ClientEarth

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# Briefing: Legal risks of carbon offsets

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## What is a carbon offset?

Many companies say they use ‘offsets’ to neutralize or compensate for their greenhouse gas emissions, or claim that their products are ‘carbon neutral’.

This means the company pays for a notional ‘carbon credit’, which entails a small payment to the costs of a carbon credit project elsewhere, which often aims to plant or protect trees. Each credit is said to represent 1 tonne of CO2 stored or saved. This carbon credit is then used by the company to say it has ‘offset’ or compensated for 1 tonne of its greenhouse gas emissions.

Companies use carbon credits as ‘offsets’ in this way as a substitute for actually reducing emissions in their business strategy plans to transition to ‘net zero’, and a widely used marketing tool is to sell high-emitting products bundled with carbon credits: things like airline flights, car petrol, home gas supply, red meat or plastic packaging.

Companies make ‘offsetting’ claims to their key consumer and investor audiences, who are increasingly considering the climate impact of companies and their products. Therefore, ordinary consumers and investors alike are wondering: is a carbon offset a way of dealing with emissions?

# Carbon credits: contributions, not compensation

Carbon credit purchases to contribute to a project can help mitigate climate change, but using the contributions as an 'offset' for emissions inhibits climate action.

Provided the carbon credit projects are done well and support local communities, investments in projects can be valuable 'climate finance' to protect and enhance natural sinks of CO2 such as forests, which is a necessary part of climate goals according to the IPCC. However, there are problems with the 'quality' of the carbon credit projects, which are privately owned, unregulated and depend on opaque and complex 'verification' procedures characterised by conflicts of interest and containing "*gaping loopholes*". According to McKinsey, carbon credit projects operate in a "*[f]ragmented and complex market with low to no regulation, different accounting methodologies with varying degrees of rigor and a variety of industry-created standards*". Too many carbon credit projects have been found to harm the interests of local communities and offer false claims of actually making a difference to CO2 storage.

The carbon credit project system is not the only way to make contributions to climate action. For example the Green Climate Fund established by the Paris Agreement raises and pays out funds for climate action in developing countries, and has a private sector facility. A recent UN report calls urgently for funding to address the catastrophic gap in covering climate loss and damage. Instead of leaving decisions about contributions to individual companies, there are proposals for regulatory instruments to set tariffs to accomplish the same thing.

The problem, however, is that contributions to carbon credit projects do not really compensate for (or 'offset') fossil fuel emissions.

1. According to the IPCC, compared to 2019 levels we need to reduce CO2 emissions by 48% by 2030 and by 80% by 2040, reaching 'net zero' CO2 by around 2050 to have a fair chance at limiting global heating to a 1.5°C rise above pre-industrial temperatures – the goal of the Paris Agreement. Any delay pushes the world into increasingly dangerous territory of overshooting a 1.5°C rise, with escalating and irreversible climate impacts and risk of triggering catastrophic tipping points. Globally, 'net zero' means when the emissions of CO2 are reduced enough that remaining emissions are equal to removals of CO2 by natural carbon sinks (such as forests) and artificial means (such as carbon capture and storage). But there are far more emissions than we have room for sinks, so we simply can't rely on the sinks alone to get to 'net zero'. Instead we need to reduce CO2 emissions rapidly and significantly, for climate goals as much as for health, biodiversity and related economic reasons. The 2022 IPCC report confirms that this requires substantial reductions in fossil fuel use. Put simply, climate goals require both urgently reducing fossil fuel emissions *as well as* enhancing natural sinks, so relying on one in place of the other doesn't work.

2. On a 'tonne for a tonne' level, the logic of carbon offsets that a carbon credit is equivalent to an tonne of emissions is not backed up by the science. Claims that the project makes a difference and so can claim its credits actually do represent emissions reductions ('additionality') rely on a theory of what would have happened *without* the project. But the theory is not certain, whilst the fossil fuel emissions which are notionally 'balanced out' are all too certain. Trees, used for many carbon offsets, are inherently different from the CO2 emissions they are said to 'offset'. This is because the CO2's warming effect in the atmosphere lasts hundreds of years but trees are temporary and may not last tens of years ("permanence"). Measuring the carbon storage of natural sinks is difficult. Offsetting logic essentially means shifting CO2 from millennia-long

storage in fossil fuel deposits underground to fragile short-term storage in forests, which face climate risks of their own over coming decades. Double counting the saved emissions is another problem. To avoid a situation where a project claims an emission reduction which is also claimed by a government requires that governments must agree to 'give up' the emissions reductions for their own pledges. It's not yet clear they will do so. The carbon credit projects and verification bodies are unregulated and issues have repeatedly cropped up with over claiming and double counting, and with projects linked to social and environmental problems for local communities. One carbon credit organisation which screened projects over the two years up to 2022 found that "*over 90% of projects fail basic sustainability checks*", with illusory or inflated additionality, a lack of permanent storage or serious human rights violations.

This all explains why carbon credits are not a way of dealing with emissions. If done and regulated properly, carbon credit projects may provide a way of contributing to global efforts to fight climate change, but they don't counterbalance continuing emissions, and they don't affect the increasingly urgent need to reduce emissions – and therefore fossil fuels - in the first place. Expert bodies agree on the principle that carbon credits must not get in the way of the priority of emissions reductions. Despite this, the practice of using carbon credits to 'offset' any emissions the buyer chooses has become prevalent, essentially as a marketing fiction.

"*The upshot is that any trade in forestry related carbon credits is likely to involve unwarranted acts of faith*"
Professor G. Cornelius Van Kooten, writing in *Forest Policy and Economics*

"*[C]onsidering carbon storage on land as a means to 'offset' CO2 emissions from burning fossil fuels (an idea with wide currency) is scientifically flawed.*"
Professor Brendan Mackey, Director of the Griffifth Climate Change Response Program, and others, writing in *Nature Climate Change*

"*Carbon offsetting is without scientific legitimacy and is dangerously misleading*."
Professor Kevin Anderson, Deputy Director of the Tyndall Centre for Climate Change Research, writing in *Nature*

# Carbon offsets: a fiction too far

The fiction of carbon offsets appears to serve the purpose of incentivizing contributions to carbon credit projects. However, separating carbon credits from emissions and referring to carbon credits as a contribution, similar to a charitable donation, would achieve the same purpose. Meanwhile, there is an obvious danger to maintaining the fiction of carbon offsetting.

Carbon offsets offer a means of 'greening' a high-carbon product. Offsets are often used in marketing for the same high-carbon goods and services (flights, internal combustion engine cars, liquid natural gas, home gas supply, single-use plastic packaging) which are limited or phased out in net zero transition pathways. Suggesting that the climate impact of such products has been addressed (saying that the product is 'carbon neutral') blocks and distracts from the far-reaching changes in transport and energy required by transition pathways. In this way, carbon offsets operate as a key barrier to the societal transformation, and the so-called 'social tipping points', necessary for decarbonisation. To take one example, a fast-growing trade in 'carbon neutral' liquid natural gas (LNG) has sprung up, which conflicts with the need to reduce gas production for climate goals. The science of decarbonisation is clear. In order to limit the dangers of climate change we need to phase down or phase out the use of high-carbon products. Labelling them 'carbon-neutral' is misleading, and unhelpful to this aim.

Use of carbon offsets in corporate business strategy and transition plan reporting is also problematic. Shareholders and investors need to assess the viability of a company's transition plan, including to calibrate their own investment risk. Such plans involve transformational business opportunities and challenges, and decisions about business investment and strategy. In Europe, the topic of net zero transition "*is discussed in one in two earnings calls of European G2000 companies*", according to Accenture. Markets worldwide need much more accurate and detailed climate information to drive decision making. Large companies in the EU, the US, the UK and across Asia will be legally required to publish their plans to reduce exposure to climate risks. Many major companies already are, with more than 700 of the G2000 (Forbes Global 2000) publicly listed companies declaring a net zero target of some description as of June 2022. Around 40% of these companies intend to use 'offsets' for their targets, and most of the rest do not say whether they do or not. Only 2% rule out use of offsets.

At worst, companies using carbon credits in place of emissions reductions is distracting from the decision to avoid reducing emissions. At best, using carbon credits as offsets clouds the picture, feeds uncertainty and disincentivizes companies to plan for real emissions reductions. There is a lack of clarity of which emissions are to be 'netted' and which are to be reduced to 'zero'. This incentivizes companies to argue that their emissions are 'unavoidable' or 'hard to abate' and so should be offset rather than reduced, pushing the need for yet more emission reductions onto others. Companies may avoid scrutiny and avoid the need to set out a costed business strategy and plan for delivering their targets, because part of the targets will be 'delivered' by carbon credits. Offsets introduce a 'thumb on the scale' of corporate transition plans. In the words of one CEO, carbon offsets can be "*a fig leaf for a CEO to write a check, check a box, pretend that they've done the right thing for sustainability when they haven't made one wit of difference in the real world.*"

There is increasing recognition that applying global net zero goals directly to the scale of a company is inappropriate. Owing to the limits on carbon sinks, net zero corporate goals do not add up to a net zero planet. Rather, aligning with the transition to *global* net zero by 2050, and fitting company strategies into a net zero world, means first and foremost reducing emissions rapidly. This matters, because there is a significant 'credibility gap' in corporate net zero claims. According to the CA100+ Net Zero Benchmark, in March 2022 over 90% of the 166 highest emitting companies in the world did not have 1.5°C aligned emission reduction targets, despite the majority making 'net zero' claims. Accenture found in 2021 that 5% of the 1000+ largest listed European companies were on track to meet targets of net zero by 2050 in their operations alone. It is then hardly surprising that three out of four institutional investors do not trust companies to achieve their stated 'ESG' commitments, and that US investors expect litigation on these issues. Flaws in decarbonisation targets will expose shareholders to future climate-related losses.

In the EU, the draft standards[1] for corporate reporting law requires companies to report any carbon credit purchases separately from emissions, and does not allow companies to count carbon credits toward meeting emissions reductions. This approach is similar to the Science-based Target Initiative's Corporate Net-Zero Standard, the UN's Race to Zero criteria and the materials issued by the French agency for ecological transition, ADEME, and the French financial markets regulator, the AMF. These

[1] Paragraph AG 61 on page 39

institutions are acting on the IPCC's conclusions that overshooting 1.5°C warming, even temporarily, will result in severe and irreversible adverse impacts on humans and ecosystems, limiting the capacity for adaptation and increasing the chance of triggering climate 'tipping points' like forest collapse or permafrost thaw.

"*Many stakeholders are concerned that use of carbon credits could hinder, delay, or replace the GHG abatement action within companies and their supply chains that is essential for addressing climate change. Without clear and transparent guidance about the use of carbon credits for underpinning credible claims, investors and consumers are not able to effectively allocate capital and direct their purchasing power to incentivize real company leadership on climate mitigation. Companies making noncredible claims when using carbon credits face significant risks, ranging from loss of reputation due to accusations of overstating climate performance to potential fines by domestic authorities and litigation (where such claims are deemed false or deceptive).*"

Voluntary Carbon Market Integrity Initiative, Draft Claims Code

"*In a world where neither biodiversity protection, nor carbon removal are being delivered at socially desirable levels, it may be tempting to see offsetting as a means of mobilising additional finance to such ends. This is a dangerous perception. The offsetting process currently guarantees the continued emission of greenhouse gases by the purchaser. […] [O]ffsets today do not guarantee the removal of an equivalent quantity of CO2 […] they deter concerted action on emissions reduction by suppressing carbon prices and sustaining illusions of easy future fixes for climate change*."

CSSN Research Paper, 11 authors

## Carbon offsets: an emerging legal risk

The fiction of carbon offsetting is attracting increasing legal risk – risk of non-compliance, shareholder action, litigation and regulatory enforcement.

In the Netherlands, Shell has found itself reprimanded twice in succession, first for advertising 'CO2-neutral' car petrol, then for trying a different claim that carbon credits mean 'CO2 compensation'. On both occasions, the company was unable to persuade the Dutch advertising watchdog that the offsets advertising was substantiated by the evidence. The airline KLM is facing a court action, supported by ClientEarth, for breaching consumer law with its CO2 compensation marketing. In Germany, a claim is being brought against a list of eight companies, including TotalEnergies, for misleading 'carbon neutral' claims. Legal academics say that using offsets in marketing claims breaches European consumer law standards. The EU Commission has proposed a new 'anti-greenwashing' consumer law, which will place heightened restrictions on 'carbon neutral' claims. In France, after a citizens' assembly called for a ban on 'carbon neutral' claims, the legislature enacted a law requiring companies to clarify how emissions are being actually reduced before being offset. The French advertising watchdog has acted on vague claims about fossil gas based on carbon credits, noting that marketing exaggerates the contribution made by buying 'carbon offset' gas. With greenwashing cases between competitors, competition lawyers have also picked up on the potential for infringements of competition (antitrust) requirements.

A claim against TotalEnergies in France for misleading advertising of its 'net zero' plan illustrates the legal risk of telling shareholders that carbon credits will deliver emissions reductions. The company plans to use carbon offsets to achieve part of the steep emission reduction targets it promotes to the public, and presents to its shareholders.[2] ClientEarth is supporting the claim against TotalEnergies. In Australia, the government has commissioned an independent review into concerns that carbon credits do not represent emissions reductions.

Prohibitions on misleading consumers exist across jurisdictions in consumer protection law and advertising regulation, enforced by regulators, consumer associations, environmental organisations and ordinary people. Using 'carbon neutral' or compensation marketing, and giving consumers the impression that the climate impact of high-carbon products is thereby addressed, raises a real risk of being found to breach these prohibitions, in false advertising or mis-selling claims and regulatory investigations.

Similarly, companies which rely on carbon offsetting in their corporate transition plans, and their directors, face range of legal risks. In many jurisdictions, corporate law provides shareholder protection against misleading communications, and listed companies are increasingly subject to detailed climate reporting obligations. In the UK, EU and USA, as well as in Asian jurisdictions like Hong Kong, Japan, Singapore, and South Korea, regulators are moving towards mandatory climate reporting obligations, including targets to manage climate-related risks and opportunities. Companies and their directors will need to ensure that their climate and transition plan disclosures under such frameworks, including in relation to their use of carbon credits, do not mislead shareholders, or breach other relevant legal rules.

What are the rules at play? Various principles are engaged by a misleading statement regarding the use of offsets to achieve 'net zero'. For example, shareholder protection rules mean that companies listed in the UK are prohibited from publishing misleading, false or deceptive information[3], and may be sued by shareholders who suffer a loss as a result of a scandal linked to a misleading statement published by the company.[4] Use of 'offsets' by financial businesses, or by investee companies underlying investment products, implicate financial regulation. In the UK, large regulated financial institutions are subject to detailed climate related disclosure requirements[5] and must generally ensure that disclosures are fair, clear and not misleading.[6] Institutions are subject to a new consumer duty of transparency about financial products services. Competition, or antitrust, laws also bite on misleading statements which distort markets, whether or not associated with cartel behaviour.

Regulators are actively looking at the quality of corporate transition plan reporting. The UK FCA, for instance, says it will "*have regard to*" the standards set for corporate transition plans by the UK Transition Plan Taskforce, which aims to set a 'gold standard' for the content and quality of transition plan disclosures. In its July 2022 review of 171 listed company disclosures, the FCA observed that, while 80% of listed companies made a net zero commitment, "*these were often not clear and in some cases they risked being misleading as a result.*"

Given the legal and reputational risks associated with the reliance on offsets in corporate transition plans, and advertising based on claims of 'CO2 compensation' or 'carbon neutrality', company directors

[2] Paragraph 200.
[3] See Listing Rule 1.3.3R.
[4] Under s.90 and s.90A of the Financial Services and Markets Act 2000.
[5] https://www.handbook.fca.org.uk/handbook/ESG.pdf
[6] COBS 4.2.1R.

will need to consider if such strategies are compatible with their duties to act in the best interests of the companies they serve.

Risk of liability means companies will be considering the viability of insurance coverage for losses and for legal costs. Directors' and Officers' liability insurers consider climate to be a "*new and major issue*", with underwriters keeping a close watch on legal action for climate-related misstatements. Insurers are even checking themselves whether directors' corporate net zero strategies have been independently reviewed, because inadequate strategies are expected to drive liability risk. At the same time, insurers may exclude coverage for climate claims, inflating climate litigation risk because costs must be borne by the company itself, or its directors.

"*The problem is that some companies claim that they are doing more for the environment than they actually are. This practice of making misleading environmental claims (so-called "greenwashing") carries increasing risk in Europe, as the European Commission (EU Commission) as well as national consumer protection and/or competition authorities (including the UK Competition and Markets Authority) are more committed than ever to fight it*."

17 June 2021, Reed Smith Client Alerts, Greenwashing - When making green claims can get businesses into trouble

"*A well-developed body of jurisprudence has led to advertising claims and other statements about companies and their products and services becoming justiciable on a broad scale. […] A company can also get into trouble with regard to statements whose inaccuracy would not be easily recognised by a person outside the industry when its competitors know the market well and closely follow its activities as a market participant. Misleading statements can also result from the concealment of a relevant fact*."

7 Sept 2021, Osborne Clark, Greenwashing in advertising: legal requirements in Germany for claims on environmental protection and sustainability

"*The KLM lawsuit is a wake-up call to any business relying on the rapidly expanding market for carbon offsets to fulfill stated "net zero" commitments. […] The [voluntary carbon market's] lack of oversight, combined with the difficulty in accurately measuring the impact of carbon offsets, makes it ripe for litigation. […] Regulators have taken notice of the growth in VCM, which almost certainly portends increased enforcement activity and civil litigation. […] As the VCM continues to expand, there are multiple statutes that could be used to impose liability for misstatements about carbon offsets, including state truth-in-advertising and consumer protection laws prohibiting false and deceptive practices. Criminal cases are not out of the question.*"

7 September 2022, Quinn Emanuel, Carbon Offsets: A Coming Wave of Litigation?

# Last word

The use of carbon credits to 'offset' or neutralise a company or product's impact is a problem for reducing emissions to keep climate goals alive. The need to channel resources toward enhancing carbon sinks and support carbon removal technologies is pressing, but incentivizing finance should not result in delays in reducing emissions. Some companies already act in line with this, for example by buying carbon credits set by reference to their historic emissions or otherwise separated from reduction targets.

Reductions must be separated from contributions via carbon credits. Clarity and transparency is essential for both company emission reduction plans and for high-carbon product marketing. Using carbon credits as 'offsets' is a way to limit transparency.

From a legal and regulatory perspective, the use of 'offsetting' to 'green' high carbon products and to obscure corporate decarbonisation plans raises real and increasing risks.



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