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Duty to Protect: Corporate Directors and Climate-Related Financial Risk

by
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- Canada's economic recovery post–coronavirus pandemic will take shape alongside its commitment to achieve net-zero carbon emissions by 2050. Although COVID-19 is an unexpected catastrophe, climate change is an expected one.
- All risks are important, but this E-Brief focuses on climate risk because there is significant government, corporate and public focus on this issue right now, even with the continuing pandemic, including recent announcements by the Bank of Canada, the UK Government and US President Biden[1] on significant climate action.[2]
- It makes the political risks related to climate policy – and the risks that directors will be taken to task for not anticipating the consequences of climate change on their companies, or that their companies will themselves be seen as risky investments for not anticipating them – particularly salient.
- This E-Brief offers insights as to how boards can better gauge and offset these risks. It focuses on the legal duties of corporate directors to act in the best interests of their company as they develop strategies to address climate-related financial risks to their business.
- Canada should clarify and adopt mandatory uniform reporting on climate metrics and finance, so that corporate officers can offer investors information that is transparent, comparable year over year and comparable between companies in a sector.

Climate Change: A Systemic Risk for Canadian Businesses

Climate change presents a unique challenge for Canadian businesses due to the interconnected nature of the risk: the Sustainability Accounting Standards Board (SASB 2015) reports that climate

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1 See https://www.washingtonpost.com/graphics/2020/politics/biden-climate-environment/.

2 For example, from the Bank of Canada, "Bank of Canada and OSFI launch pilot project on climate risk scenarios" (16 November 2020), https://www.bankofcanada.ca/2020/11/bank-canada-osfi-launch-pilot-project-climate-risk-scenarios/; UK Government announcement to make TCFD-aligned disclosures mandatory across the economy by 2025, with a significant portion of mandatory requirements in place by 2023, UK Government, *Interim Report of the UK's Joint Government-Regulator TCFD Taskforce* (9 November 2020), https://www.gov.uk/government/publications/uk-joint-regulator-and-government-tcfd-taskforce-interim-report-and-roadmap; President-elect Biden's Climate 21 Action Plan, (2020) https://joebiden.com/climate-plan/#.

change is materially impacting 72 of 77 industry subsectors. The risk to businesses can be broken down into two components: physical risks and transition risks.

"Physical risks" include acute events such as disruption to business activity from wildfires, hurricanes, extreme rainfall and flooding attributable to climate change, all of which are already damaging business assets and disrupting manufacturing operations and supply chains in Canada (Mercer 2019; TCFD 2017).[3] Sectors such as agriculture and forestry, that may in some respects benefit from increased temperatures, are affected by damage to roads, bridges and other infrastructure caused by extreme weather events; and thawing permafrost and rising sea levels are negatively affecting resource development. The Bank of Canada (Lane 2017) reports that climate change effects are already having a material negative impact on the Canadian economy and financial system. The International Accounting Standards Board notes that potential financial implications include asset impairment, and changes in the fair valuation of assets, in contingent liabilities and in expected credit losses for loans and other financial assets (IASB 2019).

"Transition risks" from climate change include market risks due to changing consumer and investor preferences; policy risks as governments implement carbon pricing and other decarbonization requirements; technological risks as companies adopt low-carbon processes or innovations or languish for failure to adopt them; and reputational risk in respect of investors, consumers and civil society (TCFD 2017).

Transition risks also include "litigation risk" – the costs to companies from lawsuits for damages paid for breach of fiduciary obligation, failure to disclose material financial risks to investors or tort claims as a result of losses due to acute events.[4] Although civil litigation against corporations has not yet commenced in Canada, 1,600 climate cases are pending globally. Some are brought by climate activists against governments pursuing strategies outside the electoral process, but many are initiated by state and municipal governments seeking damages against high-carbon-emitting companies for the costs to repair infrastructure from climate impacts. The allegations against companies in these cases are for breach of statutory disclosure obligations, breach of fiduciary duty and directors' duty of care, for failure to mitigate harms caused by corporations' activities and tort claims for their contribution to climate change. The absence of lawsuits against companies in Canada is because of courts' deference to well-reasoned business decisions, legal rules that allow courts to order the losing party to pay the winning party's legal costs and nascent use of litigation financing to bring class action lawsuits. Canadian cases often wait until US lawsuits set precedents.

Depending on the sector, a company may be more or less at risk. Directors therefore need to consider the risks – now well documented by both the scientific and investment communities – determine what are material to the business, and have a strategy to minimize such risks and capture any opportunities presented by new technologies and energy-saving innovations. Oversight of managers means that directors should be alert to how risks specifically might affect their company, sector and region, including supply chains or distribution of products and services, and what strategies can be deployed to manage those risks.

3 Physical risks can also be chronic, such as loss of freshwater supply for production processes due to sea level inundation into freshwater sources and increased employee morbidity/mortality due to sustained heatwaves.

4 Grantham Research Institute on Climate Change and the Law, "Climate Change Laws of the World Database," 2017, online at http://www.lse.ac.uk/GranthamInstitute/climate-change-laws-of-the-world. US cases are listed in the Climate Litigation Database maintained by Columbia Law School, Sabin Center for Climate Change Law, online at http://climatecasechart.com/us-climate-changelitigation.

Effective governance of climate risk can benefit companies economically because production and transport efficiencies can reduce the cost of products and services. There is also a growing amount of green and transition capital available for firms that move to develop products and services responsive to mitigation and adaptation strategies.

Existing Directors' Obligations Regarding Climate Change

Both the Saskatchewan and Ontario Courts of Appeal have held that human-caused climate change poses an existential threat.[5] Given these appellate court findings, directors and officers can no longer plausibly argue that they are unaware of the serious threat of climate-related legal risks to their companies. Thus, action is required.

The legal standard of fiduciary obligation is long-standing in Canada, enshrined in common law, corporate and financial services laws. At common law, fiduciary obligation includes both a duty of care and a duty of loyalty (Yalden et al. 2017). These common law obligations have been enshrined and strengthened in statutes across Canada. The *Canada Business Corporations Act* (*CBCA*) separates the duties into a duty of care and a statutory fiduciary duty (duty of loyalty), mirrored in every provincial corporations law in Canada. It requires directors and officers to exercise their powers and discharge their duties "honestly and in good faith with a view to the best interests of the corporation" and to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."[6] In 2019, the *CBCA* was amended to clarify factors that directors and officers may consider when acting with a view to the company's best interests, including the interests of shareholders, employees, pensioners, creditors, consumers and governments; the environment; and the long-term interests of the corporation.[7] This language confirms the range of considerations that directors can take into account in their oversight, and allows for a more nuanced balancing of the costs and benefits of particular actions.

The Supreme Court of Canada has been clear that directors and officers must exercise care, diligence and skill, and that their decisions and conduct will be assessed against an objective standard of what a reasonably prudent person would do in comparable circumstances.[8] This "objective standard" means a director's personal views on climate change are irrelevant: given that climate-related risks are widely recognized, directors have a duty to identify and ensure effective oversight of management of the company's exposure to those risks. The Court has held that 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."[9] In *BCE Inc v 1976 Debentureholders*, it held: "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. Where the corporation is an ongoing concern, it looks to the long-term interests of the corporation."[10]

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5 *Reference re Greenhouse Gas Pollution Pricing Act*, 2019 ONCA 544 at paras 3, 104; *Reference re Greenhouse Gas Pollution Pricing Act*, 2019 SKCA 40 at para 4.

6 Section 122(1), *Canada Business Corporations Act*.

7 Ibid.

8 *Peoples Department Stores Inc. (Trustee of) v Wise*, [2004] 3 SCR 461 (SCC) at 491, [*Peoples*]; *BCE Inc v 1976 Debentureholders*, [2008] 3 SCR 560 (SCC) at paras 36–8 [BCE].

9 *BCE*, at paras 66, 81.

10 *BCE*, at para 38; *UPM-Kymmene Corp v UPM-Kymmene Miramichi Inc*, [2002] OJ No 2412 at para 130 (Ont SC), appeal dismissed, *UPM-Kymmene Corp v UPM-Kymmene Miramichi Inc*, [2004] OJ No 636 (Ont CA) [*UPM-Kymmene*].

Managing risk is a core function of board oversight. Boards need to determine if and how climate-related risk is material to the business, and then devise strategies to address that risk as part of their duties to the company.

The courts will assess "reasonableness" by whether boards sought relevant information and exercised prudence in acting on that information in the best interests of the company.[11] "The standard of a "reasonably prudent person" accepts that risk is an unavoidable element of running a business and outcomes will not always be positive" (Hansell 2020, 14). Board-level action is required, however, where risks are material. Distinguished corporate lawyer Carol Hansell writes that the "well-publicized socio-economic implications of climate change risk support the argument that a reasonably prudent person in circumstances comparable to those facing directors today would address the climate change risk facing the corporation and its business" (Hansell 2020, 14). Failure to act on both risks and opportunities leaves companies and their fiduciaries vulnerable to charges that they have breached their duties to the company.

Equally clear is the protection of reasonable business decisions in the face of uncertain outcomes. Provided that directors are duly diligent, do not have conflicts of interest and make decisions within a range of reasonableness, courts will defer to directors' business judgment as to the best interests of the company.[12] They can rely on managers and professionals to advise them, but cannot delegate their duties. Directors' decisions will not be subject to microscopic examination, but the courts have been clear that they will examine directors' decisions.[13] The Supreme Court of Canada has held that the decisions directors make

> must be reasonable business decisions in light of all the circumstances about which the directors or officers knew or ought to have known. In determining whether directors have acted in a manner that breached the duty of care, it is worth repeating that perfection is not demanded. Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, but they 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.[14]

As stewards of governance, directors and officers have a duty to be proactive and to evaluate critically and address the material financial risks and opportunities associated with climate change. Boards must ensure their managers are giving them the most effective information on these risks and opportunities, to allow them to devise short-, medium- and long-term strategies for the business. Balancing these different time horizons, risk factors and different stakeholders is a key responsibility of directors and officers, and as information on climate risk continues to become available, these decisions can be complex.

For publicly held companies, in addition to statutory and common law fiduciary obligations, securities law requires directors and officers to provide timely and accurate information regarding material change in business, operations or capital (Condon et al. 2017). Canadian securities regulators have stated: "Climate change-

11 *UPM-Kymmene*.

12 Peoples, at 492. See also *Maple Leaf Foods Inc v Schneider Corp* (1998), 42 O.R. (3d) 177 at 192; Hutley and Hartford-Davis (2019); Sarra (2018).

13 *BCE*, at para 155.

14 *Peoples*, at para 64.

related risks are a mainstream business issue. Issuers should consider these risks as part of their ongoing risk management and disclosure processes and they must disclose any such risks that are material to their business" (CSA 2019, 2). Their guidance to companies states that, "despite the potential uncertainties and longer time horizon associated with climate change-related risks, boards and management should take appropriate steps to understand and assess the materiality of these risks to their business. Boards are to consider a broad spectrum of potential climate change-related risks over the short-, medium- and long-term" (CSA 2019, 4-5).

We can also learn from previous cases on directors' liability for breach of statutory fiduciary obligation for environmental harms, where the courts have articulated their expectations regarding directors' conduct (Sarra 2018). In *R v Bata Industries Ltd*, the Ontario Court of Justice held that environmental legislation creates a duty on directors and officers to take all reasonable care to prevent the corporation from causing or permitting an unlawful discharge of contaminants that might impair the quality of water, and that, in the exercise of their duties under environmental law, directors and officers are to take guidance from their responsibilities under corporate law to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. The Court also set out baseline considerations for directors' oversight of the actions of individuals charged with managing environmental risks.[15]

Recently, Canadian securities administrators published a list of questions that corporate boards should be asking: Is the board provided with appropriate information to help directors understand sector-specific climate-change-related issues? Has the board been provided sufficient information to oversee appropriately management's assessment of the materiality of climate-related risks? Is the board comfortable with the methodology management uses to capture the nature of climate-change-related risks and assess their materiality? Is the board aware of how investors factor climate-related risks into their investment and voting decisions? Is oversight and management of climate-related risks and opportunities integrated into the company's strategic plan? Has the board considered the effectiveness of the disclosure controls and procedures in place in relation to climate-change-related risks? (CSA 2019).[16]

15 *R v Bata Industries Ltd* 9 O.R. (3d) 329, [1992] O.J. No. 236 (Ont CJ), appealed allowed on issue of indemnification, *R v Bata Industries Ltd* 25 O.R. (3d) 321, [1995] O.J. No. 2691 (Ont CA). In the United States, there is a line of recent cases on directors' "*Caremark*" duties (named after a 1996 judgment), not part of Canadian law, in which the Supreme Court of Delaware has allowed cases to proceed against directors personally, alleging they failed to make a good faith effort to monitor corporate risk and sustainability. One such case is *Marchand v Barnhill*, 212 A 3d 805 (Del 2019), where the Court held that directors have "a duty to exercise oversight and to monitor the corporation's operational viability, legal compliance, and financial performance," and that the particularized facts "supported a reasonable inference that directors failed to implement any system to monitor [the company's] food safety performance." The company, Blue Bell, settled for US$60 million. Two cases that survived early attempts to dismiss and are ongoing are: *Hughes v Hu* (Del Ch 27 April 2020), No 2019-01112-JTL, alleging lack of financial oversight and monitoring, and *Inter-Marketing Group USA Inc v Armstrong* (Del Ch 31 January 2020), for alleged failure to oversee pipeline operations, leading to a significant spill in an environmentally sensitive coastal area.

16 See also the guidance by the Canadian Climate Governance Experts, comprised of 55 senior Canadian lawyers, institutional investors, accountants, CEO, and capital markets experts who are donating their time pro bono to meet with boards of directors to enhance effective governance of climate-related risk, https://ccli.ubc.ca/list-of-canadian-climate-governance-experts/.

In a landmark legal analysis,[17] Carol Hansell observes that "[d]irectors must put climate change on the board agenda. They must require reports and recommendations from management and external sources as necessary, and be satisfied that the corporation is addressing climate change risk appropriately" (Hansell 2020, 1). In respect of potential civil liability for failure to disclose climate-related financial risks, Hansell notes that directors of publicly listed companies should be aware that disclosure is a legal obligation and that directors are not protected by the business judgment rule:[18] "Claims based on disclosure breaches, anchored in operational failures to adequately assess and manage a risk, [may have] a reasonable possibility of success." She further observes:

> Since there can be little doubt that directors are aware of climate change risk, they must inform themselves of the risk that climate change poses to the corporation and how that risk is being managed. If this information is not already included in management reports to the board, the board should direct management to deliver the necessary information to them….Making room in the board agenda for regular reports from management on climate change risk is an important part of the board's oversight of risk, but also sends a clear message to management that climate change risk is a priority. The board might consider conducting an internal assessment or inventory to see how the corporation is currently engaging with climate change as an issue….[Directors] must then receive reports and recommendations from management and reports from external sources as necessary, to be satisfied that the corporation is addressing climate change risk appropriately. (Hansell 2020, 22–4).

Thus, it appears clear that directors need to understand that meeting their duties of care and loyalty requires climate risk to be on the board agenda, tailoring their decisions to the sector and circumstances in which the company operates.

Investors Are Pressing Companies to Reduce Carbon-emitting Activities

Many investors are shifting their investments to renewable energy, energy-efficient technologies and low-carbon innovations. The Caisse de dépôt et placement du Québec has invested more than $10 billion in low-carbon investments, scaling up to $32 billion in 2020; a target of a 25 percent emissions reduction by 2025; and active engagement in pressing investee companies to decarbonize (CDPQ 2020). BlackRock Canada reports that it expects companies to disclose their governance of climate-related risk, and for companies in sectors that are significantly exposed, it expects the entire board to have demonstrable fluency in how climate risk affects the business and oversight of how management is adapting to and mitigating that risk (BlackRock 2020). The Ontario Teachers' Pension Plan has stated that it will consider voting against individual directors who it determines have not taken appropriate action to oversee a company's relevant climate-related risks effectively (OTPP 2020). Institutional investors are increasingly recognizing their own fiduciary obligations in respect of investment decisions aimed at achieving net zero carbon by 2050.[19] In November 2020, the Chief Executive

17 See "Directors on Canadian corporate boards are legally obligated to address climate risk, a new study reveals," press release, Canada Climate Law Initiative, June 25, 2020, online at https://ccli.ubc.ca/press-releases/.

18 Hansell (2020), citing the Supreme Court of Canada in *Kerr v Danier Leather Inc* 2007 SCC 44 at para 54.

19 For a discussion of pension fiduciaries and other asset owners, see Janis Sarra, *From Ideas to Action, Governance Paths to Net Zero* (London, Oxford University Press, 2020).

Officers of eight of the largest pension fund investment managers in Canada, representing $1.6 trillion in assets, issued a statement recognizing the need for a post-pandemic recovery that puts sustainability at the centre of the effort, seeking standardized climate disclosure from portfolio companies aligned with the TCFD framework.[20]

Future access to both debt and equity capital will depend on companies having a clear climate plan in place. Former governor of the Bank of Canada and Bank of England Mark Carney has observed that even holding global warming to 2°C means that 80 percent of coal assets, 50 percent of gas assets and one-third of oil assets are unburnable, and will be stranded (Carney 2020, citing McGlade and Ekins, 2015). Companies thus will need capital to finance the transition away from carbon-intensive production and activities.

A Green-and-Transition-Finance Taxonomy Would Provide Clarity for Directors

Despite the legal clarity in place, more could be done to help directors along the way. Finance has a key role in this regard. A number of international efforts are underway to establish a "taxonomy" – a tool that defines the effect of financial products on carbon emissions. Consistent definitions would help companies, boards, investors, underwriters and issuers navigate the transition to a low-carbon economy. A taxonomy would give investors the ability to assess whether companies are using capital to address climate-related risks and opportunities, and, by extension, would allow boards to report in a consistent manner on how their activities are reducing these risks. A common taxonomy for green-and-transition finance would encourage investor confidence in investments in sustainable finance. Carney has stated: "If we are concerned about this whole-economy transition and we are concerned about mainstreaming sustainable finance, then you need that whole transition bucket in the middle rather than just 'green' and 'brown' (high-carbon-emitting) finance" (Carney 2020).

Canada's largest banks, insurance companies and pension funds are currently funding development of a "made-in-Canada" transition-finance taxonomy that recognizes Canada's heavy dependence on natural resources and other high-carbon-emitting sectors. Working as members of the Canadian Standards Association Transition Taxonomy Technical Committee (TTTC), they are developing "Express Document CSAR1200," which will form the basis both of a Canadian standard in 2021 and of Canada's participation in formulating a new ISO Sustainable Finance Standard.[21] The TTTC has stated that it will support Canada's move toward net-zero emissions, and will propose a classification tool for transition-based financial instruments for all types of financial products that will align with international standards. It is not yet clear whether this process anticipates government regulation or just voluntary standards; either way, it is important that the process embed opportunities for public input before the content becomes enshrined as a standard.

It is critically important that Canada's transition taxonomy align as much as possible with existing international standards in the European Union, UK, the United States, and China.[22] The Canadian taxonomy might

20 https://www.bci.ca/wp-content/uploads/2020/11/Nov-24_Maple-8-CEO-Statement_EN.pdf

21 International Organization for Standardization (ISO) Sustainable Finance Standard (ISO/TC322).

22 European Commission, EU Sustainable Finance Taxonomy (2020), https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en; UK, Climate Bonds Taxonomy (2020), https://www.climatebonds.net/standard/taxonomy; and United States Sustainability Accounting Standards Board, https://www.sasb.org/.The IFRS Foundation in November 2020 is considering creating an International Sustainability Accounting Standards Board; China Climate Bonds Taxonomy, 气候债券分类方案, (being updated 2020), https://www.climatebonds.net/standard/taxonomy.

offer a short-term tool to assist directors, officers and others navigate the transition, but it should adopt, as the primary principle, the goal of moving, within five to ten years, to sustainable finance that creates a resilient and resource-efficient economy aligned with Canada's goal of net-zero carbon emissions by 2050. At the same time, companies and investors need clarity and certainty in respect of financing to support the decarbonization of the economy and the transition to a "circular" economy.[23]

Government Policy Should Support Directors in the Transition

In addition to helping support the development of a common taxonomy, governments could support transition in a number of other ways. To be clear, and as stated above, corporate laws do not need to be amended specifically to include a duty of care in respect of climate risks – it already exists. If, however, governments accept the Expert Panel on Sustainable Finance's (2019) finding of a lack of clarity on fiduciary obligation by some companies, they could take additional action to improve clarity such as engaging in broad public education for businesses regarding their duties, or consider corporate law regulations to make it crystal clear that managing material climate risks (without prejudice to the importance of other risks) is a core obligation. For example, Section 122(1) of the *CBCA* could be amended expressly to embed identifying and managing climate-related risks as a core duty, or best practice regulations issued to that effect. Such a change would offer clear guidance to directors, rather than waiting for an appellate court judgment that explicitly finds them personally liable for failure to act.

To the extent the Canadian federal government, as part of its overall climate strategy, would seek to clarify obligations beyond mere public education, the *Bank Act* and the *Insurance Companies Act* would seem to be natural priorities for either statutory clarification or improved best practice guidance, due to their impact on the economy. BMO, TD Bank and Scotiabank are already implementing disclosure using the TCFD framework.[24] Sections 158 and 748 of the *Bank Act* on duties of bank directors and section 166 of the *Insurance Companies Act* mirror the obligations of directors under the *CBCA* prior to the 2019 amendments. Although the duties of directors under these laws are also clear, the same mandatory language on climate change could make their obligations more transparent to all stakeholders. These sectors are already subject to extensive regulatory oversight, and should not be overburdened, especially with the Office of the Superintendent of Financial Services (OSFI) already requiring insurers to quantify their exposure and to develop strategic approaches to climate risk (OSFI 2019) and the Bank of Canada and OSFI implementing a new pilot program of climate-related scenario stress testing (Bank of Canada 2020).

The Task Force on Climate-related Financial Disclosures (TCFD 2017) recommended that, in order for publicly traded companies to identify and disclose material risks and how they are addressing them, the

23 Transition to a circular economy involves the use of products and services for as long as possible; energy is renewable or highly efficient; and waste is designed out by recovering and regenerating products and materials at the end of each service life (World Economic Forum 2020a).

24 BMO Financial Group 2019 Climate Report, https://corporate-responsibility.bmo.com/wp-content/uploads/2019/12/BMO-2019-Climate-Report.pdf; TD Bank 2019 Environmental, Social and Governance Report (2020), https://www.td.com/document/PDF/ESG/2019-ESG-Report.pdf; Scotiabank 2019 Environment, Social and Governance (ESG) Report, https://www.scotiabank.com/content/dam/scotiabank/canada/en/documents/about/Scotiabank_2019_ESG_Report.pdf.

measurement of climate financial risk and return should use consistent metrics and standards, be part of financial reporting and be verifiable. The federal government has expressed support for the TCFD standards. An important policy decision for Canadian securities regulators now would be whether to implement mandatory TCFD- and SASB-compliant disclosure for issuers, scaling implementation of mandatory disclosure by size of company so as not to overburden companies as they seek to go public. Canadian policymakers should also align governance practices with the TCFD's recommendations. A safe-harbour provision should be adopted for climate-related disclosures, as our understanding of material risks will change as we learn more about and navigate climate change (Sarra and Williams 2019).

Conclusion

The duties of directors and corporate officers already require diligent consideration of climate change risks and opportunities, but more clarity is needed. For some, a green-and-transition taxonomy would allow financial institutions to communicate clearly their investment priorities to stakeholders and how they are managing climate-related financial risks; for others, clarity would help focus their attention on the transformative potential of their operations. Governments could also provide more clarity through legislative reforms – at the federal level, changes to the *CBCA*, the *Bank Act* and the *Insurance Act* or regulatory guidance on best practice. Failure of directors to address the implications of climate change, however, is not an option.

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