Directors' personal liability for corporate inaction on climate change

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- A proactive stance on governance of climate change is now seen as consistent with financial wealth interests.
- Boards must actively engage with how the issue of climate change impacts on their operations, risk and strategy.
- A passive approach to climate change governance may be inadequate to satisfy directors' duties of due care and diligence.

The science relating to climate change is no longer in credible dispute. Its biophysical impacts — from gradual increases in average global temperatures and sea levels, to more frequent extreme weather events — present unparalleled economic risks and opportunities to strategically placed corporations.

Corporations who do not proactively adapt face increasing competitive disadvantage, bringing with it the prospect of value impairment and, in some cases, insolvency. Accordingly, climate change can no longer be treated as an environmental 'externality', but as a material determinant of corporate wealth.

At the same time, courts are demanding higher standards of proactivity and engagement from corporate boards in order to satisfy their statutory directors' duties.

Taken together, these developments prompt the question whether common corporate governance approaches to (or inaction on) climate change may contravene directors' primary duties under the *Corporations Act 2001*.

This research concludes that passivity, reactivity or inactivity on climate change governance is increasingly likely to contravene the duty of care and diligence under s 180(1) of the Corporations Act. Specifically, this includes governance strategies that emanate from climate change denial, a failure to consider its impacts due to ignorance or unreflective assumption, paralysis caused by the inherent uncertainty of its magnitude and timing, or a default to a base set by regulators or industry peers. In addition, even considered decisions to prevail with 'business as usual' are increasingly unlikely to satisfy the duty (or the 'business judgment rule' defence) — particularly if they are the product of a conventional methodology that fails to recognise the unprecedented challenges presented by an erratically changing climate. Accordingly, directors who do not proactively respond to the commercial risks and opportunities of climate change, now, may be held to account under the Corporations Act if corporate value becomes impaired into the future.

A change is occurring, in two contexts…

The evolving relationship between climate change and financial wealth

Historically, climate change was often regarded as an ethical issue for corporations — a 'non-financial environmental externality' that was secondary to, and largely inconsistent with, the commercial imperative to maximise financial returns. However, the relationship between climate change and financial wealth continues to rapidly — and radically — evolve. Front-page headlines report that the United Nations and its Intergovernmental Panel on Climate

Change, the International Energy Agency, the World Meteorological Organisation and our own Commonwealth Scientific and Industrial Research Organisation and Bureau of Meteorology, consider that the science on climate change has solidified. The economic and financial implications of the science have been examined by institutions such as the International Monetary Fund, World Bank, World Economic Forum, Organisation for Economic Co-operation and Development and Carbon Disclosure Project (representing 767 institutional investors with over US$92 *trillion* of assets under management), who conclude that the *economic* consequences of observed, committed and potential climate change are significant — if not unparalleled. Regardless of directors' personal views on climate change, the positions being taken by such significant stakeholders suggest that the issue presents material financial risks and opportunities, which must be actively considered in the pursuit of wealth-based interests.

Increasingly, a proactive governance response to climate change is not only consistent with, but essential to, the maximisation of corporate value. There is no doubt that many corporations will suffer value impairment (if not insolvency) as a result of the observed, committed and potential impacts of climate change. Where they do, shareholders may look to the governing directors (and their deep-pocketed insurers) to recover their loss. And courts will assess whether directors adequately discharged their duties to govern the relevant risks and opportunities, today. So what does this mean for directors who remain passive, inactive or reactive in their approach to climate change?

Directors' duties

A director's primary duty of 'competence' is that to exercise 'due care and diligence'. In Australia, this duty is codified in section 180(1) of the Corporations Act, which requires directors to exercise the degree of care and diligence that a *reasonable person* would apply in the circumstances.

The courts apply the subjective characteristics of the director and their corporation (including the type of company involved, the size and nature of its business or businesses, its constitution, the composition of the board and its reserved powers, and whether the company is public or private)[1] to an objective assessment of whether the director has taken '*all reasonable steps to be in a position to guide and manage the company*'.[2] This, in turn, requires a balancing of the magnitude of the relevant risk (its gravity, frequency and imminence) and the probability that it will crystallise, as against the *expense, difficulty and inconvenience* of any countermeasures, and the defendant's *conflicting responsibilities*.[3]

Within this framework, it is clear that *proactivity* and *engagement* are necessary to discharge a director's duties. In recent cases the courts have emphasised that there are certain *minimum* obligations inherent in the duty of care. In short, a 'reasonable' director must:

(a) proactively acquire, and maintain, an '*irreducible core*' of knowledge and understanding of the fundamentals of their corporation, including in relation to its activities, its financial position and the relevant regulatory framework

(b) monitor corporate affairs and policies

(c) 'take a diligent and intelligent interest in the information available to them or which they might appropriately demand from the executives or other employees and agents of the company'.[4]

This knowledge must be brought to bear by the director in an *independent* and *critical evaluation* of the matters for which they are responsible.[5]

A defendant director's conduct must, of course, be assessed on the facts of each case — which will vary across sectors, geographies and companies. However, a number of general observations can be made in respect of the diligent governance equation with regard to climate change. The *probability* that climate change is occurring, and will continue to occur, must now be regarded as virtually certain. It is also beyond question that *magnitude* of the commercial risks and opportunities presented by climate change are significant — if not unparalleled. The need for economy-wide mitigation, at scale and speed, to avoid catastrophic climate change, and for individual corporations to adapt to observed and future 'committed' climate change that is now locked in (at a minimum), is unavoidable.

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In this general governance context, what does the development in the science and economics on climate change mean for specific governance action (or inaction) on risks and opportunities associated with climate change?

What do these developments mean for directors in governance practice?

To satisfy the duty of due care and diligence, it is the *process* of information gathering and deliberation that is critical. The relevant inquiry is whether, in their oversight of corporate strategy and performance against its objectives, the directors are appropriately informed and engaged in relation to risks and opportunities, have sought expert advice where warranted, have constructively evaluated the strategic consequences of material issues with methodologies and assumptions that are fit for their forward-looking purpose.

This is not to say that directors are duty-bound to decarbonise their operations, or that environmental sustainability must be universally prioritised. Nor does it suggest that directors must reconsider the nature of their shareholders' 'best interests' and extend them to incorporate external, ethical goals. But it does mean that boards must actively engage with how the issue of climate change impacts on their operations, risk and strategy.

Whilst the broad prerequisites to 'due diligence' in governance are relatively straightforward, it is difficult to list actions which can be 'checked off' to satisfy the duty. However, it is possible to set out those reasons for inaction on climate change that are unlikely to satisfy the duty — *even where directors' subjective bona fides are not in question*. These include:

(a) Denial — overt denial or climate change scepticism.

Even if there *were* circumstances in which a director could establish that their climate change denial was both honestly held and based on robust information gathering and analysis, such robust systems would also necessarily inform the director that their view *differs* from that of the overwhelming majority of regulators, insurers, creditors and other market stakeholders. This presents, at a minimum, indirect stakeholder risks, and likely direct regulatory, litigation, market and insurance risks, that must be managed in order to maximise corporate wealth. Accordingly, a 'reasonable' director could not also genuinely maintain that the risks and opportunities presented by climate change were insignificant or improbable — *regardless of whether the prevailing consensus conflicts with their genuine personal ideologies*.[6]

(b) Honest ignorance — a failure to consider the risks and/or opportunities presented by climate change (at all, or in relation to specific projects).

It is extremely unlikely that ignorance of the observed, anticipated or potential impacts of climate change could now be defended as the conduct of any 'reasonable' director. Directors have a positive obligation to apply an inquiring mind to their role, bringing to bear knowledge that they ought reasonably have known about the corporation and its operational context.[7] It has been clearly established that the duty to exercise care and diligence is not limited by the director's subjective ignorance or inaction (or, by extension, the fact that their knowledge is outdated) — even where they are acting with subjective honesty and in good faith.[8] This may include '*failing to make relevant inquiries or raise matters which ought to have been raised*',[9] or a failure to '*join the dots*'.[10]

It is clear that an issue of such high profile and potential economic significance as climate change would put a reasonable, yet uninformed, director on notice that further inquiries were warranted.[11] If analysis of the relevant risks and strategic opportunities were *not* being presented to the board, it would be incumbent upon directors to inquire of management (and/or relevant experts), and to query the veracity and completeness of the corporation's risk management systems.[12]

(c) Uncertainty paralysis — honest uncertainty regarding the speed, scope and scale of climate change impacts.

Difficulty in quantifying relevant risks does not mean that directors are relieved of their obligation to manage them. It is unlikely that pervasive uncertainty, *without more*, would justify 'business as usual' (or doing very little) as 'all reasonable steps' in the oversight of the risks and opportunities of climate change. This is for a number of reasons. First, whilst the scope, scale and speed of climate change impacts remains inherently uncertain, the fact that climate change has occurred, is occurring and will continue to occur, is not. Accordingly, at a *minimum*, corporations need to *adapt* to the shift in environmental and economic conditions that result from observed climate change, and that committed into the future as a result of past emissions. Secondly, any argument that action to mitigation or adaptation is premature, or the range of potential climate futures so vast to be effectively 'unmanageable', may actually *strengthen* the imperative for corporate action. The wealth-maximising response in such circumstances cannot be to 'do nothing', but to reduce exposure and vulnerability by proactively developing corporate resilience, flexibility and adaptive capacity. There are in fact a number of recognised economic methodologies that can be applied to augment traditional cost-benefit analysis under conditions of pervasive uncertainty. These include sensitivity analysis, stress testing and scenario planning, which allow corporations to model risks, opportunities and resilience across the range of plausible potential futures. Moreover, even in the face of pervasive and continuing uncertainty, it is extraordinarily unlikely that the phenomenon of anthropogenic climate change will be conclusively *disproved* overnight. Therefore, at a *minimum*, the accordant regulatory, litigation, market and insurance risks demand a strategic response.

(d) Conscious cost/benefit — an informed, active decision to continue with 'business as usual'.

The 'Conscious Cost/Benefit' scenario considers the situation where directors, appreciating the range of potential climate futures and the risks and opportunities to their corporation, make a *considered decision* that 'doing nothing' (or doing little) is the most advantageous strategy for their corporation. In the context of the relevant legal test, the director would submit that they had made an independent judgment after informing themselves as to the magnitude and probability of the relevant risks and opportunities, and critically evaluating them in the context of available treatments and competing resource demands. Indeed, for a given corporation, it may be that the costs of current action on climate change adaptation measures are wholly disproportionate to the risk and expected benefits. Corporations must necessarily prioritise the finite pool of resources at their disposal.

However, such judgments must be defensible on the basis of robust, sophisticated and fit-for purpose modelling, based on the unique forward-looking risks and opportunities associated with climate change. In short, 'business as usual' *methodologies* may now themselves be insufficient to demonstrate that a director was adequately informed and took 'all reasonable steps' in their assessment and governance of future climate change risks. In particular, such analysis is likely to be open to challenge if does not take consider factors such as: the clear economic consensus that late adaptors face significantly higher relative costs; a 'value-chain', or systems thinking, approach to vulnerabilities, both within and beyond business fencelines; the limitations of historical data as a predictor with climatic and economic scenario modelling; the risks of *maladaption* from the short-term strategy — that is, measures that may deliver short-term economic gains but exacerbate vulnerability to expected climate change impacts in the medium to long-term (such as locking in capital-intensive infrastructure in a carbon intensive business with no regard to treatment of 'stranded asset' risks); and the likelihood that climate change impacts will not be incremental or gradual, but occur in dramatic 'step-changes'. Accordingly, it is unlikely that a decision to persevere with 'business as usual' on climate change would be considered 'duly diligent' if that conclusion is a product of conventional methodologies and assumptions that are increasingly inappropriate for their forward-looking purpose.

(e) **Standards-based** — default to compliance with regulatory requirements, or industry standards/norms.

The assessment of appropriate due care and diligence 'does not occur in a vacuum'.[13] Directors may argue that they exercised due care and diligence by asserting conformity with 'custom' or industry norms (or, crudely: '*we did no less than anyone else*'). Similarly, they may argue that climate change is a *policy* matter within the exclusive remit of government, and that their duty of care was discharged by ensuring corporate adherence to relevant statutory obligations. In the context of the 'all reasonable steps' test, this would equate to an argument that a response *beyond* that mandated by law, or in advance of their peers, would be so expensive, difficult or inconvenient as to outweigh the magnitude of the relevant risks.

Such arguments, of themselves, are unlikely to demonstrate satisfaction of the duty, for a number of reasons. First, 'acceptable' or 'usual' practice will be *relevant*, but *not decisive*, to determining the conduct of a 'reasonable' director. And whilst *necessary*, will not be *sufficient*. In any event, it is not that the legal, corporate governance or management literature sanctions a weak governance response to climate change risks. To the contrary. There is overwhelming literature supporting a proactive approach to the management and exploitation of environmental risks (including climate change), and warning of the economic consequences of the failure to do so. Secondly, industrial customs and norms are inherently dynamic. There can be no doubt that the trajectory of commercial risk from the impacts of climate change is trending upwards, commensurate with the solidification of the science and the increasingly dire consequences of global mitigation inaction. The *extent* of the strategic response it demands must therefore continue to increase accordingly, such that reliance on historical benchmarks — or even current industry norms — will not necessarily suggest that all reasonable steps have been taken. Thirdly, to satisfy their duty of care and diligence a director will also need to establish that they formed an *independent judgment*, borne of their own *critical evaluation* of the relevant information in the context of their *own corporation's business*. It will not be sufficient to point to the actions of other corporations alone to establish that the directors were active in their engagement with the relevant material risk to *their firm*. This is particularly salient in relation to *adaptation* strategies, which are highly context-specific, and therefore unique to each corporation. This is not to say that directors should not observe the adaptation actions and experiences of other corporations, and learn and build from them. Rather, the inaction of others is unlikely to provide an adequate justification for their corporation's own lack of strategic progress. Finally, even if a rigid delineation between 'public policy' and private responsibilities was conceptually robust or practically feasible, directors do not discharge their statutory duties by merely ensuring that the company acts 'legally'. A strategy to 'comply with minimum legal obligations' is not wealth- (or even immediately profit-) maximising: necessary in a conformance context, but not sufficient in relation to *performance*.

In short, the sharp evolution in the relationship between climate change and financial wealth suggests that, as with any material financial risk, an inactive, reactive or passive approach to its governance may be inadequate to satisfy directors' duties of due care and diligence, in pursuit of the best interests of fund beneficiaries. Risk and strategy are complex issues, and unique to each corporation. It should therefore come as no surprise that 'diligence' in their governance requires more than a blunt, disengaged, uninformed response.

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But what about the 'business judgment rule' defence?

The confines of this research synthesis do not permit a detailed discussion of the 'business judgment rule' defence to a breach of the duty of due care and diligence. As a general observation, however, this oft-raised, but rarely successful, defence is unlikely to assist defendant directors whose governance of climate change falls within the categories discussed above. In brief, this is because those failures can generally be categorised as *procedural* in nature — either a failure to consider a material issue, to remain appropriately informed, or to apply appropriate methodologies. In contrast, the business judgment rule only applies to protect governance failures of a *substantive* nature — where the director makes an active decision that a matter relating to the performance of the corporation is in its best interests, having formed a rational belief upon critical evaluation of appropriate information.

Conclusion

The courts are clear that engagement and proactivity is expected of directors in the discharge of their statutory duties. Risk management and strategic planning, by their nature, are not functions that can be optimised *post-facto*. Contemporary directors would therefore be well advised to reflect on their own approach to governance and consider whether it would withstand the scrutiny of a claim under s 180 of the Corporations Act. If a sceptic, they must act with the knowledge that most others are not. If ignorant, they must investigate. If they default to others' norms, they must refocus in their own context. 'Business as usual' methodologies must be adjusted to reflect unprecedented future variables. And above all, vulnerabilities must be assessed, flexibility embedded and resilience maximised.

In short, directors must *direct*. They have continuous responsibilities within a dynamic commercial playing field, for which they are, and will be, accountable. Good faith initiatives, based on scientific evidence and reasonable economic assumptions, should be taken now to safeguard a corporation's continuing prosperity. Risk can only be managed, and strategy determined, on the best information currently available. And the best strategy is not, and cannot be, to fail to actively govern for the reality of a changing climate.

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Notes

1. *ASIC v Rich* (2003) 44 ACSR 341, [35]; *ASIC v Rich* (2009) 75 ACSR 1, [7201], citing *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 15, 123; *ASIC v Vines* (2005) 55 ACSR 617, [1067]; *Daniels v Anderson* (1995) 37 NSWLR 438, 505.
2. *ASIC v Healy & Ors* [2011] FCA 717, [16], [143] and [162] (hereafter *Centro*). See also *ASIC v Rich* (2009) 75 ACSR 1, [7205-6].
3. *Wyong Shire Council v Shirt* (1980) 146 CLR 40, 47, applied in *ASIC v Rich* (2009) 75 ACSR 1, [7231, 7236] and *ASIC v Vines* (approved by the Court of Appeal in *Vines v ASIC* (2007) 25 ACLC 448); *ASIC v Ingleby* (2012) 91 ASCR 66, 69.
4. *Centro* [2011] FCA 717, [16], [143] and [162]. See also *ASIC v Rich* (2009) 75 ACSR 1, [7203].
5. *Centro* [2011] FCA 717.
6. *H v Royal Alexandra Hospital for Children* (1990) Aust Torts Reports ¶81-000, SC (NSW).
7. *Centro* [2011] FCA 717.
8. *ASIC v Lindberg* (2012) 91 ACSR 640, [30]. See also *ASIC v Ingleby* (2012) 91 ACSR 66; *AWA v Daniels* (1992) 7 ACSR 759; *Centro* [2011] FCA 717, [189].
9. *Centro* [2011] FCA 717, [189].
10. *ASIC v Ingleby* (2012) 91 ACSR 66 (appeal to the CAVSC upheld in relation to quantum of penalty, but not liability); *ASIC v Lindberg* (2012) 91 ACSR 640; *Shafron v ASIC* (2012) 286 ALR 612.
11. *ASIC v Ingleby* (2012) 91 ACSR 66 (appeal to the CAVSC upheld in relation to quantum of penalty, but not liability); *ASIC v Lindberg* (2012) 91 ACSR 640; *Shafron v ASIC* (2012) 286 ALR 612.
12. *ASIC v Ingleby* (2012) 91 ACSR 66; *ASIC v Lindberg* (2012) 91 ACSR 640; *Centro* [2011] FCA 717.
13. *Centro* [2011] FCA 717, [182].