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ABA Section of Environment, Energy and Resources

Environmental Disclosure Committee Newsletter

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MESSAGE FROM THE CHAIR

Scott Deatherage

This is a particularly interesting time for environmental disclosure as the environmental regulation of business and industry is going through a potentially significant transformation with impending state and federal legislation, court decisions, regulatory action by the U.S. Environmental Protection Agency regarding greenhouse gas emissions monitoring and reporting, regulation of these emissions, and potential liability for past and future emissions. Climate change pressures from various stakeholders, including shareholders, puts significant pressure on companies to measure, report, and address greenhouse gas emissions. The U.S. Securities and Exchange Commission (SEC) has issued guidance for public companies to use in making climate risk disclosure. Whatever the politics and controversy, it appears that climate change risk disclosure is here to stay and will continue to evolve.

It is fitting then that this edition of the Environmental Disclosure Committee's Newsletter devotes all of its three articles to climate risk disclosure. The first article discusses the SEC's climate risk disclosure guidance, and provides some practical issues for companies and their counsel to keep in mind as they prepare documents for filing with the SEC. The second article provides an overview of the specific SEC regulations that relate to environmental disclosure and some of the issues that arise in preparing climate change disclosures in following these SEC rules. The third article reviews recent court decisions that raise the risk of potential liability for emitters in the courts as a result of their greenhouse gas emissions, and how this potential liability may play into SEC disclosure.

As has been the goal of this Committee from its inception, our Newsletter has attempted to present analysis of cutting-edge legal issues in the realm of environmental disclosure. This proves to be no different with this edition by addressing the challenges public companies face in attempting to determine what disclosures are appropriate in a time of changing and uncertain climate regulation, and the disclosure obligations attendant to these changing rules and potential liabilities.

SEC ISSUES BROAD INTERPRETATIVE GUIDANCE OUTLINING CLIMATE CHANGE DISCLOSURE OBLIGATIONS FOR ALL FILERS

Kevin J. Klesh, Bret C. Cohen, and Mary Beth Houlihan

On February 2, 2010, the U.S. Securities and Exchange Commission (SEC) put public companies on notice in its Guidance Regarding Disclosure Related to Climate Change (the Guidance) that they must evaluate and provide financial reporting regarding climate change. After years of calls from the private and public sector for increased transparency for climate change impacts, this marks the first time that the SEC has

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formally provided direction about how public companies should factor climate change concerns into their disclosure documents filed with the SEC. *See* Doran, Kevin L. et al., Center for Energy and Environmental Security, Reclaiming Transparency in a Changing Climate: Trends in Climate Risk Disclosure by the S&P 500 from 1995 to Present (2009) (with foreword by Harvey L. Pitt and E. Donald Elliott) *available at*: http://cees.colorado.edu/10K_Report_Final_May_27.pdf. While many companies already mention climate change in their filings, most do not provide sufficient detail to comply with the new Guidance or address the business implications of climate change. Importantly, the interpretative Guidance is effective now so that filers should incorporate its guidelines regarding climate change risks, impacts, and opportunities into the preparation of 10-Ks and other filings that they may be currently drafting.

Background

As described in further detail in the Guidance, the SEC has decided to act now not just because of increasing calls for climate change disclosures from investors and public authorities such as the New York State attorney general, but also because of a confluence of climate change developments in recent years. First, domestic climate change regulations and international accords have been rapidly taking shape over the last few years to track and limit greenhouse gas (GHG) emissions, with potentially significant impacts on businesses (*see* Guidance, pp. 3–6). Second, the science of climate change has been gaining momentum in its acceptance worldwide, raising the bar for companies to discuss the potential physical impacts of such, particularly if they operate in coastal or other areas sensitive to extreme weather patterns (*see* Guidance, pp. 6–7). Finally, the information in public company filings has fallen behind that disclosed through voluntary climate disclosure programs (such as the Climate Registry) and emerging regulatory requirements (such as EPA's GHG Disclosure Rule) (*see* Guidance, p. 8).

Notably, the Guidance does not promulgate new regulations but rather provides a clarification of already

existing disclosure obligations. As the SEC notes in the Guidance:

> This release outlines our [the SEC's] views with respect to our *existing* disclosure requirements as they apply to climate change matters. This guidance is intended to assist companies in satisfying their disclosure obligations under the federal securities laws and regulations.

(emphasis added) (*see* Guidance, p. 3). Key among these existing requirements are Regulation S-K, Regulation S-X, Securities Act Rule 408, and Exchange Act Rule 12b-20 (*see* Guidance pp. 12–21).

Therefore, in an effort to bring company filings up-to-date with recent developments in the climate change arena and ensure that the public can make informed investment decisions, the SEC expects filers to begin following the Guidance immediately.

Guidance Has Broad-Based Applicability

All filers should consider how the Guidance may apply to them, including those whom climate change affects indirectly such as through impacts on suppliers and customers. Without limiting the types of businesses that would be covered by this climate change Guidance, the SEC specifically mentions the energy sector, transportation sector, agriculture, insurance companies, lenders, businesses located in coastal areas or affected by severe weather, and businesses whose environmental reputation is relevant to their operations or financial condition. Therefore, these sectors could expect particular scrutiny from the SEC regarding the consideration and disclosure of climate change impacts. A final determination regarding whether a duty to disclose exists and the extent of disclosure required will vary based on the specific circumstances surrounding a particular company's business and operations.

Types of Disclosure Are Varied and Should Be Tailored to the Specific Company

Depending on the nature of the matter, climate change-related disclosure could appear in various parts of a filing with the SEC, including the Description of Business, Legal Proceedings, Risk Factors, and Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A). The SEC's climate change Guidance provides four specific examples of climate change issues that a registrant should consider in preparing its disclosures:

> (1) *Impact of Domestic Legislation and Regulation*. Filers should consider both the consequences and opportunities that existing and pending local, state, regional, and federal legal requirements related to climate change may present. This may include regional initiatives related to carbon trading, such the Regional Greenhouse Gas Initiative (in the northeastern United States), and pending legislation in the U.S. Congress for a national GHG cap-and-trade system. Examples of potential impacts include costs or profits from GHG emissions credits trading, expenditures to upgrade facilities and equipment to reduce emissions, impacts on profits and losses from increased or decreased demand for goods and services, and changes in the costs of certain goods.
>
> Depending on the particular company, a discussion of the potential impact of climate change legislation and regulation could appear in various sections of a corporate filing. The Description of Business would include disclosure of any material costs of compliance with existing federal, state, and local climate change requirements, including estimated capital expenditures for environmental control facilities (*see* item 101(c)(1)(xii) of Regulation S-K). In MD&A, the filer would describe whether any enacted climate change legislation or regulation is reasonably likely to have a material effect on its financial condition or results of operation going forward (*see* item 303 of Regulation S-K). In the Risk Factors, any significant risks specific to the filer from existing or pending legal requirements governing climate change would be described

(*see* item 503(c) of Regulation S-K). Finally, should any material litigation or enforcement actions arise out of climate change legislation or regulations, the filer would then be required to disclose such in the Legal Proceedings section (*see* item 103 of Regulation S-K).

(2) *Impacts of International Accords.* The SEC will also look for any businesses materially affected by international climate change agreements to make disclosures similar to that outlined above for domestic legislation and regulation. Examples include the impact of the European Union Emission Trading System and the Kyoto Protocol.

(3) *Indirect Consequences of Regulation or Business Trends.* As the climate change arena evolves, new opportunities or risks may emerge that would require disclosure. Examples include increased or decreased demand (and volatility in demand) for certain goods and energy sources (based on their GHG emissions impact), increased competition to develop climate change-related innovations, and impacts on a company's reputation based on publicly available data about GHG emissions. While these would likely be discussed in the Risk Factors and MD&A sections, significant changes in operational strategies (such as mergers and acquisitions targeted at developing a certain line of business) may require disclosure in the Business Description section.

(4) *Physical Impacts of Climate Change.* Certain companies may be particularly vulnerable to the physical impacts of climate change, depending on the nature of their business and location of key facilities. These may include weather severity, sea levels, and water availability and quality. Examples to consider for disclosure include direct effects on operations concentrated along coastlines; indirect impacts from disruptions to operations of major customers or suppliers; increased insurance claims, liabilities, premiums, and deductibles; decreased insurance availability; and decreased agricultural production.

Notably, the SEC describes the four areas above as "some of the ways climate change may trigger disclosure" such that filers should also evaluate whether other areas may be relevant to their specific business when preparing climate change disclosures.

Practice Tips When Preparing Climate Change Disclosures

The Guidance provides much for companies to consider but few clear answers as to what should ultimately be disclosed. It clearly indicates that companies should be assessing a wide range of climate change issues and how they apply to their particular business. However, it provides no clear guidelines on when these issues rise to the level of materiality necessary for disclosure.

Therefore, as companies develop their climate change disclosures, the following are some practice tips to keep in mind:

- *Avoid generic risk factor disclosures.* The new SEC Guidance on climate change calls for the disclosed risks to be specific to the company and to "avoid generic risk factor disclosure that could apply to any company" (*see* Guidance, p. 22). Instead, risks, as well as opportunities that are specific to the particular filer should be included. Moreover, to the extent possible, include discussion of the type and magnitude of the risks that climate change poses to the company.

- *Remember to consider potential opportunities.* The SEC's recent Guidance regarding climate change disclosure specifically mentions that "changes in the law or in the business practices of some registrants in response to the law may provide new opportunities for registrants . . . Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for

registrants. These developments may create demand for new products or services . . ." (*see* Guidance, pp. 6, 23, 25). Therefore, it is important that the company consider any opportunities that GHG regulations or climate change impacts may present to it. For example, a wind energy provider may mention increased demand and incentives for alternative energy projects, and certain insurers may discuss opportunities to develop innovative climate-related lines of coverage (such as policies covering climate litigation or property risk). Also, if applicable, consider discussion of how the company may be uniquely positioned to be *less* exposed to potential climate risks versus competitors in the same field (for example, if the company has already taken climate adaptation measures to harden facilities against weather impacts or has invested in green power).

- *Consider the broad spectrum of potential indirect impacts.* The SEC Guidance also mentions that indirect impacts on a business, such as the effects of regulation or climate change impacts on suppliers and customers, should be discussed. For example, if the company is highly dependent on electricity for its operations or to produce its products, consider a discussion of how increased regulation of greenhouse gases could affect power supply and costs and, ultimately, the company's results of operations. Other indirect impacts may include how climate change could affect demand from certain customers and output from suppliers located in weather-prone areas.

- *Consider whether climate change disclosures made in other forums should be included.* In order to ensure consistency, filers should consider whether disclosures of certain climate change-related factors in other contexts should be included in filings with the SEC. These may include GHG emissions reported to EPA under the recently promulgated GHG Disclosure Rule or voluntarily provided to organizations such as the Carbon Disclosure Project. The insurance industry needs to consider the National Association of Insurance Commissioners' (NAIC) voluntary requirement that insurance companies disclose to regulators the financial risks related to climate change and any actions that insurers are taking to respond to such risks. The first survey, submitted where the insurance company is headquartered, is expected to be filed by May 1, 2010. Therefore, when preparing disclosures for SEC filings, insurance companies should consider including information that will be disclosed in the Insurer Climate Risk Disclosure Survey.

- *If potential climate change impacts are unclear or hard to assess, say so.* To the extent material difficulties arise in assessing the potential timing and effect of climate change-related impacts, the Guidance advises that such should be disclosed. This may be relevant, for example, when trying to evaluate the likelihood of new regulations and whether such would have a material impact on a specific business. However, as a cautionary note, filers should also take care not to fall back on generalized language regarding uncertainties about climate change in lieu of carefully examining potential impacts and risks specific to the company.

- *Stay informed about developments in the climate change arena.* From year to year, climate change-related disclosures will vary based on developments in the legal, political, technological, scientific, and business aspects of climate change. Filers should stay informed in order to keep their disclosures current. As a result, climate change disclosures are likely to remain dynamic and evolving, especially in the near term.

The Look Ahead

In the near term, it can be expected that the SEC will monitor how the Guidance has shaped company filings and evaluate whether any adjustments to the Guidance

are needed. To this end, the SEC plans to hold a public round table to further discuss climate change disclosure issues this spring. Based on its review of corporate disclosures, feedback from the public, and comments from its Investor Advisory Committee, the SEC could develop further guidance or rulemakings relating to climate change disclosure. In the long term, additional adjustments may be needed as climate change matures as a political, scientific, and business issue.

Requiring climate change disclosures in SEC filings is a hot-button issue that has been a topic of much discussion and debate in recent years. At this early stage, it is unclear what, if any, further guidance or regulations may evolve from the SEC's recent interpretative Guidance. It is clear, however, that the SEC will be examining filings more closely for climate change disclosures and scrutinizing such to ensure that investors are adequately informed about potential risks and opportunities that climate change presents for businesses. In any case, based on the breadth of the relevant climate change issues described by the SEC in its interpretive Guidance, corporate climate change disclosures will certainly become the norm for many businesses rather than the exception.

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CALL FOR NOMINATIONS

The Section invites nominations for three new awards:

The Environment, Energy, and Resources Government Attorney of the Year Award will recognize exceptional achievement by federal, state, tribal, or local government attorneys who have worked or are working in the field of environment, energy, or natural resources and are esteemed by their peers and viewed as having consistently achieved distinction in an exemplary way. The award will be for sustained career achievement, not simply individual projects or recent accomplishments. Nominees are likely to be currently serving, or recently retired, career attorneys for federal, state, tribal, or local governmental entities.

The Law Student Environment, Energy, and Resources Program of the Year Award will recognize the best student-organized educational program or public service project of the year addressing issues in the field of environmental, energy, or natural resources law. Nominees are likely to be law student societies, groups, or committees focused on these three areas of law.

The State or Local Bar Environment, Energy, and Resources Program of the Year Award will recognize the best CLE program or public service project of the year focused on issues in the field of environmental, energy, or natural resources law. Nominees are likely to be state or local bar sections or committees focused on these practice areas.

The nomination deadline date for all three awards has been extended to May 25, 2010. The Award will be presented at the ABA Annual Meeting in San Francisco in August 2010. Award recipients should plan to be present at the award presentation.

For more information, visit www.abanet.org/environ/sectaward/

EXISTING SEC REQUIREMENTS SERVE AS THE BASELINE FOR CLIMATE CHANGE RISK DISCLOSURE

Theodore Keyes and
Gina M. Schilmoeller

Three years ago, the U.S. Supreme Court issued the much anticipated *Massachusetts v. EPA* decision and provided some clarity as to the federal government's authority to regulate greenhouse gas (GHG) emissions under the Clean Air Act (CAA). *Massachusetts v. EPA*, 415 F.3d 50 (2007). Although the facts of *Massachusetts v. EPA* were limited to tailpipe GHG emissions, commentators predicted that this decision would spawn a wave of legislation and regulations directed at controlling GHG emissions and addressing climate change issues. Commentators expected that regulations imposing GHG disclosure requirements would be issued to provide regulators, industry, and the public with a more complete picture of the nation's reliance on fossil fuels and GHG emission levels. David Rich, Designing a U.S. Greenhouse Gas Emissions Registry, World Resources Institute, Climate, Energy and Transport, Feb. 2008, available at http://www.ghgprotocol.org/files/wri_us_registry.pdf (last visited Nov. 10, 2009).

Over the next three years, while several GHG bills failed to progress in Congress, the Environmental Protection Agency (EPA) began to address climate change risks by issuing several rules concerning GHG emissions. In April 2009, EPA issued its endangerment finding, determining that current and projected GHG concentrations in the atmosphere and GHG emissions from motor vehicles endanger public health and welfare. In September 2009, EPA finalized a mandatory GHG emission reporting rule, which requires large stationary sources to report data concerning their GHG emissions on an annual basis. Around the same time, the EPA also announced the proposal tailoring rule, which will subject large stationary sources of GHG to regulation and permitting requirements under the CAA. Also in September 2009, the EPA proposed a GHG light duty vehicle rule, which proposes new fuel efficiency standards to control GHG emissions from motor vehicles. Most recently, at the end of March 2010, EPA announced that it would be issuing a final rule to phase in greenhouse gas emissions control requirements for new and modified stationary sources starting on January 2, 2011.

EPA's actions following *Massachusetts v. EPA* combined with public debate over proposed GHG legislation and the growing body of scientific evidence concerning global warming have created a new emphasis on disclosure related to GHG emissions and climate change risks. Beyond EPA's GHG rules, however, predicting the ultimate scope of federal and/or state disclosure programs relating to climate change risks still requires some speculation.

Until recently, the SEC had remained silent regarding disclosure requirements relating to GHG emissions and climate change risks. However, on February 2, 2010, the SEC issued interpretative guidance—rather than proposing new rules—regarding climate change disclosure, based on existing SEC disclosure requirements. Yet even with the recent SEC guidance, public filers face the difficult task of determining at what point the mix of their business operations, proposed federal oversight, and scientific evidence of global warming combine to create a "material" risk that management is required to disclose.

Even before the SEC guidance was issued, several independent organizations had developed voluntary climate change risk disclosure databases. These databases have become increasingly popular, likely due to the anticipation of mandatory disclosure rules and the perceived market benefits of such disclosure. In addition, the National Association of Insurance Commissioners (NAIC) passed a model rule that originally mandated climate change risk disclosures for large insurance companies but is now voluntary. The voluntary disclosure databases and the NAIC model rule appear to be responses to the private sector's increasing demand for information regarding GHG emissions, projections of potential capital expenditures associated with impending GHG emission regulations, and preparation for mandated climate change disclosure rules. The voluntary disclosure surveys and the NAIC model rule questions also provide some

guidance as to the type of climate change-related information that public companies should consider disclosing in accordance with the SEC guidance.

Reporting Obligations Under Existing SEC Regulations

With the SEC's recent interpretative guidance in hand, public companies have an improved picture of their climate change disclosure obligations. However, they will still need to look to the current SEC regulations when preparing their offering documents and quarterly and annual reports.

The most straightforward existing requirement is set forth in item 103 of Regulation S-K. Item 103 requires companies to disclose material pending legal proceedings of which a company, its property, or its subsidiaries are a party. The SEC has clarified that administrative actions, including environmental enforcement actions and orders, are proceedings within the scope of item 103. *See* Environmental Disclosure Requirements, Securities Act Release No. 6130, Fed. Sec. L. Rep. (CCH) ¶ 23,507B, at 17,203–4 n.2 (Sept. 27, 1979). Therefore, item 103 requires disclosure of enforcement actions, orders, and lawsuits alleging wrongful GHG emissions or climate change-related harms (such as a common law nuisance claim). The disclosure of legal proceedings arising under laws regulating the discharge of materials into the environment is limited to those proceedings which are "material" or involve amounts exceeding 10 percent of consolidated assets or involve a governmental party and sanctions that will reasonably exceed $100,000.

While a company can estimate whether a proceeding meets numerical thresholds, the determination of whether a proceeding is "material" is not as straightforward. Federal securities case law defines information as "material" if "there is a substantial likelihood that [it] would have been viewed by a reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 448–49 (1976). Although this definition is well grounded in case law, the SEC's recent interpretative guidance provides no additional clarity on its application to GHG or climate change risk proceedings. Thus, public filers are still in the difficult position of determining whether pending GHG emission or climate change-related proceedings are material and must be disclosed, without any specific official guidance.

Item 101 of Regulation S-K, the Description of Business, requires companies to disclose in offering documents and periodic filings the material effects of compliance with laws relating to the protection of the environment. 17 C.F.R. § 229.101(c)(1)(xii) (2008). In light of the increasing number of proposed and enacted rules addressing GHG emissions, public companies must stay apprised of legislative and regulatory developments and assess whether such developments may have a material effect on the company's expenditures, earnings, and capital position. Even before the SEC guidance was issued, companies were beginning to recognize these disclosure obligations under item 101. For example, at the outset of its description of business in its annual filing for 2008, Xcel Energy stated that "there are significant future environmental regulations under consideration to encourage the use of clean energy technologies and regulate emissions of GHG to address climate change. Xcel Energy Inc.'s electric generating facilities are likely to be subject to regulation under climate change policies introduced at either the state or federal level within the next few years." Xcel Energy Inc., Form 10-K for the fiscal year ended December 31, 2008, at p. 7. Because the governance of GHG emissions and climate change is a relatively new legal area, assessing the impact of compliance with new and proposed statutes and regulations will pose a difficult and uncertain exercise for many companies.

Item 101 also requires the disclosure of "any material estimated capital expenditures for environmental control facilities for the remainder of [the company's] current fiscal year and its succeeding fiscal year and for such further periods as the [company] may deem material." 17 C.F.R. § 229.101(c)(1)(xii) (2008). Although not explicitly defined by the SEC, an "environmental control facility" generally includes facilities designed to abate, reduce, or prevent environmental pollution, contamination, or other releases. As such, item 101 arguably requires the

disclosure of capital expenses expected to be incurred for compliance with emissions allowances or clean energy technology. Likewise, item 101 also arguably requires disclosure of material costs associated with potential carbon taxes. In its 2008 annual filing, for example, CNX Gas Corp. acknowledged the possibility of new environmental regulations translating into significant future costs but also stated that it had "no significant environmental control facility expenditures for the years ended [2006–2008]." CNX Gas Corp., Form 10-K for the fiscal year ended December 31, 2008, at p. 14.

Item 303 of Regulation S-K, the Management Discussion and Analysis of Financial Condition and Results of Operation (MD&A), may also require discussion of future regulation of GHG emissions, physical risks posed by climate change, and related risks. Specifically, Item 303 requires companies to disclose known trends, events, obligations, or uncertainties unless such issue is (i) not "reasonably likely" to occur or (ii) is not "reasonably likely" to have a material effect on a the company's liquidity, capital, or operations. For example, even prior to the SEC guidance, MD&A in Federal Express Corp.'s 2008 annual filing acknowledged the "significant U.S. and international legislative and regulatory efforts to limit [GHG] emissions" and the potential imposition of future emission allowance limitations. *See* Federal Express Corp., Form 10-K for the fiscal year ended May 31, 2009, at p. 34.

In addition to assessing the potential impact of federal legislation and regulations on a company's capital, liquidity, and/or operations, public companies must also consider the likelihood and gravity of risks stemming from physical impacts to business operations due to climate change. Businesses in the utility, oil, gas, and insurance industries are especially susceptible to marketplace changes due to the physical impacts of climate change.

Finally, item 503 of Regulation S-K sets forth the rules regarding risk factors that must be disclosed in a prospectus. Accordingly, companies must disclose risk factors related to climate change or GHG emissions to the extent the risk is significant enough to make the offering "speculative or risky."

Developing Federal Legislation and Rules

Several pending bills and rules give public companies reason to examine whether their current disclosures satisfy their obligations in accordance with Regulation S-K. For example, the House of Representatives passed the American Clean Energy and Security Act (Clean Energy Act) in June 2009. Among other things, this bill includes a GHG emission reduction plan, renewable energy requirements for utilities, and a cap-and-trade scheme for carbon emissions. The Senate is in the process of considering similar legislation, although recent developments in Congress have demonstrated that there remains opposition to legislation intended to reduce GHG emissions. Nevertheless, public filers must now consider whether a bill will be passed in some form in the near future and whether that may lead to material mandated capital expenditures relating to cap-and-trade and a renewable energy statutory scheme.

As Congress has been debating the merits of the Clean Energy Act, EPA, in accordance with the Supreme Court's directive in *Massachusetts v. EPA*, has reconsidered regulation of GHG emissions under the CAA. Earlier this year, EPA issued a proposed endangerment finding which declares that GHG emissions "endanger the public health and the welfare of current and future generations" and paves the way for regulation of GHG emissions under the CAA. Proposed Endangerment and Cause or Contribute Findings for Greenhouse Gases Under Section 202(a) of the Clean Air Act, 74 Fed. Reg. 18,886 (Apr. 24, 2009) (to be codified at 40 C.F.R. pts. 86, 87, 89, et al.). Accordingly, EPA recently moved to expand GHG regulation in several areas. First, EPA issued a new GHG reporting rule that mandates disclosure of GHG emissions from large stationary sources in the United States but does not actually restrict GHG emissions. Final Mandatory Greenhouse Gas Reporting, 74 Fed. Reg. 56,260 (Oct. 30, 2009) (to be codified at 40 C.F.R. pts. 86, 87, 89, et al.). The GHG reporting rule is effective as of January 1, 2010, and will require suppliers of fossil fuels or industrial gas, manufacturers of heavy-duty and off-road vehicles and engines, and facilities annually emitting at least 25,000 metric tons of GHG to submit annual GHG disclosure reports to

EPA. The first annual reports are due March 31, 2011. The 25,000 metric ton threshold is estimated to encompass over 10,000 large GHG emission sources and, based on their disclosures, EPA will monitor and assess GHG emissions through a national emissions registry. This public registry will constitute the nation's first attempt to gain a meaningful understanding of the extent of its GHG emissions.

Next, EPA proposed the tailoring rule, which will subject large stationary sources of GHG to regulation under the CAA. If issued as a final rule, the proposed GHG permit program would require large industrial facilities that emit above a threshold volume of GHGs per year to obtain construction and operating permits under the CAA. When permitted facilities are constructed or modified, the facilities' permits would be required to demonstrate the use of best available control technologies and energy efficiency measures with the goal of decreasing emissions of GHGs and other pollutants. Proposed Rule: Prevention of Significant Deterioration and Title V Greenhouse Gas Tailoring Rule, 74 Fed. Reg. 55,291 (Oct. 27, 2009) (to be codified at 40 CFR pts. 51, 52, 70, and 71); http://www.epa.gov/NSR/fs20090930action.html. EPA has also proposed a rule to improve fuel economy by reducing GHG emissions from motor vehicles beginning with model year 2012. Proposed Rule to Establish Light-Duty Vehicle Greenhouse Gas Emissions Standards and Corporate Average Fuel Economy Standards, 74 Fed. Reg. 49,454 (Sept. 28, 2009) (to be codified at 40 CFR pts. 86 and 600); http://www.epa.gov/otaq/climate/regulations.htm.

These GHG regulations will impact many public companies, especially those in the energy industry, and require them to examine whether they are obligated to provide an emissions report to EPA and disclose related capital expenditure estimates or other related risks in their public filings. Even those companies falling outside of the scope of the GHG reporting rule may need to reexamine whether they must include GHG emissions data and climate change-related risks in their financial reports to comply with existing SEC disclosure requirements.

NAIC Model Climate Disclosure Rule

Amidst the uncertainty regarding impending federal climate change disclosure requirements, the NAIC paved the way for the first industry-wide climate disclosure requirement by passing a Model Climate Change Risk Disclosure Rule on March 17, 2009 (model rule). While the model rule, as initially passed, created a mandatory public disclosure requirement, the NAIC voted to modify the model rule on March 28, 2010 to make such disclosure voluntary and confidential. Nevertheless, it is expected that a number of states will adopt the original mandatory, public disclosure requirement. The model rule calls upon insurers to submit an annual Insurer Climate Risk Disclosure Survey (insurer survey) to their state of domestication. The model rule applies to insurers with annual premiums of $500 million or more and the first insurer survey is expected to be submitted in May 2010.

The insurer survey calls upon insurers to disclose the financial risks posed by climate change and the actions the insurer is taking to control these risks. *See* NAIC INSURER CLIMATE RISK DISCLOSURE SURVEY, Attachment Two-A, Climate Change and Global Warming (EX) Task Force, Mar. 17, 2009. Among other items, the insurer survey asks insurers to disclose internal climate change policies, anticipated climate risks facing the company and its investment portfolio, and internal plans to assess, reduce, and mitigate operational GHG emissions. In addition, the insurer survey asks insurers to disclose whether they have increased rates or limited sales in certain geographic regions due to increased climate change risks and to disclose the actions they have taken to encourage policyholders to reduce their climate change-related losses. The insurer survey excludes disclosure of information that is commercially sensitive, proprietary, or forward looking.

According to the NAIC, the impetus behind the insurer survey is to provide a means for regulators to begin discerning insurers' risk assessments and risk management efforts related to climate change. In

addition, if made public, the insurer survey will allow consumers to make informed and educated decisions regarding the underlying value and security of competing insurance policies. Although the NAIC is a nongovernmental association of insurance commissioners and relies on states to enact its model rules, the model rule serves as a starting point for insurers, and even companies in other industries, to consider effective means of assessing and minimizing their climate change risks.

Investor-Demanded and Voluntary GHG Disclosure

Even before the SEC guidance was issued, a growing number of companies, nationally and internationally, had started to recognize the potential market benefits of voluntarily disclosing risks posed by climate change. Over the past few years, consumer and investor awareness of these risks has grown alongside increasing political discourse regarding GHG emission limits and climate risk disclosure requirements. As investors are considering the financial ramifications of potential cap-and-trade programs, they are seeking greater information regarding companies' dependence on fossil fuels, current operational GHG emissions, and climate change risk preparedness, in order to fully assess the value of the companies. A company's refusal to provide investors with data regarding its fossil fuel dependency and GHG emissions can detract investors, especially in the energy industry. In addition, as aptly stated by Federal Express Corp. in its 2008 Form 10-K, even in the absence of a definitive climate change regulatory program, "increased awareness and any adverse publicity in the global marketplace about the GHGs emitted by companies in the airline and transportation industries could harm [a company's] reputation and reduce customer demand for [its] services." *See* Federal Express Corp., Form 10-K for the fiscal year ended May 31, 2009, at p. 34.

In 2004, American Electric Power and Cinergy Corp. were faced with pressure from shareholders seeking disclosure of how the companies were planning for climate change-related risks. In response, the companies agreed to issue public reports, overseen by a committee of independent directors, disclosing the companies' plans of action to mitigate the economic impact of future environmental requirements to reduce GHG emissions.

In addition to fostering investor and customer relations, participation in voluntary climate change risk disclosures provides companies with an organized methodology to assess their own preparedness for potential financial and physical risks due to climate change. After compiling information regarding their dependence on fossil fuels, GHG emissions, and climate change risk preparedness, companies are better able to protect themselves from climate change risk, prepare for impending regulatory requirements, and maximize economic opportunities brought about by shifting economic cycles due to the global impacts of climate change.

Several organizations have published climate change risk disclosure surveys, but the Carbon Disclosure Project (CDP) maintains the largest database of international corporate climate change surveys. The CDP is an independent nonprofit organization which was created in 2000 for the purpose of collecting and distributing climate change risk information and is comprised of over 475 investors with combined assets exceeding $55 trillion. The CDP survey is extensive and seeks information including management opinions regarding risks and opportunities presented by climate change, management strategy to decrease or increase such risks or opportunities, GHG emission audits, and corporate governance policies regarding climate change. Although the CDP survey is detailed, respondents tend to provide varying degrees of thoroughness in their answers.

Since the CDP commenced its annual surveying initiative in 2003, the response rate has increased each year. The CDP issued its first climate disclosure survey in 2003 and received responses from 47 percent of the surveyed companies. In contrast, 77 percent of the 3,000 companies surveyed in 2008 submitted responses. The significant increase in the response rate is likely indicative of the private sector's recognition that climate change disclosures foster investor relations. In addition, the increased response rate may also demonstrate that the private sector is seeking a structured means to inventory GHG emissions in preparation for future regulations.

The contrast between the increasing percentage of companies participating in the voluntary CDP survey and the comparably smaller number of companies publicly disclosing climate change-related risks in SEC filings suggests that the private sector has a growing awareness of the potential risks posed by climate change. However, any public company that voluntarily discloses climate change-related risks should ensure that such disclosures correlate with quarterly and annual SEC filings if such disclosures may be deemed "material" under applicable SEC regulations.

Going Forward

Despite the current lack of federal laws mandating climate change disclosures, *Massachusetts v. EPA*; congressional bills; EPA's GHG reporting rule, proposed tailoring rule, and light duty vehicle rule; the SEC's recent interpretative guidance; voluntary climate surveys; and the NAIC model rule are all indicative of unmistakable momentum moving toward future regulation of GHG emissions and mandated climate risk disclosures. Although the private sector is still in a place of uncertainty regarding the impact of GHG and climate change regulations on capital expenditures, liquidity, and ongoing business operations, the prudent company would be wise to take advantage of the present to prepare for future regulation. For example, public companies should consider implementing climate change disclosure committees to (i) keep apprised of emerging laws and regulations in order to prepare for the inevitable federal oversight; (ii) review the company's voluntary statements and disclosures regarding climate change (such as the company website, publications, and voluntary disclosures to the CDP) to ensure that such disclosures correlate with current or future SEC disclosures; (iii) ensure that all material disclosures are included in current SEC filings in accordance with the SEC guidance; and (iv) review sources of voluntary disclosure to ascertain the type of information that might be required in future disclosures.

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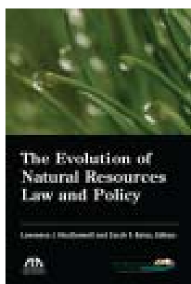

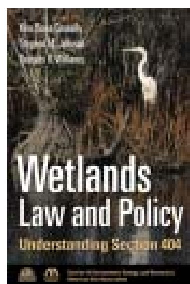

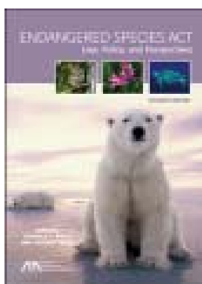

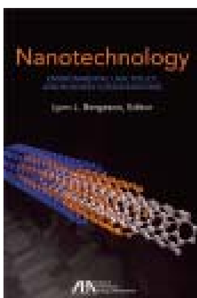

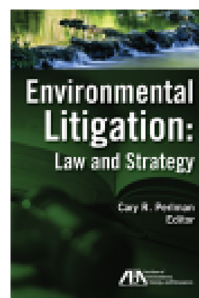

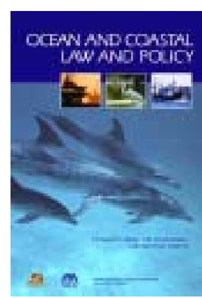

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RECENT JUDICIAL DECISIONS PROVIDE GUIDEPOSTS FOR ACCOUNTING FOR GREENHOUSE GASES AND GLOBAL WARMING IN FINANCIAL DISCLOSURES

John Klock

A troika of decisions should send chills through the halls of many utilities and corporations. The first horse of the troika is the decision by the U.S. Supreme Court that says the U.S. Environmental Protection Agency (EPA) has the authority to regulate greenhouse gases (GHGs) under the Clean Air Act, 42 U.S.C. § 7401 *et seq.* (CAA) and can be compelled to do so. The second horse, a Second Circuit case, says that states have the power to abate GHG under the federal common law of public nuisance. The third horse, a Fifth Circuit decision, takes the final step and states that private citizens affected by global warming have the right to bring private nuisance suits. Together, these judicial decisions raise new potential GHG litigation and regulatory requirements for many companies.

The Troika of Cases

In 2007, the U.S. Supreme Court ruled that carbon dioxide (CO_2), a greenhouse gas, was a pollutant that could be regulated under the CAA since it either causes or contributes to "air pollution that could reasonably be anticipated to endanger public health or welfare." *See Massachusetts v. EPA*, 549 U.S. 497, 522 (2007), *quoting* the CAA at 42 U.S.C. § 7521(a)(1). The Court, however, found, since EPA had not regulated CO_2 for new motor vehicle emissions, that Massachusetts had standing to sue EPA and challenge EPA's decision not to promulgate such regulations. *Id.* at 532. Massachusetts had standing by reason of damage to its coastal waters caused by unregulated GHGs that are warming the globe. The executive branch, through EPA, denied that the CAA authorized it to issue regulations and that, even if it was authorized, it was not time to do it. 549 U.S. at 511. EPA also argued that Massachusetts did not have standing but the Supreme Court disagreed. *Id.* at 517. Indeed, the Court found that the legislative branch by enacting the above quoted section of the CAA implicitly gave Massachusetts standing to challenge EPA's refusal to regulate GHG emissions. *Id.* at 520.

The second decision is that of the Second Circuit in *Connecticut v. American Electric Power Co.*, 582 F.3d 609 (2d Cir. 2009). In that case, eight states, namely Connecticut, New Jersey, New York, Rhode Island, Iowa, Vermont, Wisconsin, and California, together with other governmental entities, sued the five utilities that account for 10 percent of CO_2 emissions and various electric companies, asserting that they were contributors to the elevated levels of CO_2 emissions, and sought abatement of their contributions to what they termed was a public nuisance. A variety of scientific studies were used to support the plaintiffs' claims that GHGs are causing global warming. *Id.* at 6–7. The Second Circuit found that the governmental entities' complaint did state a claim under the federal common law of nuisance. Moreover, the court found that both state and non-state entities have standing to bring such claims. *Id.* at 132. Finally, the Second Circuit found that EPA had not acted under the CAA to displace any federal common law right under the public nuisance doctrine. *Id.* at 202. Therefore, there was no preemption of the federal common law right.

A third decision is from the Fifth Circuit in *Ned Comer v. Murphy Oil USA*, 585 F.3d 855 (5th Cir. 2009). The Fifth Circuit alluded to the *American Electric* decision by the Second Circuit, but basically did its own independent analysis of the Southern District of New York's decision below in *American Electric*, with which it disagreed and, of course, which the Second Circuit had reversed. The Fifth Circuit found that the plaintiffs had standing to sue defendants under a state private nuisance theory because the defendants engaged in chemical and fossil fuel production in the United States. Plaintiffs claimed these actions set in motion the sequence of events that brought Hurricane Katrina to the coast of Mississippi. In the same fashion that the Second Circuit found standing under the federal common law of public nuisance, the Fifth Circuit held that the private plaintiffs had standing to sue under the state common law of nuisance. *Id.* at 7–10.

In large measure, both the Second and Fifth Circuit Courts built on the decision by the Supreme Court in *Massachusetts v. EPA*, essentially finding that EPA, by not acting under the CAA, had not made a determination that GHG emissions are subject to

regulation and in fact had not regulated them. *American Electric, supra*, at 202. Into this vacuum, the states and private individuals had the right to bring nuisance actions. Lawsuits imply damages or contingent liabilities which complicates corporate balance sheets.

Litigation Disclosure Implications for Public Companies

These three cases have put enormous pressure on certain segments of industry that have been major emitters of CO_2 in terms of accounting for liabilities. Essentially, private parties alleging injury by GHG emissions and the potential effect of unchecked GHGs now have standing to sue such emitters and obtain damages. The *Ned Comer* plaintiffs alleged over $5,000,000 in damages. *Id.* at 2, n. 1. Hurricane Katrina is estimated to have caused at least $125 billion dollars in damages. Swiss Re, *Hurricane Katrina*, January 25, 2007. An estimated 75,000 people were made homeless and 400,000 jobs were lost (www.hurricanekatrinarelief.com). Under *Ned Comer*, the Fifth Circuit says that these individuals have a private cause of action against major emitters of GHGs.

Companies involved in suits like *American Electric* and *Ned Comer* will have to disclose under SEC Reg. S-K, items 101 and 103, any material effect the litigation may have on their businesses. The plaintiffs in *American Electric* seek to have the defendants abate their emissions. Under current SEC regulations, the companies must evaluate any material effect that, if successful, such abatement may have on their operations.

Emerging Trends in GHG Regulation, Disclosure, and Reporting

The results of these three cases, which are merging with other trends related to GHGs, threaten a perfect storm on corporate balance sheets. On September 22, 2009, EPA signed the final rule for Mandatory Reporting of Greenhouse Gases. *See* 74 Fed. Reg. 56,260 (Oct. 30, 2009). Effective January 1, 2010, large emitters of GHG will be required to collect data and report their GHG emissions on an annual basis. EPA estimates that the reports will cover 85 percent of the emissions and 10,000 facilities. Obviously, in approximately one year, there will be hard data available as to GHG emissions. These data will not only have implications for suits like *Ned Comer* but also for other reporting requirements.

GHGs implicate not only reporting litigation contingencies but also financial reporting obligations with respect to the generation of GHG. At some point in the near future, the federal government will likely enact a cap-and-trade law of some magnitude. The goal of such cap-and-trade regulations would be to reduce GHG emissions. The Kyoto Protocol's proposed goals were to cap and trade CO_2 with ever declining annual amounts. These amounts could be auctioned. A northeastern consortium of states has a program called the Regional Greenhouse Gas Initiative that has already raised millions of dollars through auctions. What is auctioned is the year's allowable emissions, i.e., the cap. The owners can then trade them. Companies will have to retool to achieve greater energy efficiency or obtain alternative sources that do not emit CO_2. Therefore, there will be the need for capital expenditures. Securities and Exchange Commission (SEC) Regulation S-K, item 101, requires a company to disclose in its reports the effect of environmental compliance. The cost of compliance implicates capital expenditures such as equipment designed to limit the amount of GHG as well as the cost to purchase emission allowances or credits. SEC Reg. S-K, item 303, also requires a company to disclose the impact of known trends on its financial condition. It remains to be seen if the SEC will issue a specific regulation related to climate change issues, although it has recently released interpretative guidance on the matter. Both of the above regulations will be brought into play in a cap-and trade-environment. Companies simply will have to assess climate risks and the impact to business in terms of purchasing emissions, availability of purchasing emission credits, and brick-and-mortar costs to employ GHG reduction equipment.

Companies subject to suits like *Ned Comer* have similar requirements under the SEC regulations and of

course have to comply with Statement of Financial Accounting Standards No. 5 (Accounting for Contingencies) (FASB 5). FASB 5 already requires companies to assess and disclose any material effect created by obligations to remediate contaminated sites under the federal Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) or state-led cleanup actions as well as private party cost recovery actions. Explicit under FASB 5 is the ability to reasonably estimate the amount of loss. In general, this financial disclosure requires an estimate of the range of possible losses or a statement that such an estimate cannot be made. In the realm of contamination, there are entities that can estimate remediation costs even to the point of assuming the obligation under a guaranteed maximum price. The goal of FASB 5 is to keep financial statements from being misleading.

Finally, Andrew Cuomo, New York attorney general, has filed suit under New York's blue sky laws asserting that energy companies' financial statements as to liabilities for climate risks were misleading to investors. Two of the companies have settled and will provide their analysis of the companies' financial risks from regulation, litigation, physical impacts of climate change, and emissions management. Based upon the foregoing, it is expected that 2009 SEC filings will contain more climate risk disclosures by many more companies.

Conclusion

In sum, the troika of cases brings global warming litigation to the forefront, as the courts have stepped in where Congress has failed to tread and EPA has been constrained from acting. Global warming has been with us for some time. There are many theories about its cause; however, its effects are palpable. Justice Stevens said, "A reduction in domestic emissions would slow the pace of global emissions increases, no matter what happens elsewhere." *Massachusetts v. EPA*, *supra*, at 525–26. The costs of slowing the amount and rate of emissions must be accounted for in financial statements in order to achieve the SEC's goal of fiscal transparency.

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One Million Trees Project—
Right Tree for the Right Place at the Right Time

One Million Trees by 2014

The American Bar Association's Section of Environment, Energy, and Resources (SEER) announces its **"One Million Trees Project - Right Tree for the Right Place at the Right Time"** nationwide public service project. We call on ABA members to contribute to the goal of planting one million trees across the United States in the next five years. Trees are important to the environment through their ability to reduce atmospheric carbon dioxide and also contribute to the overall health of communities, wildlife and aesthetics. In addition to the actual planting of trees, SEER also intends through public outreach and partnering efforts, to raise the nation's awareness of the multiple benefits of trees and their role in helping to fight climate change.

How to get started

A key aspect of the project is ABA partnerships with well recognized tree-planting organizations, including Alliance for Community Trees, The Arbor Day Foundation, Tree Link/Tree Bank, American Forests, and the Institute for Environmental Solutions. Members are encouraged to get involved in hands-on tree planting activities in their communities in addition to purchasing a tree or trees through the program partners.

To participate in this project please visit any of the information pages at our partners' websites.

For more information, please visit our Web site at:

http://www.abanet.org/environ/projects/million_trees/home.shtml

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