Client Update

Shaping the future of insurance law

Climate change is heating up boardroom risks

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AT A GLANCE

- Australian and global regulators are treating climate change as a major systemic financial risk.
- The risks affect all listed companies and the financial services sector, not just businesses with carbon-reliant assets.
- Companies, and their directors and officers, need to address climate change risks as a core part of their governance activities.
- Insurers should also proactively manage the exponentially increasing risk of D&O liability and professional indemnity exposures associated with climate change risks.

INTRODUCTION

In 2018, the Intergovernmental Panel on Climate Change found that humans had already caused the planet to warm by one degree above preindustrial levels[1]. One estimate suggests that global economic losses of about $23 trillion per year could be incurred if the planet is warmed by a further three degrees within the next century.[2]

With statistics like those, and the constant headlines about the impacts of climate change, it's hardly surprising that climate change risks are now being treated as systemic by financial regulators. APRA's recent release of its draft guidance to banks, insurers and superannuation trustees on managing the financial risks of climate change is the latest initiative from Australian regulators designed to address this critical issue.

While companies are being offered much guidance on the issue, financial lines insurers should also take a proactive approach in managing their climate risk-related D&O and professional indemnity exposures.

THE FINANCIAL RISKS

There is a strong potential for climate change risks to impact financial institutions, such as banks and insurers. This could result from increased catastrophic weather events and the eventual necessary transition from assets reliant on carbon to other assets.

If carbon-reliant assets become stranded, the value of other unrelated financial assets will be impacted and is predicted to leave financial institutions scrambling[3]. It has been estimated that potential

[1] https://report.ipcc.ch/sr15/pdf/sr15_spm_final.pdf
[2] https://agupubs.onlinelibrary.wiley.com/doi/full/10.1029/2018EF000922
[3] https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2019/feb/Oliver_Wyman_Climate_Change_Managing_A_New_Financial_Risk_paper.pdf

losses from stranded assets alone could amount to $18 trillion.[4]

Depending on the future policy approaches adopted by governments and the environmental impacts of climate change, these systemic risks may arise rapidly in a widespread context. That's one of the reasons all listed companies, regardless of sector, should address climate change risks within their governance framework and disclose those risks to the market.

REGULATOR ACTION

Regulators in Australia and around the world are treating climate change as a major systemic financial risk.

ASIC has long highlighted climate change as a systemic risk that has the potential to significantly impact companies, investors and consumers. APRA has also taken a strong lead in this area and is about to undertake climate change vulnerability assessments for the major banks.

In February 2021, ASIC released a statement[5] saying it considered "disclosing and managing climate-related risk is a key director responsibility." It has now completed a round of surveillance of companies' performance in managing and disclosing this issue under the framework established by the Financial Stability Board's Taskforce for Climate-related Financial Disclosures (**TCFD**), which ASIC has recommended for listed companies. As a result of the review, ASIC is now planning to "*pass on targeted guidance"* as companies begin their next reporting cycle. The announcement goes on to say: *"we may consider enforcement action should there be serious disclosure failures. This includes whether the failures relate to the impact of climate change, or to other matters such as operations or the prospects of the business."*

> **Climate change risks may arise rapidly in a widespread context.**

ASIC makes four high level recommendations relating to climate-risk governance, management and disclosure, to:

- consider short and long-term climate risk - boards should consider climate risk in their decision-making process
- develop and maintain strong, effective corporate governance - boards should consider the governance structures in place to assess, manage and disclose climate change risks and opportunities
- comply with the law - including disclosures in annual reports under s299(1)(a)(c) of the *Corporations Act* 2001, prospectuses or continuous disclosure announcements, and
- disclose useful information to investors – ASIC recommends listed companies with material exposure to climate risk consider reporting under the TCFD framework.

In April 2021, APRA released its draft guidance to banks, insurers and superannuation trustees on managing the financial risks of climate change. The draft *Prudential Practice Guide CPG 229 Climate Change Financial Risks* (CPG 229)[6] is aligned with the TCFD recommendations. It suggests banks, insurers and superannuation funds treat climate change risks in the same way they address other systemic issues such as credit and underwriting risks, and re-assess their client portfolios accordingly.

In its response to climate-related risks[7], APRA also announced it will commence a series of Climate Vulnerability Assessments (CVAs) of major Australian banks and will engage with the Reserve Bank and ASIC to ensure it takes a consistent approach to the disclosure of climate-related risk information.

The TCFD's disclosure regime recommendations have also been endorsed by the ASX, including in its guidance publication *Climate change risk disclosure: A practical guide to reporting against ASX Corporate Governance Council's Corporate Governance Principles and Recommendations.*

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[4] Network for Greening the Financial System, 'A Call for Action: Climate Change as a Source of Financial Risk' (April 2019).

[5] Managing climate risk for directors | ASIC - Australian Securities and Investments Commission

[6] Consultation on draft Prudential Practice Guide on Climate Change Financial Risks | APRA

[7] APRA's response to climate-related financial risks | APRA

Many industry superannuation funds and fund management groups are already signatories to the UN Principles for Responsible Investment (UNPRI), which means they have committed to mandatory climate disclosure for reporting progress on implementing the TCFD recommendations. Worldwide, this comprises around 2,372 fund managers that are responsible for around USD86 trillion of assets[8].

There is a real possibility that ASIC will begin to pursue companies and directors personally for failures to disclose climate change information to the market – whether for breaches of the *Corporations Act 2001* (Cth), including directors' duties (s.180), operating and financial review disclosures in annual reports (s299(1)(a)(c)) and continuous disclosure obligations (s.674), or for misleading and deceptive conduct under consumer law.

LIABILITY RISKS ARE INCREASING

In 2019, the Centre for Policy Development published Noel Hutley SC and Sebastian Hartford Davis' supplementary memorandum of opinion[9] on directors' duties and climate change.

The opinion, first published in 2016, flags that the potential liability of directors regarding climate change is increasing exponentially due to increased regulator intervention, scientific knowledge developments and investor group interest. The power of investors was seen in December 2019 when BlackRock, a US investment manager responsible for around USD6 trillion in assets, wrote to 120 companies requesting clearer, more comprehensive disclosure of climate change risks.[10]

The opinion suggests that company directors should address the impact on their business:

- if concerted decarbonisation efforts occur
- if concerted decarbonisation efforts do not occur, and
- the escalating physical changes under both scenarios.

Hutley and Davis also highlight the need for directors and officers to understand the directors' duties regarding these risks and to ensure adequate disclosure relating to material risks from climate change.

Liability has already been extended by the courts to the government with courts in France[11], Germany[12] and now Australia determining that the governments must consider climate change in decision making.

This month, Justice Bromberg of the Federal Court identified a novel duty of care owed by the Minister for the Environment to Australian children to consider potential personal injury to them as a result of climate change in deciding whether to approve the extension of a coal mine (*Sharma by her litigation representative Sister Marie Brigid Arthur v Minister for the Environment* [2021] FCA 560).

A Dutch court has gone further, applying a duty of care to a private company finding that Shell had a duty of care to comply with the Paris Climate Agreement and must cut its CO2 emissions by 45% by 2030 compared to 2019 levels.[13]

LIABILITY OF DIRECTORS AND OFFICERS

There are several potential avenues of liability that arise for directors when disclosing information to the market:

- failure to disclose that it emits greenhouse gases or consumes coal in violation of relevant regulations
- even if no relevant regulations apply to the company at the time, failure to disclose how known uncertainties of climate change regulation will impact the company's performance
- even if it is not perceivable that relevant regulations will ever apply to the company because of the services or products it

[8] https://www.afr.com/chanticleer/business-zeros-in-on-climate-change-20200101-p53o1v
[9] Microsoft Word - CPB - Supplementary Opinion of Hutley and Hartford Davis 26.3.19 (002).docx (cpd.org.au)
[10] https://www.afr.com/companies/financial-services/colonial-first-state-prepared-to-dump-managers-lagging-on-climate-change-esg-20171229-h0b9r1
[11] https://apnews.com/article/europe-climate-climate-change-paris-france-108722d3e8bc587d9300ec189b99a07d
[12] https://apnews.com/article/europe-climate-climate-change-business-environment-and-nature-80cc854f7d1bf4e34b157f94958df4cc
[13] https://www.dw.com/en/shell-ordered-to-reduce-co2-emissions-in-watershedruling/a-57669931

provides, failure to disclose how the company's performance could nevertheless be affected by climate change, whether by reason of broader economic stability risks, current or future assets exposed to climate change declining in value, current or future assets becoming stranded assets, environmental risks or otherwise

- failure to disclose the risk of the company being sued in negligence for failing to foresee or mitigate climate change risks, or
- failure to disclose risks arising from increased costs of projects because of
  - government approvals being declined or delayed because of environmental concerns, and
  - other delays to projects because of environmental concerns.[14]

THE POTENTIAL STANDARD FOR DISCLOSURE

ASIC, APRA and ASX have updated their respective guidelines for directors of listed companies based on the TCFD's framework.

The TCFD's recommendations were first released in June 2017, with one of the key recommendations being to include climate scenario analyses in financial reports (not just separate sustainability reports, which may not be read as extensively by investors). The recommendations cover governance, strategy, risk management, metrics setting and targets.

In a TCFD example of a company making an appropriate level of disclosure, the company's financial reports included:

- an assessment of climate change risk in a scenario of 2°c of global warming
- increased disclosure of environmental information in public filings
- third-party audit and verification for its reported carbon emissions, and
- an absolute, science-based emissions target.

The CSIRO has developed climate change risk scenarios for the majority of Australia's major mining regions, which could be adopted by mining companies in preparing their financial reports, profit forecasts and climate change risk mitigation plans.[15] For example, the CSIRO considers the following kinds of industry-specific risks when preparing its scenarios:

- increased frequency of catastrophic weather events, particularly landslides
- changes in ground and soil conditions
- migration of tropical diseases to mining communities
- decreased water reserves
- availability of power, and
- liveability of nearby towns for mining community members – which may lead to an increase in a fly-in-fly-out workforce.

THE ISSUES FOR INSURERS

D&O exclusions

Many D&O policies typically exclude claims arising from pollution – however, these tend to be defined in terms of specific kinds of physical pollution, for example asbestos or heavy metals.

Even if specific climate change exclusions are adopted, insurers must tread carefully. The US experience indicates that the construction of such exclusions, particularly in the case of securities class actions, is by no means clear-cut. *Owens Corning v National Union Fire Insurance Co*[16] arose from a securities class action commenced against Owens Corning alleging that it misrepresented its exposure to asbestos claims in its financial reports – and the follow-on risk that its insurance coverage would be exhausted. The insurer relied on a specific asbestos exclusion in the following terms:

[14] https://www.afr.com/companies/financial-services/climate-change-excuses-won-t-wash-in-court-say-lawyers-20191209-p53i8u
[15] ANU Investor Group on Climate Change, 'Assessing Climate Change Risks and Opportunities for Investors: Mining and Minerals Processing Sector'; Jane Hodgkinson, Anna Littleboy, Mark Howden, Kieren Moffat and Barton Loechel, 'Climate Adaptation in the Australian Mining and Exploration Industries'.
[16] 1998 WL 774109 (6th Cir. 1998)

> *"… any claim directly or indirectly including but not limited to shareholder derivative suits and/or representative class action suits based upon or arising out of or related to:*
>
> *A) asbestos or any asbestos related injury or damage…"*

The court held that the words "arising out of" required a close causal connection, therefore, the securities class action did not "arise out of" asbestos, but rather arose out of the directors of the company misleading investors regarding the company's projected financial performance. While caution needs to be exercised in applying US jurisprudence to Australia, the point is nonetheless an important one for D&O insurers in assessing their exposure.

Importantly, academics in the US have similarly argued that pollution exclusions will be unlikely to apply to litigation arising from climate change, given that "in such circumstances the misleading of investors has no discernible connection to issues such as the use, exposure, presence, existence, detection, removal, elimination, or avoidance of greenhouse gases."[17] Climate change is not a typical 'pollutant' and, accordingly, insurers must tread carefully when navigating this area and attempting to protect themselves from these growing risks.

It is also noteworthy that Owens Corning's business concerned the sale of asbestos products, which meant the court wanted to avoid the exclusion resulting in the policy providing coverage of no value. Given the prominence of climate change risks to directors of companies, it is possible that courts in Australia, applying a commercial interpretation, may also read down such an exclusion in D&O policies. Australian courts have previously applied a narrow application to insolvency exclusions on the basis that a wide application would render the policy "practically illusory" (see *Kaboko Mining Limited v Van Heerden (No 3)* [2018] FCA 2055 upheld on appeal in *AIG Australia Limited v Kaboko Mining Limited* [2019] FCAFC 96).

It is therefore possible that D&O policies will respond to these liabilities in the absence of specific exclusions.

> **Climate change is not a typical 'pollutant' and insurers must tread carefully when navigating this area.**

Financial services professional indemnity risks

There is a disconnect between the investment practices of asset managers around the world who continue to invest in assets tied to carbon-intensive industries and the investors to whom they owe a fiduciary duty.

That disconnect represents a significant risk of investor claims regarding the management of their money. A survey of 'ethical' fund managers by the Responsible Investment Association of Australia recently found that only 5% had exclusions for fossil fuel companies, whereas 32% of consumers who used the RIAA's online search tool searched for fund managers that exclude or at least negatively screen for fossil fuel companies.[18]

There are also serious reputational risks associated with investing in assets associated with high climate-change risk, and fund managers should consider these and the parallel risks of liability[19]. For example, in Australia, Colonial First State's survey of many of its investment managers found only 45% believed climate change was an investment risk, and none used carbon prices when valuing companies. In response to the survey results, Colonial First State issued warnings to its various fund managers to properly consider and report on climate change risks or otherwise risk losing Colonial First State as a client.[20]

[17] J Wylie Donald and Loly Garcia Tor, '*Climate Change and the D&O Pollution Exclusion*' (2006) 41(4) *Tort Trial & Insurance Practice Law Journal* 1033.

[18] https://www.smh.com.au/money/investing/ethical-fund-managers-fail-to-meet-investors-concerns-over-climate-change-20190702-p523ba.html

[19] Network for Greening the Financial System, 'A Call for Action: Climate Change as a Source of Financial Risk' (April 2019) 28.

[20] https://www.afr.com/companies/financial-services/colonial-first-state-prepared-to-dump-managers-lagging-on-climate-change-esg-20171229-h0b9r1

In 2018 an investor, Mark McVeigh, filed proceedings against REST, an industry superannuation fund[21], alleging REST:

- breached its fiduciary duties to the individual as a trustee by failing to properly consider climate change risks when making investment decisions, and
- breached its statutory duty under section 1017C of the *Corporations Act 2001* (Cth) by failing to provide adequate information that would allow him to make an informed decision about the management and condition of his investments.

In late 2020, the parties settled the proceedings with REST announcing its commitments regarding managing climate change risk.[22]

Insurers of fund managers should encourage insureds to take steps to protect themselves from liability by actively considering and responding to climate change risks in their portfolios. Appropriate actions may include integrating sustainable investment criteria, requesting more comprehensive information from companies directly and, where appropriate, withdrawing investments.

LITIGATION LOOMS LARGE

Former High Court judge Kenneth Hayne made a powerful statement in late 2019 that directors will not be able to hide behind “learned helplessness” as a reason not to take clear steps in response to climate change risks.[23]

Given the high levels of regulator scrutiny, investor activity and public interest, it is only a matter of time before significant claims (potentially including securities class actions) are brought against directors and officers who fail to properly consider and, act on, climate risks.

Many proceedings and complaints have already been initiated in Australia, including cases involving company law, climate risk and human rights. However, the risk of legal action should not be the only driver for companies and their insurers in proactively addressing climate change challenges. Appropriate corporate action, including disclosure, is likely to be in shareholders’ best interests given climate range risks are real, systemic threat to business.

[21] *McVeigh v Retail Employees Superannuation Pty Ltd* [2019] FCA 14
[22] Climate change | Rest Super
[23] https://www.afr.com/policy/energy-and-climate/hayne-rebukes-directors-on-climate-risk-failure-20191206-p53hnd

NEED TO KNOW MORE?

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