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CORPORATIONS PRESSURED TO DISCLOSE MORE INFORMATION ABOUT POTENTIAL RISKS ASSOCIATED WITH CLIMATE CHANGE

Recent developments confirm that corporations must recognize the potential need for disclosure of risks associated with greenhouse gas (GHG) emissions, regardless of the nature of their business or the uncertainty of the science. First, shareholder groups are pressuring companies to disclose what they characterize as GHG-related risks. Second, New York Attorney General Andrew Cuomo subpoenaed five utilities under a state law that allows investigation of “fraudulent practices” related to investments. The purpose of the investigation is to determine if the companies have made “misleading disclosures about climate change risk.” Third, a coalition of environmental and investor groups petitioned the SEC to rule that existing laws require publicly-traded companies to disclose information regarding the risks of climate change. Finally, even in the absence of such an SEC determination, companies with securities registered under the federal securities laws are subject to various reporting obligations that already could be construed as warranting disclosure of climate change risk, depending on the circumstances.

SHAREHOLDER PRESSURE TO DISCLOSE

According to CERES, an investor group managing over \$3.0 trillion in assets, investors filed 43 climate-related shareholder resolutions during the 2007 proxy season, “of which 15 led to positive actions.”¹ The resolutions were directed at industrial, banking, insurance, building, and financial services businesses.² For example, while financial institutions do not directly emit much GHG, they can influence significant carbon-loading decisions by financing industrial facilities and projects that directly or indirectly emit GHGs, such as power plants, office parks, and housing developments.

Common GHG resolutions include requests for: (1) calculation of the nature and extent of carbon-generating activities, e.g., an emissions inventory; (2) estimates of the financial risks related to climate change; (3) methodologies to reduce GHG emissions; (4) disclosure of the corporation’s efforts to downplay the risks of climate change; and (5) commitments to actual GHG reduction goals.

Often the proposals are made by small individual groups of activist shareholders and do not reflect the views of all, or most, of the investors in a company. Several GHG-related proposals have been soundly rejected by shareholders when brought to a vote. Also, the SEC has excluded proposals, because they do not comply with SEC proxy rules. Nonetheless, activist shareholder groups representing significant assets will play an increasing role in the course of corporate responses to climate change risks.

Shareholders advocating for GHG reductions have created a backlash among some investors who argue that some large, influential corporations are relying on bad climate change science, that the regulatory framework these corporations endorse is too aggressive and poorly conceived or premature, and that the perceived benefits will never be realized.

¹See http://www.ceres.org/news/news_item.php?nid=319.

²See http://www.ceres.org/pub/docs/Resolution_tracker.pdf.

In effect, they argue that corporations are jumping onto the climate change bandwagon without conducting the ordinary due diligence or cost-benefit analysis that would be expected for any other corporate decision. For example, some General Electric Co. (GE) shareholders proposed that GE document the “specific scientific data and studies” used to formulate its global-warming policy and “estimate the costs and benefits” of its support for mandatory emissions caps.³ The investor group explained, “GE is working to impose new, more stringent government regulations that will raise energy costs and reduce energy availability without providing significant, or even measurable, environmental benefits ...” while adversely impacting GE shareholders and pension-holders.

SEC DISCLOSURE

Aspects of federal securities laws could be construed as warranting disclosure of climate change risk, depending on the circumstances. Corporations should be aware of the following:

- (a) Under SEC regulation S-K, Item 101, 17 C.F.R. § 229.101, companies are required to disclose the material effects, including contingent effects, of state, federal or local laws on “discharge of materials into the environment.” Disclosure must include how environmental compliance may affect “the capital expenditures, earnings and competitive position of the registrant and its subsidiaries.”
- (b) Item 103, 17 C.F.R. § 229.103, requires disclosure of pending or contemplated material legal proceedings, including those “arising under any federal, state or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment.” Disclosure is also required for legal proceedings where a “governmental authority” is a party, unless the sanctions could not reasonably be expected to exceed \$100,000. In the environmental context, even single instances of noncompliance can result in a six-figure sanction because of the large base penalties in environmental statutes, and because penalties accrue on a daily basis. If climate change legislation follows form, it may have similarly expansive liability provisions.
- (c) Item 303, 17 C.F.R. § 229.303, requires that “management’s discussion and analysis of financial condition and results of operations” in securities filings provide a narrative discussion of any changes in financial condition of the issuer. Item 303 also requires disclosure of known trends, events, or uncertainties that will, or are reasonably likely to, have a material effect on the issuer’s liquidity, capital, sales, revenues, or income. Therefore, even if an obligation to report about climate change risk is not triggered by the more specific matters in §§ 229.101 and 103, climate change is a “known trend, event or uncertainty,” and companies should be assessing whether and when the effects may become “material” to the bottom line.

On September 18, 2007, a group of institutional investors representing over \$1.5 trillion in assets petitioned the SEC to “clarify that existing law requires disclosure of material climate risks.”⁴ The group also asked the SEC Chairman to increase the scrutiny of climate change disclosures in SEC filings.⁵

³ General Electric Co., Shareholder Proposal No. 7, Global Warming Report, proposed by the Free Enterprise Action Fund (February 7, 2007).

⁴ http://www.environmentaldefense.org/documents/6986_SECPetition_ClimateDisclosure.pdf.

⁵ http://www.environmentaldefense.org/documents/6987_Letter%20to%20Division%20of%20Corporation%20Finance.pdf.

The Senate Securities, Insurance and Investment Subcommittee met on October 31, 2007, to hear testimony regarding the ramifications of requiring businesses to disclose climate change risk. However, it is not likely that the SEC will adopt specific rules for climate change-related disclosure, at least not in the near term. The SEC does not have the expertise or tools to identify the means or criteria for evaluating the materiality of the risks of climate change, and concerns remain that specific climate change disclosure rules could have a chilling effect on investment.⁶

Although the SEC appears to be taking a hands-off approach for now, others are not. Recently, New York Attorney General Andrew Cuomo served subpoenas on five power companies in connection with a state security law regulating disclosure of financial risk.⁷ New York is investigating whether “selective disclosure of favorable information or omission of unfavorable information concerning climate change” was “misleading.” In letters accompanying the subpoenas, the Attorney General’s Office asked whether investors received adequate information about the potential financial liabilities of carbon dioxide emissions that exacerbate climate change. “Any one of the several new or likely regulatory initiatives for CO2 emissions from power plants – including state carbon controls, EPA’s regulations under the Clean Air Act, or the enactment of federal global warming legislation – would add a significant cost to carbon-intensive coal generation,” the letters said.

RISK FACTORS

Shareholder pressure for more disclosure, and potential SEC reporting, begs the question of what a company can realistically and accurately “report” about the risk of climate change, short of litigation or actual regulatory impacts. Even then, disclosure is difficult because regulatory frameworks are still being developed. While the evidence of warming is apparent, uncertainty exists about the degree, causes and implications, as well as future trends and our ability to mitigate climate change.

What are some of the climate change risk factors that companies should consider?

- The costs of compliance with any existing and applicable GHG regulatory requirements, such as the Kyoto Protocol;
- The costs of potential future GHG regulations “cap and trade” programs, a carbon tax, or both;⁸
- Operational changes to reduce GHG emissions;
- Raw material impacts, such increased prices or reduced ability to use coal;
- Higher energy costs; and
- Pending or reasonably foreseeable litigation associated with GHG emissions.⁹

⁶Although at least one Presidential candidate’s energy platform includes a “requirement” that publicly traded companies disclose climate change financial risk in SEC reports. See www.Hilaryclinton.com/issues/energy.

⁷See http://www.nytimes.com/2007/09/16/nyregion/16greenhouse.html?_r=1&ref=nyregion&oref=slogin.

⁸A “cap and trade” reduction framework places an economy-wide cap GHG emissions for a given year and then allocates the emissions budget among industries and other sources in the form of permits or credits that are tradeable.

⁹Two precedent-setting decisions were issued recently. In one, a federal court dismissed California’s attempt to hold six automakers accountable for creating global warming-related damages, concluding it was up to Congress and the government to deal with the climate change question. *California v. General Motors*, No. C06-05755 MJJ, 207 U.S. Dist. LEXIS 68547 (N.D. Ca., Sept. 17, 2007). In a case involving states’ abilities to set tailpipe standards for GHG emissions, a Vermont court rejected arguments that federal law pre-empted the states from setting the regulations or that such standards were not achievable. *Green Mountain Chrysler-Plymouth-Dodge-Jeep v. Crombie*, 508 F. Supp. 2d 295 (D. Vt. 2007).

There are other issues to consider. For example, while difficult to quantify or predict, companies may be at a competitive disadvantage if they have not taken voluntary GHG reductions or if they are not well-positioned market-wise to compete in a carbon-constrained world. Wall Street is taking note of the risks of climate change on the corporate landscape. For example, the Investor Network on Climate Risk, representing \$4 trillion in assets, is a vocal proponent of quick and substantial actions to reduce GHG emissions.¹⁰ These groups can influence shareholders, promote shareholder resolutions, and direct capital to businesses that are perceived as more “carbon-friendly.”

Consumer conduct is a wild card risk. While consumers, to some degree, have long taken into account a company’s environmental record when making purchasing decisions, it is difficult to gauge whether a corporation’s reputation on climate change has translated to an actual impact on revenues.

The potential for Enron-type litigation against corporations and shareholders that fail to disclose the financial risk of climate change is a risk. As CEO’s and other executives become more involved in GHG decisions, and make public statements about a corporation’s situation related to climate change, they become vulnerable to personal liability under federal or state securities laws and shareholder-related litigation.

Finally, infrastructure damage resulting from extreme weather conditions and sea level rise is a particularly significant potential risk for businesses operating in coastal areas.

CONCLUSION

It has been said that climate change is just another lens through which to view risk. In that sense, the issue should be addressed in the same stepwise, rational, and cost-benefit approach as any other corporate risk factor. However, climate change presents some unique challenges, because the risk is attributable to both past and ongoing corporate operations, the problem is long-term, the nature and extent of the risk is uncertain, the implications are global, and the regulatory framework remains in flux. In addition, the issue is often framed exclusively in terms of moral imperatives, and polemics on all sides of the issue have at times obfuscated the facts or the science. Science, risk, and public policy intersect with climate change, and the traffic is heavy and chaotic. Corporations will face difficult challenges in deciding which way to turn and how fast to go.

¹⁰ See <http://www.incr.com/NETCOMMUNITY/Page.aspx?pid=198&srcid=218>.

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