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Review

US fossil fuel companies facing legal action for misleading disclosure of climate risks: could it happen in Australia?

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Introduction

There have been a number of recent enforcement actions in the US alleging that major fossil fuel companies, such as ExxonMobil Corp (Exxon) and Peabody Energy, have not adequately or appropriately disclosed the risks posed to their businesses by climate change, as required under US federal securities law. Australian company and securities law is broadly similar to that in the US. As confirmed by a recent legal opinion issued by Sydney barristers Noel Hutley SC and Sebastian Hartford-Davis for the Centre for Policy Development and the Future Business Council[1] (the Hutley SC opinion), Australian listed companies have obligations to disclose material business risks posed by climate change, with potential liability implications for company directors who fail to consider and disclose foreseeable climate risks. This article explores recent developments in the US and the likelihood of similar actions in Australia.

How are Australian companies affected?

- Australian company and securities law requires companies to disclose material business risks to shareholders and to the market via annual reports and other continuous disclosure measures. Increasingly, climate change is recognised as posing significant material risks to Australian businesses across all sectors, but particularly the resource, energy and finance sectors.
- Company directors are bound by legal duties, including managing the interests of the company with due care and diligence. To fulfil these duties, directors should consider and disclose all material and foreseeable risks posed to their business. The materiality and foreseeability of risks posed by climate change is increasingly acknowledged.
- Regulatory developments and litigation trends internationally, and particularly in the US, suggest that Australian companies and their directors will face increasing scrutiny over climate risk disclosure practices, including potential shareholder litigation, for a failure to consider or disclose climate risks leading to harm to the company (eg, share price drop).

Background: climate risks and disclosure

The risks posed to businesses by climate change are complex and numerous, and their materiality will differ significantly depending on the nature of the business, especially its sector, size and level of diversification. Climate risks are generally categorised as physical or non-physical:

- *Physical risks* are associated with both acute weather events (eg, flood, storm, bushfire) and longer term changes to rainfall, temperature and other factors. They include potential disruptions to operations, transportation and supply chains, damage to physical assets, and reduced resource availability.
- *Non-physical risks* (also referred to as carbon risks or transition risks) refer to a range of interacting legal, technological, market and reputational risks including new laws and policies designed to mitigate climate change (eg, carbon taxes, emissions trading schemes) or changes in market conditions as a result of the transition to renewable and low emission energy sources and technologies.

Increasingly, those companies whose business model relies on the exploitation of fossil fuels — such as mining companies, conventional energy generators and retailers and their financial backers — face major business risks. For example, restrictions on the full exploitation of coal reserves may result in these assets being “stranded”, meaning they become liabilities, rather than assets, on company balance sheets. Similarly, the rise of renewable and distributed energy technologies may reduce the life span, and consequently the value, of conventional power generation assets. On the flipside, there is a range of potential commercial opportunities associated with transition to a low emission economy, including the development of new clean energy markets and improved operating efficiencies.

Observers of Australian energy policy developments in recent months could be forgiven for questioning the likelihood of new regulatory restrictions posing any material financial risks to Australian businesses in the near future. Nonetheless, climate risk is an issue that is rapidly capturing the attention of the international business community, global financial institutions and investors and, increasingly, is also being taken very seriously by domestic regulators worldwide.

In a speech delivered in September 2015, Mark Carney, Governor of the Bank of England, stressed that full and timely disclosure of climate risks is crucial to market transparency and efficiency, and underlying economic stability and resilience.[2] In December 2016, the Task Force on Climate-related Financial Disclosures (TCFD), established by the Financial Stability Board of the G20 (an international body that monitors and makes recommendations about the global financial system), released its draft recommendations for climate-related financial risk disclosures for use by companies in providing information to lenders, insurers, investors and other stakeholders.[3]

In Australia, the issue of the Hutley SC opinion in October 2016 outlining potential liability implications for company directors and others who fail to consider and disclose foreseeable climate risks (discussed further below) has focused attention domestically on the issue.[4] Significantly, Australian regulators are beginning to respond. On 17 February this year, Australia's financial regulator, the Australian Prudential Regulation Authority (APRA), announced that it views climate change as posing financially material and foreseeable risks to Australian businesses, with potentially system-wide implications for the financial system, and that it intends to monitor the consideration and disclosure of climate risks by banks, insurers, superannuation funds and wealth managers.[5]

What does Australian law require?

There are two aspects of Australian company and securities law that are directly relevant to this discussion: risk disclosure requirements and directors' duties.

Risk disclosure

- As part of their periodic reporting requirements, companies listed on the Australian Securities Exchange (ASX) are required to provide both financial statements and a director's report as part of the annual report.[6] The director's report should include information that members of the listed entity would reasonably require to make an informed assessment of the operations of the entity, its financial position, and the business strategies and prospects for future financial years.[7]
- Continuous reporting obligations also require companies to notify the ASX of any information (not already generally available) which a reasonable person would expect to have a material effect on the price or value of the entity's securities.[8]
- *Materiality* is a key concept for disclosure obligations: a particular factor will be considered to be material, and should accordingly be disclosed in financial statements and other reports, if it might influence the economic decisions of stakeholders that use that information in their assessments and decisions and if there is a real possibility that the risk in question could substantially impact the listed entity's ability to create or preserve value for security holders over the short, medium or long term.[9]
- The Corporations Act 2001 (Cth) provides variously for criminal, civil penalty or civil liability for breaches of specific disclosure requirements and, more generally, for false or misleading disclosure (eg, ss 1041E and 1041H, s 1308).

Directors' duties

- Section 180(1) of the Corporations Act requires company directors to exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person in their circumstances would exercise. Relevant case law on this duty and the associated legal tests is summarised in the Hutley SC opinion: essentially directors must inform themselves sufficiently to enable them to guide and monitor the management of the company, including considering and, in some cases, taking steps to address, any risks posed to the interests of the company. Importantly, the degree of care and diligence required, and the types of measures expected to be taken, will depend on the nature, extent and foreseeability of the risks, as well as potentially competing considerations, such as the expense and difficulty of taking measures to address the risk. A director who takes action (or decides not to take action) based on an informed and rational assessment of the company's best interests may be protected from liability for breach of the s 180(1) duty by the statutory defence — the business judgment rule (s 180(3)).
- *Foreseeability* is a key concept for the duty of care and diligence. As the Hutley SC opinion makes clear, the case law confirms that foreseeability is

distinct from probability. A risk may be foreseeable if it is not far-fetched or fanciful, even if it is quite unlikely to occur.[10]

- Importantly, ensuring full and timely disclosure of business risks is an aspect of the duty of care and diligence. Directors are required to sign off on financial accounts and reports as complying with accounting standards and amounting to a true and fair representation of the affairs of the company.[11] Further, the director's report must be adopted by a resolution of directors, dated and signed, and constitutes a representation made by directors. Indeed, "annual reports constitute and contain representations, which will often become the focus of allegations of misleading and deceptive conduct in company litigation".[12]

While existing Australian legislation, Regulations and accompanying guidance do not make explicit reference to climate risks, it is increasingly clear that, where they are reasonably judged to be foreseeable and material, the business risks posed by climate change (both physical and non-physical) should be disclosed under existing general risk disclosure requirements. Further, directors (and other officers) should carefully consider climate risks in the exercise of their legal duties.

What is happening in the US and beyond?

Like Australia, the US has federal company and securities law that requires public listed companies to disclose material business risks on a regular basis.[13] In 2010, the US securities regulator — the Securities and Exchange Commission (SEC) — issued specific guidance on how the existing disclosure requirements applied to climate change matters.[14] The SEC's guidance addresses both physical and non-physical climate risks, with the latter including the need to comply with changing climate regulatory requirements, the indirect effects of those requirements, and business trends that include declining demand for carbon intensive products.

There have been a number of recent investigations and enforcement actions in the US, brought by state Attorneys-General and, more recently, by shareholders and the SEC, relating to the climate risk disclosure practices of major fossil fuel companies. For example:

- The New York Attorney-General investigated the SEC filings from 2011–14 from Peabody Energy, and found that these disclosures misled shareholders by understating the severe potential impacts of climate risk to its business, misusing data to support claims about future fossil fuel demand, and claiming an inability to predict the financial impacts of future climate policy laws or Regulations. This investigation was conducted under state laws prohibiting false or misleading conduct in connection with securities transactions.[15] It was settled in November 2015. Peabody Energy did not admit to fraudulent disclosure practices, however did undertake to improve climate risk disclosure.[16]
- A similar investigation was launched in late 2015 by Attorneys-General in New York and California against Exxon to look into whether the company had properly accounted for the impact of heightened greenhouse gas emissions Regulations on its business and why Exxon had not downgraded the estimated value of its oil reserves, even as oil prices faced a 2-year decline.[17] In September 2016, it was reported that federal regulators (SEC) were investigating Exxon's accounting and reporting practices along similar lines.[18]
- In November 2016, a shareholder class action was commenced against Exxon on behalf of purchasers of Exxon stock during the class period (February-October 2016). The complaint alleges that throughout this period, Exxon repeatedly highlighted the strength of its business model and its transparency and reporting integrity, particularly with regard to its oil and gas reserves and the value of those reserves. It is alleged that these public statements by the company were materially false and misleading because:
  - — they failed to disclose Exxon's own internal reports concerning the nature and extent of climate change risks;
  - — that given these risks, a material portion of Exxon's reserves were stranded and should therefore be written down; and
  - — that Exxon had used an inaccurate price on carbon to value certain of its future oil and gas prospects in order to keep the value of its reserves materially overstated.

  As a result of these misleading statements, Exxon stock traded at artificially inflated prices. The claimants alleged that they suffered a loss when the value of Exxon stocks fell substantially as a result of the above noted regulatory investigations into the company's disclosure and accounting practices and subsequent announcements by Exxon that it might be forced to write down nearly 20% of its oil and gas assets.

The above investigations and enforcement actions are examples of the growing interest in enforcing corporate disclosure obligations as they relate to climate risk. For Australian companies, they provide an indication that understating the severe potential business impacts of climate risks or claiming an inability to predict business impacts of future climate laws may be found to be misleading disclosure.

However, it is not only in the US that regulatory attention to climate risk disclosure is increasing. In the UK, which has very similar company and securities law arrangements and a more comparable legal tradition to Australia's, a number of regulatory complaints have recently been made to the Financial Reporting Council (FRC) concerning the failure of major oil and gas companies to disclose climate-related risks as required by law.[19] This is further evidence, from a very similar jurisdiction, of growing scrutiny and interest in enforcing corporate reporting obligations as they relate to climate risk.

Gaps in Australian climate risk reporting practice

We conducted a baseline review of the reporting practices of a small group of large Australian resource and energy companies that represent a significant proportion of market share and value and that could be expected to be highly exposed to a range of climate risks.[20] Our review revealed that climate risk disclosure is highly variable in terms of the nature, extent, quality and form of reporting. Some of the companies within the sample reported comprehensively, adopting leading best-practice approaches such as scenario testing using a range of carbon regulation and pricing scenarios (with explicit acknowledgment of key assumptions and uncertainties) and attempts to quantify, as far as possible, the range of potential impacts to the portfolio. Others reported minimally, disclosing very little substantive information that would allow shareholders, lenders, insurers or regulators to make an informed decision about the materiality of risk posed to that particular business.

These findings were echoed in the Hutley SC opinion which states that:

> … many prominent Australian companies … did not disclose the same degree (or any) exposure to climate change risk, or disclosed a scale or type of risks that were inconsistent with those of other companies operating within similar environments. … They included major emitters (eg coal mining companies), companies dependent upon major emitters (eg airlines), and companies with lending exposure to major emitters (ie banks).[21]

Enforcement action in Australia?

The Hutley SC opinion states that:

> It is likely to be only a matter of time before we see litigation against a director who has failed to perceive, disclose or take steps in relation to a foreseeable climate-related risk that can be demonstrated to have caused harm to a company …[22]

There are, however, differences between the legal regimes and legal culture in Australia and the US that may temper such developments. First, in terms of the potential for regulatory investigations and public enforcement of disclosure obligations, it is significant to note that, unlike the US, there is currently no explicit regulatory guidance concerning climate risk disclosure in Australia. Our analysis suggests that existing general disclosure obligations and directors' duties are sufficient to require companies to disclose and take into account climate risks, however, the provision of explicit regulatory guidance to this effect has arguably strengthened the investigations and shareholder claims currently underfoot in the US. The US experience can also be distinguished in relation to the appetite of regulators to pursue enforcement actions, and particularly the additional possibilities for state Attorneys-General to pursue such matters under state legislation. To date, the Australian federal company and securities law regulator, the Australian Securities and Investments Commission (ASIC), has demonstrated no inclination for similar enforcement action. Nonetheless, recent announcements by APRA (noted above) do suggest that some Australian regulators are taking an increasing interest in climate risk disclosure, and similar regulatory reforms and associated enforcement action may well eventuate in the near future.

Further, options for private enforcement, via shareholder actions, are comparatively less well-developed in Australia than in the US, and a number of procedural and legal barriers have been identified to explain this difference.[23] While not as prevalent as in the US, shareholder class actions are, however, increasingly viewed as an established part of the legal landscape in Australia with a steady rise in the number of actions commenced in recent years.[24] Disclosure breaches have been the dominant causes of action to date, with shareholders claiming for losses incurred as a result of acquiring shares at an inflated price on the basis of misleading or deceptive conduct or a failure to disclose. Increasing acceptance of third party funding arrangements for shareholder class actions in Australia has been a significant factor behind these developments. Indeed, major litigation funders in Australia are taking an increasing interest in the climate risk disclosure issue[25] suggesting that, if a situation arises where a failure to disclose and take into account climate risks has contributed to a significant measurable loss in securities value, it is likely that there will be support for shareholder class actions to recover losses.

In the meantime, Australian companies and their directors would be well-advised to take heed of developments in the US and UK jurisdictions and sharpen their approach to climate risk disclosure. Particular attention should be paid to:

- whether companies have made positive statements to convey the impression that they are managing the risk well, which are likely to be relied upon by investors;
- whether companies are matching the disclosure practices of leading companies in similar sectors and the available guidance on climate risk disclosure (including the final recommendations of the TCFD when they are released later in 2017); and
- whether companies are conducting modelling and scenario testing and presenting this information accurately and without bias. It is not only non-physical transition risks that should be considered and managed, but also adaptation measures (eg, infrastructure design and location) that may be required to reduce the exposure and vulnerability of businesses to physical climate change impacts.

Indeed, the benefits of full and timely climate risk disclosure are not only to be reaped by avoiding future legal liability. There is also growing evidence that climate risk disclosure can have the positive effect of driving companies to lower emissions, to adopt energy efficiency measures, to switch to renewable energy, to divest of fossil fuel assets and to invest in clean energy.

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Footnotes

1. Centre for Policy Development and the Future Business Council "Climate change and directors' duties" Memorandum of Opinion (7 October 2016) http://cpd.org.au/wp-content/uploads/2016/10/Legal-Opinion-on-Climate-Change-and-Directors-Duties.pdf.
2. Mark Carney "Breaking the tragedy of the horizon — climate change and financial stability" speech delivered at Lloyd's of London (29 September 2015) www.bankofengland.co.uk/publications/Pages/speeches/2015/844.aspx.
3. See Task Force on Climate-related Financial Disclosures *Recommendations of the Task Force on Climate-related Financial Disclosures* (December 2016) www.fsb-tcfd.org/wp-content/uploads/2016/12/16_1221_TCFD_Report_Letter.pdf.
4. See above n 1.
5. See C Yeates "Climate change a 'material' risk for the financial system: APRA" (17 February 2017) www.theage.com.au/business/banking-and-finance/climate-change-a-material-risk-for-the-financial-system-apra-20170217-guffhm.html.
6. Corporations Act 2001 (Cth), s 292(2).
7. Above n 6, s 299A(1). Further guidance on reporting material exposure to business risks, including economic, environmental and social sustainability risks, is found in ASX Corporate Governance Council *Corporate Governance Principles and Recommendations 3rd Edition* (2014) Principle 7, Recommendation 7.4 www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf.
8. Above n 6, ss 674–77.
9. The Australian Accounting Standards Board provides the following guidance on the concept of materiality as it relates to financial reporting, see Australian Accounting Standards Board *Accounting Policies, Changes in Accounting Estimates and Errors* Compiled AASB Standard 108 (2011) cl 5, Definitions www.aasb.gov.au/admin/file/content105/c9/AASB108_07-04_COMPmay11_07-11.pdf:

   > … omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

10. See discussion at above n 1, at [14].
11. Above n 6, ss 295–97.
12. Above n 1, at [12].
13. The Securities Exchange Act of 1934 (US) establishes the Securities and Exchange Commission (SEC) and outlines its functions, including empowering the SEC to require periodic reporting of information by companies with publicly traded securities (s 13). Disclosure obligations are provided in Regulation S-K (17 CFR Part 229).
14. SEC *Commission Guidance Regarding Disclosure Related to Climate Change* Release Nos 33–910627, 34–61469, FR-82 (2 February 2010) www.sec.gov/rules/interp/2010/33-9106.pdf.
15. The 1921 Martin Act has very broad securities-fraud provisions — the law forbids "any fraud, deception, concealment, suppression, [or] false pretense". Crucially, it does not require a prosecutor to demonstrate that a defendant consciously intended to defraud investors or regulators and permits very broad discovery.
16. See Attorney-General Eric T Schneiderman "AG Schneiderman secures unprecedented agreement with Peabody Energy to end misleading statements and disclosure risks arising from climate change" media release (9 November 2015) www.ag.ny.gov/

press-release/ag-schneiderman-secures-unprecedented-agreement-peabody-energy-end-misleading.

17. J Gillis and C Krauss "Exxon Mobil investigated for possible climate change lies by New York Attorney General" (5 November 2015) www.nytimes.com/2015/11/06/science/exxon-mobil-under-investigation-in-new-york-over-climate-statements.html. A further investigation is underway in California: I Penn "California to investigate whether Exxon Mobil lied about climate-change risks" (20 January 2016) www.latimes.com/business/la-fi-exxon-global-warming-20160120-story.html.
18. See J Wattles "SEC is latest regulator to investigate Exxon Mobil's accounting practices" (20 September 2016) http://money.cnn.com/2016/09/20/news/companies/exxon-mobil-sec-investigation/index.html.
19. ClientEarth *Investor Briefing: Complaints filed against SOCO International PLC and Cairn Energy PLC* (2016) www.documents.clientearth.org/library/download-info/investor-briefing-complaints-filed-against-soco-international-plc-and-cairn-energy-plc/.
20. This empirical survey considered reporting in the 2014–15 financial year and is fully reported in A Foerster, J Peel, H Osofsky and B McDonnell "Keeping good company in the transition to a low carbon economy? An evaluation of climate risk disclosure practices in Australia" (2017) 35 *Company and Securities Law Journal* (forthcoming).
21. Above n 1, at [47].
22. Above n 1, at [51].
23. A Cassidy and L Chapple "Australia's corporate disclosure regime: lessons from the US model" (2003) 15 *Australian Journal of Corporate Law* 1.
24. For example, Allens Linklater *Shareholder Class Actions in Australia* (February 2017) www.allens.com.au/pubs/pdf/class/papclassfeb17-02.pdf.
25. For example, IMF Bentham were active participants in a recent 2-day international legal symposium — "Climate change risk and corporate governance: directors' duties and liability exposures in a post-Paris world" — which took place at the University of Melbourne on 29–30 August 2016 as part of the Commonwealth Climate and Law Initiative: see more at www.eucentre.unimelb.edu.au/events/climate-change-risk-and-corporate-governance/.