextual concept. It is not confined to short-term profit or share value, it looks to the long-term interests of the corporation (*Peoples, BCE*).

The standard by which to assess conduct is objective; thus, the factual aspects of the circumstances surrounding the actions of the director or officer are important to assessing whether directors met their duty of care (*BCE).*

Study examines why corporate law as currently enacted and SCC jurisprudence are sufficient to ground a fiduciary obligation to address climate-related financial risk.

In fulfilling their obligation to act in the best interests of the company, directors and officers must assess whether there is risk to the corporation from climate change and climate-related policies

- in order to do so, directors must directly engage with developments in knowledge re physical and transition risks related to climate change and how may impact their corporation.

Fiduciary obligation of corporate directors in relation to climate-related financial risk

Depending on the firm's economic activities, the risk may be minor or highly significant

Director obligations:

Securities law disclosure- materiality test

Corporate law – objective test

- reasonableness of decisions (knew or ought reasonably to have known)
- due diligence in inquiring, and acting
- material risk is one factor, in looking to long-term interests of the company

Fiduciary duties in relation to climate-related risk

Fiduciary duty requires:

That directors have undertaken efforts to identify any relevant risks to their business from climate change

Where risks identified, that they have put appropriate strategies in place to manage these risks.

Duty of care requires:

That directors and officers to supervise transition that will address the specific climate related risks identified.

There are also new upside opportunities directors may wish to consider.

Oppression remedies under corporate statutes

The SCC has held that oppression is an equitable remedy; giving the court broad jurisdiction to enforce not just what is legal, but what is fair and equitable (*BCE).*

Pegged to "reasonable expectations" regarding whether directors acted in manner that was oppressive, unfairly prejudicial to, or unfairly disregarded the interests of any security holder, creditor, director or officer

"unfair disregard" of interests extends the remedy to ignoring an interest as being of no importance, contrary to the stakeholders' reasonable expectations (*BCE).*

SCC in *Wilson v Alharayeri* 2017

SCC unanimously reaffirmed that a corporation's directors may be personally liable in an oppression action, clarifying the criteria for imposing personal liability.

Two-prong test for personal liability:

1. "the director or officer must be implicated in the oppressive conduct; and the "oppressive conduct must be attributable to the individual director because of his/her action or **inaction**".

2. imposition of personal liability "must be fit in all of the circumstances".

At least four general principles should guide courts in fashioning a fit remedy*:*

1. remedy must be a fair way of dealing with the situation
2. go no further than necessary to rectify the oppression
3. serve only to vindicate the reasonable expectations of specified stakeholders
4. court should consider general corporate law context in exercising its remedial discretion.

Proactive governance is best defence

Directors given broad authority to address climate change risk.

SCC:
"Provided the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board"

"The decisions they make must be reasonable business decisions in light of all the circumstances about which the directors or officers knew or ought to have known"

Courts "are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made"

Based on what we know about courts finding personal liability in environmental cases, courts may ask....

Did the directors identify potential transition risks and physical risks from climate change and climate change policies?

Did they develop an ongoing process or program for monitoring risk and compliance?

Did directors and officers develop appropriate strategies in place to manage and reduce climate-related risks?

Did they supervise employees carrying out emissions related activities and mitigation or adaptation activities?

Did they ensure remedial and contingency plans are in place for acute events?


Pension fiduciaries and climate-related risk

Pension trustees are in a fiduciary relationship with the beneficiaries of the trust.

Duty of Loyalty

The duty of loyalty requires fiduciaries to act in good faith in the interests of their beneficiaries, impartially balance the conflicting interests of different beneficiaries, avoid conflicts of interest, and a duty not to act for the benefit of themselves or a third party.

Duty of Prudence

The prudential obligation requires fiduciaries to act with the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person.

Image, EU High level Group on Pensions

Pension funds

Pension funds will potentially lose significant value of their investments if they do not act as prudent investors by recognizing climate change financial risk. 2011 Mercer report estimated 10% of a fund's portfolio risk exposure.

In Ontario, the *Pension Benefits Act* now requires pension funds to disclose information about whether ESG factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated - "disclose and explain" approach.

FSCO has observed that administrators have a fiduciary duty to supervise their investment managers, including ensuring that the managers are complying with the *PBA* and with the pension fund's statement of investment policies and procedures re ESG factors.

Image, EU High level Group on Pensions

International Context

UNPRI, UN Global Compact, *Fiduciary Duty in the 21st Century:* fiduciaries need to show that they have identified and assessed risks of climate change to companies and their investment portfolios over short to long term.

France *La Loi de transition énergetique pour la croissance verte* requires institutional investors, including pension funds, to disclose annually the financial risks related to the effects of climate change and measures to reduce them, including how they are implementing a low-carbon strategy in every component of their activities, and how their corporate and investment decision-making is contributing to the energy and ecological transition to limit global warming.

Climate and Canadian Pension trustees and other pension fiduciaries

Pension fund trustees and their investment managers have a fiduciary obligation to pension beneficiaries to act prudently in their best interests in making investment decisions regarding fund portfolios. Both statutory and common law.

Pension fund fiduciaries must make their investment strategy decisions based on a time frame commensurate with the pension plan's liabilities.

Prudential obligations require the fiduciary to undertake a careful and thorough evaluation of climate change risk based on information generated, prior to making decisions.

Pension fiduciaries and their investment managers

In determining asset allocation between short-term and long-term investments, the duty of care precludes short-term investments that prejudice long-term investments, as the fund must be sustained over the long-term.

Thus trustees must take account of systemic risks such as climate change, particularly in balancing intergenerational interests.

If trustees fail to act to address material climate change risk, they may be personally liable for breach of their fiduciary obligation.

Fiduciaries have a duty to act even where the potential costs and benefits of climate change cannot be fully quantified immediately.

Governance tools

Pension plan fiduciaries can exercise their power as shareholders/investors to cause corporations to address climate-related financial risk.

Where a pension fund is invested through investment managers, the pension fiduciaries must supervise the investment managers compliance with the fund’s climate-risk policy.

Looking forward

Where risk is identified, pension fiduciaries should embed mitigation and adaptation strategies in corporate decisions and investment portfolio management, and report to shareholders, pension beneficiaries and other stakeholders on how these commitments have been implemented and resultant outcomes.

Makes sense then to also consider the benefits of investment in green adaption and mitigation technologies, products and services likely to have upside financial potential for return on investment and reduce investment risk.

Expert panel report calling for policy ideas to foster sustainable finance.

Transparency and climate-related risk

Disclosure liability risks

Williams study examines current requirements and quality of current climate disclosure by Canadian public companies, and the expectations of investors.

Litigation on climate-related risk is most likely to arise in the context of securities disclosure obligations.

FSB Task Force on Climate-related Financial Disclosures (TCFD) has reported that climate-related risks include financial, reputational and liability risks related to transition to lower-carbon economy and risks related to the physical impacts of climate change

TCFD recommendations:

Core Elements of Recommended Climate-Related Financial Disclosures

Governance
The organization's governance around climate-related risks and opportunities

Strategy
The actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning

Risk Management
The processes used by the organization to identify, assess, and manage climate-related risks

Metrics and Targets
The metrics and targets used to assess and manage relevant climate-related risks and opportunities

Momentum internationally regarding climate change governance

TCFD published its 2018 Status Report to the Financial Stability Board (FSB) September 2018.

513 organizations support the TCFD recommendations, includes 287 financial and 170 non-financial companies, with a combined market capitalization of $7.9 trillion.

The supporting financial firms are responsible for assets of nearly $100 trillion.

Signals growing momentum for climate-related disclosures. e.g. BlackRock, almost $6 trillion in assets under management, sent letters to 120 companies where "material climate risk inherent in their business operations," telling them to start reporting clear information on climate risk in line TCFD.

Canadian Securities Administrators

Report on Climate-Related Disclosure Project
April 2018

Scope

Disclosure – mandatory and voluntary reports

Survey – anonymous to all TSX-listed issuers

Consultations – 50+ including focus groups

Research – existing climate disclosure requirements

Key Themes

Current Disclosure Practices

Dissatisfaction with State of Disclosure

Concerns about Mandatory Disclosure Requirements, including materiality

CSA plans

Guidance & Education

Focus on Risk Governance & Oversight

Monitoring of Climate-related Disclosures

Materiality

Materiality underpins much of the transparency requirements of Canadian securities law Important question is whether need to have different understanding of “materiality” that recognizes the scale of risk, longer timelines, and impact of failing to act

In some instances, material changes are contingent or uncertain, although directors and officers of the corporation may have some information

Disclosure relating to corporate governance is not subject to a materiality standard in Canada; climate-change disclosure should be treated similarly.

CPA Canada Study

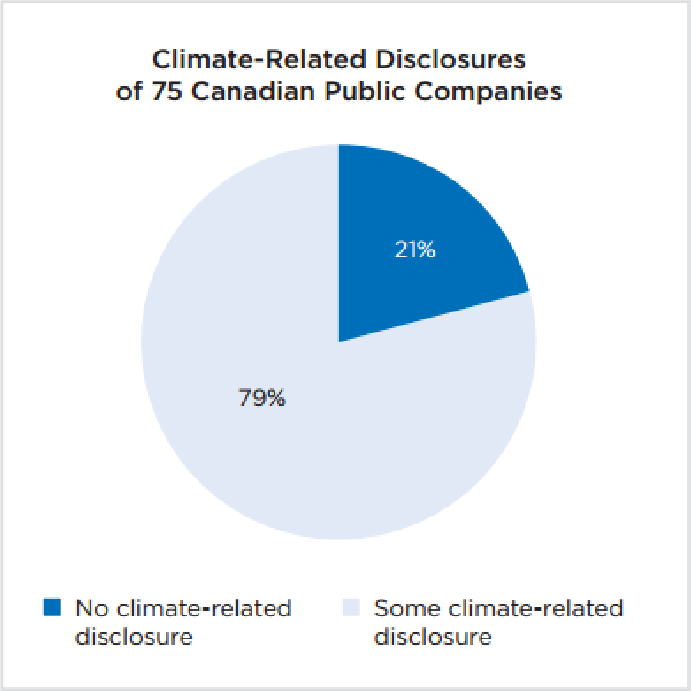
The majority of companies are making climate-related disclosures, but the **nature and extent varies**:

Climate-related disclosures did not provide sufficient context

Disclosures were not comparable across or within industries

Inconsistent use of terminology

Users are challenged to locate relevant information



Image; With thanks to CPA Canada

“The Status of Climate Change Litigation” Sabin Center, Columbia University, climatecasechart.com

As of November 2018 climate change cases had been filed in 24 countries (25 if one counts the European Union), with 1406 cases filed in the US and over 284 cases filed in all other countries combined.

Shareholder actions for failure to disclose:

Greenpeace Canada’s challenge to Kinder Morgan’s IPO in 2017 for including only the most optimistic demand projections from the IEA, and leaving others out.

Commonwealth Bank of Australia suit alleging directors’ report did not adequately inform investors of climate change risks, that CBA ought to have had business strategies to manage climate change business risks and those should be disclosed so that investors could make an informed assessment of operations, financial position, and prospects for future financial years.

“The Status of Climate Change Litigation” Sabin Center, Columbia University, climatecasechart.com

Class action on behalf of purchasers of Exxon Mobil Corporation common stock alleging Exxon directors and officers violated US securities law re the inability of the company to extract existing hydrocarbon reserves and therefore, a material portion of Exxon's reserves were stranded and should have been written down (including its subsidiary Imperial Oil’s Bitumin Operations); and misleading statements about its use of a high proxy cost of carbon when making capital investments versus its actual use of a low proxy cost of carbon.

Suits against governments on mitigation commitments: Urgenda Foundation v. Kingdom of the Netherlands: District Court order in 2015 to the government to enact policies to reduce GHG emissions by at least 25%; upheld on appeal October, 2018.

Furthering Sustainable Finance:

INVESTORS AS KEY PARTICIPANTS AND LEADERS

Governments, central banks, FSB have leadership role to play in directing attention to climate related risk disclosure, governance, adaptation and mitigation

The efforts of investors are also extremely important: Climate Action 100+ now have more than 300 signatories

Signals from investors to companies *and to governments* can help to produce clear leadership on government policy and a robust transition.

In Canada, the federal government's Expert Panel on Sustainable Finance offers us all a role, and opportunities to shape federal policy.

Expert Panel on Sustainable Finance

OVERVIEW

Definition of Sustainable Finance: "the Panel views Sustainable Finance as capital flows (as reflected in lending and investment), risk management (such as insurance and risk assessment) and financial processes (including disclosure, valuation, and oversight) that assimilate environmental and social factors as a means of promoting sustainable economic growth and the long term stability of the financial system."

Foundational elements the Panel deems necessary in Canada:

- Clarity on climate and carbon pricing
- Reliable information, especially on climate data and financial analysis)
- Effective climate-related financial disclosures
- Clear interpretation of fiduciary and legal duties
- A knowledgeable support ecosystem (lawyers, accountants, auditors, ratings agencies, and others)
- Effective and consistent financial regulation

Expert Panel on Sustainable Finance

QUESTIONS FOR INVESTORS

1. Are there specific market failures that make it difficult for investors to value climate risks and opportunities, related to projects and assets?
    1. Would companies disclosing pursuant to the recommendations of TCFD address these market failures?
2. Are there gaps that investors identify that make it difficult to invest in the transition at scale?
    1. Green bonds, climate bonds, transition-linked bonds and loans: How to scale up? What financial infrastructure is needed?
3. How could investment benchmarks better incorporate consideration of climate change?
4. What else needs to happen?

Thank you

Janis Sarra
Cynthia Williams

Image: Sustainable Finance, European Commission