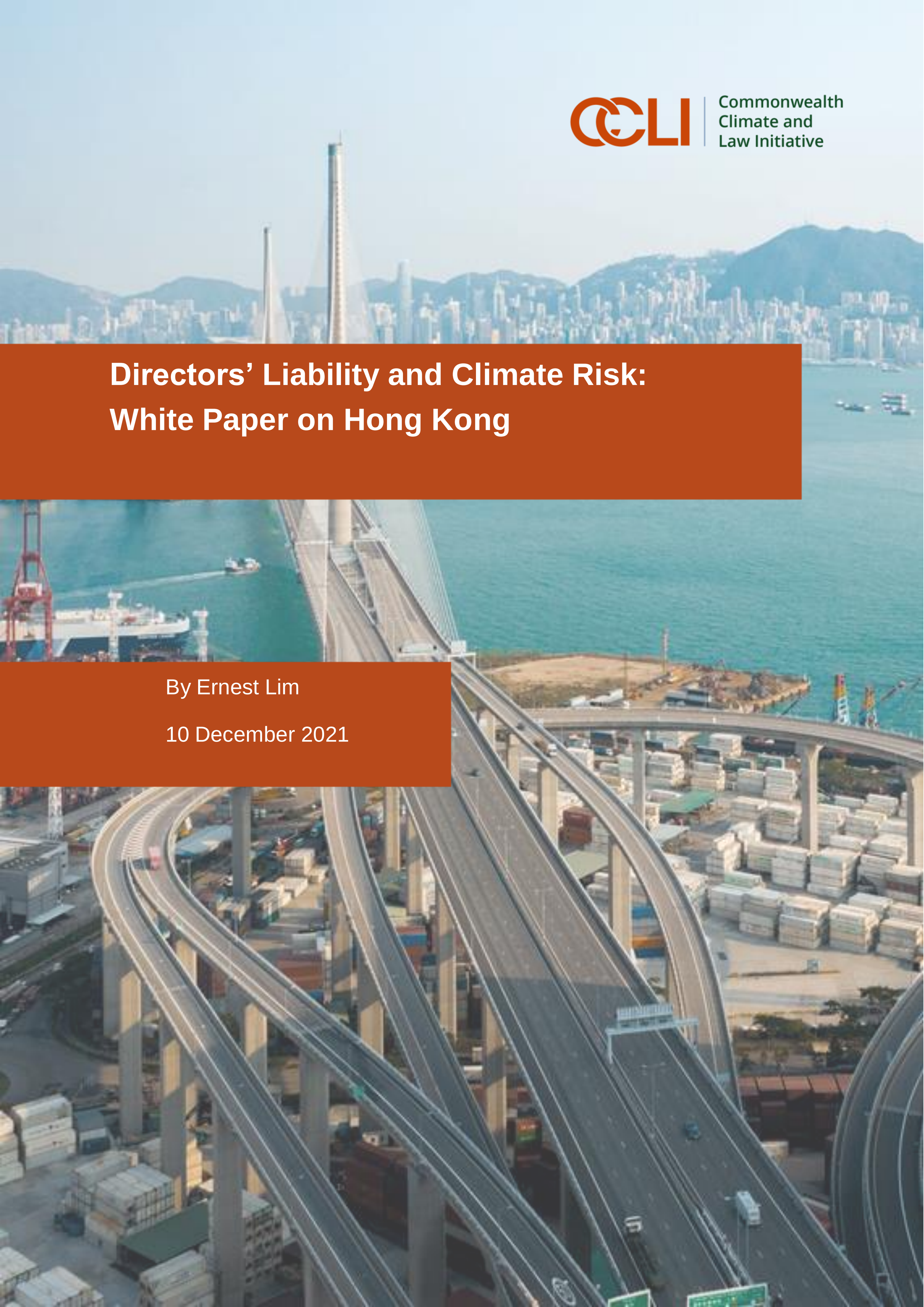
Commonwealth Climate and Law Initiative



Directors' Liability and Climate Risk: White Paper on Hong Kong

By Ernest Lim

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About the Commonwealth Climate and Law Initiative (CCLI)

The CCLI is a legal research and stakeholder engagement initiative founded by Oxford University Smith School of Enterprise and the Environment, ClientEarth and Accounting for Sustainability (A4S). We are a UK non-profit organisation funded by environmental philanthropy and research grants.

We apply existing company law to climate risk in order to drive a rapid and orderly transition towards a net zero carbon economy. We examine the legal basis for directors and trustees to manage and report on climate change-related risk and climate mitigation. Our legal research is at the forefront of the intersection of climate and biodiversity risks under existing companies and securities laws. We commission legal opinions from independent experts within a jurisdiction to build the authoritative evidence base on which to shift mainstream understanding of the requirements of corporate and securities laws to nature crises. We convene conferences, host webinars and stakeholder events to disseminate our findings and build capacity across the corporate, regulator and civil society ecosystem. Our approach is outcome-focused and evidence-led. We have partnered with world-leading behavioural science consultancy Influence at Work to undertake research on the role that psychology plays in understanding how boards engage with the subject of climate change in the boardroom.

We collaborate with leading organisations, such as the World Economic Forum, the Law Society of Singapore, the Society of Indian Law Firms and the C.D. Howe Institute.

Our Canadian partner, the Canada Climate Law Initiative, convenes 60 experts to educate Canadian boards on climate change under the Canadian Climate Governance Experts project. They also provide an online knowledge hub for climate risk and sustainable finance resources.

More information here.

About the Author

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List of Abbreviations

AIs	Authorized Institutions
COP 26	Twenty-sixth Conference of the Parties to the United Nations Framework Convention on Climate Change
D&O	Directors and Officers
ESG	Environmental, Social and Governance
GDP	Gross Domestic Product
GHG	Greenhouse Gases
HKEX	Hong Kong Stock Exchange
HKMA	Hong Kong Monetary Authority
HK$	Hong Kong Dollars
IFRS	International Financial Reporting Standards Foundation
KPI	Key Performance Indicators
NGFS	Network for Greening the Financial System
NGO	Non-Governmental Organisation
SDG	Sustainable Development Goals
SFC	Securities and Futures Commission of Hong Kong
SFO	Securities and Futures Ordinance
TCFD	Task Force on Climate-related Financial Disclosures
UK	United Kingdom
UNFCCC	United Nations Framework Convention on Climate Change
US	United States of America

Executive summary

This White Paper complements and extends the analysis in the "Legal Opinion on Directors' Duties and Disclosure Obligations under Hong Kong Law in the Context of Climate Change Risks and Considerations".

It is well-established that climate-related risks pose a material threat to the financial performance of companies and the authorities in Hong Kong have issued or proposed a variety of measures to address these risks. Under Hong Kong law, directors are required to consider and address these risks. This is because directors are required to act *bona fide* in the best interests of the company. Applying this duty to the climate context, directors are required to monitor and manage the risks arising from climate change as the failure to do so will have an adverse impact on the business and operations of the company, and in turn, the financial interests of shareholders. Directors are also required to exercise reasonable care, skill and diligence in carrying out their functions. Applying this duty to the climate context, they are required to set up effective internal risk management systems, perform adequate due diligence, exercise supervision over those to whom they have delegated the monitoring and management of climate-related risks, ensure there is proper disclosure (of asset impairment and fair valuation) in the financial statements, and refrain from making greenwashing statements. Consistent with such common law and statutory obligations are those imposed by the Hong Kong Stock Exchange listing rules which require boards to bear overall responsibility for issuers' environmental, social and governance (ESG) strategy and reporting, the obligations of which include but are not limited to detailed and granular disclosure of issuers' policies and issuers' compliance with regulations on carbon emissions.

Should directors be in breach of their duties under the common law or statutory law, the board may bring an action against those directors. The director may also be removed by shareholders by an ordinary resolution. If the board decides not to take action against that director, a minority shareholder can bring a derivative action on behalf of the company or may apply to the court for an unfair prejudice remedy. In addition to private enforcement by shareholders, there is public enforcement where the Securities and Futures Commission can apply to the court for an order if it finds that the company's business or affairs have been conducted in a manner resulting in any of its members not having been given all the information with respect to its business or affairs that the member might reasonably expect; or unfairly prejudicial to any of its members.

1 Introduction

1.1 Climate change as a material financial risk

This section demonstrates that the climate-related risks pose a threat to the financial performance of companies. Climate change presents three major risks that do and continue to impact on companies, the broader economy and society. These risks can be categorised into three types: physical risks; transition risks; and liability risks.[1] Given that Hong Kong is an international financial centre with extensive and sophisticated business operations related to asset management, insurance, as well as investment banking and brokerage, these sectors are highly vulnerable to the transition risks of climate change, and the insurance sector is particularly susceptible to both transition and physical risks. Unsurprisingly, the key regulators such as the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) have issued guidelines on the disclosure and management of climate related risks and the promotion of sustainable finance by the relevant financial sectors.

1.1.1 Physical risks

Physical risks include "changes in water availability, sourcing, and quality; food security; and extreme temperature changes affecting organizations' premises, operations, supply chain, transport needs, and employee safety."[2] These physical risks include extreme weather conditions (such as excessive heat, drought and floods) and gradual but consequential weather changes (such as higher temperatures, increased rainfall and rising sea levels). Hong Kong is susceptible to these changes, particularly rising sea levels, which have been projected to increase by 0.73-1.28m by 2091-2100 compared to the average figure from 1986-2005.[3] Storm surges caused by tropical cyclones are associated with temporary sea level rises, which can result in serious flooding in low-lying areas in Hong Kong.[4] Such flooding, which can endanger lives and cause widespread devastation to property and livelihoods, is currently a once in every 50 year event, but is likely to occur once in every five to ten years by 2021-2040, irrespective of whether the level of greenhouse gas (GHG) concentration increases by a low, medium or high amount, and is expected to occur annually by the end of the 21st century.[5] Tropical cyclones, which are also likely to increase in frequency over the 21st century, have also resulted in serious financial losses to Hong Kong. For example, the financial losses caused by the damage resulting from Typhoon Hato in 2017 – flight cancellations, business closures, stock market suspension, and disruption to public transport – amounted to HK$8 billion.[6] In 2018, Typhoon Mangkhut resulted in extensive flooding, causing damage to property and injuries to inhabitants; insurance claims of HK$3 billion were filed.[7]

1.1.2 Transition risks

Transition risks refer to the financial and reputational risks posed to organisations as a result of the legal, technological, regulatory and market changes that are required to be made in order to transition to a net zero emissions economy.[8] These changes include but are not limited to emissions reductions, carbon pricing measures, renewable energy investments, and compliance with applicable laws and regulations.

Transition risks take on a new significance as a result of the Paris Agreement, which came into force in 2016, committing parties to limit the increase in global warming to no more than 2 degrees Celsius, to take efforts to limit it to 1.5 degrees Celsius, and to achieve net zero global emissions in the second half of the century. Although Hong Kong is not a party to the

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1 See for e.g., TCFD, 'Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures' (June 2017), pp. 26-7, available at: https://www.fsb-tcfd.org/publications/final-recommendations-report/.

2 Ibid, p. 6.

3 Hong Kong Observatory, Climate Projections for Hong Kong, 2019.

4 Environment Bureau, Hong Kong Climate Change Report, 2015, p. 59.

5 Ibid.

6 Nikki Sun, Typhoon Hato could cause HK$8 billion in losses after No 10 signal storm brought Hong Kong to standstill, South China Morning Post (23 August 2017).

7 Andrew Tjaardstra, Typhoon Mangkhut: Hong Kong's claims breakdown, Insurance Asia News (25 March 2019).

8 TCFD, n 1, p. 5.

Agreement, it has acceded to it.[9] The recent 26th Conference of Parties to the United Nations Framework Convention on Climate Change (COP 26) culminated in the Glasgow Climate Pact, which reaffirms the goals of the Paris Agreement, recognises that the impacts of climate change will be lower at a temperature increase of 1.5 degrees Celsius, and calls upon parties to transition towards low-emission energy systems.[10] COP 26 also saw a range of announcements and commitments, including an announcement by the Glasgow Financial Alliance for Net Zero (GFANZ) that now comprises members with assets under management of over US$130 trillion, which it has pledged to mobilise to achieve net zero emissions by 2050 or sooner,[11] and a commitment from over 100 nations, including China, to halt and reverse forest loss and land degradation by 2030.[12]

Hong Kong has announced its targets to reduce carbon intensity by 40% by 2025 compared with the 2005 level, reduce carbon emissions by half by 2035 compared with the 2005 level, and to reach carbon neutrality by 2050.[13] China, the world's largest emitter, has set a goal of carbon neutrality by 2060.[14] While Hong Kong does not yet have a carbon tax, China has announced its intention to have one that will cover different sectors starting with coal and gas fired power plants.[15] China's Emissions Trading Scheme will be the world's largest, comprising one seventh of global emissions from fossil fuel combustion.[16] Hong Kong has also announced climate-friendly strategies in relation to decarbonisation, energy saving, transport and waste (including aiming to phase out coal-fired electricity generation by 2035), and renewable energy systems.[17]

Transition risks have also become significant following the recommendations of the G20 Financial Stability Board Task Force on Climate-related Financial Disclosures (TCFD) which set out a framework for the information – including but not limited to stress-testing and scenario planning – to be disclosed concerning the impact of climate-related risks and opportunities on the business conditions of financial institutions.[18] More than 1,500 institutions including over 1,340 companies with a combined market capitalisation of $12.6 trillion and financial institutions responsible for assets totalling $150 trillion have signed up to the TCFD recommendations.[19] These include but are not limited to 28 institutions from Hong Kong, such as the Hong Kong Monetary Authority (HKMA), the Securities and Futures Commission of Hong Kong (SFC), and the Hong Kong Exchanges and Clearing Limited.[20] Importantly, the HKMA has confirmed that the TCFD recommendations on climate disclosures will be mandatory for all relevant sectors by 2025, and has issued draft guidance for consultation on these disclosures, and management of these risks, for Authorized Institutions.[21] The disclosure requirements will apply to financial institutions including banks, asset managers, insurance companies and pension trustees. The TCFD has recently updated its guidance on implementing TCFD disclosures, including requiring banks and asset owners to disclose the extent to which their intermediary activities and investments are aligned with the aims of the Paris Agreement, requiring the disclosure of GHG emissions for assets under management, and requiring disclosing entities in all sectors to disclose of scope 1 and scope 2 emissions independently of a materiality assessment.[22]

Further, the HKMA and the People's Bank of China (which are members of the Network for Greening the Financial System (NGFS), a global coalition of more than 80 prudential supervisory authorities and central banks) have expressed their commitment to regulate climate-related risks which are a source of financial risks by seeking to ensure that the financial

9 Environment Bureau Hong Kong, Hong Kong's Climate Action Plan 2030+ (January 2017).
10 UNFCCC, Proposal by the President, Draft decision -/CMA.3: Glasgow Climate Pact (13 November 2021).
11 Glasgow Financial Alliance for Net Zero, Our Progress and Plan towards a Net-zero Global Economy (November 2021).
12 COP 26, Glasgow Leaders' Declaration on Forests and Land Use (2 November 2021).
13 Energy Saving Plan for Hong Kong's Built Environment 2015 -2025, pg. 5; Environment Bureau Hong Kong, Hong Kong's Climate Action Plan 2050 (October 2021), p. 59.
14 Matt McGrath, Climate change: China aims for 'carbon neutrality by 2060', BBC News (22 September 2020).
15 Huw Slater, Dimitri de Boer, Qian Guoqiang & Wang Shu, 2019 China Carbon Pricing Survey, China Carbon Forum (December 2019).
16 Ibid.
17 Environment Bureau Hong Kong, n 13, pp. 59-63.
18 TCFD, n 1, p. 5-6
19 TCFD, 2020 Status Report, p. 3.
20 See TCFD, 'Supporters' (https://www.fsb-tcfd.org/supporters/) (accessed 14 October 2021).
21 Cross-Agency Steering Group Launches its Strategic Plan to Strengthen Hong Kong's Financial Ecosystem to Support a Greener and More Sustainable Future (HKMA, Press Release, 17 Dec 2020) ; Hong Kong Monetary Authority, GS-1 Climate Risk Management (for consultation) (20 July 2021).
22 TCFD, Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures (October 2021).

system is resilient to these risks.[23] The HKMA has issued a circular on best practices for managing climate risks by major international banks and this is covered by its draft guidance for Authorized Institutions (see above).[24] The People's Bank of China has chaired the workstream on microprudential supervision to establish a framework to supervise climate-related risk disclosure and to consider the extent to which the differences between 'green' and dirty assets pose to financial risks.[25] During COP 26, the HKMA issued a statement, following the NGFS Glasgow Declaration,[26] setting out how it will incorporate climate considerations into carrying out its main functions in maintaining currency stability and promoting the stability and integrity of the financial system.[27]

Other than the HKMA, the SFC has established the Green and Sustainable Finance Cross-Agency Steering Group, co-chaired by the SFC and HKMA, consisting of different key government agencies (including those related to the environment, financial services, pension funds and insurance funds), for the purpose of managing climate-related risks and promoting sustainable finance.[28] The Steering Group has come up with a strategic plan comprising five major action points: first, to make TCFD disclosures mandatory by no later than 2025; second, to adopt the common sustainable finance taxonomy being developed by the International Platform on Sustainable Finance; third, to support the International Financial Reporting Standards Foundation's proposal to establish a Sustainability Standards Board; fourth, to promote climate-focused scenario analysis; and finally, to establish a platform to co-ordinate cross-sector capacity building.[29]

The SFC has also issued a consultation paper on the management and disclosure of climate risks by fund managers, and has recently published the results of that consultation[30] The SFC has announced that it will impose a requirement on fund managers to take into account climate risks (i.e. physical, transition and liability risks) in their investment and risk management processes and to furnish climate-related risk disclosures to investors. [31] Significantly, the proposed requirements oblige large fund managers to make reasonable efforts to disclose scope 1 and 2 emissions of their portfolios;[32] and second, assessment of long-term investment horizons because risks that may not be material in the short-term may become material in the medium and long-term.[33] The SFC also stated that "The board or the board committees should have overall oversight of climate-related issues and set the tone from the top."[34]

1.1.3 Liability risks

Liability risks refer to potential legal claims or regulatory proceedings to which companies and/or directors will be subject. These claims can arise from breaches of different statutes and regulations and violations of the common law.

One study found that that there were more than 1,840 cases as of July 2021 emanating from more than 40 countries.[35] Among these cases, there are two main categories of lawsuits against companies (including financial institutions).[36] The first

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23 Arthur Yuen, Welcome Remarks at HKMA and International Finance Corporation (IFC) Seminar on Greening Financial Institutions (11 October 2019).

24 Hong Kong Monetary Authority, Range of Practices for Management of Climate Risks (7 July 2020); Hong Kong Monetary Authority, n 21.

25 Network for Greening the Financial System, Workstream on Microprudential and Supervision.

26 Network for Greening the Financial System, NGFS Glasgow Declaration: Committed to Action (3 November 2021).

27 Hong Kong Monetary Authority, Supporting the Central Banks and Supervisors Network for Greening the Financial System Glasgow Declaration (3 November 2021).

28 Hong Kong Monetary Authority and Securities & Futures Commission, Joint statement on the establishment of the Green and Sustainable Finance Cross-Agency Steering Group (5 May 2020).

29 Ibid, n 21.

30 Hong Kong Securities and Futures Commission, Consultation Conclusions on the Management and Disclosure of Climate-related Risks by Fund Managers, (August 2021).

31 Hong Kong Securities and Futures Commission, Circular to licensed corporations: Management and disclosure of climate-related risks by fund managers (20 August 2021).

32 Hong Kong Securities and Futures Commission, n 30, p. 39.

33 Hong Kong Securities and Futures Commission, Consultation Paper on the Management and Disclosure of Climate related Risks by Fund Managers, October 2020, para. 52; Hong Kong Securities and Futures Commission, n 30, para. 95.

34 Hong Kong Securities and Futures Commission, n 30, para. 10.

35 Joana Setzer and Catherine Higham, Global trends in climate change litigation: 2021 snapshot, (Grantham Institute, July 2021).

36 Note that not all liability risks involve contributing to climate change or disclosure of climate-related risks as there are cases that involve companies polluting water in violation of statutes (see for eg, *Conservation Law Foundation v Exxon Mobil C.A*. No. 16-

relates to companies' contribution to climate change. The second pertains to companies' failure to disclose climate-related risks. These lawsuits will have important consequences for directors' duties.

On the first category, non-governmental organisations have sued companies – based on a tortious cause of action (comprising negligence and nuisance) – alleging that these companies have caused environmental degradation which resulted in material and adverse harm to certain groups of community.[37] Further, the UK Supreme Court – whose judgments on common law have persuasive (but not binding) effect on the jurisprudence in Hong Kong – has held that it was arguable that based on *de facto* management and a degree of control, a parent company owed a duty of care under English tort law to claimants based in a jurisdiction different from that of the parent company but in the same jurisdiction as that of the parent's subsidiary, the latter of which has allegedly inflicted environmental damage and human rights abuses on the claimants.[38] Included in the first category are also cases brought by shareholders against a company, the cause of action of which is company law and not tort law. For example, a lawsuit was brought by an NGO which was a minority shareholder of a company alleging that the resolution passed by the majority shareholders to approve the construction of coal-fired plant was legally invalid as it was an impermissible instruction under Polish company law, or should be annulled as it failed to consider the serious financial risks to the company and its shareholders; the court ruled in favour of the claimant in respect of the first ground, meaning that it did not need to reach a decision regarding the second ground.[39]

On the second category, there was an Australian case in which a company (a superannuation fund) was sued by its own members for failing to provide adequate disclosure of physical and transition climate-related risks that would impact on the fund's investments, thereby adversely affecting the financial interests of its members. The member alleged that the fund had breached its statutory fiduciary duties and disclosure obligations. The suit was settled in favour of the member, and the company acknowledged, among others, that climate-related risks pose material, direct and current risks to the fund and the management of such risks requires proper and adequate disclosure.[40] There are also cases in which a state has sued a company for making fraudulent misrepresentations in relation to the management of climate-related risks by underreporting these risks.[41]

Six lessons can be drawn from these two categories of cases. First, state and non-governmental organisations can sue and have sued companies for contributing to climate change and other forms of environmental damage. Second, victims of wrongdoing committed by a company can sue and have sued the company or its parent for breach of duty of care under tort law. Third, shareholders or members of the company can bring and have brought legal proceedings against companies for climate-related decisions or climate-related disclosures that harm or may foreseeably harm shareholders' financial interests. Fourth, while such lawsuits do not seem to have yet been brought against companies in Hong Kong, directors must be very mindful of such litigation risks which can result in reputational and financial damage to companies. In light of the increased litigation in other parts of the world[42] and its likelihood in Asia,[43] one cannot rule out the possibility of such lawsuits in Hong Kong. Fifth, should companies in Hong Kong be held liable for violating statutory law, common law or stock exchange regulations, directors may be implicated and they may be liable for breaching the duty to act in the company's best interests and the duty to exercise reasonable care, skill and diligence if the violation can be attributed to the directors' action or inaction.

Finally, even if liability risks are minimised, there remains the concern that the physical, transition and liability risks as a whole can produce systemic risks for the economy, thereby adversely affecting the business and operational performance of companies worldwide, which will have serious impact on the Hong Kong economy, as one of the leading international financial centres. Given the breadth, depth and magnitude of climate-related risks across the economy, there will be

11950-MLW) and companies being held liable for breach of contract for failing to discharge contractual obligations despite force majeure clauses which have been held not to cover climate-related risks (*Stephens Ranch Wind Energy, LLC v Citigroup Energy Inc.* Index No. 652078/2021).

37 See e.g., *Pacific Coast Federation of Fishermen's Associations, Inc. v Chevron Corp* 3:18-cv-07477 (2018).

38 *Okpabi v Royal Dutch Shell Plc* [2021] UKSC 3. See also *Vedanta Resources PLC v Lungowe* [2019] UKSC 20.

39 *ClientEarth v Enea* (2019) http://climatecasechart.com/climate-change-litigation/non-us-case/clientearth-v-enea/; https://www.clientearth.org/latest/latest-updates/news/major-court-win-shows-power-of-corporate-law-to-fight-climate-change/.

40 *Mark McVeigh v Retail Employees Superannuation Pty Ltd* ACN 001 987 739; "Rest Reaches Settlement with Mark McVeigh" (2 Nov 2020), https://rest.com.au/why-rest/about-rest/news/rest-reaches-settlement-with-mark-mcveigh.

41 See e.g., *The People of the State of New York v Exxon Mobil Corporation*, Index No. 452044/2018.

42 Joana Setzer and Catherine Higham, Global trends in climate change litigation: 2021 snapshot, (Grantham Institute, July 2021).

43 Jolene Lin and Douglas Kysar (eds.), *Climate Change Litigation in the Asia Pacific* (CUP, 2020).

endogenous risks involving significant certainty that can have a serious impact on financial stability.[44] Mispricing of assets can result from pervasive exposure to climate-risks and the varying and conflicting expectations of different stakeholders on risks. For example, physical risks arising from the intensity and timing of severe weather conditions and disasters and the correlation between these events and economic outcomes can result in mispricing of assets. In addition, these physical risks can also result in impairment of assets for businesses and diminution of income prospects for households, which can lead to overleverage. The risks caused to these businesses and households will impact on financial institutions that provide loans and other services to them because these institutions may fail to accurately and adequately capture the impact of these risks on their financial models. Should the financial exposures be extensive, there will be contagion effects on the economy. Hong Kong will not be spared. To give a concrete example, because real estate is one of the key pillars of the Hong Kong economy,[45] the physical risks posed by climate-change to commercial and residential properties may lead to a reduction in the value of these assets, which can increase the risks of mortgage-backed securities and real estate loans, thereby affecting the value of real-estate-linked assets held by, and increasing the exposure of, insurers, banks and investment firms. As a result of these climate-related financial risks, financial institutions may underestimate the depth and extent of their exposure to such risks, thereby increasing the risks to financial stability. Accordingly, it is critical that directors understand their legal duties in order to make sure that companies can effectively anticipate and address the physical, transition and liability risks arising from climate change.

1.2 Brief overview of directors' duties

The law governing directors' duties in Hong Kong consists of both common law and statutory law (principally but not exclusively the Companies Ordinance (Cap 622)). The Hong Kong Companies Ordinance defines directors to include any person occupying the position of director (by whatever name called); the definition covers both *de jure* directors and *de facto* directors but not shadow directors (unless expressly stated in statute, such as under s 465 of the Companies Ordinance).[46] The consequence is that these persons are subject to duties under the common law and the Companies Ordinance.

Under Hong Kong law, directors owe fiduciary duties to the company which include the duty to act *bona fide* in the best interests of the company, the duty to avoid unauthorised conflicts of interest and unauthorised receipt of profits, and the duty to act for proper purposes. In addition, directors also owe non-fiduciary duties, the most important of which is the duty to exercise reasonable care, skill and diligence.

1.3 Relationship between statutory and common law duties

The common law fiduciary duties (acting *bona fide* in the company's best interests, avoiding conflicts of interest; and exercising powers for proper purposes) have not been codified; only the common law duty to exercise reasonable care, skills and diligence has been codified in s 465 of the Companies Ordinance. In interpreting and applying s 465, one issue is whether the case law is relevant. On one view, it is not relevant because s 465(4) states that the statutory duty has replaced the common law duty. However, the better view is that it is relevant because the court has held that the statutory duty is derived from the common law.[47] Finally, the Companies Ordinance imposes extensive disclosure obligations which are more onerous than or different from those imposed by the common law.[48]

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44 Bank of England, Prudential Regulation Authority, "Transition in Thinking: The Impact of Climate Change on the UK Banking Sector" (September 2018) at 21ff; United States Federal Reserve Bank Board of Governors, Financial Stability Report (Nov 2020).

45 See e.g., Bart Wissink et al, "Tycoon City: Political Economy, Real Estate and the Super-Rich in Hong Kong" in Bart Wissink et al, *Cities and the Super-Rich: Real Estate, Elite Practices and Urban Political Economies* (Springer, 2017) at 229-252; Roger Nissim, "Hong Kong: A Review of Its Land System, Real Estate Market, and Related Matters" in Bing Wang and Tobias Just, *Understanding China's Real Estate Markets Development, Finance, and Investment* (Springer, 2021) at 71-85.

46 Section 2(1), Hong Kong Companies Ordinance; Stefan HC Lo and Charles Z Qu, *Law of Companies in Hong Kong* (Sweet & Maxwell, 3rd edn, 2018) [7.005].

47 *Securities and Futures Commission v Yin Yingneng Richard* (unrep., HCMP 2502/2012, [2015] HKEC 86), [45].

48 See the disclosure of interests in transactions, property and offices requirements under Part 11, Div 5 of the Companies Ordinance.

2 The Duty to Act in Good Faith in the Company's Best Interests

2.1 Overview of the common law duty

It is trite law that directors are required to act *bona fide* in the best interests of the company.[49] There are two aspects to this duty: *bona fide* and best interests. The *bona fide* aspect consists, primarily, of a subjective element and, to a lesser extent, an objective element. The subjective element lies in the court's consideration as to whether directors have exercised their discretion *bona fide* in what they consider (and not what the court considers) to be in the interests of the company.[50] Thus, a court will be slow to interfere with commercial decisions made honestly but which, on hindsight, were financially detrimental to the company. However, this does not mean that the court will simply accept the directors' subjective assertion; rather, the court will determine the veracity of the directors' assertion on the evidence before it. If the directors' assertion as to their subjective belief is contradicted by evidence, the court may rule that the directors fail the subjective test, i.e. they did not honestly believe that the decision was in the company's best interests. For example, if the directors asserted that they honestly believed that their decision not to address the problem of the company's stranded assets was in the company's best interests, despite the evidence of climate-related risks impacting on the company's financial interests, the directors are unlikely to have met the subjective test.

The test for the objective element – whether an intelligent and honest person in the position of the director of the company concerned could, in the whole of the circumstances, have reasonably believed that an action was taken for the company's benefit – is only applicable if the director has failed to consider the question of whether the action is in the company's interests.[51] If the director has considered the question, only the subjective test will apply; however, the fact that the objective test is inapplicable in such a case does not imply that courts have abandoned their exercise of supervisory powers over the board's decision-making process. This is because if the decision is one that no reasonable director could have ever come to, the court will invalidate the decision. Moreover, courts have held that in discharging their fiduciary duties, directors are required to take into account all relevant considerations and exclude irrelevant ones; the failure to consider a relevant factor renders the decision voidable.[52]

What amounts to the "best interests of the (solvent) company" is determined by reference to the interests of the members as a whole,[53] and these interests are equated with "… their financial interests following from maximisation of the company's profits …"[54] But this does not imply that directors can only focus on short-term profits; rather, directors are required to act in the long-term interest of shareholders as a whole.[55] As the next section shows, the fact that Hong Kong law adopts a shareholder primacy approach is not an issue given that directors are required to take into account climate-related risks insofar as these have a material impact on the company's financial interests as part of their best interest duty.

2.2 Application of duty in a climate risk context

As mentioned earlier, in light of the well-established and widely publicised evidence demonstrating that climate-related risks (particularly physical and transition ones) can have an adverse and material impact on the business and operations of companies, which will affect their long-term financial performance, directors are and should be required under Hong Kong law, in their discharge of their common law duty to act *bona fide* in the best interests of the company, to take into account these climate-related risks in their decision-making process, insofar as these considerations have or are likely to have a material impact on the financial interests of shareholders.

It might be argued, however, that the best interest duty merely requires directors to honestly believe that they are acting in the company's best interests (provided that they have considered the company's interests). Thus, as the argument goes, if the directors honestly believe that in advancing the company's interests, they are not required to consider climate-related risks, they will not be in breach of the best interest duty. However, as examined in the earlier section, the court will ascertain

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49 *Re Smith & Fawcett Ltd* [1942] Ch 304.
50 *Regentcrest plc v Cohen* [2001] 2 BCLC 80, 105; *Extrasure Travel Insurance Ltd v Scattergood* [2003] 1 BCLC 598 [90], [97].
51 *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch 62, 74; *Akai Holdings Ltd v Kasikorn Bank plc* [2010] 3 HKC 153 [64].
52 *Passport Special Opportunities Master Fund LP v eSun Holdings Ltd* [2011] 4 HKC 62 [142]-[156].
53 *Greenhalgh v Arderne Cinemas Ltd* [1950] 2 All ER 1120, 1126.
54 Stefan HC Lo and Charles Z Qu, *Law of Companies in Hong Kong* (Sweet & Maxwell, 3rd edn, 2018) [8.030].
55 Ibid.

the veracity of the director's assertion. Given that there is well-established evidence that climate-related risks have a material financial detriment on the company, the court is unlikely to accept directors' assertions that they have honestly considered the company's best interests and yet have deliberately or negligently failed to account for climate-related risks. However, if directors have not even considered the company's interests, then they are unlikely to have complied with the objective element of the test because an intelligent and honest person in the position of the director concerned could not have, in the whole of the circumstances, failed to consider climate-related risks to the extent that these risks have a material impact on shareholders' financial interests.

There are two matters that warrant elaboration. First, the scope of the obligation to consider climate-related risks. Second, the position if taking into account climate-related risks were to conflict with short-term shareholder value.

Regarding the first issue, the board has to show how it monitors and manages the risks arising from climate change. The process of monitoring and managing should include: (1) ensuring that adequate and appropriate resources and expertise are devoted to identifying and assessing climate-related risks, the process of which should include, but is not limited to, allocating appropriate responsibilities to the relevant senior management and seeking expert advice; (2) identifying, evaluating and disclosing climate-related risks and the types and extent of their impacts on the company; and (3) developing and implementing measures to address the material impacts of these risks[56] such as investing in new technology, adopting low-emission energy sources, and producing low-emission products and services.

Specifically, the monitoring and management of climate-related risks should include scope 1, 2 and 3 emissions. Scope 1 relates to GHG emissions from sources controlled or managed by the company. Scope 2 relates to indirect emissions from sources (such as energy) purchased by the company. And scope 3 emissions are all indirect emissions emanating from the upstream and downstream supply chain of the company and in the case of financial institutions, the emissions generated from sources that are financed by these institutions.[57] One comprehensive empirical study found that climate change and supply chains mutually influence each other through natural disasters and GHG emissions.[58] The monitoring and management of risks related to scope 3 emissions should require directors to carry out due diligence of their supply chain.[59] After all, asset owners, asset managers, insurance companies and banks would need to appraise the due diligence findings in order to gain a clearer understanding of how their underwriting, investments and loans are exposed to carbon related assets.

Directors will fail to meet their obligation to take into account climate-related risks not only when failing to consider those risks; but also when they have considered climate-related risks but failed to (a) take measures to address them; or (b) give proper or adequate weight to them. For example, directors may fail to take measures to address risks if they are aware of them but fail to take action. Directors may be found to have failed to give proper or adequate weight to the risks which they have considered if they failed to seek expert advice or have sought expert advice but unreasonably placed little or no reliance on it.[60]

The second issue – the position where taking into account climate-related risks causes a conflict with short-term shareholder gain – may arise since the measures to reduce or prevent climate-related risks may incur substantial expense. Such measures could include long-term investments in, and deployment of, renewable energy and new technologies; upgrading existing equipment; or rethinking marketing and sales strategy in order to alter consumer behaviour.[61] These measures may entail substantial expenses that could reduce short-term profitability of the company and thus impact short-term shareholder value, but have the overall aim of improving long-term profitability and thus long-term shareholder value.

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56 See for e.g., John Colas et al, "Climate Change: Managing a New Financial Risk" (Oliver Wyman, 2019), https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2019/feb/Oliver_Wyman_Climate_Change_Managing_a_New_Financial_Risk1.pdf.

57 Emma Hawker, "TCFD Scope 3 Review Supports Net-Zero Scrutiny" *Regulation Asia* (21 June 2021); Allens and Linklaters, Targeting NetZzero – A Climate Change Guide for Legal and Compliance Teams in Australia (May 2020) at 14-17, 39.

58 A Ghadge, H Wurtmann and S Seuring, "Managing Climate Change Risks in Global Supply Chains: a Review and Research Agenda" (2019) 58 *International Journal of Production Research* 44.

59 On the duty of companies to carry out supply chain due diligence, see European Parliament Resolution of 10 March 2021 with Recommendations to the Commission on Corporate Due diligence and Corporate Accountability, https://www.europarl.europa.eu/doceo/document/TA-9-2021-0073_EN.html.

60 *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd* [2003] BCC 885, 907-9.

61 GSBGEN 390: Climate Change and Capital Markets (2015), p. 9, https://law.stanford.edu/wp-content/uploads/2015/07/Climate-Change-and-Capital-Markets-FINAL-05-13-2015.pdf.

It is suggested that in such a situation, directors will not be in breach of their duty to act *bona fide* in the company's best interests if they decide to incur such expenditures where there is evidence (however inconclusive) that these measures are in the long-term interests of the company. This is because insofar as corporate interest has been equated with shareholder value, the latter has been understood not in terms of the short-term but long-term horizon.

However, if directors honestly believe that the benefit of improved long-term performance of the company arising from incurring expenditure to address climate-related risks is clearly outweighed by substantial reductions in short-term profitability (because, for example, evidence of such a benefit is equivocal or the costs of investing in new technologies significantly outweigh the benefit), they should not be in breach of the best interest duty if they decide not to incur such expenditure, provided that they have put in place a proper and adequate system of monitoring and managing climate-related risks. This is consistent with the court's approach of not interfering with commercial decisions that are honestly made but at the same time ascertaining the veracity of the directors' assertions.[62]

2.3 Conclusion

Although the duty to act *bona fide* in the company's best interests is a subjective duty (unless the director did not consider the company's interests at all, in which case the objective test will apply), it will not be easy for directors to escape from liability if they have failed to take into account climate-related risks. There are at least three reasons for this.

First, courts will not simply accept a director's word that they have acted honestly, and will instead assess the veracity of this assertion. In light of the well-established evidence that climate-related risks are likely to have a material and adverse impact on the company's financial performance, as demonstrated in the scientific literature and the pronouncements and actions of the regulators in Hong Kong and elsewhere, courts are unlikely to simply accept directors' assertions that they honestly believe that they need not or should not have considered climate-related risks. For example, the HKMA has emphatically stated that "[c]limate change is one of the major risks threatening the well-being of mankind" and has highlighted its "far-reaching impacts in breadth and magnitude", "foreseeable nature but uncertain timing and outcome", "irreversibility", and "dependency on short-term actions".[63]

Second, where the entity is a financial institution, a decision that fails to take into account climate-related risks is vulnerable to be challenged on the basis that it is one that no reasonable director could have made. This is because of the aforementioned extensive pronouncements and proposed and enacted measures regarding climate-related risks that have been announced by the key financial regulators in Hong Kong such as the HKMA and SFC.

Finally, in any event, the failure to take into account climate-related risks insofar as they impact on shareholders' financial interests is likely to be considered a failure to take into account a relevant factor in the board decision-making process, thereby rendering the decision or action voidable by the courts.

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62 Stefan HC Lo and Charles Z Qu, *Law of Companies in Hong Kong* (Sweet & Maxwell, 3rd edn, 2018) [8.044].

63 HKMA, Supervisory Policy Manual, Climate Risk Management (20 July 2021), https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/GS-1_for_consultation_20Jul2021.pdf.

3 Competence – Due Care and Diligence

3.1 Overview of statutory duty

Section 465(1) of the Companies Ordinance states: "A director of a company must exercise reasonable care, skill and diligence." Section 465(2) states: "Reasonable care, skill and diligence mean the care, skill and diligence that would be exercised by a reasonably diligent person with—(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and (b) the general knowledge, skill and experience that the director has." Paragraph (a) sets out the minimum objective requirements that are expected of all directors. Paragraph (b) allows the standard to be raised (but not lowered) to take into account the special knowledge, skill and experience possessed by the director.[64] Both thresholds must be met. Although s 465(4) states that the statutory duty in s 465(1) replaces the common law duty, the existing common law cases that apply the objective and subjective standard are applicable because the statutory duty is derived from the common law.[65]

Three common law principles are relevant to the interpretation of the s 465(1).[66] First, directors have a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business. Second, while directors are permitted to delegate certain functions to management and to rely on their recommendations or advice, directors are required to supervise the persons to whom they have delegated the functions. Finally, although there is no specific rule on how or the extent to which directors should supervise, whether directors have discharged their supervisory obligation will depend on the facts of each case. So for example, if there are no issues that have come or ought to come to the director's attention, then ordinary supervision is required. But if there are matters that put or should put them on inquiry, then a closer level of supervision is warranted.

3.2 Application of duty in a climate risk context

The statutory duty to exercise reasonable care, skill and diligence is applicable to the climate risk context in at least five respects: risk management; due diligence; supervision of delegated responsibilities; the duty pertaining to financial statements; and accurate and adequate disclosures.

Regarding risk management, directors are required to set up an effective internal risk management system that is able to identify, monitor, evaluate and mitigate risks, including but not limited to those related to climate change, to which the company is susceptible and which the company imposes on society. Directors need to put in place reasonable safeguards against financial losses resulting from climate-related risks.

Failure on the part of directors to carry out adequate due diligence could put them in breach of their duty to exercise reasonable care, skill and diligence. Directors are required to engage in due diligence in determining whether the transactions that the company intends to pursue pose any climate-related risks to the company by undertaking adequate risk assessment analysis. The due diligence process should include identifying and assessing all material climate-related risks based on the company's internal risk management system, and if new information or expertise is needed but these are lacking in-house, directors should engage outside experts to identify and evaluate the risks as well as to recommend measures to mitigate those risks. For example, where a transaction involves investment in another company, due diligence would require directors to engage in both negative and positive screening to minimise all material climate-related risks.

Regarding supervision, non-executive directors are required to exercise adequate supervision over executive directors if the former have delegated the responsibility for evaluating and addressing climate-related risks to the latter. Likewise, executive directors are required to supervise management if the latter have been delegated those functions. While the level of supervision will depend on the specific facts of each case, a higher level of supervision will be warranted if the director possesses expertise – such as if the director holds a role pertaining to sustainability or if the director is chair of the audit committee – connected to the delegated functions or if there are matters that put or ought to put them on inquiry.

Regarding the duty pertaining to financial statements, where financial statements that have been approved by the directors of a company fail to disclose matters that are significant to the assessment of the risks facing the company, and the non-

64 *Re D'Jan of London Ltd, Copp v D'Jan* [1994] 1 BCLC 561, 563.
65 *Securities and Futures Commission v Yin Yingneng Richard* (unrep HCMP 2502/2012, [2015] HKEC 86) [45].
66 *Re Barings plc (No 5)* [1999] 1 BCLC 433, 489.

disclosure results in a failure to comply with the accounting standards' requirement to give a true and fair view, directors may be held liable for breaching the duty of care,[67] if their failure to consider climate-related risks have materially affected the disclosure in the financial statements or if they fail to make further inquiries on matters that are warranted by their review of the financial statements. For example, directors will be in breach of the duty of care, if – as a result of their failure to consider the materiality of climate risks (such as the absence of climate scenario analysis, ESG risk evaluations, stress tests, sensitivity analysis or credit risk assessments) in the financial statement line items – material disclosures pertaining to stranded assets are omitted from the financial statements. Similarly, they will be in breach of the duty if the amount of bad debts is understated in the financial statements because they failed to evaluate the impact of climate change on the customer's ability to service and repay loans.[68]

Finally, directors need to exercise care in terms of the disclosures they or the company make in public filings (including any reports the company is required to furnish). Directors may be in breach of the statutory duty to exercise reasonable care, skill and diligence if the company makes negligent or fraudulent misrepresentations under the common law or misleading disclosures pursuant to the listing rules and any statutory law. Directors may also be liable if the company makes public statements such as plans or aspirations to move towards net zero carbon emissions or to achieve a certain level of emissions profile by a certain date, if the company has no reasonable grounds for making such statements.[69]

3.3 Conclusion

Provided that directors have made decisions in good faith, they will not be in breach of the statutory duty to exercise reasonable care, skill and diligence merely because a poor decision was made in hindsight.

Therefore, for example, should directors approve the company's investment in a new technology to mitigate a climate-related risk but bad financial consequences ensue, or decide not to invest in such a technology after a considered cost-benefit analysis which subsequently turned out to be unjustified, it does not follow that they have breached the duty to exercise reasonable care. Rather, much will depend on the precise standard of care that will be applied to the particular director of that company in question. It will also depend on whether the director has exercised an appropriate level of supervision over the people to whom the function of monitoring and managing climate-related risks have been delegated, and whether it was justified for that director to rely on their advice or recommendation. This requires a fact- and context-specific exercise, as discussed earlier. However, should directors approve transactions that pose or foreseeably pose material climate-related risks to the financial interests of shareholders, they are likely to be held liable for breaching the statutory duty to exercise reasonable care, skill and diligence.

67 *ASIC v Healey* (2011) 83 ACSR 484.

68 Deloitte, "Climate Risk and Financial Statement Impacts" (2020) https://www2.deloitte.com/content/dam/Deloitte/au/Documents/risk/deloitte-au-risk-climate-risk-financial-statement-impacts-200720.pdf.

69 There is no Hong Kong case law on point but there is an Australian authority that supports the point that making such statements without reasonable grounds can render the statement maker in breach of consumer law and corporate law: *Australian Competition and Consumer Commission v Woolworths Ltd* [2019] FCA 1039. See Noel Hutley SC and Sebastian Hartford Davis, Further Supplementary Memorandum of Opinion, 23 April 2021.

4 Duty of Disclosure

4.1 Disclosure and reporting requirements

4.1.1 Hong Kong Stock Exchange Listing Rules: continuous obligation disclosure

The Hong Kong Stock Exchange (HKEX) has a duty to ensure, so far as reasonably practicable, an orderly, informed and fair market.[70] To that end, issuers are subject to continuous disclosure obligations under the HKEX Listing Rules, i.e. to disclose inside information as soon as reasonably practicable after the information has come to issuers' knowledge, so that all users of the market have simultaneous access to the same information. A breach of these obligations may result in HKEX taking disciplinary action in addition to its power to suspend or cancel a listing.

Among the specific matters of which the HKEX requires disclosures by issuers, one has a bearing on climate-related risks, i.e. material matters which impact on profit forecasts. Under rule 13.24B(1) of the HKEX Listing Rules, if an event during the profit forecast period would have made the assumptions underlying the profit forecast made by the issuer materially different, the issuer must make an announcement promptly.[71] In addition, under rule 13.24B(2), if there are activities outside the issuer's ordinary course of business that materially contribute to or reduce the profit stated in the profit forecast, the issuer must announce this information.[72]

Economic transition risks during the shift to a net zero emissions economy may amount to such an "event" or such "activities" under rules 13.24B(1) and (2), respectively. This is because the economic transition risks may be the result of policy or regulatory changes that seek to reduce climate-related risks, such as carbon pricing or emissions restriction measures; technological developments, such as those related to renewable energy, electric vehicles, and battery storage; and changes in stakeholder behaviour.

Further, when there is an issuance of securities, the issuer is required to publish an announcement containing a detailed list of prescribed information including any other "material information with regard to the issue".[73] Given that climate change can pose material physical, transition and even liability risks to the company, the failure to disclose material climate-related risks or the deliberate under-disclosure of such risks can amount to a failure to disclose material information. For example, if the issuer fails to take into account climate-related risks, it could produce misleading disclosures in relation to over-valuation of its assets, under-valuation of its liabilities (by under-provisioning for bad debts) or inaccurate disclosure of risk management.

Under s 108(2) of the Securities and Futures Ordinance (Cap 571) (SFO), where a company has made any fraudulent, reckless or negligent misrepresentation by which another person is induced to acquire any securities or investment products from the issuer, the directors of that company will be presumed to have made the misrepresentation unless they prove that they did not authorise the making of the misrepresentation. Under s 281(3)(b) of the SFO, a director may be liable to compensate an investor if he or she has consented to or connived in relation to the company's commission of the relevant act related to market misconduct (which includes misleading disclosures). Finally, under s 307Z of the SFO, investors can sue the company (or its directors) to claim for compensation by way of damages for the losses they have sustained as a result of the breach committed by the company (or its directors).

4.1.2 Hong Kong Stock Exchange: Environmental, Social and Governance (ESG) Reporting Guide

Under rule 13.91 of the HKEX Listing Rules, companies are required to furnish an annual ESG report. In the report, it is mandatory to disclose on a comply or explain basis: (i) the board's oversight of ESG issues; (ii) the board's ESG management approach and strategy, including the process used to evaluate, prioritise and manage material ESG-related issues (including risks to the issuer's businesses); and (iii) how the board reviews progress made against ESG-related goals and targets with an explanation of how they relate to the issuer's businesses.[74] In addition, the issuer must disclose the process and criteria under which they selected the material ESG factors, and the assumptions or methodologies used for reporting

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70 LR 13.05(1) Mainboard; LR 17.06(1) GEM.
71 LR 13.24B(1) Mainboard; LR 17.26B(1)(a) GEM.
72 LR 13.24B(2)(a) Mainboard; LR 17.26B(1)(b). GEM.
73 LR 13.28(15) Mainboard; LR 17.30(15) GEM.
74 LR 13.91 Mainboard LR; S 13, Appendix 27, Environmental, Social and Governance Reporting Guide, https://en-rules.hkex.com.hk/sites/default/files/net_file_store/HKEX4476_3841_VER20.pdf

emissions/energy consumption.[75] Accordingly, should the company fail to provide an explanation for its failure to comply, it would be in breach of the listing rules.

Moreover, on a comply or explain basis, issuers have to furnish within the subject areas (environmental and social) general disclosures and a report on how they have performed using the key performance indicators (KPIs) set out in the reporting guide.[76] For example, under the subject area of "environmental", there are four aspects: use of resources; the environment and natural resources; and climate change.[77] In respect of each of these four aspects, issuers have to produce general disclosures and show whether and how they have complied with the KPIs. With regards to "climate change", issuers have to produce general disclosures on the "policies on identification and mitigation of significant climate-related issues which have impacted, and those which may impact, the issuer".[78] The relevant KPI is for a "description of the significant climate-related issues which have impacted, and those which may impact, the issuer, and the actions taken to manage them".[79]

The HKEX has also released a guide on climate disclosures under the TCFD recommendations.[80] This guide is designed to assist entities in preparing TCFD-aligned disclosures, and anticipates climate-related disclosures aligned with the TCFD recommendations becoming mandatory by 2025, as announced by the Green and Sustainable Finance Cross-Agency Steering Group. The guide states that boards have a responsibility to develop their company's climate change strategy, oversee the management of climate-related issues, and establish mechanisms to be informed of climate-related issues.

While the listing rules do not seem to impose any sanctions on the issuer for failing to comply with the comply or explain disclosure, the company can be liable under the common law for fraudulent or negligent misrepresentations (provided that the elements of causation and losses are also proven).

4.2 Conclusion

An important consideration is whether directors may be held liable for breaching their common law duty to act *bona fide* in the best interests of the company and their statutory duty to exercise reasonable care, skill and diligence, if the company is found to have violated its disclosure and reporting obligations.

In the US, shareholders have brought class action derivative lawsuits against directors for breaching their duties as a result of the company's misleading disclosures related to climate-related risks, but no ruling with regards to directorial liability has been issued yet.[81] In Australia, directors have been subject to liability under the Corporations Act as a result of the company's violation of the same statute such as the provision of misleading disclosures (but none of which so far concernsclimate-related risks). This is known as "stepping stone liability."[82] The first stepping stone is that the company has been found to have breached the Corporations Act (or another law). The second stepping stone is that because the directors have exposed the company to the risk of liability, they have breached the duty of care under the Corporations Act. In Hong Kong, unlike in the US, derivative lawsuits have not yet been brought against directors for breach of duties resulting from the company's misleading disclosures related to climate-related risks. Nor have Hong Kong courts (unlike those in Australia) accepted the stepping stone liability doctrine. But one cannot rule out both possibilities in the future.

75 S 13, Appendix 27, Environmental, Social and Governance Reporting Guide.

76 S 6, Appendix 27, Environmental, Social and Governance Reporting Guide.

77 Part C, Appendix 27, Environmental, Social and Governance Reporting Guide.

78 Part C, Aspect A4: Climate Change, Appendix 27, Environmental, Social and Governance Reporting Guide, p. 7.

79 Ibid.

80 HKEX, Guidance on Climate Disclosures (November 2021), https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Environmental-Social-and-Governance/Exchanges-guidance-materials-on-ESG/guidance_climate_disclosures.pdf?la=en.

81 The US cases are *Ramirez v Exxon Mobil* No. 3:16-CV-3111-K (N.D. Tex. 2018) and *In re Exxon Mobil Corp. Derivative Litigation* 19-cv-01067 (N.J.D). No ruling has been issued yet. For a summary, see by Jonathan E. Meer and Carl Pernicone, "United States: Is Climate Change Impacting D&O Liability?" *Mondaq* (24 September 2021). Although not a shareholder derivative action against the directors, see the Australian case *Australasian Centre for Corporate Responsibility v Santos* in which a shareholder has brought shareholder proceedings under the Corporations Act for alleged misleading disclosures around net zero targets and 'clean energy' representations. No documents have yet been publicly released, but for a summary of the case see by Angela Macdonald-Smith, "Santos sued over 'clean energy' claims, *Australian Financial Review* (26 August 2021).

82 Ian Ramsay and Miranda Webster, "An Analysis of the use of Stepping Stones Liability against Company Directors and Officers" (2021) 50 *Australian Bar Review* 168-198.

5 Establishing Liability

5.1 Evidentiary requirements

Under the common law and its statutory equivalent under s 466 of the Companies Ordinance, a breach of the directors' duty to exercise reasonable care, skill and diligence (a non-fiduciary duty) will result in common law damages, whereas a breach of the duty to act *bona fide* in the company's best interests (a fiduciary duty) will result in equitable compensation.

In the case of equitable compensation, which may be ordered if it is found that a director has breached their duty to act *bona fide* in the best interests of the company, the claimant has to prove "but for" causation; however, the elements of foreseeability and remoteness will not apply.[83] Thus, all consequential losses flowing from the breach of an equitable obligation are recoverable once the claimant can show that the breach caused the loss complained of — a claimant would not need to show that a specific loss was attributable to a foreseeable climate-related risk, only that the loss was caused by the directors' breach of their duty to act *bona fide* in the company's best interests. In cases where an alleged breach of this duty was caused by an omission on the part of a director, rather than the commission of an action by them, the claimant does not need to demonstrate a definitive link between the omission and the loss (i.e., the claimant does not need to prove that, had the directors performed their duty properly, the loss would not have occurred), because the court arguably only has to construct a "a necessarily hypothetical edifice so as to ascertain what would probably have happened if the relevant duties had been performed."[84] Therefore, it is possible that an omission to consider climate change-related risks may be more likely to give rise to liability for a director, as the court may impute the losses based on a hypothetical counterfactual.

In the case of common law damages, the claimant has to prove causation, and the elements of foreseeability and remoteness will apply.[85] Therefore, the claimant may encounter difficulty in demonstrating that it was within the reasonable contemplation of the directors that the loss suffered was due to the failure to take into account climate-related risks. But this difficulty should not be overstated if the market practice – as shown in the expectations of shareholders – demonstrates otherwise and in light of the advancements in scientific literature on attribution which demonstrate the causal link between the climate-related risks and the losses complained of.[86]

In short, where directors have failed to consider climate-related risks insofar as these have a material impact on the shareholders' financial interests, it is arguable that it may be easier for shareholders to establish liability on the part of the directors in a claim that directors have breached their duty to act *bona fide* in the company's best interests rather than a claim that directors have breached their statutory duty to exercise reasonable diligence.

5.2 Possible defences

Section 903 of the Companies Ordinance provides that if directors have been liable for negligence, default, breach of duty or breach of trust, but have acted honestly and reasonably, and if they ought fairly to be excused, having regard to all the circumstances of the case, the court may relieve them either wholly or partly from liability.

In order for relief to be obtained, two elements must be proven by the director: first, he or she has acted honestly; and second, he or she has acted reasonably.[87] But directors who ignore or downplay climate-related risks in their decision-making process where these have a material bearing on the financial performance of the company could not be said to have acted reasonably. Once these two elements have been proven, the court has to decide whether he or she ought fairly to be excused, having regard to matters including but not limited to the position held by the director, and the seriousness of the breach and the consequences.

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83 *Target Holdings Ltd v Redferns* [1996] AC 421; *AIB Group (UK) plc v Mark Redler & Co Solicitors* [2014] 3 WLR 1367.

84 *Lexi Holdings Plc v Luqman* [2008] EWHC 1639 (Ch), [28].

85 *Kao Lee & Yip v Koo Hoi Yan Donald* [2003] 3 HKLRD 296, 312-3; *Thanakhrn Kasikorn Thai Chamkat (Mahachon) v Akai Holdings Ltd (No 2)* (2010) 13 HKCFAR 479, [155].

86 Rupert Stuart-Smith et al, "Filling the Evidentiary Gap in Climate Litigation" (2021) 11 Nature Climate Change 651.

87 Directors who have been negligent may still be relieved from liability under s 903 if the negligence was minor and inconsequential: *Barings plc v Coopers & Lybrand* [2003] EWHC 1319, [1133]-[1134].

5.3 Personal liability and availability of D&O insurance

5.3.1 Ratification

Section 473 of the Companies Ordinance permits shareholders to ratify the conduct by a director involving negligence, default or breach of duty in relation to the company at a general meeting. However, the votes of the interested director cannot be counted in the ratification but can be counted towards the quorum. The difficult question is whether there are restrictions or limitations on the ratification, although nothing is stated in the statute. It has been said that insofar as creditors' interests are not adversely affected[88] or there is no violation of the capital maintenance rules,[89] any act is generally ratifiable.[90]

Thus, where directors have breached the duty to exercise reasonable care, skill and diligence or the duty to act bona fide in the best interests of the company by failing to consider climate risks, the company's shareholders, voting at a general meeting, can ratify these acts. However, ratification by a general meeting does not in itself preclude the court from granting permission to a member of the company to bring a derivative action; nor can ratification be a basis for the court to determine the derivation action in favour of the defendant.[91]

5.3.2 Exemption, indemnification and insurance

Under ss 468(2) and (3) of the Companies Ordinance, any provision in a contract or in the corporate constitution that exempts directors from liability or indemnifies them against any liability, in connection with any negligence, default or breach of duty to the company, will be void. However, insurance taken out by the company for the director for any negligence, default or breach of duty (except for fraudulent breaches) is permitted.[92]

Further, a company can indemnify a director against any liability to a third person except liability that is incurred as a result of (a) breaching the criminal law or other regulations or (b) lawsuits brought by the company against the director or by shareholders in derivative actions.[93] Thus, for example, should directors be liable for breaching the disclosure requirements under HKEX Listing Rules or the SFO, no indemnification is permitted.

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88 *Chintung Futures Ltd v Arthur Lai Cheuk Kwan* [1994] 1 HKLR 95; *Re PV Solar Solutions Ltd* (in liq) [2018] 1 BCLC 58.

89 *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 Ch D 519; *Re Halt George* (1964) Ltd [1982] 3 All ER 1016.

90 Stefan HC Lo and Charles Z Qu, *Law of Companies in Hong Kong* (Sweet & Maxwell, 3rd edn, 2018) [8.190].

91 S 734(1)(b) and (c). But the court can take the ratification into account in deciding what order to make: s 734(2).

92 S 468(4)(a), Hong Kong Companies Ordinance.

93 S 469(2), Hong Kong Companies Ordinance.

6 Enforcement

6.1 Derivative action

The proper claimant for a claim for loss suffered by a company is the company itself; in such a case, the board would decide whether or not to bring the claim. However, if the board decides not to pursue a claim, a shareholder may bring a derivative action on behalf of the company. Therefore, if a board decided not to bring a claim against a director for a breach of his or her duties, a shareholder of the company could bring a derivative action on behalf of the company against the delinquent director.

Common law and statutory derivative actions are available under Hong Kong law in order to address breaches of duties committed by directors against the company. In order for the common law action to succeed, the claimant has to prove that the wrongdoer has committed a fraud on the minority.[94] However, the fraud exception to the proper plaintiff rule is subject to two restrictions. First, while the meaning of fraud includes equitable fraud (i.e. abuse or misuse of power) and breach of directors' fiduciary duties, negligence (i.e. breach of the duty to exercise reasonable care, skill and diligence) does not fall within the meaning of fraud unless directors have profited from their wrongdoing.[95] Thus, if the delinquent director has breached the duty to exercise reasonable diligence but has not obtained any benefit, the fraud exception will not be satisfied. This will pose an obstacle to a potential claim by shareholders where directors have been negligent because they have failed to monitor and manage climate-related risks that have a material impact on the company's business, but they have not obtained any benefit. By contrast, in a statutory derivative action, there is no requirement for the wrongdoer to have gained a benefit. The Hong Kong Companies Ordinance uses the term "misconduct" – "fraud, negligence, breach of duty or default in compliance with any Ordinance or rule of law"[96] – which term is wider than equitable fraud.

The second restriction is that the claimant has to prove that the wrongdoer is in control of the company.[97] If the board which has the power to sue under the corporate constitution is not subject to the wrongdoer's control, the fraud exception does not apply. But there is no requirement to prove the wrongdoer control requirement in a statutory derivative action.

In view of the hurdles to the common law derivative action, shareholders may resort to the statutory derivative action under s 732 of the Companies Ordinance. Nevertheless, there is one situation where the common law derivative action may be the action of choice for shareholders wishing to bring a claim: if a company is neither incorporated in Hong Kong nor falls within the definition of "non-Hong Kong companies" (which are companies incorporated outside Hong Kong which have established a place of business in Hong Kong[98]), only the common law derivative action can be brought (provided that the law of the place of incorporation of the company recognises common law derivative action).[99]

Unlike the common law derivative action, permission has to be sought from the court to bring the statutory derivative action. Only members have standing to bring action and the criteria according to which the court will grant leave for a member to bring the action are: (1) there is a serious question to be tried ; (2) it appears to be in the company's interests that leave be granted; (3) the company has not itself brought proceedings; and (4) the member has served 14 days' written notice to the company before the member applies to the court for leave.[100]

The first requirement of a serious question to be tried is a low threshold,[101] comparable to that of an application for an interlocutory injunction.[102] The applicant is merely required to demonstrate that the company has some prospect of success in the action at the full trial; the court should hesitate to find against the claimant unless the prospects of success are slim.[103] The second requirement that the action is in the company's interests is also a low threshold because of the word "appears" – the applicant only needs to show that an arguable case subsists.[104] It is pertinent to note that just because the company

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94 *Anglo-Eastern (1985) Ltd v Knutz* [1988] 1 HKLRD 322; *Waddington Ltd v Chan Chun Hoo* (2008) 11 HKCFAR 370, 380.
95 *Daniels v Daniels* [1978] Ch 406, 413.
96 S 731, Hong Kong Companies Ordinance.
97 *Tam Lai King v Incorporated Owners of Malahon Apartments* [2010] 5 HKLRD 63 [59].
98 S 2, Hong Kong Companies Ordinance.
99 *Waddington Ltd v Chan Chun Hoo* (2008) 11 HKCFAR 370 [55].
100 S 733, Hong Kong Companies Ordinance.
101 *Re Grand Field Group Holdings Ltd* [2009] 3 HKC 81 [21]; *Re Li Chung Shing Tong (Holdings) Ltd* [2011] 5 HKLRD 274, 285.
102 *Re F & S Express Ltd* [2005] 4 HKLRD 743, 746.
103 *Re Li Chung Shing Tong (Holdings) Ltd* [2011] 5 HKLRD 274, 285; *Leung Tung Hoi v Lai Yip Dyeing Factory Ltd* (unrep CACV 54/2015, [2017] HKEC 1775).
104 *Re F & S Express Ltd* [2005] 4 HKLRD 743, 746.

has not suffered financial losses does not mean that the derivative action is not in the company's interests because the proceedings may be connected to mismanagement of the company which has to be rectified.[105]

However, the most important disadvantage of the derivative action (both common law and statutory) is that any damages that the court will award will go to the company and not to the shareholder who brought the derivative action. This, coupled with the prohibition of contingency fee arrangements and class action suits in Hong Kong, often disincentivise derivative actions from being brought.

That said, even if minority institutional or retail shareholders are reluctant to bring derivative lawsuits for the above reasons, one cannot rule out the possibility that environmental NGOs will buy shares in the company in order to bring such an action (provided that the four criteria for granting leave are satisfied). This is one of the strategies that has been adopted with success in other jurisdictions, and companies in Hong Kong must be prepared for this possibility.[106]

6.2 Unfair prejudice

Generally, breaches of directors' duties amount to wrongs done to the company and thus a derivative action is the appropriate course of action. But for wrongs committed personally against the claimant, the unfair prejudice remedy is the appropriate course of action. The unfair prejudice remedy is available to both Hong Kong companies and non-Hong Kong companies.[107] Members, including past members, personal representatives and the Financial Secretary can bring a petition for unfair prejudice.[108] Under s 724(1) of the Companies Ordinance, a member of a company may apply to the court for a remedy where the company's affairs are conducted in a manner unfairly prejudicial to the member's interests; or an actual or proposed act or omission of the company is or would be so prejudicial. Members' interests include financial[109] and non-financial interests.[110]

The elements of both unfairness and prejudice must be established. Prejudice includes damage to financial[111] and non-financial interests.[112] Breaches of directors' fiduciary duties such as the duty to act *bona fide* in the best interests of the company,[113] breaches of listing rules[114] and other applicable statutory rules can amount to unfair prejudice.[115] Thus, a director's failure to take into account climate-related risks insofar as these risks are likely to impact on the company's financial interests can amount to unfair prejudice. Similarly, if directors fail to make the requisite disclosures on climate-related risks in breach of the regulations, that may amount to unfair prejudice.

In addition to private enforcement, public enforcement is available.[116] The SFC can apply to the court for an order if it finds that the company's business or affairs have been conducted in a manner either: resulting in any of its members not having been given all the information with respect to its business or affairs that the member might reasonably expect; or unfairly prejudicial to any of its members.

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105 *Yu Yuchuan v China Shanshui Investment Co Ltd* (unrep. HCMP 360/2015, [2015] HKEC 437) [42].

106 "Major Court Win Shows Power of Corporate Law to Fight Cimate Change" ClientEarth (1 August 2019), https://www.clientearth.org/latest/latest-updates/news/major-court-win-shows-power-of-corporate-law-to-fight-climate-change/; "Green Investors Are Embracing Litigation: Some Are Winning" *Economist* (21 November 2020).

107 S 722(1), Hong Kong Companies Ordinance defines company to include non-Hong Kong company, the latter of which are companies incorporated outside Hong Kong and which have established a place of business in Hong Kong (see s 774 Companies Ordinance).

108 S 724(1)-(3), Hong Kong Companies Ordinance.

109 *Securities and Futures Commission v Mandarin Resources Corp Ltd* (unrep, HCCW 348/1996, [1999] HKEC 688) (CFI).

110 *Jaber v Science and Information Technology Ltd* [1992] BCLC 764.

111 *Nicholas v Soundcraft Ltd* [1993] BCLC 360.

112 *Wong Man Yin v Ricacorp Properties Ltd* (2003) 6 HKCFAR 265.

113 *Re Forecast Nominee Ltd* [1996] 4 HKC 12; *Re Texgar Ltd* [2002] 1 HKLRD 687; *Re Bondwood Ltd Development Ltd* [1990] HKLR 200; *Re Playmates Investments Ltd* [1996] 4 HKC 577.

114 *Luck Continent Ltd v Cheng Chee Tock Theodore* [2013] 4 HKLRD 181.

115 *Re Asia Television Ltd* [2015] 1 HKLRD 607.

116 S 214, Securities and Futures Ordinance (Cap 571).

6.3 Remedies

The remedies that the court can award pursuant to a statutory derivative action are not spelled out in the Companies Ordinance. Where there is a breach of fiduciary duty, equitable remedies such as account of profits, recission, restitution and equitable compensation is available. Where there is a breach of the statutory duty of care, compensation is available and the common law principles of causation, remoteness and measure of damages will apply.

The remedies that the court can award for oppression are stated in s 725(2) of the Companies Ordinance; these include: restraining the unfairly prejudicial conduct; ordering proceedings to be brought in the company's name; regulating the company's future affairs in future; requiring the purchase of the shares of any member; ordering the company or any other person to pay damages to a member; and any other order that the court deems fit.

Where the SFC applies to the court for an order, the relief that the court can grant includes (1) requiring an act to be carried out or not to be carried out; (2) ordering the company to sue any person; (3) removing any director or officer; and (4) making any order that the court considers appropriate.[117]

117 Ibid, s 214(2).

7 Conclusion

In light of the extensive and well-established evidence that climate-related risks pose material threats to the interests of a company, and because of the measures taken by the Hong Kong regulatory authorities to address climate-related risks, a reasonable director is legally required to take into account climate-related risks in the discharge of his or her duties to the company, failing which the director can be held personally liable; there may also be adverse reputational repercussions on that director and the company.

Such legal requirements are manifested not only in the law governing the duties of directors to act *bona fide* in the best interests of the company and to exercise reasonable care, skill and diligence, but also in the disclosure obligations imposed by the listing rules and other applicable regulations.

Should directors be in breach of their duties under the common law or statute, they may be dismissed by the general meeting or sued by the board. Shareholders can also bring civil proceedings against them. The SFC can also bring enforcement action. Finally, one cannot rule out the possibility that the company (but not the directors) may be sued by other interested parties (who are non-shareholders).[118]

118 See for e.g., Asian Development Bank, Climate Change, "Coming Soon to a Court Near You: Climate Litigation in Asia and the Pacific and Beyond" (Dec 2020).