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Lifting the Veil: Pressures Mount for Climate Change Disclosures

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Measures from Sarbanes-Oxley to climate change legislation will pervasively transform the manner in which American businesses relate to shareholders and consumers. Capping a month of extraordinary changes, the National Association of Insurance Commissioners adopted a rule that mandates broad disclosures by insurance companies regarding the impact of climate change on their financial stability – thereby enlisting the insurance industry as a “partner” in the enforcement of global and national climate change policies.

Richard O. Faulk

Whatever one may think about the scientific merit of climate change arguments,1 the legal and regulatory storms have already broken. Indeed, climate change issues are changing the landscape of American industry – and the changes will surely accelerate as the Environmental Protection Agency and Congress move toward a comprehensive regulatory and statutory policy.

On Apr. 16, 2009, EPA issued its proposed “endangerment finding” regarding greenhouse gases, concluding that emissions of those compounds presented a danger to health and welfare.2 The finding began the process toward regulating greenhouse gases under the Clean Air Act.3 Almost

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simultaneously, Rep. Henry Waxman introduced climate change legislation in the House of Representatives⁴ – legislation that, if passed, will pervasively transform the manner in which American businesses conduct their operations and, ultimately, how they relate to shareholders and consumers. Finally, capping a month of extraordinary changes, the National Association of Insurance Commissioners (NAIC) adopted a rule that mandates broad disclosures by insurance companies regarding the impact of climate change on their financial stability – thereby enlistng the insurance industry as a “partner” in the promotion, effectuation, and enforcement of global and national climate change policies.⁵

Although these developments encompass a broad range of issues, they are especially relevant to corporate disclosure obligations.⁶ Pressures have been mounting for the past few years for businesses to reveal their climate change postures, profiles, and initiatives to shareholders, regulators, and the public. Although all enterprises should be concerned about these issues, certain businesses are already under substantial scrutiny. The electrical power industry is certainly a principal target, principally because the industry is responsible for significant greenhouse gas emissions from operations that use coal-fired facilities.⁷ Pressures are also focused, however, on virtually all companies that are substantial energy consumers, as well as industries that are directly sensitive to climate changes, such as farming, ranching, construction, transportation, resort destinations, and last but not least, insurers.

Much has been written about the controversy prompted by New York Attorney General Andrew Cuomo’s investigation about whether the SEC filings of targeted companies elected not to ignore when they compromised and amended their disclosures. Other efforts to force climate change disclosures were initiated by petitions to the SEC, and by reports by environmental groups, such as CERES, which have influenced and chronicled changes within a wide variety of industries.¹¹ In its efforts, CERES has surveyed, examined, and reported regarding numerous industry sectors, commended companies that have enhanced their disclosures, and critiqued companies that were less forthcoming.¹²

To be sure, current SEC disclosure requirements do not address climate change issues specifically. Indeed, the SEC seldom mandates disclosures regarding particular substantive concerns. Instead, it generally requires disclosures of “material information” that allows investors to make informed choices. This is the premise underlying both the Securities Act of 1933, which governs offerings, and The Securities Exchange Act of 1934, which mandates regular reports.¹³ Within that general framework, climate change disclosures may be implicated by at least three sections: Item 101, which deals with business descriptions;¹⁴ Item 103, which addresses legal proceedings;¹⁵ and Item 303, which deals with management’s assessment of the company’s financial condition and the results of its operations.¹⁶

Item 101 may entail disclosures if, as is expected, the costs of...
complying with the growing web of climate change laws and regulations become material. Under that provision, corporations must reveal the “effect of existing or probable governmental regulations” on their operations. The breadth of this inquiry is extraordinary – sweeping within its scope not only the impact of complying with current laws, but also those which are likely to become effective. The disclosures are not limited to impacts and anticipated issues within the current year. Instead, they extend into the future if failures to disclose will result in misleading investors. The mass of global, federal, state, and local initiatives bearing down on industry – as well as those which already apply, such as regional and state greenhouse gas initiatives – raises complex issues under Item 101 that cannot easily be ignored.

Item 103 comes into play when pending or anticipated legal proceedings are material to a corporation, its subsidiaries, or its property. Although massive climate change litigation has been filed and prosecuted against electrical power companies and other industries, the litigation has been unsuccessful – so far.17 Although it is beyond the scope of this article to discuss the specifics of these cases, most of them fail because the courts refuse to entertain them in the absence of standards established by the political branches of government.18 If, however, the EPA or Congress specify those standards, or if they are set by global agreements or treaties, the validity of this rationale might be re-examined. Suits that survive dismissal and reach the merits might motivate disclosures, depending on the facts and issues involved.

Item 103 may also encompass citizen suit opportunities available under present law or which may be created by federal climate change legislation currently being considered in Congress. The “American Clean Energy and Security Act of 2009” presently includes an expansive provision allowing suits by “any person who has suffered, or reasonably expects to suffer, a harm attributable, in whole or in part” to climate change.19 Citizens can recover up to $75,000 per violation, and violations include “any effect” that is “currently occurring or at risk of occurring” and any “incremental exacerbation” associated with a “small incremental emission.”20 Some commentators have argued that the bill “will trigger a lawsuit landslide.”21 This potential threat should be monitored and evaluated carefully.

Item 303 requires a discussion of trends that are currently known, as well as uncertainties or events that the company reasonably expects to have material effect on capital resources, revenues, net income, or liquidity. This disclosure is commonly referred to as “Management’s Discussion and Analysis, or “MD&A.” If there is a substantial likelihood that a reasonable investor would deem the information important when making a decision or purchase or sell securities, the effect meets the materiality standard. Although MD&A disclosures are restricted to information that is “without undue effort or expense,” and companies are not required to provide “forward-looking information,” these limitations provide little practical guidance. Distinguishing “forward-looking information” from “known trends and uncertainties” can be extremely difficult. Moreover, this item’s importance is enhanced because it specifically addresses the mindset of investors – and because it specifically requires companies to assess whether “reasonably expected” developments are sufficiently important to ensure informed investment decisions. A few years ago, a fair reading of Item 303 might have justified silence on climate change on the part of most public companies. But today, the Kyoto Protocol is a reality for corporations operating...
in countries that ratified the treaty and carbon trading markets have been established. Moreover, here in the United States, consensus is growing to institute a market-based regulatory program to address greenhouse gas emissions and some states are actively pursuing their own regulatory mandates to regulate greenhouse gas emissions. Thus, companies operating in countries that have ratified the Kyoto Protocol may already be required to disclose in their MD&A any material costs of compliance with the protocol. Additionally, in the near future it may be possible that two power companies with plants in adjacent states (or even adjacent counties) may have vastly different disclosure obligations, depending on factors as simple as fuel feed stock or as complex as long-range corporate planning for capital improvements.

Financial accounting standards also may be implicated by climate change developments. Generally, a company is required to accrue a charge against current income for the entire amount of a probable liability or one that can be reasonably estimated. Companies may also be required to estimate or footnote their statements regarding such potential liabilities. Environmental advocates argue that a wide range of companies have already “crossed the threshold” that requires action under this standard. They include emitters of greenhouse gases whose emissions are regulated by various international, regional, or state initiatives, companies that are making major capital expenditures that may be subject to greenhouse gas regulations, and industries that are particularly susceptible to warming climates and severe weather episodes.

Perhaps even more important in today’s reality, the Sarbanes-Oxley Act of 2002 has dramatically expanded the scope and the timeliness of company information that must be disclosed. Although Sarbanes-Oxley does not alter environmental disclosure requirements, § 302 of the Act now requires that responsible corporate officers personally certify the accuracy of quarterly and annual financial statements and disclosures – making them ultimately liable for the accuracy of disclosure of environmental-related liabilities in company financial filings, including climate change. Under this analysis, senior executives may be pressed to be more “forward-looking” in their company’s disclosures because they must meet an all-embracing “fair presentation” standard that is more exacting than “clinical” materiality. Hence, management may choose to disclose plans that involve material expenditures in response to climate change concerns. In this vein, some auditors are altering their approach to ensure that they have “properly evaluated the off-balance-sheet risks” related to climate change.

Collectively, these items and standards probably require more than an analysis and disclosure of the effect of existing and forthcoming laws and regulations. Depending on the company’s situation, it also may be necessary to address the actual and anticipated impact of emerging legal requirements, such as, for example, the strict regulation of greenhouse gases by the State of California, or the effects of participation in regional greenhouse gas initiatives, such as the system currently effective in the Northeastern United States. For business with international activities, particularly those with European operations, an assessment of the impact of participating in the European “cap and trade” program is appropriate. If participating in any such programs raises concerns – within the broad sweep of the items above – disclosures should be considered. Certainly, all companies with significant greenhouse gas emissions should,
at the very least, analyze their susceptibility to climate change liabilities, including common law litigation, and be prepared to address those risks in the event climate change cases mature into serious threats.

Beyond laws, regulations, and lawsuit liabilities, companies may also be required to assess and disclose the financial impact of climate change itself. For example, if the company’s business is especially sensitive to the warming impact of global climate change itself, analysis and disclosures may be necessary. Some operations, such as agricultural operations and hospitality industries, are uniquely dependent on weather conditions. Production failures, diminution of asset values, declining demand and reduced productivity may, in certain circumstances, have a material impact. Even when no material effect is currently foreseen, analysis and discussion may be needed to ensure that investors are fully informed of potential risks.

Failure to comply with these standards risks serious consequences, including investigations under the securities laws, civil and criminal enforcement, and shareholder suits. Although no federal enforcement actions have been undertaken at this time, they should not be ruled out, either under existing law or under federal climate change legislation that is currently under consideration. Petitions have already been filed with the SEC to require specific climate change disclosure rules, and pressures to do so will surely continue. Moreover, risks are not limited to federal actions. As the New York example shows, states may also commence investigations under their own securities laws – as well as under any climate change provisions they may enact.

Responding to these threats can be extraordinarily expensive, and can interfere significantly with normal business operations. Depending on information revealed in the response, it may also enhance the risk of regulatory, tort, and criminal liability. For example, a company may find itself forced to produce voluminous electronic and documentary materials dealing with its analysis of climate change concerns – and those materials may find their way into pending or future shareholder cases and may even be used to support tort liability. Already, such materials, including Web site postings, are being used in climate change tort cases to support findings of “conspiracies” to mislead or manipulate regarding climate change dangers. For that reason, it is important to review corporate statements for candor and accuracy, especially those which claim strong records of “environmental stewardship.” Unless such statements are examined carefully to ensure accuracy, investigators, enforcers, and lawsuit plaintiffs may characterize them as “hype” and may claim that they are deceptive.

The most recent – and potentially one of the most important – disclosure mandate was approved last month by the National Association of Insurance Commissioners. Although the mandate still needs to be implemented by the insurance commission of each state, its overwhelming endorsement by the national organization suggests that state regulations will be promulgated relatively soon. The NAIC Survey is the “first step” in enlisting insurers as new “partners” in the promotion, effectuation, and enforcement of global and national climate change policies. It is no coincidence that CERES immediately hailed the survey as a “wake-up call” that “bolster[s] CERES’ ongoing efforts to press the Securities and Exchange Commission to require all publicly traded companies to provide full disclosure of climate-related risks, whether from physical impacts or regulatory impacts.”

The NAIC mandate goes far beyond the internal operations of insurance companies. The NAIC’s
disclosure policies also impose external responsibilities on insurers – requiring work with policymakers, regulators, and – most notably for industry – policyholders themselves to ensure financial stability. The survey requires answers to eight broad questions:

- Does the company have a plan to assess, reduce, or mitigate its emissions in its operations or organizations? If yes, please summarize.
- Does the company have a climate change policy with respect to risk management and investment management? If yes, please summarize. If no, how do you account for climate change in your risk management?
- Describe your company’s process for identifying climate change-related risks and assessing the degree that they could affect your business.
- Summarize the current or anticipated risks that climate change poses to your company. Explain the ways that these risks could affect your business. Include identification of the geographical areas affected by these risks.
- Has the company considered the impact of climate change on its investment portfolio? Has it altered its investment strategy in response to these considerations? If so, please summarize steps you have taken.
- Summarize steps the company has taken to encourage policyholders to reduce the losses caused by climate change-influenced events.
- Discuss steps, if any, the company has taken to engage key constituencies on the topic of climate change.
- Describe actions your company is taking to manage the risks climate change poses to your business including, in general terms, the use of computer modeling.37

These questions cannot be answered candidly and completely without an understanding of the risks faced by policyholders who may claim coverage for losses associated with climate change. Virtually every line of coverage is implicated by climate change questions, including flood and crop insurance, business interruption, directors and officers coverage, health, life, professional liability, and property liability. More than ever before, it will be important for insurers to ensure that their climate change posture is responsibly aligned with the business practices of their policyholders. Both parties face risks of director-and-officer liability associated with inadequate or misleading disclosures of climate change risks in these lines of insurance. They also risk shareholder suits for lack of due diligence regarding climate change risks in mergers, acquisition, and business development.

The NAIC provides some vague guidance for insurers who must answer these questions. For example, insurers are required to answer all questions in “good faith” and with “meaningful responses,” but they need not provide information that is “immaterial to assessing financial soundness.”38 They are not required to provide “quantitative” information, information that they believe is “commercially sensitive or proprietary,” or “forward-looking” information.39 As we saw earlier with existing SEC requirements, however, particularly Item 303, it can be difficult to interpret such requirements in actual practice.

Because of the NAIC’s mandate, industry should expect that insurers will be more active in a number of areas, such as:

- Assessing and evaluating financial exposures to climate change and supporting public policy actions to reduce warming emissions.
- Evaluating their corporate investment portfolios to determine sensitivity to climate change risks and impact of public policy decisions.
Revising underwriting models to account for climate change risks.

Reviewing and analyzing categories of insurance for climate change risks and pricing policies accordingly.

Investigating and requiring disclosures of information by their customers regarding liability risks associated with climate change and the impact of climate change on their business operations.

Creating programs that educate and provide policyholders with the incentives and tools to manage risks and control costs.

Creating new insurance products and preventive practices that assist in projects that reduce greenhouse gas emissions.

Some of these actions, such as the creation of new insurance products to cover risks associated with “cap and trade” programs and insuring the value of alternative energy investments, will undeniably prove useful. Others, however, may be far more intrusive than experienced in pre-mandate relationships. Most importantly, however, the NAIC mandate provides a regulatory framework that may inform and guide the SEC and state securities regulators as they consider disclosure regulations regarding climate change. Accordingly, it may be wise for companies to consider the NAIC questions as a “template” for developing their own information and disclosure policies. In addition to the NAIC questions, ASTM International has also released an excellent guidance document for climate change disclosures. These developments illustrate the profound impact that the emerging legal framework regulating climate change, and indeed climate change itself, is already having on corporate disclosure obligations.

Increasingly, lawmakers, regulators, shareholders, insurers, and environmental groups are insisting on candid assessments of the risks and opportunities climate change poses to publicly held corporations. Although existing laws arguably require such disclosures, those laws may be amplified soon by mandates that apply specifically to climate change concerns. As these initiatives move forward, industry may reasonably anticipate that greater transparency will be required – transparency that will allow investors to evaluate their decisions more completely and accurately. Beyond legal and financial issues, disclosures plainly impact public perception – and in the final analysis, public confidence may be the most critical factor for future success. Informed companies should anticipate these concerns and begin addressing them now.

Endnotes:


3. See generally, John S. Gray, A Glorious Mess: Congress’ Creation if Its Inaction Forces EPA to Regulate Climate Change under Existing Laws, 46:3 Hous. Law. 30 (Nov./Dec. 2008). Curiously, the EPA Administrator told Congress on May 12, 2009, that the endangerment finding “does not mean regulation.” Ian Talley, EPA’s Jackson: Then Again, Maybe We Won’t

Other relationships, however, may be far more intrusive than experienced in pre-mandate relationships.
(Regulate Emissions), Wall St. J., May 13, 2009. The comment came simultaneously with Republican outrage prompted by a report from the Office of Management and Budget that concluded that “regulating greenhouse gases under the Clean Air Act “is likely to have serious economic consequences for regulated entities throughout the U.S. economy, including small businesses and small communities.” Stephen Tover and Ian Talley, Republicans Pounce on OMB Memo, Wall St. J., May 12, 2009. The Administrator’s comments are perplexing because she appears to lack discretion to refuse regulation on an endangerment finding is made – and she could probably be compelled to do so if environmental groups press the issue in court.


8. See generally, Richard O. Faulk and John S. Gray, Stormy Weather Ahead?

The Legal Environment of Global Climate Change, at 166–117, at http://works.bepress.com/richard_faulk/subject_areas.html#Climate%20Change (pre-publication copy).


14. 17 C.F.R. § 229.101 (2007); see also, Jeffrey A. Smith, The Implications Of The Kyoto Protocol and the Global Warming Debate for Business Transactions, 1(2) N.Y. J. LAW & BUS. 651, 669 (Spring 2005) Healy and Tapick, supra note 13, at 106–107 (“A fact is ‘material’ for such purposes, if there is a ‘substantial likelihood’ that a ‘reasonable shareholder’ would change their behavior if the omitted or misstated fact were accurately disclosed.”); see also Securities & Exchange Commission, Materiality, SEC Staff Accounting Bulletin Release No. SAB 99, Aug. 12, 1999 (emphasizing that materiality should be measured by a “reasonable investor” standard).


16. 7 C.F.R. § 229.303(a)(1) (2007); see also, Smith, supra note 10, at 676 (citing Concept Release on Management’s Discussion and Analysis of Financial Condition and Operations, Exchange Act Release No. 6211, 52 Fed. Reg. 13,715, 13,717 (Apr. 26, 1987)); JEFFREY A. SMITH AND MATTHEW MORREALE, DISCLOSURE ISSUES, IN GLOBAL CLIMATE WARMING AND U.S. LAW 453, 458–68 (Michael B. Gerrard ed. 2007) (providing a detailed discussion of SEC disclosure issues and climate change). With respect to “materiality,” corporations must decide whether a “known uncertainty” is “reasonably likely to occur” and if so, the issuer must “evaluate objectively the consequences of the known ... uncertainty.” Disclosure is required “unless [the corporation] determines that a material effect ... is not reasonably likely” to result from the known uncertainty. See Healy and Tapick, supra note 13, at 107 (citing SEC Management’s Discussion and Analysis of Financial Condition and Results of Operations; Certain


20. Id.


22. According to the SEC, “to the extent any foreign [environmental] provisions may have a material impact upon the company’s financial condition or business such matters should be disclosed.” Smith, supra note 10, at 669 (citing Air Products and Chemicals, Inc., SEC No Action Letter, June 11, 1973 (interpreting precursor to Item 101(c)(xii))).


25. Id.


27. Id.


30. See Smith, supra note 10, at 668.

31. Christina Ross, et al., Limiting Liability in the Greenhouse: Insurance Risk-Management Strategies in the Context of Global Climate Change, 43 A STAN. J. INT’L L. 251, 269 (2007). James E. Copeland, Jr., the Chief Executive Officer of Deloitte & Touche LLP stated, “[t]he real driver of change in the post-Enron environment is intense scrutiny – and an investing public that is demanding stricter enforcement of the law.” He further identified that a company’s lack of response to climate change could have a material bearing on financial performance and shareholder value and that climate change disclosure practices of U.S. insurers stand in stark contrast to those of most other U.S. business sectors. Id. (citing Financial Reporting Value Chain Must Restore Trust to Meet Challenges Of Post-Enron Environment, says Deloitte & Touche CEO Copeland, Institutional Shareholder (date unavailable)).


33. See, e.g., supra note 23; see also Zacharias, supra note 32, at 9–10.

34. See, e.g., Native Village of Kivalina v. Exxon Mobil Corp., No. 08-01138, complaint filed (N.D. Cal. Feb. 26, 2008) (seeking relief for relocation of Native American village in Alaska as a result of coastline erosion caused by global warming attributable to defendants’ emissions, and citing a wide variety of allegedly misleading materials and statements by defendants).

35. See supra, note 3.


38. Id. at 1.

39. Id.
