Climate Governance Initiative Australia

Australian Institute of Company Directors

MinterEllison

Biodiversity as a material financial risk

WHAT BOARD DIRECTORS NEED TO KNOW

BIODIVERSITY – HOW IS IT RELEVANT TO DIRECTORS?

Biodiversity - the variability among living organisms - is being lost at a rate 100 to 1,000 times higher than that of the past million years. This poses significant risk to economic activities and financial assets, which depend on biodiversity. It may also create opportunities for businesses to be part of the transition to a 'nature-positive' economy.

It is imperative that boards understand all of the indirect, but very real, implications of biodiversity loss for their business. For example, compromised access to key feedstocks, exposure to chronic or extreme environmental damage, customer boycotts and moratoria, punitive trade and regulatory constraints, litigation, pressure from investors or premature termination of permits.

Changes to natural habitats and biodiversity loss are also inextricably linked to both the drivers and impacts of climate change and should not be addressed in isolation. While companies' climate governance, strategy, risk and reporting are likely to be more advanced than that on nature and biodiversity, the interdependence between these two issues means that corporate strategy is only likely to converge. Directors should therefore consider the role that addressing nature-related risks and opportunities can play in meeting climate-related targets.

This update draws out the key points of the **Commonwealth Climate and Law Initiative (CCLI) report: Biodiversity Risk: Legal Implications for Companies and their Directors**. As part of the Climate Governance Initiative Australia, AICD and Minter Ellison have adapted this briefing for an Australian audience.


CCLI Commonwealth Climate and Law Initiative

Biodiversity Risk:
Legal Implications for Companies and their Directors

Commonwealth Climate and Law Initiative
Jennifer Ramos and Zaneta Sedilekova
13 December 2022

Following a short refresher on the relevance of biodiversity and the applicable elements of directors' duties, the final page includes questions for boards to engage with management.

This update explores:

- The relationship between biodiversity and companies.
- How ecosystem services support many sectors of the economy.
- The indirect nature of many companies' interface with biodiversity through value chains.
- Changes to the standards of materiality used in assessing biodiversity risks and opportunities.
- Market, social, regulatory and legal context that influences biodiversity risk and opportunity assessment.
- Biodiversity litigation risk.

HOW BIODIVERSITY LOSS AFFECTS COMPANIES

There is international consensus on the financial and systemic materiality of biodiversity risk, including statements by the Network for Greening the Financial System, the UN Principles for Responsible Investment, the Taskforce on Nature-related Financial Disclosures (TNFD), the World Economic Forum (WEF), the Organisation for Economic Co-operation and Development, governments and national banks (see page 14 of the CCLI report for details on central banks).

Biodiversity underpins 'ecosystem services', such as replenishing stocks of renewable natural resources, pollination and water purification.

Companies depend on ecosystem services to produce their goods and services.

This gives rise to risks and opportunities to the company. Loss of ecosystem services, the ability to utilise those services, or the ability to protect and improve those services can affect business, including through loss or creation of income streams and brand and reputational consequences.

These risks and opportunities can flow through supply chains and across multiple sectors, impacting companies which are not directly dependent on ecosystem services.

Companies can also be responsible for significant impacts on biodiversity.

These can be negative impacts that drive biodiversity loss, or 'nature positive' impacts that protect and restore biodiversity.

This also gives rise to risks and opportunities to the company. These can be:

- **direct** (where the impact affects an ecosystem service on which the company depends or improves the company's prospects through better ecosystem services); or
- **indirect** (where the impact does not directly affect the company, but gives rise to reputational risk or opportunity, or legal risk).

Boards are required to consider material risks and opportunities as part of their duties to their company. These duties sit in the context of increasing discussion of the transition to a 'nature-positive' economy.

Under some disclosure frameworks, although not yet adopted in Australia, companies may be required to disclose both "outside-in" and "inside-out" impacts referred to as "double materiality" (**see page 6**) i.e. both:

- risks or opportunities that are financially material to the company within a standard financial planning horizon; and
- impacts of the company on biodiversity, even where such impacts do not translate into risks or opportunities that will directly affect the company's financials within such a standard time period.

BIODIVERSITY AND ECOSYSTEM SERVICES

The functioning of the global economy and the actors within it depend on the services supplied by healthy ecosystems, known as 'ecosystem services'.

According to the World Economic Forum, US$44 trillion of economic value (over half of global GDP) is moderately or highly dependent on ecosystem services. Biodiversity underpins ecosystem services.

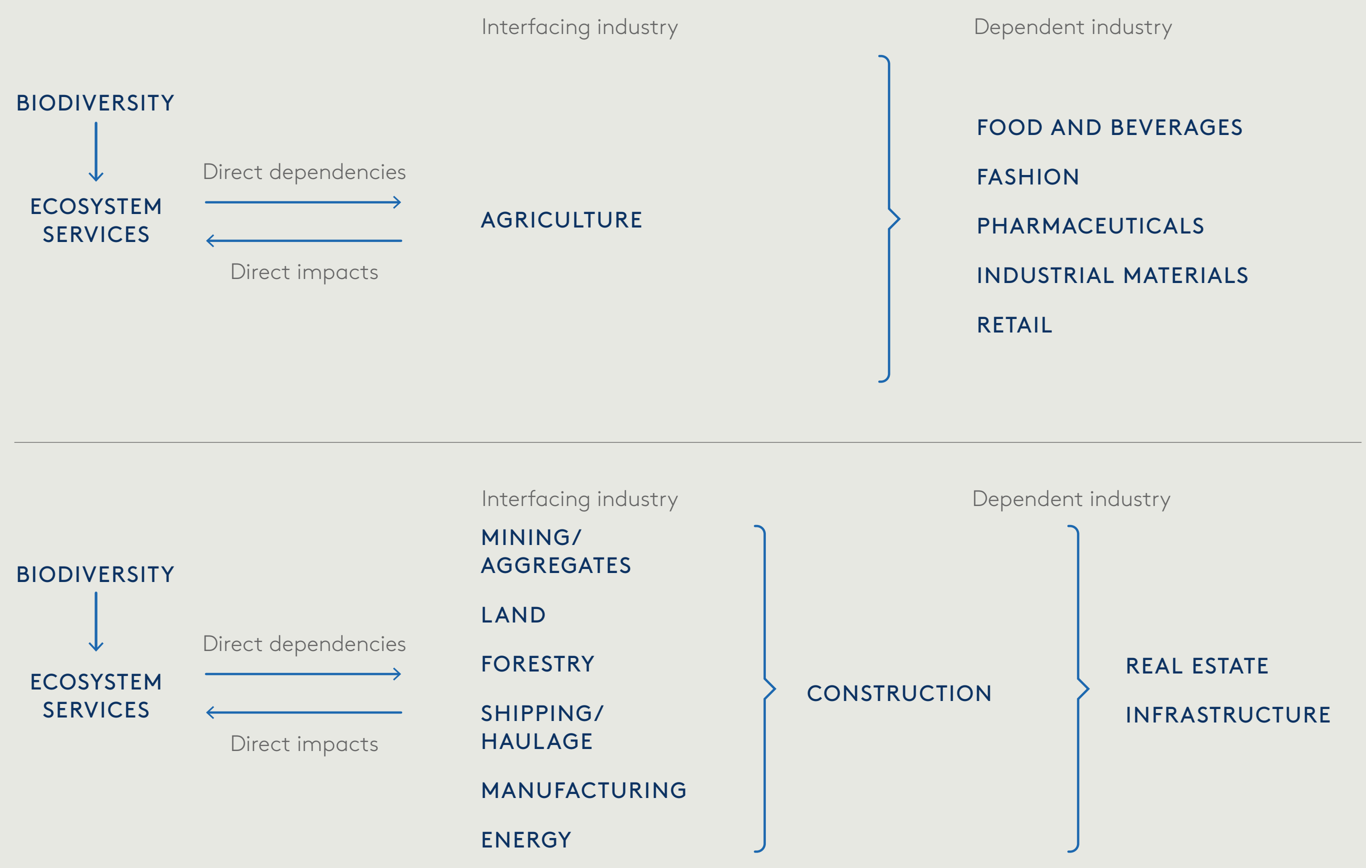
Ecosystem services can be categorised as provisioning, regulating or cultural services. See below for examples of some sectors that they directly underpin.

ECOSYSTEM SERVICE	RELEVANT SECTOR (NON-EXHAUSTIVE EXAMPLES)
Provisioning ecosystem services provide materials and energy for products.	
Water supply	Food and beverages, agriculture, green hydrogen, paper, construction and mining
Genetic material	Agriculture, forestry and pharmaceuticals
Biomass provisioning	Energy
Other provisioning services (food, fibre… etc.)	Fashion, retail, fisheries, aviation, automobile, industrials, forestry and pharmaceuticals
Regulating ecosystem services and processes, supporting industries which rely on the stability of those services	
Pollination	Agriculture, fashion, food and beverages
Soil and sediment retention	Agriculture, fashion, food and beverages
Water flow regulation	Construction, real estate and mining
Solid waste remediation, soil quality regulation	Agriculture, construction, real estate, mining
Water purification	Food and beverages, agriculture and healthcare
Flood mitigation	Construction and real estate
Air filtration	Construction, real estate and healthcare
Nursery population and habitat maintenance	Fisheries and tourism
Local climate regulation	Agriculture, food and beverages, fashion and tourism
Biological control	Agriculture, food and beverages, fashion and healthcare
Global climate regulation, rainfall pattern regulation and storm mitigation	Agriculture, construction, renewable energy, mining, oil and gas, real estate and insurance
Cultural ecosystem services provide non-material benefits, e.g. spiritual, recreation, well-being	
Recreation-related or visual amenity services	Tourism and entertainment
Education, scientific and research services	Education and science
Spiritual, artistic, symbolic and cultural services	Education, cultural, media, tourism

COMPANIES' DEPENDENCIES AND IMPACTS ON BIODIVERSITY

Many companies have direct or indirect dependencies on biodiversity through their use of ecosystem services or through their value chain. Companies can be responsible for significant impacts on biodiversity, including by their: use of land and sea space; use of organisms (e.g. for raw materials); contributions to climate change; pollution; and by contributing to the invasion of alien species (the 5 main drivers of biodiversity loss).

Figure 1: Dependencies and impacts on biodiversity



ASSESSMENT AND DISCLOSURE OF BIODIVERSITY RISKS AND OPPORTUNITIES

Companies' dependencies on biodiversity can create risks to and opportunities for the company, for example where biodiversity loss may affect the supply of goods or income generation.

A company's impacts on biodiversity can create risks and opportunities, either by affecting ecosystem services on which the company depends or by negatively affecting other parties, creating potential reputational and/or legal risks.

Generally, companies are required to disclose risks to their business that meet the classic definition of financial materiality. However, under emerging disclosure frameworks, this may be changing.

The traditional approach to materiality, known as 'single materiality', considers the risks posed to a company (i.e. "outside-in") within a planning horizon that is considered material to financial valuations.

Some disclosure frameworks adopt a 'double materiality approach', as adopted by the EU Non-Financial Reporting Directive and the proposed TNFD framework. 'Double materiality' requires companies to disclose both risks posed to and impacts caused by the company.

Therefore, companies' biodiversity impacts that do not create any any direct material risks material risks or opportunities to the company could in time fall within directors' governance and disclosure practices. This is an open question that will require directors to use business judgement.

These risks (and opportunities) are particularly acute in Australia. Australia is one of 17 mega diverse countries on Earth (and one of only two developed countries on that list) and is disproportionately affected by biodiversity and nature loss. For example, according to the **State of the Environment Report 2021**, over the past two centuries, Australia has lost more mammal species than any other continent, and continues to have one of the highest rates of species decline among countries in the OECD.

Australia is also home to the oldest continuous living Indigenous culture in the world. The intersectionality between nature, biodiversity and human rights can give rise to locationally-specific risks and opportunities involving Indigenous connection to land such as strategic litigation and collaborative engagement to unlock nature positive approaches.

Figure 2: Double materiality

LEAP – THE RISK AND OPPORTUNITY ASSESSMENT APPROACH

To assist with the assessment of nature-related risk and opportunities, the TNFD has developed voluntary guidance for organisations using a 'LEAP' framework.

- **Locate** your interface with nature;
- **Evaluate** your dependencies and impacts;
- **Assess** your risks and opportunities; and
- **Prepare** to respond to nature-related risks and opportunities and report.

LEAP is not, in itself, a recommended disclosure or a mandated process to align with the disclosure recommendations put forward by the proposed TNFD framework. As such, not everything that is identified, assessed and evaluated using the LEAP approach would be disclosed.

The LEAP framework has been designed as a general approach to assessment for use by a wide range of corporates and financial institutions. However, given variations in business models, sector-based market dynamics and the information needs of users, it can be adapted to suit specific enterprise risk management processes or used as a checklist to ensure existing internal processes adequately address nature-related risks and opportunities.

L	LOCATE The interface with nature
E	EVALUATE The interface with nature
A	ASSESS Material risks and opportunities
P	PREPARE The interface with nature

Source: TNFD

LEGAL AND REGULATORY CONTEXT

Biodiversity risk does not just include physical risks and opportunities (e.g. in raw materials supply chain) but also includes risks posed by policy, regulatory, investor and customer responses to biodiversity loss. These are commonly referred to as 'economic transition' risks and include legal and liability risks. These, in turn, include policy and regulatory developments such as the following:

- Proposed and enacted environmental due diligence legislation around the world is likely to cascade information requests through value chains. This has major implications not just for directly affected companies incorporated or operating in the territories where such legislation is passed but through its cascading effect, for companies outside those territories. It may also influence global best practice.
- Proposed legislation for a biodiversity certificate trading scheme for land and marine conservation and regeneration projects; signalling natural capital as an emerging asset class. (The Australian Government has introduced the **Nature Repair Market Bill** (2023) into Parliament. The scheme is broadly based on the regulatory architecture already in place for carbon credits in Australia, with a range of adaptions and enhancements to address the unique attributes associated with creating a market relating to nature protection, repair and restoration.
- Courts are considering biodiversity-related cases against companies. See **page 13** below.
- The Global Biodiversity Framework (sometimes referred to as the 'Paris Agreement for Nature') adopted at the fifteenth conference of the parties to the UN Convention on Biological Diversity in December 2022 (COP15) includes indicative targets relevant to companies, which could, if translated into government policy or legislation, create risks for companies. In Target 15 governments committed to implement measures to ensure that large and transnational businesses and financial institutions assess and disclose their risks, dependencies and impacts on biodiversity along value chains and portfolios. The Australian Federal Government is a signatory to the Global Biodiversity Framework, as well as a number of international initiatives aligned with the proposed action-oriented targets under that Framework. This includes an October 2022 commitment to the **High Ambition Coalition on Nature and People** which (like the Global Biodiversity Framework) includes targets to ensure 30% of degraded lands are under restoration, and 30% of terrestrial and marine ecosystems protected, by 2030 (amongst other targets on extinction, invasive species and pollution).
- The Australian Federal Government's **Threatened Species Action Plan 2022-2032** (released in October 2022) maps a pathway to protect, manage and restore Australia's threatened species and important natural places. It includes an objective to prevent new extinctions, and a commitment to protect and conserve more than 30% of Australia's land mass.

- The forthcoming frameworks of the Taskforce on Nature-related Financial Disclosures (TNFD) (which is due to be published in final in September 2023) and the International Sustainability Standards Board (ISSB) may lead to companies being obliged to make biodiversity risk disclosures in financial reports. In Australia, Treasury and the AASB are currently focused on implementing the ISSB's IFRS S2 Climate Change reporting standard. Over time however it is expected that Government will consider how the IFRS S1 Sustainability reporting standard, including nature and biodiversity issues, could apply in Australia.
- The ASX Listing Rules require the disclosure of 'material' information by ASX listed companies (i.e. information which would affect an investor's decision to invest); therefore, investors' attention to biodiversity may affect duties of disclosing companies. Investor frameworks indicate a growing appetite by the world's biggest investors for managing biodiversity risk, which signals that investors deem biodiversity issues to be material. For example, the UN Principles for Responsible Investment, the Finance for Biodiversity Pledge and Nature Action 100. As disclosure of biodiversity risk becomes more widespread, this will raise market expectations of both 'minimum' and 'good' practice. Such expectations, in turn, can inform the standards of 'reasonableness' against which directors' conduct is assessed (as discussed at **page 10** below).
- In addition to biodiversity risk disclosure requirements, investors may request companies to set science-based targets for nature or disclose biodiversity-related lobbying activities.
- Developments in natural assets, impact investing and natural capital accounting are bringing biodiversity into the financial mainstream, recognising its intrinsic value. This indicates a general direction of travel rather than any imminent new requirements for companies while 'nature' in financial terms is still relatively nascent.
- Legal recognition of the 'rights of nature', in which natural entities are granted legal status similar to a company or person, presents an emerging legal risk with future potential to accelerate biodiversity litigation against companies. This risk is limited to companies operating (including through value chains or subsidiaries) in specific areas where such rights are relevant (areas within over 30 countries defined through local constitutions, statutes or court decisions), who will need to assess whether company activities might breach such rights. This risk is particularly acute in Australia given its disproportionate degree of biodiversity and nature loss.

DIRECTORS' DUTIES UNDER AUSTRALIAN LAW

Generally, directors' duties require acting with loyalty, and with minimum standards of care and diligence, in discharging their obligations as 'fiduciaries' of their companies. These duties apply across directors' exercise of their functions, including in strategic planning, oversight of foreseeable and material risks, and in attesting to the accuracy of disclosure and financial reporting.

'BEST INTERESTS' DUTY

In Australia, the duty of loyalty is set out in section 181(1) of the Corporations Act 2001, as the obligation to exercise powers and duties '(a) in good faith in the best interests of the corporation, and (b) for a proper purpose'. In his **flagship opinion commissioned by the AICD**, senior barrister Bret Walker SC made clear that directors have a broad discretion to determine corporate best interests, and that those interests (including reputational interests) may include stakeholder interests beyond shareholders (such as those of employees, the community and environment).

Even where such interests are purely financial, as this Update demonstrates, it is clear that biodiversity may present foreseeable financial risks and opportunities for certain companies (particularly in the sectors set out in the table on **page 4** above). In those circumstances, directors would be permitted to consider biodiversity impacts and dependencies in their companies' best interests, and indeed may need to prioritise them relative to other stakeholder interests where relevant regulation applies.

This is not to say that directors should always prioritise the interests of the environment over those of their company. Rather, it is a recognition that the scarcity and degradation of the natural environment in which a company operates, and market and legal trends towards accelerated protection and valuation of that environment, means that biodiversity-related issues are now far more likely to have direct consequences for corporate best interests.

DUTY OF CARE AND DILIGENCE

The standard applied to directors' duty of care and diligence, as set out in section 180(1) of the Corporations Act 2001, is that of a reasonable person in comparable circumstances and involves making informed decisions after reasonable enquiry,

The standard of care to which directors may be held depends on the corporate context. The degree of consideration required will be proportionate to the magnitude of the relevant issues to the company. In the context where biodiversity is a foreseeable risk (and opportunity) for significant sectors across the economy (as set out in the table on **page 4** above), it is possible that a director may breach their duty of care and diligence by failing to consider and govern for foreseeable biodiversity-related issues and their potential impact on the company. Directors should stay proactively informed of biodiversity-related issues so that they are able to:

- ask the right questions of management and/or independent experts; and
- critically evaluate the relevant implications for company strategy, oversight of material risks and disclosure – actively applying their independent judgment.

This is not to say that directors need to become 'experts' in biodiversity, or spend a disproportionate amount of time considering biodiversity-related issues if they are not material to the company. However, directors should be turning their minds to biodiversity-related risks to the extent they foreseeably impact on the interests of the company,[1] in order to then diligently consider whether those risks are material - and from there exercise a proportionate degree of consideration of the impact on corporate strategy, risk oversight and disclosure. And given the dynamics with which this issue has evolved, and continues to evolve with forthcoming disclosure frameworks in a financial context, directors would be well-advised to ensure that the issue is on the board agenda.

It is important to note that directors enjoy the latitude set out in the business judgment rule under section 180(2) of the Corporations Act 2001. The business judgment rule essentially provides a defence for directors against a claim of breach of their duty of due care and diligence (only) where a commercial decision (or 'business judgment') is made that the directors rationally believe to be in the best interests of the company. This defence recognises that the law is ill-equipped to second-guess commercial decisions that are made by directors.

However, the business judgment rule is relatively limited in practice[2] and will not protect a director from liability if they are not appropriately informed about the relevant subject matter. Accordingly, it will be critical for directors to ensure that any decision in relation to strategy, risk oversight or disclosure in relation to biodiversity-related issues is made on the basis of contemporary knowledge in what is a highly-dynamic area. Depending on the company context, specific capacity-building on biodiversity may be warranted.

1. Noel Hutley SC and Sebastian Hartford-Davis of Counsel, Climate Change & Directors Duties (here). See also 2019 update (here) and 2021 update (here).
2. See Allens Linklaters advice regarding the business judgment rule, commissioned by the AICD (available here).

LITIGATION RISK

There are multiple examples of cases around the world against governments that indicate increasing appetite of litigants for biodiversity claims. This includes the US, Turkey, France, Ecuador, Australia, Argentina, Colombia, China, Costa Rica, Tanzania and the Philippines.

Biodiversity-related litigation is being brought against companies. Beyond administrative claims associated with consents or approvals given to projects under environment and planning laws, claims brought to date generally relate to disclosure obligations, or duties to manage subsidiaries or value chain partners:

- In Australia, a potential claim against an Australian bank may soon be filed on the grounds that the Corporations Act requires its directors' report to disclose that biodiversity loss represents a material risk.
- In the US, investors have filed a securities class action against wood pellet company Enviva and its directors, including allegations that Enviva misrepresented the environmental sustainability of its wood pellets and its sourcing practices are negatively impacting forest biodiversity.
- A 2021 case against the French supermarket chain Casino alleged that Casino's yearly due diligence plans failed to detail the environmental and human rights harms caused by the supply of cattle from deforested areas to Casino's Brazilian subsidiary.
- Cases in the UK, the Netherlands and Canada indicate that courts may not strike out claims against parent companies for conduct of foreign subsidiaries. In the UK this includes claims by alleged victims of environmental harms located in Zambia, Nigeria and Brazil. Although substantive judgments in these cases are pending and some of these cases deal with alleged human rights abuses, the same legal principles could allow for lawsuits against parent companies for the impacts of their subsidiaries in biodiversity-rich regions.
- While no biodiversity-related cases have yet been filed alleging breaches of directors' duties, cases filed against directors for alleged mismanagement of climate risk indicate the potential for similar biodiversity claims.

Avoidance of liability is a minimum bar, and directors will want to avoid or mitigate reputational issues by aiming for prudent governance informed by best practice. Directors should require risk management processes that assess foreseeable biodiversity dependencies and impacts of the company for materiality and measure those that are material. Directors can then include material dependencies, impacts, risk and opportunities within strategy, disclosure and decision-making.

QUESTIONS DIRECTORS SHOULD BE ASKING

Company directors can use this checklist to assist their oversight of biodiversity risk:

RISK MANAGEMENT

- To what extent are biodiversity risks and impacts embedded into my company's risk management processes?
- Is the management team assessing the company's foreseeable biodiversity dependencies and impacts?
- Is the management team measuring the company's material dependencies and impacts on biodiversity?

CAPABILITY

- Do I have the appropriate skills and information to assess how biodiversity issues could affect my company and my ability to discharge my governance and disclosure obligations?[3]
- What training or information would help the board, executive and management teams build our capacity?
- Do we have the appropriate internal expertise to interrogate relevant issues, or do we need to engage external experts?
- What can we learn from industry networks and peers?

DISCLOSURE

- How have we assessed whether our dependencies and impacts on biodiversity are material to financial performance, position and/or prospects?
- What is our approach to potential disclosure? If we disclose, what kind of external assurance is obtainable?
- If we are not required to apply the TNFD framework under Australian law, do expectations of regulators, investors and/or emerging market practices make it advisable that we have regard to them?

STRATEGY

- Does my company have a strategic biodiversity plan, based on identified dependencies and impacts specific to the company?
- Does this plan:
  - align with the company's overarching strategy and purpose;
  - define the company's vision, measurable goals, objectives and strategies to address biodiversity risk; and
  - ensure that the company's external activities, including membership of professional associations and voluntary initiatives, align with its goals.
- To what extent will nature positive initiatives support our climate transition plans?
- Are there any market and/or competitive opportunities in developing a nature positive approach?

3. Climate related resources can be applied to biodiversity to help assess this. See 'The climate risk reporting journey: a corporate governance primer' and 'How to Set Up Effective Climate Governance on Corporate Boards'.

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