LegalUpdate

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Climate Change: the next wave of corporate liability

Australia is undergoing significant regulatory reform in response to global concerns regarding climate change. Corporate officers are required not only to focus on compliance with new legislation but on the commercial, financial, and risk management challenges facing their business. Climate change litigation emerging from the United States provides a preview of what we may expect in Australia, with the adequacy of corporate disclosure a key issue.

With an increase in disclosure obligations, comes an increase in liability risk to directors and officers. This expansion of liability is likely to prompt D&O insurers to fine tune further their underwriting criteria and will also inevitably result in directors and officers revisiting the scope of their D&O insurance cover.

Climate change regulation in Australia - compliance challenges

The present position in Australia with respect to climate change legislative policy focuses on two key mechanisms: the *National Greenhouse and Energy Reporting Act 2007* (Cth) (NGER Act) and the Federal Government's proposed greenhouse gas (GHG) emission trading scheme called the Carbon Pollution Reduction Scheme (CPRS).

NGER Act

The NGER Act is a national framework for corporations to report GHG emissions, energy consumption and energy production from 1 July 2008. Administered by the Department of Climate Change, the NGER Act makes registration and reporting mandatory for corporations whose energy production, energy consumption or GHG emissions meet or exceed certain thresholds. Responsibility for reporting is assigned to the company at the top of a corporation hierarchy known as the "controlling corporation."

A key element of the enforcement framework under the NGER Act is to impose civil penalties on chief executive officers (CEO) of corporations that contravene the Act.

Section 47 of the NGER Act provides that a CEO will be liable for all breaches for which the corporation has civil liability if:

- the CEO either knew, or was reckless or negligent as to whether the contravention would occur
- the CEO was in a position to influence the conduct of the corporation in relation to the contravention, and
- the CEO failed to take all "reasonable steps" to prevent the contravention.

The NGER Act civil penalty provisions mirror the extended accessorial liability model for corporate officers recommended in the Corporations and Markets Advisory Committee's (CAMAC) Personal liability for corporate fault report (released in September 2006). That model, which was developed in the context of criminal liability, is based on the theory of the "designated officer" approach, which imposes statutory responsibility on at least one individual in a company to guarantee compliance with the statute and ensure that relevant remedial steps are taken by the company.[1]

The NGER Act inclusion of a "reasonable steps" due diligence defence stems from another principle developed by the CAMAC Report. Under the NGER Act the court is to have regard to the following factors in determining whether a CEO failed to take all reasonable steps:

(a) what action (if any) the officer took directed towards ensuring the following (to the extent that the action is relevant to the contravention):

(i) that the corporation arranges regular professional assessments of the corporation's compliance with the Act and regulations;

(ii) that the corporation implements any appropriate recommendations arising from such an assessment;

(iii) that the corporation's employees, agents and contractors have a reasonable knowledge and understanding of the requirements to comply with the Act and the regulations in so far as those requirements affect the employees, agents or contractors concerned; and

(b) what action (if any) the officer took when he or she became aware that the corporation was contravening the Act or the regulations.[2]

CPRS

Most of the recent public debate on climate change and carbon reduction in Australia has been focused on CPRS. It is proposed that businesses covered under the Scheme will be required to purchase enough emission permits to match their annual GHG emissions where they emit more than 25 kilotonnes of carbon dioxide equivalent (CO2e) or where they are designated as a

1 Personal Liability for Corporate Fault, report by Corporations and Market Advisory Committee, September 2006

2 Section 48 of the NGER Act

"proxy" for downstream emitters. In general terms, at the end of each year, liable businesses under the Scheme will have to surrender to the Government a permit for every tonne of its CO2e emitted that year. A failure to surrender sufficient emissions permits to cover emissions will lead to penalties and potentially a "make good" obligation.

Part 20 of the CPRS Bill 2009 (Bill) provided for liability of executive officers of a body corporate.[3] In essence, if a body corporate contravenes a civil penalty provision, and an executive officer of the body corporate was involved in the contravention, the officer will contravene a civil penalty provision. Section 324 of the Bill provided that liability applies if the executive officer of the body corporate knew, or acted recklessly or negligently and was in a position to influence the conduct but failed to take reasonable steps to prevent the company from contravening a simple penalty provision. It is interesting to note here that the Bill included a "reasonable steps" due diligence defence in similar terms to the NGER Act.[4]

Not surprisingly, on 13 August 2009 the Government's contentious emissions trading laws were voted down in the Senate 42 to 30, with all non-Government Senators voting against the Bill. The Government must now wait three months before reintroducing the same legislation. It is expected that the Rudd Government will reintroduce the CPRS Bill in November 2009 in the hope that it is passed before the United Nations Framework Convention on Climate Change in Copenhagen in December 2009 (UN FCCC).

Corporate climate change litigation: an increase in liability risk

Whilst we await the reintroduction of the Bill, there is value in monitoring regulatory and case law developments in the US. The controversial "Waxman-Markey Bill", otherwise known as the *American Clean Energy & Security Act* (ACES Act) is scheduled to go before the US Senate in September 2009. The ACES Act, the aim of which is to "create clean energy jobs, achieve energy independence, reduce global warming pollution and transition to a clean energy economy", is not unlike CPRS in that its global warming pollution reduction programme is based on a cap and trade system that contains progressively more stringent limits on overall GHG emissions. Given that the ACES Act is expected to be the subject of debate in Copenhagen, it is likely that the Australian Senate will push for its consideration of the CPRS to be deferred until after the result of the US Senate's decision on the ACES Act.

It seems clear that climate change litigation is likely to go far beyond pollution litigation. The new cases and settlements emerging in the US are focusing on the sufficiency of a company's assessment of the financial consequences of climate change and the adequacy of disclosures to stockholders of the effects of climate change on

3 The Bill defines "Executive Officer" of a body corporate to mean:
(a) a director of the body corporate; or
(b) the chief executive officer (however described) of the body corporate; or
(c) the chief financial officer (however described) of the body corporate; or
(d) the secretary of the body corporate.

4 Section 325 of the Bill

the company. With the increase in disclosure requirements, US commentators warn of an increase in liability risks to directors and officers for omissions and material representations.[5]

US regulators have fashioned even greater levels of specificity in climate-risk disclosures. As in Australia, US public companies and their boards are governed by disclosure requirements that were well established before climate change appeared on the world's agenda. A number of major US energy companies are now being required to make periodic disclosure of financial risks posed by climate change and include climate change risk disclosures in their annual reports. One major US energy company makes the following risk disclosures in its annual reports:

- analysis of state regulations relating to climate change, which have a material financial effect on the company
- discussion of trends in greenhouse gas legislation and regulation that would have a material financial effect on the company's business and an assessment of what that financial effect would be
- description of climate change litigation involving the company
- assessment of any climate change related decisions by the US Supreme Court or any court in any jurisdiction in which the company operates that the company concludes is likely to have a material financial effect on its business, and
- analysis of all material financial risks to the company's operations from the physical impact of climate change, including increases in sea levels and weather changes.[6]

The US has also experienced an escalation in the number of shareholder resolution submissions seeking information on whether companies have evaluated, communicated, priced and planned for mitigating exposure to climate change.[7] Various advocacy groups are also pushing for greater climate change related assessments and disclosures by corporations.

Implications for Australian Directors and Officers

In Australia, executive officers are faced with compliance issues such as reporting under the NGER Act and complying with obligations under the proposed CPRS. Failure to do so brings liability for the same maximum civil penalties as the corporation is liable under the relevant provisions.

Directors may find their companies, and potentially themselves, involved in litigation for not only non compliance but also a number of other allegations including damage to the environment, the non disclosure of climate change liabilities, and/ or a breach of directors' duties by failing to prepare or respond to the financial impact of climate change.

5 Carol A.N. Zacharias, Climate Change Is Heating Up D&O Liability, the John Liner Review, Volume 23, No. 1, Spring 2009

6 Investor Protection Bureau, Environmental Protection Bureau, Office of the Attorney General of New York, "Assurance of Discontinuance No. 09-132".

7 Carol A.N. Zacharias, Climate Change Is Heating Up D&O Liability, the John Liner Review, Volume 23, No. 1, Spring 2009, referencing Young, Beth "Whose Carbon Footprint is Too Big for their Corporate Boot?", The Corporate Library (December 2007)

Pursuant to section 299A of the *Corporations Act* 2001 (Cth), listed public companies are required to include in their annual directors' report, information that shareholders would reasonably require to make an informed assessment of the financial position of the company and the company's business strategies and prospects for future financial years. This broad requirement includes matters of environmental significance that could impact a company's future financial prospects.

This anticipated new wave of corporate liability will potentially impact upon the ability of directors and officers to obtain D&O insurance if insurers are not satisfied with a Board's response to climate change. A Board's rigorous approach to assessing climate change risks and disclosing such risks will become a major issue for D&O insurers in determining whether to provide such cover.

Directors and officers will also need to re-examine the scope of cover provided under their D&O insurance, particularly with regard to the availability of cover in certain circumstances for fines and penalties which may arise in respect of liability under the NGER Act and the proposed CPRS. In addition, directors and officers will need to consider the breadth of any exclusion pertaining to pollution and whether notwithstanding such exclusion, cover will at least be available for the costs of defending any litigation arising under these Acts which in many cases are likely to be substantial.

Conclusion

Climate change regulation in Australia is yet to take definite shape, however when it does we are likely to see increased calls from shareholders for disclosure on the economic risk associated with the company's past, present and future GHG emissions as is now emerging in the US. To take advantage of any reasonable due diligence defence, directors and officers should be complying with their reporting obligations under the NGER Act and preparing for the introduction of CPRS. Climate change is no longer just an environmental issue or a compliance risk issue. It is a corporate issue. Boards will be challenged to adequately identify the climate change risks posed to their companies so that they can prepare for them appropriately, make the necessary disclosures and be active in implementing suitable procedures and governance arrangements.

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