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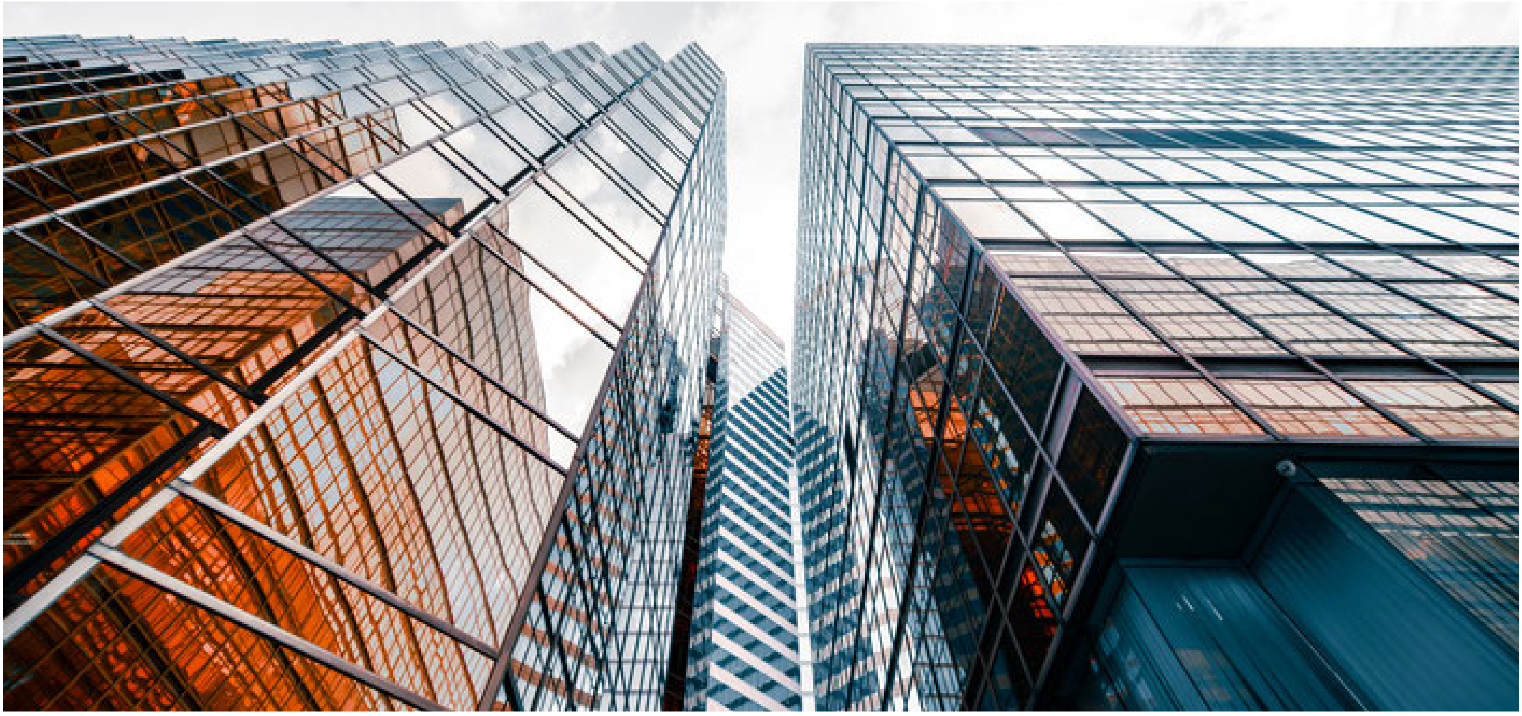
UK: COP26, carbon coins, and cockroaches - Can a new form of currency mitigate corporate liability climate risks?

Greenwashing, net zero, and Environmental, Social, and Governance ('ESG') are now familiar phrases and slogans. It is difficult to see them disappearing. However, in terms of corporate liability, questions on what these phrases and slogans actually mean and where they will lead us have arisen. Ben Trust, Louise Pearce, and Tim Malloch, from CMS Cameron McKenna Nabarro Olswang LLP, provide an overview over corporate liability, as well as different strategies to decouple carbon emissions from economic activity and mitigate corporate climate risks in the UN context and beyond.



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Definitions and context

Corporate liability, including parent company liability, directors' duties, and disclosure requirements, is set to evolve and expand to accommodate concepts previously regarded as soft law or best practice investment guidance. These changes will influence both how markets operate, and how the insurance sector measures risk. The recent pandemic suggests that government intervention (and financial support) will play an increasingly significant role in markets. For some global risks, the challenges cannot be solved by any one individual company. Economies and legal systems will need to design frameworks that provide the appropriate level of support and create a value for carbon that rewards climate stewardship and sequestration services. During this process, the central challenge that companies will have to confront is how to decouple carbon emissions from economic activity. This in turn prompts the related question on what else needs to be done if the existing UN Conference of the Parties ('COP') process will not achieve this.

Corporate liability

It is anticipated that non-governmental organisation ('NGOs') will continue to bring litigation claims that press governments and private companies to take more urgent action on climate change and other ESG issues. Generally, judges are reluctant to make decisions that disturb or overturn the policy decisions that have been made by elected politicians. Legislation in the UK, including the Climate Change Act 2008, imposed new legal obligations on the UK Government. However, an increase in climate-related legislation may also serve to insulate politicians from public law judicial review claims brought by NGOs. Without a 'hard-edged' challenge on a question of illegality, claimants may be forced to bring more speculative claims that the policies they wish to challenge are irrational.

In terms of climate change and ESG issues, following the UK's departure from the EU, important rights bestowed by EU Directives may fall away. UK courts will also not be able to refer matters to the European Court of Justice ('ECJ'). As a result, NGOs and other third-party claimants may start to develop more tort-based arguments that seek to target private companies or groups of private companies directly. For example, If the collective impact of published business plans in carbon-intensive sectors put targets of the Paris Agreement at risk, then this may represent a form of 'combination' for a tort-based conspiracy claim. In such cases, there is likely to be a distinction between traditional tort claims that seek to obtain remedies for retrospective damage and forward-looking claims based on human rights being infringed. Other forms of tort claims that claimants seeking redress for climate and ESG matters may consider, include negligence, nuisance, and unjust enrichment.

Some of the legal issues that are likely to come into play in climate change litigation include:

Causation

Fairchild v Glenhaven Funeral Services Ltd [2002] UKHL 22(1): The concept of modified causation was applied by the House of Lords to an asbestosis exposure claim The widow of a worker was unable to identify which of the four former employers was responsible for the malignant mesothelioma. The material increase in risk replaced the conventional 'but for' test of tortious liability. Lord Bingham noted that ''[i]ndeed, it would seem to me contrary to principle to insist on application of a rule which appeared, if it did, to yield unfair results''.

The precautionary principle

The normal evidential burden requires a claimant to prove its case. However, the precautionary principle, a public law concept, reverses the burden of proof and places the onus on a defendant to demonstrate that what they have done, or propose to do, is safe.

Parent company liability

Okpabi and others v Royal Dutch Shell Plc and another [2021] UKSC 3: This Supreme Court decision relates to an ongoing oil pollution claim in Nigeria. The case suggests that when deciding where decisions about important or sensitive topics, are actually taken within corporate structures, English courts will now be more prepared to adopt a more flexible and fact-based approach that reflects the reality of what is occurring on the ground. Climate change, and how a parent company decides to deal with it within the group structure, now seems a likely candidate for claims of this type.

Claims against directors

Attempts may be made to hold the directors of UK-based parent companies responsible for sub-standard ESG compliance in subsidiary companies. This could manifest through directors being held liable for breach of directors' duties, in particular Section 172 of the Companies Act 2006 which requires a director of a company to have regard to 'the likely consequences of any decision in the long term', 'the need to foster the company's business relationships with suppliers, customers and others', and 'the impact of the company's operations on the community and the environment'. In addition to Section 172, fiduciary or directors' duties may give rise to claims arising out of climate change and ESG concerns.

Claims against advisors and consultants

Parallels may be drawn between climate change and the US opioid crisis. Advisors, including law firms, could be targeted with climate-related claims for their role in facilitating transactions. In this context, it will be interesting to see what steps law firms take to demonstrate that they have complied with the Law Society Climate Change Resolution, including Resolution 3(c) which requires solicitors to engage in climate conscious legal practice by providing (whether themselves or through others) competent advice to their clients on:

- how they can achieve their objectives in ways which mitigate the effects of the climate crisis and promote adaptation to climate change and
- the potential legal risks and liabilities that may arise from action or inaction that negatively contributes to the climate crisis.

Climate change reporting and disclosure requirements

The UK has become the first G20 country to make it mandatory for large companies and financial institutions to disclose climate-related risks. This legislation will become law in April 2022, subject to obtaining parliamentary approval. Any company with more than 500 employees and more than £500 million in annual turnover in the UK will have to disclose potential risks associated with climate change and the net-zero transition into annual reports.

Mandatory reporting will help both businesses and investors to understand 'the financial impacts of their exposure to climate change, and price climate-related risks more accurately, while supporting the greening of the UK economy'. UK companies will now also have a uniform way of assessing how climate change may impact their business models and strategy.[1]

Positive disclosure developments are also underway in the accounting sector. Most of the world uses International Financial Reporting Standards ('IFRS'), which are established by the International Accounting Standards Board ('IASB'). Following the 26th annual United Nations Climate Change Conference ('COP26'), the IFRS Foundation Trustees announced three significant developments to provide the global financial markets with high-quality disclosures on climate and other sustainability issues:

- the formation of a new International Sustainability Standards Board ('ISSB') developing in the public interest;
- the commitment by leading investor-focused sustainability disclosure organisations to consolidate into the new board; and
- the publication of prototype climate and general disclosure requirements.[2]

These new reporting obligations are likely to become a key feature of corporate liability in relation to climate risks. The information disclosed as a result of these new mandatory processes is likely to confirm and compound existing concerns that the UN COP process, in its current form, is inadequate.

Problems with the UN COP process: A circus tent without a central pole

It now appears to be common ground that what happens in the next few years is crucial to the survival of humanity. According to a Chatham House report published in September 2021, if emissions follow the current trajectory, there is a less than 5% chance of keeping temperatures well below 2°C, relative to preindustrial levels, and a less than 1% chance of reaching the 1.5°C Paris Agreement target. Post-COP 26, the immediate signs are not encouraging. US coal mining companies are reportedly enjoying the best results in decades and a profit bonanza, whilst a UN-backed green investment fund is on the brink of failure. The Paris Rulebook provides a methodology for trading carbon credits, but not an economic motive to reduce carbon emissions through trading. With no mechanism to create a strong and stable long-term carbon signal, it is a circus tent without a central pole.

What then is the plan? Gideon Rachman has put forward a convincing argument as to why the existing politics mean that the UN COP process is unlikely to succeed. Arguing that whilst world leaders have acknowledged the need for radical action, the reality of the situation is that the pressure they are under represents a recipe for inaction. Gerald Fox and George Yarrow analyse the problem from an economic perspective. They contend that the existing top-down global approach has been more of a barrier than a facilitator of progress and represents another attempt to address complex issues via what is intended to be a form of central planning.[3]

Climate-proof laws: Addressing the cause, not the symptoms

In terms of the legal framework that is likely to evolve and shape corporate liability climate risks, Inger Andersen, Under-Secretary-General of the United Nations and Executive Director of the UN Environment Programme speaking at the UK Bar Council's 19th Annual Law Reform Lecture titled 'Exploring the role of Law Reform in the context of climate change' has said:

> *''An obvious starting point is for countries to review and strengthen their legal frameworks to make them fit-for-purpose to implement their commitments under the Paris Agreement. Good framework legislation helps put the right institutions in place. Enshrines stable and ambitious targets. Creates mechanisms for realising these targets. Ensures proper oversight and accountability.*
>
> *Beyond developing national framework legislation, we need a root and branch analysis and strengthening of laws relevant to all sectors. Tax laws. Company laws. Securities laws. Trade practices laws. Environmental laws. Energy laws. Land-use and planning laws. Transportation laws. You name virtually any law, and countries likely need to climate-proof it''.*

Many important legal changes will undoubtably be necessary to introduce 'climate-proof' laws. However, there is also the risk that countries will introduce measures that only attempt to tackle the symptoms and not the underlying cause of the problem: the acknowledged causal link between carbon emissions and the way economic growth is measured and valued.

Net positive companies need to take a long-term view

Paul Polman's book 'Net Positive' puts forward the case for a more responsible form of capitalism. It counsels against short-term reporting of financial results and recognises the importance of companies taking a long term view on how best to mitigate climate risks. It also emphasises the importance of working collaboratively with a number of stakeholders, including NGOs. Polman argues that the causal link between carbon emissions and economic growth has to be decoupled. It is not sufficient for companies to attempt to compensate for continued emissions through the use of carbon off-setting mechanisms. This is a point of view that recognises that there is a dangerous gap between what many government policies currently permit and what the science of climate change actually requires. For example, Kate Dooley, a research fellow at the University of Melbourne, argues that carbon off-setting should not allow fossil fuels to continue and that their use should be confined to biological carbon within the agriculture and land-use sector.

'Net Positive' also recognises that companies, whilst important, are only part of a solution. Governments will need to be persuaded not only to do more but to do things differently. In short, if the fundamental obstacle that humanity faces is the causal link between carbon emissions and economic activity, then effective policies need to be developed that break that link.

An existing example of such a policy is a regulatory mechanism used in energy markets known as 'decoupling'. Decoupling originated in California, but is now applied in a number of other states in the US. It creates an economic incentive that removes throughput incentives by providing stable revenue for utilities regardless of sales volume. In the case of regulated electricity markets, this may be applied to all of the integrated utility's short-run fixed costs (generation, transmission, and distribution), whereas in restructured markets only transmission and distribution utilities will have their revenues decoupled from sales volume. An energy company's profits are thus derived from the energy efficiency services it provides to customers rather than the actual volume of electricity it sells to them.

Could a carbon coin and the Holistic Market Hypothesis mitigate corporate climate risks?

Could this concept of decoupling be applied to the global economy? Kim Stanley Robinson's 'The Ministry for the Future' suggests that it can. It contends that of the total of 3,000 gigatons of fossil carbon that have already been located in the ground, 2,500 gigatons of fossil carbon will need to be left in the ground as stranded assets. One of the ways through which climate change is tackled is by issuing a new form of currency, a carbon coin: a digital currency disbursed on proof of carbon sequestration, in return for leaving fossil carbon in the ground.

The concept of the carbon coin used in the 'Ministry for the Future' is based on the work of Dr Delton Chen, founder of the Global Carbon Reward project.[4] Dr Chen's paper 'Hypothesis for a Risk Cost of Carbon: Revising the Externalities and Ethics of Climate Change' puts forward a Holistic Market Hypothesis ('HMH') that argues that standard climate policies are failing to manage the systemic risk of dangerous-to-catastrophic climate change and that a global reward for carbon mitigation as a form of 'preventative insurance' is required.

Climate stewardship services recognising the value of carbon sequestration

Classical economists, such as Adam Smith and Karl Marx, held different perspectives on economic endeavours of individuals. However, they shared a common view that the environment formed a continuous and infinite backdrop to these efforts. Assets are relatively easy to value. Climate change risk, like other forms of environmental liability, is difficult to price in conventional monetary terms. Moreover, with climate change the problem is compounded as not only are the planet's environmental resources finite, but carbon emissions are inextricably linked to how we currently measure economic growth and wealth.

The HMH solves this problem by using the laws of thermodynamics and treating the economy as an engine or heat system. Primary energy supplies, the agricultural sector, and many other economic activities are strongly coupled to carbon. On this basis the expectation is that, in line with Rachman's political analysis, civilisation's agency (i.e. the existing financial system and global economy) will undermine attempts to reduce carbon emissions. Previously successful strategies for mitigating other types of pollution are unlikely to be effective when applied to carbon, as most other pollutants are not strongly coupled to the energy supply (e.g. sulphur in acid rain and ozone depleting substances).

As the HMH creates effective economic incentives at an individual company level, it avoids the top-down central planning approach that Fox and Yarrow caution against. A different transformed version of capitalism that places a positive economic value on climate stewardship services would emerge. This has the potential to turn what are currently perceived as sticks (i.e. a negative burden), such as a carbon tax, into carrots or a carbon reward. Previously, the gold standard was used to value a currency. At the moment, cryptocurrency derives value from performing data mining equations. There is not a logical reason why a society looking to mitigate climate risk should not adopt a currency that derives its fundamental value from carbon sequestration.

Conclusion

In 'Cockroach', Ian McEwan's satirical parody of Brexit, the UK Government introduces the fictional economic concept of 'Reversalism'. The entire financial system is inverted or reversed so that every transaction that once earned money must now be paid for. People compensate their employer for their job, but are paid by retailers for everything they buy. Savings attract such high negative interest rates that a citizen must find a more expensive job in order to spend their cash. Hence, the economy is stimulated by more work and more demand. Reversalism is deliberately ludicrous. But in terms of climate policy, it does identify the root problem that needs to be addressed: the structure of the existing economy and the financial system that supports it. Given the strong link between economic growth and carbon emissions, are we really going to trade our way out of this position?

On the other hand, if the global economy can be redesigned so that carbon emissions are effectively decoupled from economic growth then perhaps humanity has a chance. Introducing a carbon coin, would create a decoupled global economy that places a value on climate stewardship services. This reduces the risk that irreversible non-linear tipping points will be passed. It is a radical change, not a ludicrous one. Companies looking to effectively mitigate their climate risk should already appreciate that it is not possible to do this in isolation. Polman advocates that net positive companies work actively with peers to change industry norms, reduce combined impacts, and greatly improve outcomes and the sector's images. Companies have an important role to play in persuading central banks that it is necessary, and in everyone's best interest, to introduce a carbon coin.

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1. See: https://www.gov.uk/government/news/uk-to-enshrine-mandatory-climate-disclosures-for-largest-companies-in-law
2. See: https://www.ifrs.org/news-and-events/news/2021/11/ifrs-foundation-announces-issb-consolidation-with-cdsb-vrf-publication-of-prototypes/
3. See: Fox, Gerard & Yarrow George (2022). Re-thinking climate change policies: A tale of two externalities. Studies in Regulation, NS 12.1. Regulatory Policy Institute.
4. See: https://globalcarbonreward.org/