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CLIMATE CHANGE DISCLOSURE: A GROWING ISSUE FOR PUBLICLY TRADED COMPANIES

By Scott D. Deatherage

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INTRODUCTION

Climate change disclosure, or climate risk disclosure, has increasingly become an important issue for publicly traded companies when preparing financial disclosures for public stock or public debt offerings or periodic reports submitted to the Securities and Exchange Commission (SEC). After the U.S. Supreme Court decision in *Massachusetts v. EPA*[1] declaring greenhouse gases (GHGs) are air pollutants under the Clean Air Act, the regulation of GHGs appears inevitable. Even if the Supreme Court had not ruled, numerous bills have been filed in Congress to regulate GHG emissions and eventual passage of climate change legislation appears likely. Even without federal regulation, the states are adopting GHG restrictions on their own, making GHG regulation a reality in many regions of the United States. As a result, the importance of evaluating what climate change disclosure may be appropriate has increased significantly. The New York attorney general announced an investigation of five utilities for alleged failure to adequately disclose climate risk. A group of institutional investors' filed a petition with the SEC requesting that an interpretive release be issued clarifying that material climate-related information must be included in corporate disclosures under existing law. All of these developments should cause public companies to carefully evaluate to what extent climate risk should be included in their financial disclosures.

First and foremost, to understand how financial disclosure obligations may involve climate change risk, one must review the mandatory disclosure requirements promulgated by the SEC under the traditional securities laws and the many requirements of the Sarbanes-Oxley Act (Sarbanes-Oxley). Second, it is critical to appreciate disclosure pressures that extend beyond the mandated requirements of the SEC and Sarbanes-Oxley. The pressure for "voluntary" disclosure arises from initiatives and protocols developed by non-governmental organizations (NGOs) that seek to create enough awareness among the public and institutional investors to compel companies to disclose environmental risk and impacts, and as a result to change their behavior to avoid future negative disclosure. NGO pressure on public companies and their investors and lenders are becoming increasingly effective.

Because climate change disclosure involves issues of strategic importance to the company, the management and board of directors of public companies should be involved in the setting of policies and procedures for determining what will be disclosed. In doing so, it is key for management and directors to evaluate the many interconnected and interrelated entities and interest groups that may affect their economic success. As these entities and interests groups

[1] 549 U.S. 1438 (2007).

demand ever more information on environmental and corporate social responsibility, how companies manage climate change disclosure demands is becoming increasingly important in managing shareholder and public stakeholder expectations.

For some companies with operations in states or countries where climate change regulation is already in effect or is in the process of being implemented, climate risk may present material financial effects on the company that may require discussion in their public disclosures. For other companies, any disclosure at this stage will be forward-looking, focusing on potential future risks. Even for these companies, the stage is rapidly changing, as U.S. states have or are preparing to impose restrictions on GHG emissions. Care must be taken in deciding what to disclose—too little disclosure may not provide a full picture to investors; too much disclosure, particularly of inchoate or never realized financial effects, may not provide realistic information to investors.

Significant developments in climate change regulation occurred in December 2007. After the U.S. Supreme Court handed down the *Massachusetts v. EPA* decision earlier in the year, concluding that GHG emissions can be regulated under the federal Clean Air Act, December proved to be a full month of international and domestic developments.

From December 3 through December 14, 2007, in Bali, Indonesia, the United Nations conducted climate change talks to begin negotiations of a successor treaty to the Kyoto Protocol. Based upon the European Union position, it appears that a successor treaty will be negotiated, with or without U.S. participation. Developing countries would appear to have gained enough in the process to commit to a post-Kyoto agreement. The United States is still pressing for GHG reductions by the major developing countries such as China and India. How the United States will participate in any future climate change treaty will depend on the upcoming presidential elections.

On December 5, 2007, the Senate Committee on Environment and Public Works voted the first climate change bill, the Climate Security Act, co-sponsored by Senators Joe Lieberman and John Warner, out of committee. The committee vote on Senate Bill 2191 was 11-8, with all Democrats, the two Independents, and one Republican on the Committee voting for the bill, and the other eight Republicans voting against the bill. Numerous amendments to the bill were debated in the Committee. Fourteen were adopted and many more were voted down. The bill requires cuts in carbon dioxide and other greenhouse gases from electric utilities, fuel production and importation, and certain other sources of GHGs. The regulations would cover an estimated 75 percent of U.S GHG emissions. The bill would cap GHGs at the 2005 emission level starting in 2012 and gradually reduce them by 15 percent to 1990 levels by 2020, with a long-term reduction of GHG emissions of 65 percent reduction in 1990 levels by 2050.

On December 21, 2007, Congress moved forward with the foundation of any future GHG regulatory system by including in the Omnibus Spending bill a requirement that the U.S. Environmental Protection Agency (EPA) promulgate an economy-wide greenhouse gas reporting regulation and create a GHG registry. President Bush signed the spending bill, making this obligation law. A proposed rule is due in September 2008, and a final rule in September 2009. The details of this GHG reporting system will be developed by the EPA unless additional legislation is passed in the next nine months to further define the parameters of the reporting requirements and registry. Absent such legislation, how the EPA will handle this mandate under the current administration is not clear, particularly with respect to which industries and sources will be required to submit reports, what de minimis level of emissions will be set, and what other exemptions will be provided. In any event, it would appear that a GHG reporting requirement will go into effect in less than two years. Thus, within a couple of years, each company's and facilities greenhouse gas emissions will be posted on the Internet for all stakeholders to review.

A More Expansive View of "Regulation"

In developing strategies for disclosure, corporate management and directors should appreciate that the concept of "regulation" has evolved in the latter part of the twentieth century and the beginning of the twenty-first century. The source of activity that attempts to constrain corporate behavior continues to evolve into much broader sources of impact on the corporation than what was understood twenty years ago. Traditionally "regulation" has involved legislation and regulations promulgated by regulatory agencies, such as the EPA, the U.S. Occupational and Health Administration (OSHA), and other federal and state agencies that promulgate environmental, health, and safety regulations. With respect to financial disclosure, the SEC has developed regulations pursuant to various securities laws and, more recently, Sarbanes-Oxley.

In the beginning of the twenty-first century, financial institutions; banks; investors, particularly pensions funds and other institutional investors, consumers, and NGOs assert influence on company policy and behavior to such a degree that "regulation" must be understood to extend now to the influence of various economic, political, governmental, and citizen groups and entities on corporate decisions and strategy. In terms of environmental disclosure, environmental NGOs have become increasingly sophisticated and successful in exerting pressure on the marketplace and the investment community to require additional financial disclosure or other "voluntary reporting," particularly by larger, publicly held multi-national corporations.

"Regulation" is no longer limited to direct governmental restrictions on corporate action, but now is in fact broader, involving more entities and organizations, all of which may influence a "regulated" company. As a result of the interrelationships between these entities and organizations, the influence of one entity or organization may have a cascading effect throughout the system of interconnected investors, financial entities, consumers, and NGOs. The best example of this is the growing concern about global warming and climate change where NGOs have been able to foster a certain amount of voluntary action by public companies to address the issue and to disclose the effects of climate change and future potential regulation on the company. The disclosure demands reflect an adaptation by both NGOs and the corporations whose behavior NGOs are attempting to change.

Publicly traded companies should consider how they may be affected by such a system of governmental and nongovernmental entities and market influences and attempt to develop strategies for addressing the many entities attempting to drive their behavior. Because of the interrelationships of various stakeholders in the financial and economic marketplace, it is more effective to link environmental disclosure with environmental risk management and regulatory compliance. Disclosure decisions should not be made in isolation from or without adequate information about the management of risks that may require disclosure.

As discussed above, the traditional concepts of regulation have involved a legislative body passing legislation and subsequently a governmental agency enacting regulations to regulate a particular activity. Traditional legislation has been applied to climate change issues through California legislation and its participation with several western states in the Western States Climate Initiative (WSCI), the northeastern states Regional Greenhouse Gas Initiative (RGGI), and, more recently, the nine Midwestern states entry into the Midwestern Regional Greenhouse Gas Reduction Accord. Now, almost half the U.S. states are participating in a multi-state compact designed to limit GHG emissions from industrial sources and power plants. Various other states are acting as observers and may join one or more of these multi-state compacts. Thus, even without federal legislation, GHG emissions limitations will be in force in a significant part of the country, in some of the most populous states, and with a significant portion of the overall U.S. economy.

Some companies operating in these states may face significant financial effects on their business as a result of reductions in GHG emissions. The effects of climate change concerns have already affected TXU and its failed attempt to permit eleven coal-fired power plants in Texas. In perhaps the first of its kind in the United States, ConocoPhillips has been forced to pay $10 million to offset new GHG emissions from expansion of an oil refinery in California.[2] In another apparent first in this country, an air emissions permit has been denied for a coal-fired power plant on the basis of GHG emissions by the Kansas Department of Health and Environment.[3] The agency stated that the GHG emissions of the proposed plant threatened public health and the environment.

In 2007, Congress was very active in the climate arena. More than ten bills were filed in the House and Senate. Most recently, Senators Lieberman and Warner have sponsored a bill that purportedly will serve as the basis for negotiation of a climate change bill that will be offered for a vote in the Senate. With a Democratic majority, it is clear that climate change legislation is top priority of the Congress and likely that legislation will be proposed in the coming years.

In Bali, Indonesia, the United Nations convened a conference of countries to initiate negotiations to develop a climate change treaty to follow the Kyoto Protocol. Tremendous international pressure has and will come to bear on the United States to seriously participate in the next GHG reduction treaty and take action to accomplish the goals of that treaty by reducing US GHG emissions.

These rapidly developing regulations or the enforcement of existing regulations and statutes to address or limit GHG emissions present a potential financial risk to many companies that have significant GHG emissions. Thus, it is important to evaluate these issues in the process of preparing financial disclosures, particularly in preparing periodic filings with the SEC.

[2] http://ag.ca.gov/newsalerts/release.php?id=1466&year=2007&month=9
[3] http://www.washingtonpost.com/wp-dyn/content/article/2007/10/18/AR2007101802452.html

Beyond such regulatory programs, voluntary industry standards have played a role either in establishing nongovernmental standards for industry, which are designed to fill a void left by existing government regulation, or as an attempt to stave off further regulation as being unnecessary, or both. "Voluntary reductions" certainly have been touted with respect to climate change by the current presidential administration as a means to avoid new regulation. However, all signs point toward probable US participation in some form of an international treaty designed to reduce greenhouse emissions after the 2012 expiration of the Kyoto Protocol and domestic legislation at the state and federal level to limit GHG emissions.

Financial Disclosure and Publicly Traded Companies

Based on the potential material effect that existing and developing regulatory programs may have, publicly traded companies should develop an appropriate strategy for climate risk disclosure. In doing so, public companies may have to manage disclosure in more than one form—ranging from SEC regulation to broader protocols for voluntary disclosure. Many larger companies have chosen to participate in these voluntary environmental, sustainability, or climate change disclosure programs. For these companies, disclosure takes on a broader process than simply attempting to comply with SEC regulations alone.

SEC regulations involve several provisions that mandate disclosure surrounding environmental issues that implicate climate change issues, from new regulations imposing reductions in GHG emissions to litigation filed by plaintiffs seeking damages allegedly caused by a company's GHG emissions. For some companies, these regulations or litigation could have a potential material effect on financial costs, profits, and liabilities. A brief review of the specific SEC regulations is helpful in understanding the potential impact climate change disclosure issues may have on the content of a company's disclosure statements.

SEC Rule S-K 101

S-K 101 requires companies to disclose material effects that compliance with environmental laws will have on earnings, competitive position, and capital expenditures.[4] Specifically, the rule requires disclosure of estimated material capital expenditures for environmental control facilities for the current fiscal year, the next fiscal year, and further periods, if material.[5] Climate change issues are implicated as those doing business in the European Union, for example, may be required to expend additional capital to reduce GHG emissions from their facilities in EU countries. As states impose restrictions, such as California and states participating in the WSCI, RGGI, and the new Midwest Regional Greenhouse Gas Reduction Accord, companies with operations in those states must evaluate the extent to which disclosure is necessary of the costs to meet the greenhouse gas regulations of these jurisdictions.

[4] 17 C.F.R. § 229.101.
[5] *Id.* § 229.101(c)(1)(xii).

SEC Rule S-K 103

S-K 103 requires that companies disclose legal proceedings, including those related to environmental and health issues.[6] Environmentally related proceedings include pending or known to be contemplated claims, including administrative or judicial proceedings, even if initiated by the company itself. These proceedings must be material before they must be disclosed. The materiality issue has been specifically addressed for governmental proceedings. If a government agency is a party to the proceeding and monetary sanctions could reach $100,000 or more, whether or not otherwise material to the company, the company must disclose these proceedings.[7]

Climate change litigation against individual companies may be limited in the United States currently, but such litigation has been filed. Some plaintiffs' attorneys have pledged to obtain civil damage awards for climate change litigation that exceeds what was obtained in the tobacco litigation.[8] Any material climate change cases filed against publicly traded companies would have to be disclosed under S-K 103. To the extent the New York attorney general proceeds with litigation against electric utility companies claiming that these companies failed to disclose climate risk, these cases would likely have to be disclosed under this rule. It is necessary to keep in mind the low threshold for cases brought by government agencies.

SEC Rule S-K 303

S-K 303 requires that companies disclose, in the Management Discussion and Analysis (MD&A) section, "known trends, events or uncertainties" that may have a material effect on the company's financial condition.[9] A 1989 SEC Interpretive Release emphasized that S-K 303 applies to environmental trends and uncertainties, such as anticipated new regulations and Superfund liabilities.[10] This is the SEC regulation that may present the most immediate concern for publicly traded entities. In late 2006 and in 2007, climate change issues and the potential for GHG regulation in the United States have changed dramatically. As discussed above, twenty-two states have entered into multi-state compacts to develop regional GHG reduction programs. The Supreme Court in *Massachusetts v. EPA* concluded that GHGs are air pollutants and may, if not shall, be regulated under the Clean Air Act. More than ten climate change bills have been filed in Congress, three of which would require the SEC to take action to impose more specific climate risk disclosure on public companies.

With the New York attorney general's investigation into the alleged failure of five utilities to disclose the potential effects of climate change regulation on their financial condition and the petition filed by a large number of state pension fund managers among other parties to require the SEC to issue guidance on climate risk disclosure, ever greater pressure is mounting on firms to disclosure trends and uncertainties under Item 303 relating to climate change and

[6] *Id.* § 229.103.
[7] *Id.* § 229.103, Instructions, Item 5.
[8] Lawyers Preparing for Explosion of Climate-related Work, *The Dallas Morning News,* June 25, 2007.
[9] 17 C.F.R. § 229.303.
[10] Securities Act Release No. 33-6835 (May 18, 1989).

GHG emission regulation. After these important developments in 2006 and 2007, firms should carefully consider the degree to which discussion of these trends and uncertainties should be included in their pubic securities filings.

ACCOUNTING RULES

The next level of concern for public (as well as privately held companies) involves disclosure required by the Generally Accepted Accounting Principles (GAAP). In the environmental and safety context, the most important of these historically has been Financial Accounting Standard No. 5, Accounting for Loss Contingencies (FAS 5). FAS 5 would typically cover lawsuits and other claims for damages, such as Superfund liabilities. A more recent accounting standard, Financial Accounting Standard No. 143, Accounting for Asset Retirement Obligations (FAS 143), and the follow on interpretation, Financial Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations (FIN 47), apply to legal obligations that arise at the time of retirement of an asset. Since most climate change legislation includes a cap-and-trade program, GHG emission allowances or credit will need to be accounted for in the coming years. The Financial Accounting Standards Board (FASB) is currently engaged in a project to provide comprehensive accounting guidance for participants in emission allowance programs. The project will provide guidance on accounting for emission allowances and related liabilities.[11]

SARBANES-OXLEY ACT

Finally, Sarbanes-Oxley raises issues for public companies in the environmental disclosure context. Most prominent of these are Sections 302 and 906 that require CEOs and CFOs to certify that the financial statements fairly present the financial status of the company, and Sections 302 and 404 that require certain certifications that the internal controls established by the company are adequate to ensure the accuracy of financial statements. In addition, Section 404 requires that the independent financial auditor review and attest to the adequacy of the company’s internal controls. Consideration should be given as to disclosures being made by companies to meet these requirements. Are climate risks being considered by CEOs and CFOs when they make certifications? Do the internal financial controls address climate risk issues? At what point would it be appropriate to include climate risks, such as new capital costs or liability risks, in Sarbanes-Oxley compliance programs?

SEC ENFORCEMENT

The importance of these internal controls as they relate to environmental reserves and disclosure was demonstrated in a recent SEC enforcement case against Ashland Inc. (Ashland) and an environmental manager for alleged failure to properly record and report environmental financial liabilities.[12] This case indicates the expectations of the SEC for corporate environmental disclosure and the necessary internal controls required for accurate disclosure. As a result of its factual and legal findings, the SEC ordered Ashland to take several steps, including

[11] http://72.3.243.42/project/emission_allowances.shtml.

[12] *In re Ashland Inc. and William C. Olasin*. SEC File No. 3-12487 (Nov. 29, 2006).

to better document all adjustments to its environmental remediation estimates and to form a complete audit trail for environmental estimates with reasons for each adjustment. The SEC also required that Ashland retain PricewaterhouseCoopers (PWC) to review its policies, procedures, and internal controls relating to environment reserves, review its procedures to address internal complaints, and to submit the reports to Ashland's audit committee and the SEC. Finally, the SEC required that Ashland's audit committee or full board of directors review and adopt PWC recommendations, or develop and adopt alternative policies or procedures that are reviewed and approved by PWC.

The SEC required participation in this process by the audit committee or the full board of directors, apparently placing the expectation of ultimate authority and responsibility for implementing adequate financial internal controls to monitor and report environmental disclosure on the board of directors. It is important to note that this case was decided on the law as it existed before the passage of Sarbanes-Oxley. The SEC expectations may be higher under Sarbanes-Oxley.

The importance of climate change disclosure should not be overlooked. Consideration should be given by the audit committee and, if it exists, the environmental committee of public companies to disclosure requirements as they apply to climate change and GHG emission regulations, and the impact these issues may have on a company and their current and future financial conditions.

VOLUNTARY STANDARDS AND INSTITUTIONAL/SOCIALLY RESPONSIBLE INVESTORS

Beyond SEC regulations, accounting standards, and Sarbanes-Oxley, a plethora of protocols have emerged for "voluntary reporting" of environmental matters. These protocols have been developed by NGOs attempting to influence corporate behavior. These voluntary disclosure protocols include disclosure of information regarding environmental, sustainability, corporate social responsibility, and, more recently, climate change and GHG emissions.

These voluntary standards have evolved as a result of growing concern about corporate impacts on the environment and public health, but also at least in part as a result of the difficulty in achieving results through the more traditional regulatory system. As NGOs in the United States have found a Congress and White House over the last ten or more years that have been generally unfriendly to environmental regulation, the NGOs have adapted and shifted their efforts to other means of exerting influence. One such approach has been in the area of institutional investing, particularly state pension funds. Finding like-minded people in decision-making roles in public pension funds, the NGOs have developed socially responsible investing groups and protocols, and utilized the power of the media and the Internet to launch public campaigns to convince companies to disclose their activities that affect the environment.

Sustainability and corporate social responsibility have been the watchwords for several years. Many public corporations began issuing sustainability reports as a result of this pressure. Shareholder initiatives that involve environmental matters began to be proposed at a greater frequency. Most recently, climate change has become the focus of socially responsible investors.

Protocols for disclosing a company's "carbon footprint" and what they are doing about their GHG emissions have emerged.

The NGO pressure has similarly reached the financial sector. Publicly funded and private banks have adopted lending principles such as the "Equator Principles" to provide environmental criteria to be used when making loans.[13] Pressure has also been placed on investment firms, many of whom have retreated from investing in certain industries. For example, one investment firm has withheld investments in coal projects as a result of global warming concerns associated with the burning of coal.

More recently, chemical manufacturers and oil companies have been facing numerous shareholder initiatives filed by socially responsible investors to protest products or practices they consider to be public health or environmental threats. These resolutions urge management to change corporate policies to reduce the activities that the NGOs assert are harming the natural world or people. No greater demand has been voiced by NGOs in the last five years than that public companies disclose the effect climate change and GHG regulation will have on their companies. In the voluntary disclosure area, climate change disclosure is the central focus of many of the organizations developing voluntary corporate environmental disclosure.

For example, the Global Reporting Initiative, the Carbon Disclosure Project, and Global Framework for Climate Risk Disclosure focus on climate change reporting. Care must be taken in considering engaging in any of these programs, as the motivations and goals of the disclosure requirements or protocol may go well beyond true "financial" disclosure and instead address more "regulatory" disclosure. For example, one would not expect to disclose a company's GHG emission levels company-wide or by facilities in a financial report, but may do so in the context of a climate change regulatory program. In fact, measuring and reporting one's GHG emissions would be a fundamental aspect of such a regulatory system.

VOLUNTARY STANDARDS EVOLVING INTO LEGAL REQUIREMENTS?

The demand for voluntary disclosure sprung from NGOs, and in recent years, has extended to state pension funds, where state officials in charge of these funds with substantial investments in publicly traded companies have joined the call for voluntary disclosure. Recently, this voluntary call has evolved into a more pressing legal or mandatory demand.

With respect to reporting actual emissions, Congress has passed a law whereby EPA is to promulgate regulations to require companies to report their environmental regulations and several states have passed similar legislation. Thus, voluntary reporting of greenhouse gas emissions will soon become a mandatory reporting system.

With respect to voluntary reporting of climate risk in the context of financial disclosure, the voluntary nature of these disclosures is being questioned. In September 2007, New York Attorney General Andrew M. Cuomo opened an investigation of five major utility companies regarding whether their plans to build coal-fired power plants pose undisclosed financial risks

[13] http://www.equator-principles.com/.

that should be disclosed to investors. The investigation is based on the same New York securities law used by former New York attorney general and now governor of New York, Elliot Spitzer. The attorney general sent subpoenas to AES Corporation, Dominion, Dynegy, Peabody Energy, and Xcel Energy.

Only a week after the New York attorney general's announcement of an investigation into the climate risk disclosures of five major utilities that operate coal-fired power plants, a group of states and NGOs announced the filing of a petition with the SEC to promulgate a rule that would provide specific climate risk disclosures. The petition asserted that (1) "recent scientific, legal, and regulatory developments make it unavoidably clear that the risks and opportunities many corporations face in connection with climate change fall squarely within the category of material information that is required to be analyzed and disclosed in many corporate filings," and (2) that "corporate disclosures of the risks and opportunities created by climate change lag behind these developments, and investors are left with little or in some cases no useful information about corporate exposure to these risks."[14] The petition requests an interpretive release clarifying that material climate-related information must be included in corporate disclosures under existing law, and may draw even greater attention by public companies as they evaluate to what extent climate risk should be included in their public disclosures.

Congressional activity in 2007 after the Democratic takeover of Congress, growing development at the state level, and international pressure on the United States to join in serious negotiations of a post-Kyoto Protocol treaty and adopt its own climate change legislation that curbs GHG emissions have led to numerous bills that provide various approaches to GHG emission reductions. What has not received as much discussion are the provisions in several of these bills that would require the SEC to promulgate specific regulations that impose climate risk disclosures.

Three bills filed in the Senate would require the SEC to promulgate regulations mandating specific disclosure of climate risk. As stated above, on Dec. 5, 2007, the Senate Committee on Environment and Public Works voted out of committee the first climate change bill, the Climate Security Act, co-sponsored by Senators Joe Lieberman and John Warner. The Climate Change Security Act, Senate Bill 2191, contains a provision requiring the SEC to issue an interpretive release clarifying that under Items 101 and 303 of Regulation S-K that (1) the commitments of the United States to reduce emissions of global warming pollution under the United Nations Framework Convention on Climate Change are considered to be a material effect, and (2) global warming constitutes a known trend. The legislation would require the SEC to promulgate a regulation in accordance with Section 13 of the Securities Exchange Act of 1934 within two years of enactment of the climate change legislation. This rule would direct each issuer of securities to inform investors of the risks relating to (1) the financial exposure of the issuer arising from their net greenhouse gas emissions, and (2) the potential economic impacts of global warming on the interests of the issuer. In addition to promulgating this rule, the legislation would require the SEC to enter into an agreement with the FASB, or another

[14] Petition for Interpretive Guidance on Climate Risk Disclosure, http://www.sec.gov/rules/petitions/2007/petn4-547.pdf.

appropriate organization, to develop a uniform format for disclosing information on climate risk to investors.

Two other bills offered in the Senate would require similar actions by the SEC. Senate Bill 309, sponsored by Bernard Sanders, Patrick Leahy, and several other senators, and Senate Bill 485, sponsored by John Kerry, Olympia Snow, and Edward Kennedy, provide provisions that would require the SEC to issue an interpretive release and later promulgate regulations imposing specific climate change disclosure requirements on publicly traded entities.

In 2007, Congressional hearings were held to discuss climate change disclosure. Several experts testified about the need for increased disclosure under the SEC regulations, and the need for the SEC to issue interpretive guidance for public companies to direct them in how to address climate change in their SEC filings.[15]

In November 2007, Kiplinger.com reported that the SEC, under pressure from the large institutional investors and state officials through the petition for an interpretive release, will issue guidance as early as 2008 clarifying that certain types of climate-related information is "material," and must be included in corporate filings under existing securities laws and regulations.[16] The accuracy of this report is not clear at this time.

In 2008, the New York Attorney General settled its claims against Xcel and Dynegy. Under these settlements, the utilities agreed to make significant disclosures regarding climate risk:

The potential impact of present and probable future climate change regulation and legislation;

- Climate-change related litigation;
- Physical impacts of climate change;
- Current carbon emissions;
- Projected increases in carbon emissions from planned coal-fired power plants;
- Company strategies for reducing, offsetting, limiting, or otherwise managing its global warming pollution emissions and expected global warming emissions reductions from these actions; and
- Corporate governance actions related to climate change, including whether environmental performance is incorporated into officer compensation.

[15] http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=285.
[16] http://www.kiplinger.com/businessresource/forecast/archive/SEC_Wants_More_Information_on_Climate_Risks_071113.html.

The agreement to disclose these issues is unprecedented in terms of corporate environmental disclosure, whether under mandatory or even voluntary disclosure. Some of the disclosure points appear to go well beyond what mandatory financial disclosure requirements under SEC rules or FASB standards would require. The disclosure appears to be designed as much or more to change behavior as to inform shareholders.

To what extent other utilities subject to the New York Attorney General investigation will agree to similar disclosures or those not under investigation will adhere to such disclosure requirements remains to be seen.

Considering the growing demand for climate change disclosure and actions to investigate and compel such disclosure, corporations should take care in evaluating what should be disclosed with respect to climate change issues and the potential impact of GHG emission limitations on their financial performance.

Officer and Director Liability

Environmental and Climate Risk Management

One of the growing concerns about the evolving mandatory financial disclosure obligations and voluntary disclosure demands are the roles and responsibilities, and thereby potential personally liability, of officers and directors for overseeing these issues. Clearly, the individual responsibilities and liabilities of the CEO and the CFO have been increased by Sarbanes-Oxley. Other developments over the last couple of years have contributed further to the potentially greater responsibility for officers and directors to manage the risks encountered and to ensure adequate disclosure is made regarding such risks.

The case law regarding director liability and responsibility has been hinting at greater responsibility in the Delaware courts, long a reliable protector of directors. For example in the *Caremark* case,[17] the Delaware court held that directors owe a fiduciary duty of care to the company they serve. To fulfill his or her duty of care, a director must make a good faith effort to be informed and to exercise appropriate judgment.

The duty of care includes a duty to supervise the company, including maintaining procedures to monitor compliance with law. Directors do not have a duty to "ferret out" wrongdoing in the absence of a red flag; however, where there are facts or circumstances which would create suspicions in the mind of an "ordinarily prudent director," directors have an affirmative duty to make reasonable inquiries and, if appropriate, to take action.

To ensure that they are receiving adequate information upon which to base their judgment, directors must be satisfied that adequate reporting procedures are in place and being followed. As the *Caremark* court noted, "relevant and timely information is an essential predicate for satisfaction of the board's supervisory and monitoring role." Furthermore, though directors are generally entitled to rely on reports of management, directors should critically

[17] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

review those reports (not just accept them blindly) and ask questions as necessary to become fully informed and to satisfy their concerns.

The *Caremark* decision has taken on particular importance in light of the report issued by the expert panel that investigated the explosion at the BP Texas City refinery in March 2005. The expert panel led by Howard Baker issued the report (the "Baker Report"), which concluded that the company had not properly maintained safety policies and procedures, resulting in the explosion. The Baker Report called on directors to participate in overseeing the company's safety planning and practices.

The Baker Report and the *Caremark* case together suggest that a corporate director should exercise enough due diligence to understand health and safety issues relating to the operations of the company and to ensure that adequate information is being supplied to him or her to carry out the director's duty of care. In other words, there must be sufficient gathering and boiling down of information and presentation of that information so it is readily understandable by the director. The key to such a process is appropriate information flow and adequate metrics being provided to the directors.

These developments may be raising the bar for directors as expectations for overseeing environmental and safety practices of their company are converging with growing expectations after the passage of Sarbanes-Oxley that directors increase their oversight of financial disclosure and internal controls to ensure fraud and inaccuracies are avoided in gathering, processing, and reporting corporate financial information.

This convergence may be seen in the recent SEC order issued against Ashland discussed above, involving corporate environmental financial disclosure and internal controls. The decision by the SEC indicates the agency expects the audit committee, if not the full board, to exercise oversight of the internal controls used to gather and report environmental costs and liabilities and to properly report them to the public through securities filings.

In light of such responsibilities, personal liability may arise for directors. A significant slide in the stock price of a company after an environmental liability becomes public knowledge could result in a shareholder suit against directors. When this occurs, a question exists as to whether officers and directors are covered by director and officer (D&O) insurance. A troubling appellate court decision has been issued on this topic. The U.S. Court of Appeals for the Fifth Circuit, in *National Union Fire Insurance Co. Pittsburgh, P.A. v. U.S. Liquids, Inc.*,[18] ruled that the pollution exclusion in a D&O insurance policy effectively excluded claims filed by shareholders against directors and officers alleging they failed to disclose environmental liabilities in filings with the SEC and in press releases. As a result of this case, directors and officers need to not only evaluate their potential risk of being sued, but also whether they would be covered by corporate D&O insurance policies. If environmental exclusions apply to shareholder suits, the company may be able to purchase additional coverage so that directors are not left without recourse for defense costs and protection against an adverse judgment.

[18] 2004 U.S. App. LEXIS 2694 (5th Cir. Feb. 17, 2004).

Practical Approach to Climate Change Disclosure

Raising these potential risks to companies and their corporate leaders should not cause flight from positions of leadership in companies with environmental risks, particularly companies where the potential environmental and safety risks may yet be undiscovered or may prove remote. Rather, climate change disclosure issues and the degree to which mandatory and voluntary disclosure is necessary or advisable should encourage corporate leadership to develop strategies from which policies and procedures emerge to address these management and corporate risks.

In facing these issues head on, some practical issues the board of directors and management should consider include the following:

Develop a Realistic View of Potential Risks: Significant risks may face companies with substantial GHG emissions or "carbon footprint" as climate change regulation are adopted at the state, federal, and international level. Companies should consider the conclusions of scientific academies so that the peer-reviewed science on climate change and human contribution to that change are understood. Tracking of climate change regulation in the jurisdictions in which the entities conduct their business and where significant emission sources owned or operated by the entity are located is critical to understanding what disclosure may be appropriate. Developing a greenhouse gas inventory would be advisable at this time, as mandatory reporting will be required nationally in less than two years. For larger corporations, it may take a year to conduct an adequate GHG inventory. Moreover, it is difficult to manage a risk that has not been measured. Developing a risk analysis based on potential regulatory impacts on the company is advisable in order to allow development of corporate climate strategy.

Determine What Risks Should Be Disclosed: Fully evaluate potential risks and determine which of these risks rise to the level that some mention of the risk should be included in financial disclosures. Risks obviously will vary from industry to industry. Developments in a particular jurisdiction are important as well. For example, companies with natural gas-fired boilers in California and certain western states may be regulated, while they may not be regulated in the northeastern states implementing RGGI. Utilities in both regions may find it necessary to discuss the potential risks as coal-fired power plants will be regulated in these states. As regulations are promulgated, and specific emissions limitations become clear, then the company may then need to disclose any liabilities or capital costs that may be incurred, and any offset credits that may need to be purchased.

Beyond Costs and Liabilities, Assets May Need to Be Described in the Form of Carbon Allowances: In addition to liabilities, if a cap-and trade system goes into effect, to the extent greenhouse gas emission allowances are provided without charge to regulated GHG emitters, then real financial value will be received in the form of these allowances, which can be sold. The value of these allowances may require some form of disclosure under GAAP, and perhaps under SEC regulations. The need to purchase additional allowances or offsets may require disclosure as a cost or liability.

UNDERSTAND WHAT YOUR COMPETITORS ARE DOING: Review the disclosures by other industry members to understand the statements being made in the market place by competitors. Increasing disclosure by competitors regarding climate change regulation may show in an industry developing expectations of shareholders for climate risk discussion in public filings. On the other hand, care should be taken in taking too much comfort that limited disclosure among participants in a particular industry demonstrates meets shareholder expectations or achieves compliance with legal requirements. As the New York attorney general investigation shows, regulators or shareholders may bring actions alleging failure to disclose, and collective inadequate disclosure may not provide any form of defense.

UNDERSTAND WHAT OTHER INDUSTRIES HAVE DONE IN SIMILAR SITUATIONS: Consider other industries and what disclosures were made initially and over time with the development of regulations and filing of suits. How companies addressed disclosure in the early days of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) may provide some assistance or guidance to companies evaluating disclosure as a result of developing climate change regulation.

UNDERSTAND THE MIGRATION FROM GENERAL TO SPECIFIC DISCLOSURES AS REGULATIONS AND OTHER ISSUES DEVELOP: Where regulation is only being developed and where lawsuits are only a potential risk, a more general disclosure in the MD&A may be all that is required. As regulations are promulgated or decisions by California, the WSCI, and RGGI, or bills are passed in Congress and become law, companies will be required to disclose more specific information about potential affects on the company. Where litigation is filed, then, depending on the materiality of the matter, specific disclosure of that lawsuit or lawsuits may be prudent. The likelihood of loss may factor into disclosure as there may be significant legal and scientific barriers to plaintiffs succeeding in such suits. Since the likelihood of success may be remote in climate change lawsuits, but the potential losses may be fairly significant, care should be taken in evaluating what disclosure is required if such lawsuits are filed. Consideration should also be given to the potential effect of lawsuits filed by the EPA or other governmental entities attempting to force climate change regulation under existing statutes.

GOLDILOCKS APPROACH: The goal is to disclose realistic potential risks without stating more than would be appropriate. Seek the "Goldilocks Approach;" that is, just the right amount of disclosure: attempt to disclose enough, but not to overstate the risk. In some cases, overstatement of the risk may mislead investors as much as understatement.

UNDERSTAND THE RELATIONSHIP BETWEEN MANDATORY AND VOLUNTARY DISCLOSURE: Be prepared to deal with NGO pressure to disclose information beyond what is mandated by SEC regulations, GAAP, and Sarbanes-Oxley. Such pressure can arise quite quickly and consideration of particular issues at an early stage may allow the company the ability to deflect concern from regulators, investors, and other parties who may have an impact on a company. If the company is not subject to any existing laws (such as EU or US state laws) that may create risks, costs, or liabilities requiring disclosure, the company would have to decide whether it wants to participate in voluntary programs to disclose climate risk or GHG emissions. In participating in voluntary disclosure programs, it is key to understand the differences between environmental financial disclosure and disclosure of emissions. NGOs often fail in pushing voluntary disclosure to appropriate disclosure of the amount of emissions and other environmental data that may not be appropriate in financial disclosure documents which focus on financial and liability risk. Care should also be taken in divulging only positive anecdotes for public relations reasons and not addressing more rigorous numerical disclosure or negative information. As federal and state mandatory reporting requirements come into effect, these pressures may lessen. The public and investor relations issues may only grown as this information is published on the Internet.

MANAGE RISK INTERNALLY: If not yet established, companies should develop appropriate systems to identify, measure, and report information relating to environmental, health, and safety costs, risks, and liabilities to management and the board of directors. As with other environmental issues, companies should establish appropriate policies and procedures for information flow through the organization to management and the board on climate change issues. Directors should consider what steps they can take to assure themselves the appropriate systems and controls are in place and that necessary and accurate information is flowing to them for review with respect to climate change risk and related disclosure. With respect to climate change issues, as stated above, a climate change inventory should be conducted and provided to management and the board of directors.

DEVELOP POLICIES AND SYSTEMS TO INVOLVE AND INFORM MANAGEMENT AND DIRECTORS IN CLIMATE RISK ISSUES: Environmental management and disclosure as practiced by many companies have often failed to properly involve and inform management and the board of directors. In the case of climate risk and GHG emissions, it is perhaps even more critical to develop systems that provide the appropriate information flow to management and the board and involve them in developing policies to govern both how the company manages these risks and determines how mandatory disclosure is made and the extent to which the company participates in any voluntary disclosure protocols.

REVIEW D&O INSURANCE COVERAGE: As climate change risk and disclosure should involve management and director participation, it is critical to evaluate director and officer insurance coverage to insure that directors and officers are covered for shareholder claims or state or federal government claims arising from allegations that climate change risks or potential liabilities were not properly disclosed. The New York Attorney General's investigation of utilities for alleged failure to disclose climate risk illustrates the potential risk related to climate change disclosure for companies, but also those who manage those companies.

CONCLUSION

Environmental disclosure and risk management are inextricably intertwined, and no more relevant instance may exist over the coming years than in disclosure of climate risk. In evaluating the best approach to meet Sarbanes-Oxley and SEC requirements for climate risk, disclosure and risk management should be managed together in the context of corporate strategy, and interrelated systems should be developed for environmental management and internal controls for environmental financial disclosure.

Voluntary disclosure should be carefully considered in light of the information generated by the environmental management and environmental disclosure systems to ensure the accuracy of statements made to the public in any environmental or corporate social responsibility report. Management and directors of public companies should develop a practical, proactive approach to evaluate climate-related issues and formulate strategies for responding to the myriad pressures and influences that can arise from the interconnected economic, political, and social entities and organizations that may affect business enterprises in the twenty-first century. Based on current scientific studies and current political and legal realities, climate change issues are unlikely to go away, and will only become more significant for publicly traded companies.

Scott D. Deatherage is a partner in the Environmental Law Section of Thompson & Knight LLP in Dallas, Texas, and is the head of the Firm's multi-disciplinary Climate Change and Renewable Energy Practice Group.

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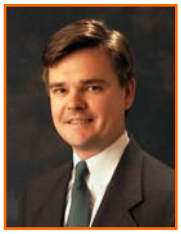

SCOTT DEATHERAGE
Thompson & Knight LLP
1700 Pacific Avenue
Suite 3300
Dallas, Texas 75201
Direct: 214.969.1206
scott.deatherage@tklaw.com