CIEL® Center for International Environmental Law

Trillion Dollar Transformation

Fiduciary Duty, Divestment and Fossil Fuels in an Era of Climate Risk

Summary for Decisionmakers

Climate change poses material financial risks that must be considered when making investment decisions. Public pension fund trustees owe fiduciary duties to fund beneficiaries which may be breached by a trustee's failure to evaluate and act on climate risks in their portfolios. Such breaches may result in liability for pension fund trustees as well as financial losses for the fund. Trustees should employ active, climate-aware strategies to avoid liability and prevent fund losses.

Key Findings and Recommendations

In addition to its profound human and environmental impacts, climate change presents an array of material financial risks, which reasonable investors must take into account when making investment decisions. These risks include impact risks, carbon asset risk, transition risk, and litigation risk.

As pension fund fiduciaries, trustees are obliged to act solely in the interests of plan beneficiaries, and must exercise reasonable care, skill, and caution when making investment decisions. They must also balance the interests of current beneficiaries with future retirees and benefit recipients, and must ensure stability while pursuing growth.

Because climate change could pose a risk to these interests, fiduciary duties may be triggered, and climate change should, therefore, be considered an independent risk variable along with other modeling inputs used when making investment decisions.

Addressing the materiality of climate-related risk implicates and triggers several duties pension fund fiduciaries owe to their beneficiaries. These include:

- duty to inquire,
- duty to monitor,
- duty to diversify,
- duty of impartiality,
- duty of loyalty, and
- duty to act in accord with plan documents.

As with any other financial risk, fiduciaries should weigh climate-related risk when making decisions about where to invest, what to divest from, how to allocate resources, and how to plan for the future. Moreover, because climate-related risks will likely affect future beneficiaries more than current beneficiaries, a lack of consideration of longer term climate-related risks in the plan's portfolio could be seen as an unreasonable bias favoring short-term gain at the expense of long-term sustainability, and favoring older over younger beneficiaries.

Failure to act with reasonable care, skill, caution, loyalty, impartiality, and fact-based inquiry in the face of climate-related risks could expose fiduciaries and their attorneys and advisors to legal liability.

To avoid liability and prevent fund losses, pension fund trustees should employ the following strategies:

- modify plan documents to reflect climate risks as a material risk factor,
- avoid climate-vulnerable investments,
- engage actively with owned climate-vulnerable companies to demand information and assess resilience to climate risks, and
- invest deliberately in clean energy assets both as an opportunity for returns and as a hedge against climate risk.

Climate Change Is a Material Market Risk

As the global impacts of climate change mount, these effects are increasingly reflected in more discrete identifiable impacts not only to human lives and the environment, but also to sectors, industries, and individual companies around the world. Those impacts will accelerate rapidly in the years ahead. Climate change poses four distinct but interrelated categories of risk to the value of fund assets:

- **Impact risk** - risk of loss due to destructive physical effects of climate change.
- **Carbon asset risk** – the fact that fossil fuel companies can exploit only a fraction of their massive carbon reserves to keep within safe climate boundaries.
- **Transition risk** - risk that a given business or asset will be negatively affected by the global transition to a low-carbon economy.
- **Litigation risk** - risk that a firm may be subject to climate litigation in an array of forms, resulting in major financial losses.

Climate change poses both systemic risks to the whole financial system and idiosyncratic risks to particular investments. In the Paris Agreement, nations committed to keep the world below 2° Celsius of warming and to strive to stay below 1.5 degrees. Over a 35-year time horizon, overall market returns are not markedly different between a transformation scenario (where warming is capped at 2°C) and a fragmentation scenario (where warming reaches as high as 4°). However, some sectors – particularly fossil fuel linked sectors – are especially vulnerable to climate risk. These risks have not gone unnoticed; banks, credit ratings agencies, regulators, and civil society organizations have all issued warnings on the financial risks presented by climate change.

Climate Change Triggers Trustee Duties

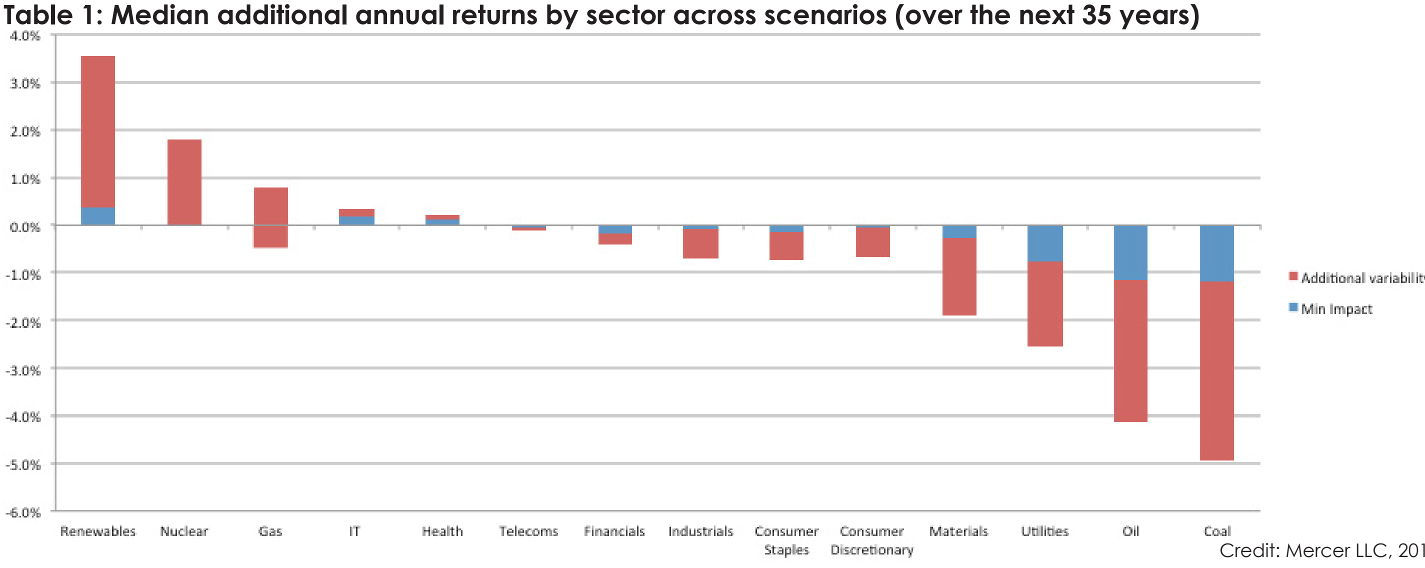
The financial risks presented by climate change have implications for many of the fiduciary duties that pension fund trustees owe to their beneficiaries. Because they must act impartially in the interest of all current and future beneficiaries, trustees are required to safeguard fund assets in both the near term and over longer time horizons. Pension funds must be able to provide consistent payments to beneficiaries while protecting the value of the fund overall.

Climate change poses a financial threat to trust assets, triggering pension fund trustees' duty to inquire, duty to monitor, and duty to diversify.

Duty to Inquire. Pension fund trustees must inquire into the relevant facts and circumstances surrounding each investment decision to ensure they are investing prudently. Because of the financial threat posed by climate change, fiduciaries should consider climate change as an independent risk variable when making investment decisions. This consideration can include looking at how legislation, regulation, international agreements, the indirect consequences of regulations and business trends, the physical impacts of climate change, and other issues that affect the value of potential investments. For example, trustees could and should inquire whether and how long-term demand assumptions underpinning a company's revenue projections reflect the realities of a carbon-constrained future.

Duty to Monitor. The duty to monitor requires fiduciaries to continually review their positions and monitor their portfolios. In the same way that buying or selling assets constitutes an investment decision that warrants investigation, choosing not to change positions is also a decision that must be made prudently and with care. In the climate change context, as the rapid collapse of the US coal industry exemplifies, this duty is critical because changes in market conditions, domestic regulations, and international agreements do have immediate and long-lasting effects on climate-vulnerable investments. Though the duty to monitor is periodic in nature, it is also triggered if fiduciaries receive new negative information about an investment.

Table 1: Median additional annual returns by sector across scenarios (over the next 35 years)



Credit: Mercer LLC, 2015

Duty to Diversify. Pension fund trustees have a duty to diversify their holdings so as to minimize risk. The duty to diversify doesn't require individual investments to be riskless, but it mandates that fund fiduciaries do not take on uncompensated risk, i.e., a risk that is not compensated with commensurate potential for positive return.

Climate change may trigger the duty to diversify by challenging the prudence of investing in climate-vulnerable assets when they are not outperforming non-climate-vulnerable alternatives. This risk consideration must be balanced against the time horizon over which the pension fund will be required to make payments.

A long-term investment strategy that assumes a status quo economy may be uniquely exposed in a period of rapid and potentially non-linear economic transition in which new technologies, behaviors, and market realities may arise over short time frames.

Even if investments in climate-vulnerable companies, sectors, and asset classes produce acceptable returns in the near-term, they may still trigger trustee duties as they relate to future generations of beneficiaries due to the incongruence of a low-carbon future and the potential for significant, hard-to-predict losses. A long-term investment strategy that assumes a status quo economy may be uniquely exposed in a period of rapid and potentially non-linear economic transition in which new technologies, behaviors, and market realities may arise over short time frames.

Because public pension funds must ensure stable and predictable returns over decades, the possibility of adverse financial outcomes as a result of climate-related risk should be a greater concern to fiduciaries administering such funds.

Duty of Impartiality. The duty of impartiality requires trustees to consider the interests of all beneficiaries of the funds they manage, including present and future beneficiaries. This duty may also be expressed as a long-term duty to protect fund principal. Protection of the fund value is of equal importance to maximizing growth, and trustees should prioritize long-term stability even if it dampens short-term returns for current beneficiaries. In recent years, the high price of oil drove heavy investments into ever more extreme and risky oil resources, such as the Arctic and deepwater offshore drilling, which assumed continued high prices throughout the lives of the investments. In the wake of the Paris Agreement, which signals that the era of fossil fuels must end, such investments appear increasingly risky. Because climate-vulnerable investments may devalue rapidly and unexpectedly, they present a looming danger to the value of a pension fund irrespective of their current rates of return. Trustees should therefore take special care when considering their climate-vulnerable investments, as they may inappropriately threaten the long-term value of the fund despite producing acceptable returns in the present.

Duty of Loyalty. The duty of loyalty requires a trustee to act solely in the interests of pension fund beneficiaries. This duty extends beyond explicit conflicts of interest and self-dealing and requires fiduciaries to carefully decide the best course of action for all fund beneficiaries. This duty can be breached in a number of ways, but climate change invokes two in particular. First, for trustees, asset managers, investment officers, and other fiduciaries whose compensation is tied to fund performance, pursuing short-term returns at the expense of stability may violate the duty of loyalty. Second, a failure to consider climate-related risk due to political or social concerns may also be a violation of the duty of loyalty, as doing so subjugates the interests of beneficiaries to a trustee's political or social preferences.

Duty to Act in Accord with Plan Documents. Pension fund trustees have a duty to act in accord with plan documents. To protect their funds from harm, pension fund trustees can modify investment principles to provide procedures and protocols for dealing with climate risk. If they do so without acting on the new provisions in their documents, though, trustees may be liable for a breach of the duty to so act.

Potential Liability for Trustees

Just as climate harms themselves take a variety of forms—from impacts to human rights and property rights to shareholder losses—the litigation those harms can and will generate in growing numbers takes a diverse array of forms. Recent years have witnessed a growing acceptance—and body of precedent—by courts that such cases are cognizable and justiciable. Put simply, more and more climate plaintiffs—alleging a growing array of harms—will have their day in court. Given the increasing momentum of climate litigation, pension fund trustees should take an active role to avoid exposure to climate liability claims in the current litigation context.

Climate Litigation. Both private and public entities have been sued under various constitutional, statutory, and private tort claims for injury caused by climate change. Government agencies are investigating major fossil fuel companies under climate related claims. Private individuals are filing suit against fossil fuel companies for potential harms caused by climate impact, and international plaintiffs are suing fossil fuel producers in tort for money damages. Moreover, across the globe, climate litigation has taken root not only in domestic tribunals, but also in international human rights law. Taken together, this body of litigation demonstrates that the prima facie arguments about the justiciability of climate change have been settled. Climate change is in the courts, and cases are casting renewed light on obligations to investors, consumers, affected communities, and to future generations.

Liable as fiduciaries. Pension fund beneficiaries have rights that can be enforced against pension fund fiduciaries. These rights and the obligations of trustees give rise to myriad causes of action under both common law and statutory law, as well as federal and state enforcement. Potential private common law claims include: breach of fiduciary duties, negligence, gross negligence, negligent supervision, breach of contract, unjust enrichment, voluntary assumption of a legal duty, common law fraud, and negligent misrepresentation. The emergence and growth of climate litigation, paired with mounting evidence of financial risks in the climate change era mean that the risk of pension litigation arising from climate-driven fund losses cannot be discounted.

Prudence in the Face of Climate Change

Modification of investment principles. The most fundamental way to protect a fund from climate-related risk is to modify its investment principals to include procedures and criteria that incorporate the risk. Several large public pension funds – including CalPERS, the largest – have already incorporated investment principles to address climate vulnerabilities to some degree. Although modification of investment principles is a good step, it may not be enough to protect a fund from climate-related risk. If the change in principles is not followed by action, then pension fund trustees may find themselves in breach of the duty to act in accordance with plan documents.

Avoidance. The simplest way to avoid climate risk in a portfolio is to eliminate or dramatically reduce investments in fossil fuel assets and other highly-climate-vulnerable holdings. As long as the rest of the portfolio is performing adequately, there is no legal obstacle to such negative screening. This may be an especially attractive option for smaller funds with fewer resources to monitor and engage with each climate-vulnerable investment in the portfolio.

Engagement. If, notwithstanding the risk, fund fiduciaries find it necessary to retain some fossil fuel or climate-vulnerable investments, the fund should undertake "asset stewardship" or "active ownership" and participate actively as a shareholder to ensure the companies in which it invests are prepared for climate change. This can include using shareholder resolutions to demand scenario analyses or other plans, filing books and records requests to demand information, or by voting for board members prepared and competent to lead the company in an era of climate change.

Proactive Investment in Clean Energy. Whether or not a fund reduces its exposure to fossil fuel and other climate-vulnerable investments, investing in clean energy assets can act as a form of hedging against climate risks.

Conclusion

Just as it presents a threat unlike any humankind has faced before, climate change presents a financial challenge unlike any we have yet seen. Pension fund trustees must acknowledge these risks and prepare for unprecedented market changes in major sectors of the global economy. A failure to do so could expose their funds to severe losses and themselves to liability. Fortunately, pension fund trustees have the notice and the opportunity to address these risks in their portfolios, and can confidently navigate this new future with care, skill, and caution.

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