

The SEC Is Getting Hot And Bothered Over Climate Change

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Warning/Disclaimer: *This article discusses climate change (a topic over which reasonable individuals may disagree) and its implications for publicly traded companies that must disclose to investors information that is material to financial performance. The author is not responsible for fits of rage or physical outbursts that readers may experience.*

Let's begin with the bottom line: Publicly traded companies should evaluate whether global warming (or, if you prefer, climate change) is reasonably likely to have a material impact on the company's future financial performance. If the company concludes that there is a material impact, it must disclose that conclusion to the U.S. Securities Exchange Commission ("SEC") in the various periodic reports. Whether you believe human activities that emit carbon dioxide ("CO₂") are a cause of global warming has absolutely no bearing on this conclusion. Regardless of the cause, the Earth is warming according to the overwhelming majority of scientists studying the issue. As the Intergovernmental Panel on Climate Change ("IPCC") states in its 2007 report, evidence of climate change "is unequivocal, as it is now evident from

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observations of increases in global average air and ocean temperatures, widespread melting of snow and ice, and rising global average sea level."¹ Thus, the only question is whether the potential consequences these physical effects of global warming on the company – such as damage to company property, interruption of revenue streams that such property generate, increased costs to comply with regulations attempting to minimize global warming, and potential liability in lawsuits seeking damages from parties perceived as causing global warming – are "reasonably likely" to have a "material" impact on a company's financial performance. How to interpret these two squishy quoted terms and to apply them in the context of climate change, given the unknown time horizons during which the financial impacts may arise? That is the difficult task that publicly traded companies must now face.

SEC Disclosure Requirements and Climate Change

Under the Securities and Exchange Act of 1934, publicly traded companies must file periodic reports disclosing information that would be material to investment decisions. The SEC has promulgated three separate disclosure requirements, which are contained in Regulation S-K. These regulations set forth non-financial disclosure guidelines for annual reports (Form 10-K), quarterly reports (Form 10-Q), and episodic reports (Form 8-K). Following is a summary of each disclosure requirement and its potential applicability to climate change-related impacts on a business.

Item 101: Description Of Business

Item 101 requires a description of the "general development of business," including plan of operation, "any anticipated material acquisition of plant and equipment and the capacity thereof," and "other material areas which may be peculiar to the registrant's business."² Notably, Item 101(c)(1)(xii) expressly requires disclosure of the cost of complying with environmental laws where such compliance costs are material:

Appropriate disclosure also shall be made as to the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment. The registrant shall disclose any material estimated capital expenditure for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such periods as the registrant may deem material.

The cost of complying with greenhouse gas emission limits is precisely the type of cost that is covered by Item 101(c)(1)(xii). Contrary to popular belief, such emission limits are not some theoretical possibility; they are already on the books and in the process of being implemented. Although the United States has yet to adopt greenhouse gas limits, numerous states – and groups of states – have done so. For example, ten northeastern states are signatories to the Regional Greenhouse Gas Initiative ("RGGI"), which establishes a cap-and-trade program to reduce carbon dioxide (CO₂) emissions from power plants. Under

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RGGI, CO₂ emissions will be capped starting in 2009 at then-current levels, and thereafter must be reduced by 1 percent annually until 2019 – for a total reduction of 10 percent. A similar initiative – the Western Climate Initiative (“WCI”) – has been adopted by six western states and several Canadian provinces and Indian tribes.

Companies with operations regulated by these multi-state initiatives must disclose estimated compliance costs under Item 101 if the company considers such costs to be “material.” The SEC defines “material” broadly: “A fact is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”³ Whether a given company’s anticipated costs of complying with such regional climate change initiatives (or the myriad of state and local climate change requirements that have been enacted in the last few years) qualifies as “material” information obviously cannot be reduced to a simple calculation or formula. Clearly, however, companies that are subject to such a climate change initiative have a mandatory duty to evaluate materiality, and should be prepared to defend any decision against disclosure.

Item 103: Legal Proceedings

Item 103 requires registrants to “describe any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject.”⁴ Additionally, the SEC has made clear that a company subject to such litigation must accrue a charge if it is probable that the liability has been incurred and can be reasonably estimated.⁵ Climate change has already generated significant litigation, mostly aimed at compelling the federal government to regulate CO₂ emissions⁶ or to take CO₂ emissions into consideration when evaluating the impact of proposed regulations or other federal actions, pursuant to the National Environmental Policy Act (“NEPA”).⁷ Less common is litigation against publicly traded companies seeking damages for the impact of operations on the climate. Such lawsuits have failed for a variety of reasons, including failure to prove causation⁸ and lack of jurisdiction under the “political question” doc-

trine.⁹ Thus, at this juncture disclosure of climate-related litigation under Item 103 remains primarily a hypothetical concern for publicly traded corporations.

Item 303: Management Discussion & Analysis (“MD&A”)

By contrast, there is nothing hypothetical about the potential obligation to disclose the impacts of climate change under Item 303, which requires a company to discuss its financial condition, changes in financial conditions and results of operations in the MD&A portion of 10-K and 10-Q reports. In particular, forward-looking information is required in the MD&A where there are known trends, uncertainties or other factors enumerated in the rules that will result in, or that are reasonably likely to result in, a material impact on the company’s liquidity, capital resources, revenues and results of operations, including income from continuing operations. A company must focus on known material events and uncertainties that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.¹⁰

The SEC’s December 2003 interpretive guidance makes clear that the discussion of the future challenges facing corporate management is central to MD&A: “A good introduction or overview would ... provide insight into material opportunities, challenges and risks, such as those presented by known material trends and uncertainties, on which the company’s executives are most focused for both the short and long term, as well as the actions they are taking to address these opportunities, challenges and risks.”¹¹

For some companies the requirement to address “known trends and uncertainties” in the MD&A may very well encompass the potential impacts of climate change, even though the severity of the impacts is unknown and the associated cost is inestimable. In this regard, the SEC has stated:

The requirement to discuss uncertainties in MD&A encompasses both financial and non-financial factors that may influence the business, either directly or indirectly. In many cases, there will be current or immediate accounting implications associated with an uncertainty, as occurs when the likelihood of a loss contingency becomes probable and the

amount of loss is reasonably estimable. However, the need to discuss such matters in MD&A will often precede any accounting recognition when the registrant becomes aware of information that creates a reasonable likelihood of a material effect on its financial condition or results of operations ...¹²

Most of the physical impacts associated with climate change are predicable at this point: rising temperatures, and more violent and more frequent hurricanes and tropical storms; longer droughts; rapidly melting glaciers and rising sea levels. All of these changes obviously could have an impact on a company at some point in the future. The question is whether that future impact is “reasonably likely” and “material” to the company’s financial performance, such that disclosure is required. Reasonable minds may differ on that analysis, to put it mildly.

To illustrate the point, consider the impact of climate change on insurance companies with policies covering property on the hurricane-prone Gulf of Mexico. The insurance industry suffered \$80 billion of insured weather-related losses in 2005 – much of that stemming from Hurricanes Katrina and Rita.¹³ Insurance industry modelers forecast that significantly more costly storms than Katrina are possible – indeed inevitable – and could bankrupt as many as 40 insurers.¹⁴ A number of insurance companies have concluded that this type of climate-change related impact is both “reasonably likely” and “material,” and therefore disclosed the potential impact in MD&A filings. But most insurers do not disclose the impact of climate change-related risks in their MD&A.¹⁵

It is difficult enough to identify the myriad potential impacts of climate change on a company’s financial performance, but that task seems downright concrete alongside the more difficult conundrum of quantifying subtle effects of global warming, such as a rise in the sea level, and that is before addressing the time horizon of such impacts.

Focus On Climate Change-Related SEC Disclosures Is Increasing

Publicly traded companies can expect to face increasing scrutiny on whether they are in compliance with SEC disclosure obligations for climate change-related impacts on financial performance. Two recent events signal such increased

scrutiny. First, on September 14, 2007, New York Attorney General Andrew Cuomo sent subpoenas to five of the nation's largest energy companies – AES Corporation, Dominion Resources, Xcel Energy, Dynergy, and Peabody Energy – demanding that they disclose the financial risk of their greenhouse gas emissions to shareholders. In the case of AES, Cuomo asserts that the company is one of the largest producers of greenhouse gas emissions, yet did not disclose the impact of upcoming greenhouse gas regulation on the company's financial picture in its 2006 Form 10-K. As to the other companies, Cuomo seeks disclosure of risks associated with plans to build coal-fired power plants.

Second, on September 18, 2007, a group of state pension plans and institutional investors joined with environmental groups to petition the SEC to issue an opinion stating that companies must consider climate change-related risks in their review of information that may be material and subject to disclosure.¹⁶ This was not the first time that a group of investors requested the SEC to clarify the disclosure requirements for climate change issues. Twice in 2004 and once in 2006, the Investor Network on Climate Risk (“INCR”), a group of public pension plans and private investors claiming to control \$1 trillion in assets, wrote letters to the SEC seeking clarification of disclosure obligations concerning the risks of climate change impacts.¹⁷ A similar request was filed in 2002 by the Rose

Foundation (an environmental group); the SEC has never formally responded.¹⁸

Some of the climate change bills that have been introduced in the Senate would mandate the SEC to issue regulations clarifying the applicability of the disclosure requirements to climate change. Regardless of whether such legislation is enacted, however, publicly traded companies can expect scrutiny of their SEC filings to increase. Given such scrutiny, companies that have yet to squarely confront the question should consider taking a closer look in preparing future filings.

¹ See IPCC Report, Summary for Policymakers, in *Climate Change 2007: The Physical Science Basis* at 5.

² 17 C.F.R. § 229.101(a).

³ SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 12, 1999) (quoting TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976)).

⁴ 17 C.F.R. § 229.103. Item 103 also requires disclosure of proceedings that are “known to be contemplated by government entities.”

⁵ SEC Staff Accounting Bulletin 92, 56 Fed. Reg. 33,376 (June 14, 1993).

⁶ Massachusetts v. United States, 123 S. Ct. 1438 (2007) (holding (1) CO₂ is a “pollutant” under Section 302(g) of the Clean Air Act; and (2) the U.S. Environmental Protection Agency must determine whether CO₂ emissions from motor vehicles may be reasonably anticipated to endanger public health or welfare, which is the prerequisite to regulating such emissions).

⁷ See Center for Biological Diversity v. National Highway Transportation Safety Administration, No. 06-71891 (Nov. 15, 2007) (vacating regulations establishing federal fuel standards for “light trucks” because the NHTSA failed to adequately analyze potential climate change impacts of the regulations in its “Endangerment Assessment prepared pursuant to NEPA.

⁸ Comer v. Nationwide Mut. Ins., 2006 WL 1066645 (S.D. Miss. 2006) (court dismissed homeowner claims asserting that property damage stemming from Hurricane Katrina was caused by climate change, which in turn was caused in part by CO₂ emissions from defendants’ industrial operations, noting “daunting evidentiary problems” regarding causation).

⁹ Connecticut v. American Electric Power Co., 406 F. Supp. 2d 265 (S.D.N.Y. 2005) (court dismissed action by eight states against five electric utilities seeking to enjoin their CO₂ emissions, stating that the case “present[ed] non-justiciable political questions that are consigned to the political branches, not the Judiciary”).

¹⁰ SEC Div. of Corp. Fin., Significant Issues Addressed In The Review Of The Periodic Reports Of The Fortune 500 Companies (Feb. 23, 2003) (emphasis added), available at www.sec.gov/divisions/corpfin/fortune500rep.htm.

¹¹ Interpretation: Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 8350, Exchange Act Release No. 48,960, 68 Fed. Reg. 75,056 (Dec. 29, 2003).

¹² SEC Div. of Corp. Fin., Current Accounting and Disclosure Issues In The Division of Corporation Finance (Nov. 30, 2006), available at www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf.

¹³ See Evan Mills & Eugene Lecomte, Ceres, From Risk to Opportunity: How Insurers Can Proactively and Profitably Manage Climate Change (2006), available at http://www.ceres.org/pub/docs/Ceres_Insurance_Climate_%20Report_082206.pdf.

¹⁴ See Mills & Lecomte, supra, at 4.

¹⁵ Michelle Chan-Fischel, Friends of the Earth, Fifth Survey of Climate Change Disclosure in SEC Filings of Automobile Insurance Oil & Gas Petrochemical and Utilities Companies (2006).

¹⁶ The petition is available on the CERES website: www.ceres.org/pub/docs/full%20petition.pdf.

¹⁷ These letters are accessible on the INCR website, www.incr.com. Many INCR members took part in the September 18, 2007 petition to the SEC.

¹⁸ Gabrielle Siegel, Donald E. Batterson, March E. Harrison and Michael R. Strong, Investors Petition SEC for Climate Disclosure Rules, Climate Change Update