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# **Environmental, Social & Governance Law**

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Wachtell, Lipton, Rosen & Katz

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# Facing the Energy Transition Challenge: Navigating Complexity, Uncertainty and Opportunity

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## Introduction

The global energy transition will undoubtedly be one of the most transformational and capital-intensive undertakings of the coming decades. The past year has continued to see climate records tumble across the globe, leading to UN Secretary General Antonio Guterres urging countries to “turn up the tempo, turn plans into action and turn the tide”. While global regulatory efforts at addressing climate-related risks and facilitating the energy transition continue to grow, it is businesses that face the day-to-day challenges of navigating the significant uncertainties brought on by the energy transition. In addition to the evolving policy and regulatory landscape, boards and management over the past year have faced continued macroeconomic headwinds, geopolitical uncertainty, supply chain disruption and investor and stakeholder pressures, all of which have further complicated efforts to make near-, medium- and longer-term capital allocation decisions, including decisions on how best to invest for a lower carbon future. In the United States, domestic political divisions and a decentralised approach to climate policy have added another layer of complexity to the energy transition as states pursue divergent investment and climate-related policies.

This chapter discusses the current state of the global energy transition, key recent and pending policy and regulatory developments, and how investors are continuing to shape the evolving transition landscape; as well as setting forth considerations for boards and management as they prepare their businesses to face the complexities and uncertainties of the coming decades.

## Current Trajectories and Progress Since the Paris Agreement

In September 2023, the United Nations Framework Convention on Climate Change (UNFCCC) published the technical dialogue of the first global stocktake since the adoption of the Paris Agreement, whose central goal is to keep global average temperature rise this century well below 2 degrees Celsius and drive efforts to limit the temperature increase to 1.5 degrees Celsius above pre-industrial levels. Under the Paris Agreement, a global stocktake is held every five years and is intended to inform the next round of nationally determined contributions (NDCs) (i.e., the national GHG emissions targets determined by each country party to the Paris Agreement) to be put forward by 2025. The first global stocktake started with a data collection phase in 2021 that encompassed inputs from signatories, international parties and other non-party stakeholders. The data collection phase was followed by three technical dialogues in 2022 and 2023 which sought to identify key areas for further action to bridge gaps and address challenges and barriers in the implementation of the Paris Agreement. In connection with the

technical dialogue stocktake report, the International Energy Agency (IEA) concurrently released its assessment of the global energy transition. Taken together, the two reports arrive at the following key conclusions:

- Current global emissions are not in line with mitigation pathways consistent with the temperature goals of the Paris Agreement and the window to implement commitments to limit warming to 1.5 degrees Celsius above pre-industrial levels continues to narrow. While emissions appear to have peaked in developed and some developing countries, global emissions continue to rise and global gas and oil production under government plans and projections will continue to increase until 2050. In order to achieve global net-zero emissions, there will need to be systems transformations across all sectors and contexts, including the adoption of both supply- and demand-side measures to curb emissions.
- In order to reach net-zero carbon emissions by 2050 globally, NDCs will need to decline by 43% globally by 2030 and by 60% by 2035 compared to 2019 levels – thresholds that are currently not within reach. The UN’s most recent estimates which assume full implementation of the latest NDCs (and are contingent on factors such as access to enhanced financial resources, technology transfer and technical cooperation, and capacity-building support; availability of market-based mechanisms; and absorptive capacity of forests and other ecosystems) would result in global emissions declining by 8.2% below 2019 levels.
- Considerations regarding justice and equity will remain a key point of contention. The global energy transition is dependent on cooperation between and within nations. While the transition is expected to generate 3.5 times the number of jobs it will displace by 2030, there will inevitably be economic dislocation and displacement. Larger questions remain as to which countries are set to reap the greatest benefits and which are already paying significant costs from climate change. In 2022, countries in the global south received only 20% of the world’s clean energy investments even though many countries in the global south possess abundant clean energy resources. It is also estimated by the UN that countries in the global south may need over \$2 trillion by 2030 to combat the climate crisis.
- There remains reason for optimism, however: growth in clean energy and other technologies has delivered surprising gains in recent years and private and public investments continue to accelerate. For every dollar currently spent on fossil fuels, \$1.70 is now spent on clean energy, whereas five years ago this ratio was 1:1. Utility-scale solar photovoltaics and onshore wind have increased in capacity and become commercially competitive alternatives to traditional energy sources in a number of

countries. The growth of electric car markets have also increased rapidly, accounting for 10% of all new cars sold in 2022, while sales of heat pumps in Europe grew by 40% over the past year. Investments in direct air capture technology, which has long faced scalability challenges, has also accelerated with the Biden Administration investing \$1.2 billion in projects in Texas and Louisiana which has been followed by a \$550 million investment from BlackRock. And since 2020, governments globally have allocated over \$1.3 trillion in clean investment support with clean technologies not yet available comprising 35% of emissions reductions needed to reach net zero (compared to 50% just two years ago), according to IEA estimates.

## Policy and Regulatory Responses

The growing call for climate action from the UN since the Paris Agreement has yielded some notable policy and regulatory developments to spur on the energy transition. The European Union has led global efforts to advance comprehensive transition plans with the European Green Deal which was adopted in 2020. The initiative commits the European Union to eliminating net emissions by 2050 and reducing net GHG emissions by 55% by 2030 compared to 1990 levels. The European Green Deal has spurred on a series of directives which encompasses emissions reduction targets across a range of sectors, a target to boost natural carbon sinks, an updated emissions trading system to cap emissions, and social support for citizens and small businesses. Notably, the EU's Carbon Border Adjustment Mechanism (CBAM), which came into force in 2023, will embed a price on carbon emissions generated in the production of certain goods imported into the EU, beginning with goods whose production is carbon intensive and at most significant risk of carbon leakage: cement, iron and steel, aluminum, fertilizers, electricity and hydrogen.

By contrast, climate policies and regulations in the United States continue to remain fragmented at the federal, state and local levels, although significant federal commitments have been made to date focused on spurring investments in clean technology and infrastructure resilience. Shortly after taking office, President Biden issued an executive order on tackling the climate crisis at home and abroad, in which he called on federal agencies to take action, and “drive assessment, disclosure, and mitigation of climate pollution and climate-related risks in every sector of our economy”. Since then, a number of federal agencies including the U.S. Securities and Exchange Commission, the Financial Stability Oversight Council, the Federal Trade Commission, and the Environmental Protection Agency have taken largely incremental steps to assess climate issues that fall under their statutory authority and implement responsive policies, such as efforts to enhance public company disclosures around climate risks and tighten vehicle emissions standards.

The two most significant pieces of federal legislation to date have been the Inflation Reduction Act (IRA) which was enacted in 2022, and the Bipartisan Infrastructure Law (BIL) which was enacted in 2021. The IRA provides approximately \$370 billion in the form of tax credits, grants and loans directed to develop and deploy the clean energy technologies and investments to facilitate the clean energy transition. Since its adoption, the IRA has helped spur additional private sector investments in clean energy investments with approximately \$240 billion in clean energy manufacturing investments. The BIL, meanwhile, provides \$973 billion over five years beginning in 2022, including \$550 billion in new investments for all modes of transportation, water, power and energy, environmental remediation, public lands, broadband and resilience. It is projected that these initiatives will help reduce U.S. climate pollution by as

much as 40% below 2005 levels by 2030, although reaching such a goal would require coordination and action among the federal, state and local government agencies tasked with spearheading projects eligible for funding under the IRA and BIL.

Partly as a result of the IRA and BIL, a number of U.S. states have adopted, or are seeking to adopt legislation to address climate change. State level actions fall broadly into the following categories:

- (1) GHG emissions targets (which encompass statutory, executive and recommended targets in 24 states and the District of Columbia);
- (2) comprehensive state-level climate action plans (covering resilience strategies, clean energy targets, and economic and social goals in 33 states, with some legislation still pending);
- (3) carbon pricing (which has been implemented through cap-and-trade programmes in 11 states);
- (4) electricity sector policies (which require utilities to deliver a certain amount of electricity from renewable or clean energy sources and have been implemented in 36 states and the District of Columbia); and
- (5) transportation policies (which largely target vehicle emissions and transportation fuels and are in place in 36 states and the District of Columbia).

It is important to note that not all states are traveling in the same direction. Several states have implemented legislation in recent months that could impede new investments in clean technology. Such legislation has largely taken the form of so-called “pecuniary factor” legislation, which limits the ability of state pension fiduciaries and other state agencies to make investments only on the basis of pecuniary factors. Such legislation does not *per se* prohibit ESG-oriented investments but will demand greater accountability and justification from state pension fiduciaries who seek to make such investments. A smaller number of states have also implemented anti-boycott laws which prohibit state entities from doing business with companies that have been deemed to have boycotted certain industries or groups of industries, such as the fossil fuels industry.

Opposition to climate-related policies has also emerged outside the United States. In the face of surging energy costs and rampant inflation, the UK recently delayed the implementation of its net-zero commitments, including delaying the ban on the sale of new petrol and diesel cars by five years, delaying the ban on the sale of oil, liquid petroleum gas (LPG) and new coal heating for off-gas-grid homes by nine years, and scrapping planned regulations on minimum energy efficiency standards for rental properties, among other changes. Similarly, Germany recently watered down proposed new rules on phasing out oil and gas heating systems. The European Union's Nature Restoration Law also faced significant political opposition from groups representing the farming, forestry and fishery sectors before its ultimate passage this year.

## Investor and Stakeholder Pressure on Companies

The recent political backlash against climate-related policies and initiatives has left an imprint on investor and other stakeholder messaging and expectations on companies and their role and responsibilities in the energy transition. During the past year, institutional investors, proxy advisors, shareholder advocacy groups and advisors have all faced political and legal pressure from state attorneys general in the United States, who have issued letters questioning the legitimacy of their investment decisions and recommendations, and raised concerns of antitrust violations surrounding climate-related commitments and communications. U.S. lawmakers have also convened congressional hearings on



ESG matters, including to discuss legislation that would impact the ability of shareholders to bring proposals relating to environmental or social matters.

Perhaps the most noticeable impact of the political backlash against ESG-related initiatives has been in public messaging of expectations and focus by investors and asset owner coalitions. In contrast to his 2022 letter in which he asked CEOs, “as your industry gets transformed by the energy transition, will you go the way of the dodo, or will you be a phoenix?”, Fink’s 2023 letter, which was addressed to both BlackRock clients and shareholders was more circumspect on the role of asset managers in the energy transition: “it is not the role of an asset manager like BlackRock to engineer a particular outcome in the economy, and we don’t know the ultimate path and timing of the transition. Government policy, technological innovation, and consumer preferences will ultimately determine the pace and scale of decarbonization. Our job is to think through and model different scenarios to understand implications for our clients’ portfolios”. In her 2023 letter to CEOs, State Street CEO, Yie-Hsin Hung also called on companies to “provide transparency into their plans for managing climate-related risks, and encourage boards to have oversight of relevant climate risks and opportunities”. Several institutions, including Vanguard, also exited the Glasgow Financial Alliance for Net Zero (GFANZ) to pursue their own climate policies and agenda.

The shifting focus among the largest asset managers from actively pushing a singular transition pathway to seeking to mitigate risks and understand the potential different pathways their portfolio companies may adopt has been particularly noticeable in the levels of shareholder support for GHG emissions reduction proposals. For two consecutive years, overall support for shareholder proposals seeking emissions targets aligned with the Paris Agreement’s goal of keeping temperature increases to no more than 1.5 degrees Celsius above pre-industrial levels has fallen, even as the number of such shareholder proposals has grown significantly. Investors have become increasingly cautious of supporting one-size-fits-all approaches that they deem to be too “prescriptive” and which may not support long-term shareholder value, particularly as macroeconomic headwinds and geopolitical uncertainty further complicate transition efforts and strategies. Among the kinds of proposals that BlackRock has singled out as potentially prescriptive include proposals ceasing financing to traditional energy companies, decommissioning the assets of traditional energy companies, requiring alignment to the Paris Agreement’s 1.5 degree scenario, setting absolute scope 3 GHG emissions targets, establishing mandated climate risk reporting or voting and directing climate lobbying activities or public positions or political spending.

As support for one-size-fits-all emissions-related shareholder proposals have waned, attention appears to have swung back to board accountability on climate matters. Investors have continued to indicate willingness to hold members of the board responsible for failing to adequately oversee climate matters, even where the same investors have chosen not to support shareholder proposals on such matters. Similarly, proxy advisory firm Glass Lewis’s 2024 proxy voting guidelines also continue to expand its focus on board accountability for oversight and disclosures on climate-related risks. For the first time, Glass Lewis will examine whether the board has codified a meaningful level of oversight of, and accountability for, a company’s material environmental and social impacts. Glass Lewis has also expanded its policy on board accountability for climate-related issues to all S&P 500 companies operating in industries where the Sustainability Accounting Standards Board (SASB) has determined that the companies’ GHG emissions represent a financially material risk, as well as companies where Glass Lewis believes emissions or climate impacts, or stakeholder

scrutiny thereof, represent an outsized, financially material risk. Similarly, ISS’s most recent benchmark policy survey examined whether the boards of high emitting companies should be subject to more rigorous assessment of their oversight of climate risks and disclosures.

Pressure on boards and directors may continue to increase in the United States as climate advocacy groups and smaller shareholders seek to apply pressure on companies to accelerate energy transition efforts. The introduction of universal proxy cards last year, which would require, among other things, all proxy cards to contain the names of all candidates for election (including dissident candidates), may potentially create new opportunities for issue-oriented activists to seek a board seat. The growing volumes of sustainability reporting have also provided external stakeholders with more information and metrics by which to assess corporate performance and enforce accountability. Frequent shareholder engagements involving management and/or members of the board on matters relating to sustainability and climate issues are likely here to stay and may very well become a fixture of the corporate landscape as parties increasingly recognise the value of information sharing and iterative planning in managing the uncertainties of the energy transition.

## The Role of the Boards and Management in Navigating the Transition

Boards and management will continue to play a central role in helping their companies navigate the energy transition and their actions will continue to face ever greater scrutiny from investors, regulators, proxy advisors and other stakeholders. Directors should, through their risk oversight roles, collaborate with management to integrate climate-related considerations into enterprise risk management processes, contingency plans and longer-term strategic decision-making. From a risk management perspective, directors should satisfy themselves that the climate-related risk management policies, procedures, internal controls and disclosures designed and implemented by the company’s senior executives and risk managers are consistent with the company’s strategy and business purpose; that these policies and procedures are functioning as directed; and that necessary steps are taken to foster an enterprise-wide culture that supports appropriate risk awareness, behaviour and judgments about risk, and that recognises and appropriately addresses risk-taking that exceeds the company’s determined risk appetite. Successfully navigating the energy transition is also very much an exercise in capital allocation that takes full advantage of the significant public and private investments pouring into transition initiatives. Consequently, from a strategic oversight perspective, boards should seek to understand how climate and transition risks may impact the business’s near-, medium- and long-term strategic plans, and seek to understand pathways for steering the business toward opportunities and investments that will preserve the long-term health of the business.

## Keeping Pace with Change Will Be Key

The biggest challenge for boards and management is the sheer number of variables at play and the speed of change. Policy and regulatory changes, technological developments, geopolitical uncertainty, evolution of climate science, shifting investor sentiments, and macroeconomic pressures are among the many factors that need to be considered when evaluating and developing an energy transition strategy. As part of their preparations, boards should engage in ongoing director training and education to build on existing skills and leverage management and advisor expertise to develop working knowledge of climate issues relevant to the business, including an understanding of

the technical issues. In addition, the recruitment of new directors should address any potential knowledge, skill and experience gaps. While in certain instances it may be necessary to seek directors with climate-related expertise, many boards may rightly conclude that it is more appropriate to further educate existing board members and leverage their range of experiences to make the right judgment calls. Directors may also want to periodically re-evaluate the appropriate allocation of oversight responsibilities among the board and its committees, including whether dedicated *ad hoc* or formal committees may be necessary to focus oversight on particular risks or potential scenarios.

## Understand Evolving Expectations on Fiduciary Duties

In the United States, the Delaware courts have taken the lead in formulating legal standards for directors' risk oversight duties, particularly following *In re Caremark International Inc. Derivative Litigation*, the seminal 1996 decision addressing director liability for the corporation's failure to comply with external legal requirements. Delaware courts in the *Caremark* line of cases have held that directors can be liable for a failure of board oversight only where there is "sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists", or a culpable failure to monitor an existing system resulting in a disregard of a pattern of "red flags".

Recent Delaware rulings have shown that the risk of exposure for failure of oversight is real, and that courts are willing to permit stockholder claims alleging breaches of fiduciary duty by directors to proceed to discovery where the complaint alleges with specificity that the board ignored red flags reflecting underlying compliance, safety, reporting or other risks, or that the board gave insufficient attention to such matters, despite the existence of company-wide policies and procedures on the topic. These decisions have denied motions to dismiss claims that boards failed to act in good faith to maintain board-level systems for monitoring mission-critical functions, which have extended to ESG-related matters such as product safety and workplace sexual harassment. A history of unaddressed deficiencies and a failure by the company to provide books and records documenting active board supervision of the compliance and risk assessment functions have been among the chief aggravating factors driving these judicial decisions. The Court's recent decision in a shareholder derivative action against officers of McDonald's also affirmed that both officers and directors owe fiduciary duties to the corporation and its shareholders.

## Specific Recommendations

Even the best-run companies may likely face challenges in navigating the energy transition and balancing the competing pressures placed on businesses by their different stakeholders. Below are specific actions which boards and appropriate board committees may consider, as part of their ongoing efforts to manage the energy transition and the potential risks arising from climate change:

- reviewing with management the categories of material climate-related risks (including physical and transition risks) the company faces, including risk concentrations and risk interrelationships, as well as the likelihood of occurrence, and the potential near-, medium- and long-impact of those risks on business and strategy;
- reviewing with management the company's climate risk-related monitoring, assessment and reporting processes, including whether these processes are sufficiently robust and holistic, so as to avoid growing regulatory and shareholder scrutiny on greenwashing;
- recognising that there will be, from time to time, climate-related issues that may require, in certain scenarios, assessments of the public stance the company is willing to take and the responsibilities it is willing to assume (including with respect to various stakeholders);
- ensuring that consideration of climate-related risks is integrated into enterprise risk management, crisis management and business contingency plans;
- reviewing the skills, professional experiences and practices that are required by the board to effectively oversee climate matters, to assess whether the current board's mix of skills and professional experiences are sufficient and identify selection priorities to be used as part of the board recruitment and refreshment process;
- assessing and assembling a team of internal and external advisors who can provide the expertise necessary to help the board make informed decisions on climate and transition-related matters;
- continuing to periodically engage with the company's stakeholder with the goal of understanding and appropriately balancing evolving expectations of different stakeholder groups; and
- recognising that in the face of continued uncertainty as to practicable transition pathways, transition planning is likely to remain an iterative process that will need continued close attention and fine-tuning.



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