Climate Change Related Legal Issues

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CLIMATE CHANGE RELATED LEGAL ISSUES (PART 2) – CONTRACTS & DISPUTES BETWEEN PRIVATE PARTIES

I. INTRODUCTION

Climate change is increasingly shaping business outlook, investment opportunities, funding scrutiny, emerging technologies, corporate governance, corporate environmental responsibility, internal policies, international and national regulation, and public activism. There is a surge in projects that make products or develop technologies that are primarily aimed at reducing greenhouse gas emissions or supporting the use of clean energy, and a consequent surge in ancillary services.

These developments and changes in outlook generate uncertainties and enlarge the risk profile for businesses. An increasing number of disputes are being seen between contracting private parties (such as investors, funders, contractors), States, foreign investors and state-owned entities, and third parties (such as shareholders, non-governmental organizations and the general public). These disputes are epi-centred in contracts, international treaties (such as a bilateral investment treaty), international law principles, y national statutory law and policy, and internal corporate policies.

Climate change dispute resolution has gained immense significance worldwide. At a conference on 'Climate change related disputes' convened during the COP 21[1] at Paris in 2015, then-President of the International Bar Association David W. Rivkin said, "commercial stakeholders in climate change-related issues, such as international monetary lenders, insurers, construction companies, states, and extraction industries, all stand to benefit from certainty of contract, including in respect of internationally or state or industry imposed climate change or sustainable development objectives and targets".

He further stated that there was "huge potential to consider how the existing use of international arbitration and ADR mechanisms in resolving climate change related disputes may be advanced and expanded, both in the context of contractual obligations and treaty mechanisms". The World Economic Forum's Global Risks Report of 2022 identifies geopolitical risks and regional or global implications of border disputes, environmental commitments, trade disputes etc. Several international conferences are being held to discuss and improve the current climate change dispute resolution framework.

With global attention to climate change disputes, there is a need for businesses to adopt a distinct approach towards projects involving environmental elements and resultant disputes. These disputes will often involve sensitive commercial nuances and decision-making, require immediate expert attention, engage technical and scientific expertise, abide by special laws, and minimize impact in minimum time.

The business and reputational risks arising out of climate change run deep, and can even unsettle a company's core responsibility structures. For example, in May 2021, a small hedge fund called Engine No. 1 dealt a major blow to Exxon Mobil Corporation, unseating at least two board members in a bid to force the company's leadership to reckon with the risk of failing to adjust its business strategy to match global efforts to combat climate change. The fund successfully rallied support from institutional investors, shareholders like BlackRock Inc., and shareholder advisory firms upset with Exxon Mobil for its weak financial performance in recent years and who agreed to vote for three members of Engine No. 1.[2]

Hence, businesses that are often in a better position to mitigate, transition and adapt to the impact and growing demands of climate change are those that are cognizant of climate change impact, scrutinize their investment opportunities, seek proper funding, tailor their internal policies and transaction documents, comply with applicable laws and regulations, manage risk, and plan their approach to dispute resolution. These practices help them safeguard against business and reputational risks.

In the first article in this series (see here), we provided insight into the impact of climate change on businesses and the resultant risk profile - including uncertainties in operations, funding, risk allocation, damage quantification, applicable laws and remedies. We provided an overview on disputes-risk and the types of disputes businesses can anticipate from climate change related events or policies, with an aim to better tailor dispute prevention, mitigation and management strategies.

In the present article, we will provide insight into commonly seen issues in contractual disputes relating to climate change, and their commercial and legal nuances - to enable businesses to tailor dispute prevention, mitigation and management strategies. This article will also cover general contracts that may not involve green projects or clean energy, but could be affected by climate change related events, national laws and regulations, and corporate policies.

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II. CLIMATE CHANGE RELATED CONTRACTS

A wide range of businesses may be impacted by climate change. For the purposes of private parties engaged in contractual relationships, climate change related contracts could fall under any of the following categories:

a. contracts that involve environmental or climate change related goals and elements - such as generation and supply of clean energy; manufacturing of products or developing processes or technologies aimed at reducing greenhouse gas emissions (Category A);

b. contracts that are derived from or support the above category - such as contracts involving investments in companies manufacturing or supplying renewable energy, project finance of construction sites for renewable energy plants, funding, licensing, insurance, technology transfer (Category B); and

c. general contracts that do not involve environmental goals or related elements but could be impacted by change in climate, national laws, or internal corporate policies (Category C).

The aforesaid categories cover a wide range of commercial contracts. Hence, a wide range of businesses need to be aware of the common risks, legal and commercial issues that could arise from their contracts. Following is an overview of these types of risks and issues, with hypothetical case studies for effective understanding.

III. COMMON RISKS AND ISSUES IN CLIMATE CHANGE RELATED CONTRACTS – WITH EXAMPLES:

Apart from common contractual breaches (for example - failure to supply agreed quality or quantity of components for construction of a renewable energy plant, breach of confidentiality in technology transfer agreements, violation of exclusivity in contracts to develop green processes), performance of contracts may be impacted by climate related action and policies.

Violation of environmental laws by parties, change in laws and regulations, introduction of policies requiring businesses to transition and adapt to alternate practices, voluntary commitments by industry associations - could give rise to claims involving breach of representations and warranties, breach of contract, allocation of liability, and indemnity among others.

Performance under contracts may be impacted by climate related natural events. This could result in disputes involving force majeure, frustration, re-negotiation, variation, price reduction, admissibility of claims, damages, insurance etc.

i. Breach of representations and warranties:

International cooperation on climate change – since the Montreal Protocol in 1989 and the United Nations Framework Convention on Climate Change (UNFCCC) in 1995 to the Paris Agreement in 2015 - has resulted in a robust framework of mandatory and recommendatory environmental obligations for States. These obligations have been adopted in varying degrees by States, either through international commitments, national legislations, regulations or policies.

This body of hard law and soft law is applicable to all stakeholders operating in the respective States. Resultantly, businesses need to comply with these laws, regulations and policies for smooth and effective functioning, transition, adaptation, and risk-mitigation. Obligations to comply with applicable environmental laws are increasingly built in covenants, representations and warranties in contracts.

For example, in a share purchase agreement for acquisition of a hydroelectric power plant in a multi-purpose river valley project in India, the seller could warrant that it has obtained all consents, approvals, permits, licenses, permissions, registrations, clearances, as is required for the functioning of the plant by the company, and that the seller and the company are in compliance with all aspects of laws applicable to the business of the company. Absence of the requisite permits from the Ministry of Environment, Forest and Climate Change; non-compliance with legislations such as Environment Protection Act, 1986; or newly introduced regulations in line with the Paris Agreement and non-compliance thereto; could result in claims for breach of representations and warranties, inability to operate the plant, and/or even administrative action against the business. (This is a 'Category A' contract.)

In construction agreements, companies have begun to prescribe undertaking of substantial measures by contractors, that ensure sustainability of the project site. Similarly, financial institutions in the project finance industry are commonly integrating the Equator Principles in their contracts, in order to reduce carbon footprint as well as the social risk involved in the project completion. If the borrowing party violates the standard of protection and caution as laid down in the principles, financial institution could initiate action for such violation.[3] (This is a 'Category B' contract.)

Thus, disputes may arise out of breach of promises or compliance standards built into commercial contracts. It is therefore essential for businesses to be aware and seek opinion on applicable environmental laws, regulations and industry standards; comply with the law; fulfil environmental obligations; and conduct stringent due diligence for environmental compliances where applicable.

Additionally, businesses need to keep close watch on climate change related policies and bills. Businesses need to actively participate in consultation processes and industry-level discussions, assess ambiguities and uncertainties in the draft policies, and evaluate the feasibility of their business models in light of the policies.

ii. Indemnity claims:

An indemnity clause in a contract involves a promise by the indemnifying party to save the indemnified party from any loss caused to it, by actions of the indemnifying party or a third party. In climate change context, indemnity clauses could be built into almost all contracts that engage state action or action by a party vis-a-vis third parties to the contracts.

For example, an electronics supplier supplied carbon fibre fans to an engine manufacturer for installation in aircraft engines. The engines were installed in a range of aircrafts operated by a leading aircraft operator. During inspection, it was found that the engines did not meet the engine emission standards, and the aircrafts were

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grounded. The aircraft operator sued the engine manufacturer for damages, which were settled by the engine manufacturer. The engine manufacturer then initiated arbitration against the carbon fibre fan supplier for indemnification, by claiming that the aircrafts were grounded and engines had to be replaced due to faulty fans. (This is a 'Category A' contract.)

In contracts such as the above, and particularly in acquisition or investment contracts, acquirers or investors should seek specific indemnities from the sellers or investee companies for any liability that the company or the investor may incur as a result of non- compliance with environmental laws. Clauses need to be tailored in contracts to account for claims that can be covered in indemnity clauses such as fraud, misrepresentation and wilful misconduct; timely notice of indemnity claims; limitation period for claims; definition of loss and special inclusions such as costs and expenses arising from enforcing indemnification rights, mitigation, expert determination of loss, and arbitration among others.

iii. Breach of performance due to natural events:

Climate change related natural events may result in failure of performance and breach of contract. For example, a large fishing company near the Gulf of Mexico entered into a contract with a marine life institute to provide infant dolphins for a period of one year for research and education purposes. Due to an uncontrolled oil spill in the Gulf of Mexico, extensive damage was caused to marine and wildlife habitats, and dolphins and other marine life died in record numbers with infant dolphins dying at six times the normal rate. The fishing company cited difficulty in providing infant dolphins from the region, and claimed additional costs for providing infant dolphins from neighbouring waters. The institute refused to pay additional costs, citing failure on the part of the fishing company to provide the infant dolphins as per the agreed schedule that fell prior to the accident. (This is a 'Category C' contract.)

A cement company entered into a contract with an offshore oil exploration company to provide cement, and with a rig operator to build cement walls for rigs. A sudden explosion in the rig resulted in leakage of oil into the sea, and extensive damage to the environment. The exploration company was banned from contracting and operating in the region for five years, and ordered to pay huge penalty. The exploration company paid the penalty. It then initiated arbitration against the cement company for providing defective cement on the walls, and the rig operator for inadequate safety systems. It claimed indemnity for the penalties paid by the exploration company to the State government, and loss of economic benefit arising from its suspension to continue its existing operations in the region. (This is a 'Category C' contract.)

A salt mining company entered into a contract with a cosmetics company to provide salt and minerals from the Dead Sea. Due to increased shrinkage of the Dead Sea, replacement of salt water with fresh water, and formation of multiple sinkholes in the area, the salt company is forced to abandon its operations in the area and move to a more stable section of land surrounding the Dead Sea. The salt company requested the cosmetics company for extension of time to provide salt, and payment of additional costs in light of the events and the resultant transition. On the other hand, the Jordanian government introduced higher taxes on cosmetic products made from Dead Sea minerals to prevent salt mining from the Dead Sea. The cosmetics company requested the salt company for price adjustment and re-negotiation of terms. (This is a 'Category C' contract.)

In order to avoid escalating claims/disputes which are time consuming and expensive to defend against, parties are endeavoring to increase predictability against such events, in light of ever-increasing global warming and emissions.[4] To reach this effect, contracts are incorporated with comprehensive force majeure clauses (such as Model Clauses of top arbitral institutions like the ICC or SIAC), with inclusion of specific climate change incidents that may occur in the particular business activity.

In such cases, it might be difficult to attribute the loss or damage to failure of performance by the erring party. Nevertheless, pertinent risks are identified and commercial clauses are carefully drafted to allocate risk or safeguard against such risks. Timing of the natural event, duration of its existence, extent of impact on performance, suspension or impossibility of performance, mitigation guidelines or instructions, percentage of attributable loss, pre-determined damages can be reasonably accounted for in commercial contracts to cater to unforeseen natural events.

iv. Funding and investment agreements:

There has been a surge in interest from companies and some major investors in adopting sustainable business plans that are compatible with a 1.5°C future, as decision-makers recognize the vast growth opportunities ahead in the global transition to a decarbonized economy by 2050.[5]

Rise of green projects and initiatives - aimed at reducing emissions, enhancing sinks of greenhouse gases, and reducing vulnerability and increasing resilience of human and ecological systems to negative climate change impacts - has spurred local, national and international funding to mitigate and adapt to climate change. Companies engaged in such projects enter into funding agreements with financial institutions, multilateral banks and special climate change related funds such as the Green Climate Fund, Special Climate Change Fund, Least Developed Countries Fund to obtain funding for special purposes. These funds have policies, priorities and eligibility criteria for funding. Major pensions funds and investments firms, who acknowledge that their portfolios are now more aligned with a 3.5°C future, are now starting to move at scale by working with the asset managers and companies in their portfolios to decarbonize and align with net zero targets.[6]

With increase in climate finance, chances of breach of funding agreements also rise. For example, misappropriation of funds by businesses for purposes not covered under the funding agreement could result in claims involving breach of representations, fraud, mis-appropriation and compensation among others. A financial institution could withdraw its promised funding due to breach of a condition in the funding agreement by the funded party. Change in local regulations and extent of adaptation measures could compel the funder to withdraw its funding on ground of viability despite no fault on the part of the funded party. The above situations could result in disputes between the funder and the funded party. (These are 'Category B' contracts.)

Several multi-development banks impose stringent terms and conditions that could be difficult to negotiate and navigate. Nevertheless, there is potential to mitigate risk and incorporate safeguards for businesses that seek climate funding. It is necessary to carefully review and negotiate the terms of funding agreements. (Please watch this space for our detailed piece on climate finance.)

v. Mis-representation and non-disclosures:

Non-disclosure is a highly plausible ground for commercial disputes. An example is of the UK Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018.[7] These regulations mandate that companies make disclosures of their emissions (carbon dioxide tonnes) annually. Non-disclosure in light of such regulation might lead to breach of trust or misrepresentation by the company and can lead to commercial arbitrations by shareholders or lenders.[8] We will elucidate on climate change related shareholder disputes in our subsequent articles in this series.

IV. SOLUTIONS TO MITIGATE RISKS AND IMPACT OF CLIMATE CHANGE DISPUTES:

A. Incorporating effective remedies in contracts:

While providing hypothetical examples in the previous section, we have offered some insight into effective remedies to manage risk and minimize impact. At the negotiation stage, it is important for parties to identify key clauses for incorporation and negotiation in contracts. Some of these are –standards of performance, binding obligations, best or reasonable efforts clauses, conditions precedent and conditions subsequent, general breach or particularized events of default, specific representations and warranties, detailed indemnity clauses and process for enforcement of indemnification rights, deferred considerations, liability for loss, pre-estimate of damages or reasonable basis to calculate damages, capped and uncapped liability, specific performance, hand-over obligations, mechanisms to enforce post-termination obligations, among others.

B. Foreseeing emergencies and accounting for them:

Urgency is a natural possibility in subject matters concerning climate change and performance of contracts. Contracts must make room to accommodate or exercise rights such as urgent interim reliefs before courts or emergency relief before arbitral tribunals, continuation of work post-termination and during pendency of dispute, deposit of security or bank guarantee to safeguard claims, conditions to restrain unconditional invocations of bank guarantees, creation of escrow accounts for safe keeping of impugned funds, providing letters of guarantee, safeguarding their enforcement in particular situations. The purpose of these reliefs is to ensure that the subject matter of the contract is preserved and that parties remain interested in the suit property/goods/funds than abandoning performance. These remedies are highly relevant for climate change disputes, which require urgent action coupled with interim remedies till the substance of the dispute has been addressed.

C. Choice of effective dispute resolution forum:

A commercial party could initiate litigation or submit a dispute to arbitration, depending on the terms of the contract or mutual agreement of the parties after a dispute arises. Majority of commercial parties today prefer arbitration for resolving contractual disputes, over litigation. Several reasons support this choice.

Arbitration offers timely and efficient resolution of disputes, in contrast to long-standing litigation. This characteristic is extremely relevant for climate change issues, which require urgent and comprehensive action. This is accompanied with special features offered in arbitration, such as expedited arbitration which can ensure that a dispute is resolved efficiently, in a pre-mandated, time bound manner.

Climate change issues are scientifically complex and warrant expertise in adjudication. It is therefore, contentious, if courts are best equipped to deal with such matters. In arbitration, parties are permitted to choose expert arbitrators, and the tribunal and the parties can both benefit from appointment of expert witnesses. Various arbitral institutions such as the Permanent Court of Arbitration offers a panel of specialised arbitrators skilled to deal with the complex issues that may arise in environment specific arbitrations.[9]

Thirdly, arbitration offers the benefit of clear and specific interim relief under most arbitration legislations. based on the UNITRAL Model Law on International Commercial Arbitration. Parties may have the option of approaching the Court for claiming interim reliefs of several types 'before, during or after the arbitral proceedings'[10], or arbitral tribunals during arbitration proceedings.

Further, awards arising out of the climate change arbitration can be enforced without any major hurdles under the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention). This is because the New York Convention has almost worldwide acceptance and application. Award debtor can enforce the award in any of the Contracting States and can receive the remedy in a timely and efficient manner.

However, arbitration may not be best suited when dispute involves third parties that are not signatories to the commercial contracts, or where multiple commercial contracts exist between some or same parties. Majority of arbitral institutional rules provide guidelines for joinder of third parties, and consolidation of arbitrations. However, parties should be mindful of the uncertainties arising out of such issues in arbitration proceedings and the chances of challenge to resultant awards, ultimately jeopardizing enforceability of the awards.

It may also be worthwhile for parties to choose amicable modes of dispute resolution such as cooling off periods for friendly negotiations, or formal mediation, before proceeding with adversarial modes such as litigation and arbitration. The Singapore International Arbitration Centre has introduced unique Med-Arb-Med clauses, that allow parties to explore mediation even after commencement of arbitration. Such clauses can be incorporated in contracts to provide parties a chance to maintain their relationship and continue an amicable dialogue to resolve disputes.

D. Tailoring arbitration clauses to suit climate change disputes

When parties agree to arbitration to resolve disputes, it is necessary to engage in careful drafting and tailoring of arbitration clauses to suit a climate change related dispute, avoid issues that could drag parties to courts before or during arbitration, and ensure saving of time and costs. For example, in an ad hoc arbitration (i.e. not administered by an arbitral institution), parties can choose to agree to requisite qualifications of an arbitrator, or choose an arbitral institution to appoint expert arbitrators specializing in environmental disputes to avoid approaching courts for such appointments. Parties can choose the rules of a specialized arbitral institution, such as the PCA Optional Rules, for effective administration of arbitral proceedings. Provisions can be made in the arbitration clause to accommodate third parties in arbitration proceedings, or consolidate multiple related arbitrations on certain grounds, to avoid multiple litigations and arbitrations and inconsistent decisions and awards. Parties could agree to publishing of awards with sufficient redaction to avoid confusion on confidentiality obligations. Soft laws such as the IBA Rules on Taking of Evidence can be incorporated to enable taking of evidence and appointment of experts with certainty of process. As such, arbitration clauses need a detailed look depending on the nature of the dispute.

E. Managing costs and working capital during disputes:

Climate change related commercial contracts generally involve high stakes and value, and disputes remain the last priority for businesses to expend funds into. Climate change disputes often involve technical and scientific experts, legal experts, expert arbitrators, and specialized arbitral institutions. These add to the costs of parties involved in a climate change related dispute. There may not be sufficient visibility on recovery of these costs. These factors add to cost uncertainties for businesses.

To ring-fence these uncertainties, parties are increasingly resorting to third-party funding of disputes, either to enable themselves to access dispute resolution mechanisms or maintain a healthy working capital during subsistence of the disputes. Third party funders provide funding based on their assessment of several factors such as chance of success, certainty in applicable laws and enforceability of award etc. Several third party funders provide funding for climate change related disputes, and tailor their agreements to cater to the uncertainties and technicalities of these disputes.

It may be worthwhile for businesses to have their case assessed by legal experts to determine some of the aforesaid factors employed by third party funders, explore third party funding or portfolio funding with third party funders, and negotiate terms suitable for continuity of the business and effective resolution of disputes.

V. CONCLUSION – THE IMPORTANCE OF BUSINESS FORESIGHT, NEGOTIATION & EXPERT ATTENTION

The impact of climate change is inescapable for businesses, as it is for societies and States. Global trade, commerce and investment cannot continue with business as usual in light of the existing and aggravating threat of climate change. Several course corrections need to be undertaken by businesses now to mitigate impact, adapt to the change and transition to greener practices for survival and sustenance.

Studies and reports conducted before the COVID-19 pandemic showed that investments in climate action would go far to build a sustainable economy. The benefits that flow from these investments dramatically outweigh any upfront costs. Although greater and faster progress is needed, and the journey of companies and investors in aggregate is only in its early stages,[11] businesses are becoming increasingly aware of climate change related risks today and are taking climate risks and opportunities into account in financial decisions.

As businesses engage more actively in green projects and initiatives, it will be imperative to accompany the long-term vision of their goals with deep foresight of challenges arising out of climate change. Businesses will need to pre-empt change and claims at early stages of their transactions or engagements; adopt comprehensive strategies to manage and combat risk; and ring fence a larger risk profile including the risk of burdensome, long-standing and uneconomical disputes. They will need to negotiate this terrain with expertise and skill, navigate change with planned yet adaptable strategies, and guard against risks that could drain resources, damage reputation and take the business off course. Disputes activate these risks, and managing them will require business foresight, effective negotiation and expert attention.

Prelude to the Next Article:

In the next article, we will discuss climate change related disputes between foreign investors and sovereign States relating to foreign investment (this may also include lenders and project financiers). These disputes arise often out of State measures such as change in regulatory framework, administrative measures, or actions of contracting state-owned entities, that directly or indirectly affect investments of foreign investors. For instance, Germany's decision to accelerate the phase-out of nuclear energy generation pursuant to the Fukushima catastrophe was challenged by a foreign investor before the International Centre for Settlement of Investment Disputes.[12] A foreign investor in renewable energy challenged the arbitrary and discriminatory award of feed-in tariff contracts by Canada to investors.[13] In reverse, investor action or breaches could also result in state action against the investors in the form of counter-claims. Investor-State disputes travel beyond the scope and legal issues emanating in general contractual disputes. They open the possibility for investors and States to additionally use international law and investment treaties to seek remedies against State or investor actions respectively.[14]

Please watch this space for our next article on Investor-State disputes arising out of climate change.

– Kshama A. Loya & Vyapak Desai

You can direct your queries or comments to the authors

[1] United Nations Conference on Climate Change, termed as Conference of Parties, conducted in 2015

[2] https://www.reuters.com/business/sustainable-business/shareholder-activism-reaches-milestone-exxon-board-vote-nears-end-2021-05-26/

[3] Lucy Wilson, The Equator Principles, Equator Principles Association, https://equator-principles.com/about-the-equator-principles/ (last visited Jul 12, 2022)

[4] Impacts of climate change – foreseeable or unforeseeable? Drafting force majeure clauses in the era of climate uncertainty | McCarthy Tйtrault, https://www.mccarthy.ca/en/insights/blogs/canadian-era-perspectives/impacts-climate-change-foreseeable-or-unforeseeable-drafting-force-majeure-clauses-era-climate-uncertainty (last visited Jul 13, 2022).

[5] https://www.un.org/en/climatechange/raising-ambition/climate-finance

[6] Ibid.

[7] The Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018, https://www.legislation.gov.uk/ukdsi/2018/9780111171356 (last visited Jul 15, 2022).

[8] Susan Field & Helin Laufer, Climate Change, the Environment and Commercial Arbitration, Kluwer Arbitration Blog (2020), http://arbitrationblog.kluwerarbitration.com/2020/03/09/climate-change-the-environment-and-commercial-arbitration/ (last visited Jul 14, 2022).

[9] Panel of Arbitrators and Experts for Environmental Disputes, Permanent Court of Arbitration, https://pca-cpa.org/en/about/panels/panels-of-arbitrators-and-experts-for-environmental-disputes/ (last visited Jul 10, 2022).

[10] Section 9 of the Indian Arbitration & Conciliation Act, 1996

[11] https://www.un.org/en/climatechange/raising-ambition/climate-finance

[12] Vattenfall AB and others v. Federal Republic of Germany, ICSID Case No. ARB/12/12 (this case was discontinued in November 2021).

[13] Mesa Power Group, LLC v. Government of Canada, UNCITRAL, PCA Case No. 2012-17

[14] The authors acknowledge the research assistance provided by Akshat Trivedi, 4th year student of Symbiosis Law School, Pune.