We're Getting Warmer: Why Advising Clients To Disclose Material Risks Associated With Climate Change Is Best Practice

Article By
Larissa Lee
S.J. Quinney College of Law

- Law Office Management
- Biotech, Food, Drug
- Utilities & Transport
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- All Federal

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I. Introduction

At the State of the Union address this year, President Obama issued a firm warning to Congress: if Congress continues to refuse to address climate change, then his office will take action to “reduce pollution, prepare our communities for the consequences of climate change, and speed the transition to more sustainable sources of energy.”

The President is not the only one talking about climate change regulation; in 2010, the Securities and Exchange Commission (SEC) issued interpretive guidance (“Guidance”) on climate change disclosure. This Guidance specifically addressed when companies must disclose to their investors the material risks they face from global warming. Although the SEC has yet to bring anyone to trial for nondisclosure of climate change risks, based on the growing trend of legal and ethical requirements to disclose, investor expectations, and the ever increasing need to reign in climate change, attorneys should advise clients to take action now and
disclose material risks related to climate change.

II. Background

A. Weather Changes Related to Climate Change

We have seen unprecedented natural disasters and extreme weather events in the past few decades. These include extreme heat, wildfires, droughts, and floods. In the year 2012 alone, record high temperatures were set over 25,000 times. In 2011, a new record was set for total economic and insured losses caused by natural disasters costing $380 billion. This loss was even more devastating than the previous high set in 2005, the year of Hurricane Katrina.

As weather-related losses continue to grow, so too has the desire to regulate and mitigate the impacts of climate change. In 2007, twelve states, four local governments, and 13 private organizations filed suit against the Environmental Protection Agency (EPA). This group of plaintiffs argued and presented supporting evidence that the EPA had authority to regulate greenhouse gas emissions, and that its refusal to regulate motor vehicle emissions contributed to an increase in global warming.

On the other side, ten states and six trade associations sided with the EPA. In the brief filed by the EPA, they argued that “nearly 70% of United States greenhouse gas emissions are from non-transportation sources and thus would not be affected by the rulemaking petitioners (plaintiffs) request.” Indeed only 7% of global emissions was attributed to the transportation sector, making regulation of this sector speculative. It added that a causal link between rising temperatures and emissions could not definitively be established, and therefore it would be unwise to regulate greenhouse gas emissions.

The Supreme Court found the EPA’s refusal to regulate greenhouse gas emissions “arbitrary, capricious, . . . or otherwise not in accordance with law. This authority was clearly present within the federal Clean Air Act, and the Court required the EPA to implement rules and regulations for greenhouse gas emissions.

B. Leading up to the SEC’s Interpretive Guidance

While Massachusetts v. EPA focused on greenhouse gas emissions, the rising awareness of climate change in general led to increased demands of accountability. In light of the growing risk stemming from climate change, in 2007, twenty-two organizations submitted a petition to the SEC asking it “to clarify that corporations should assess their climate risk, analyze whether that risk is likely to have a material impact on them, and if so, disclose it to the public as required under the Commission’s rules.” Disclosing material risks is nothing new for public companies; SEC regulations as well as other Federal securities laws have long required “certain disclosures by public companies for the benefit of investors.” However, the SEC had yet to offer any guidelines for companies in disclosing risks
related to climate change, and therefore very few companies were making these types of disclosures. Material disclosures related to climate change recommended in the petition included: physical risks, financial risks and opportunities stemming from legislation, and legal proceedings.

C. 2010 Interpretive Guidance on Disclosure Related to Climate Change

On January 27, 2010, three years after the petition asking the SEC to provide instructions on disclosing climate change risks, the SEC took action. In a 3-2 vote, the SEC issued interpretive guidance on what constitutes material risk, and included specifics for when companies need to disclose risks related to global climate change.

The SEC specifically declined to take a position on climate change, as the Chairman Mary Shapiro stated: “we are not opining on whether the world’s climate is changing; at what pace it might be changing; or due to what causes. Nothing the Commission does today should be construed as weighing in on those topics.” Shapiro also made sure to emphasize that the Guidance did not create new laws or regulations, it was simply meant to “provide clarity and enhance consistency.” Therefore, the Guidance is intended to ensure compliance with already existing disclosure requirements.

1. **Must Disclose Risks that are Material**

To determine whether a risk needs to be disclosed to investors, companies traditionally would look at “the impact it would have on the company’s liquidity, capital resources, or results of operations, and disclose to shareholders when that potential impact will be material.”

The Supreme Court defined risks as “material” if “there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” Later, the Court advocated a balancing test for determining materiality of speculative events. This called for a “balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity,” where probability weighs less than the expected magnitude of the event.” The SEC wanted to ensure that “a company must disclose the significant risks that it faces, whether those risks are due to increased competition or severe weather.” It all comes back to materiality.

Whether a disclosure is adequate is “judged from the perspective of a reasonable investor seeking to understand the company’s business, risk profile and future financial prospects.” Where there is doubt as to whether a risk is material, it is typically “resolved in favor of investors.” This is because the laws and regulations promulgated by the federal government are created to benefit investors.

2. **Which Companies are Affected by Climate Change Disclosure?**
The risks associated with climate change impact “[v]irtually every sector of the economy . . . across the entire business value chain, from raw materials through to the end users.”[xxvii] The industries most affected by climate change are: agriculture, apparel, electric power, food and beverage, insurance, mining, oil and gas, and tourism.[xxviii]

Some aspects of the business that can be affected by climate change risks include: “a registrant’s operating costs, physical assets, distribution channels, supply chains, water supplies, financial well-being, creditworthiness, demand chains, and, importantly, investment opportunities.”[xxix]

3. Potential Climate Change Issues that must be Disclosed

There are several possible areas which can affect the decision to disclose the risks of climate change. Some of the possibilities addressed in the Guidance include: legislation and regulation, international accords, indirect consequences of regulations, and the physical impacts associated with climate change.[xxx]

Companies should disclose any effects new domestic or international legislation or treaties would have on the business, when those effects are found to be material. Companies may be indirectly affected by new “[l]egal, technological, political and scientific developments regarding climate change,” and these developments should also be disclosed.[xxxi] Finally, companies should address the actual physical impacts that global climate change is likely to have on their businesses.

III. Analysis

A. Effects of Guidance

Since the release of the Guidance, “the federal government, many U.S. states, and the international community have taken a number of measures designed to address the perceived and increasingly recognized effects of climate change.”[xxxii] The international landscape of climate change disclosure changed after the release of the Guidance. Both the UK and Canada issued their own guidance on climate change disclosure, with the UK requiring “certain companies (e.g., in the energy, water, and transport sectors) publish a report on how they are assessing and acting on the risks posed by the impacts of a changing climate.”[xxxiii]

Not everyone is on board with the recommendations in the Guidance. This section will discuss: the argument against disclosure, other methods of obtaining disclosure, and finally, why I believe attorneys need to advise their clients to disclose material risks related to climate change.

B. The Argument Against Disclosure

Like most attempts to regulate environmental risks, the climate change interpretive guidance issued by the SEC has been controversial. The vote to adopt the Guidance was 3-2, with one of the dissenting commissioners arguing that: “(1) the state of the science and the law underlying the idea of global change lack certainty; (2) existing
SEC disclosure rules were adequate with respect to corporate reporting on environmental change; and (3) while certain interest groups had advocated for such climate change disclosure guidance, the usefulness of the information to most investors from the Guidance was questionable.”[xxxiv]

Congress has also fought the enforcement of the SEC’s interpretive guidance. In 2012, Senator John Barrasso and Representative Bill Posey both introduced bills to prevent enforcing the guidance.[xxxv] These men presented the bills because they believed that the Guidance actually made it worse for investors, as it shifted the responsibility of the SEC away from protecting investors to instead regulating climate change. “This is yet another startling example of how the Administration is making it worse for job creators across our country. Our bill blocks the SEC from forcing American employers to conduct burdensome and expensive climate analysis.”[xxxvi]

Another argument against requiring climate change disclosure is that it has been largely ineffective at increasing disclosure, because “[m]any companies appeared to believe that there were few, if any, penalties from the SEC for nondisclosure of climate change matters, a perception that was reinforced by observations that also characterized the SEC’s level of enforcement in this area as negligible.”[xxxvii] Indeed several companies that did not disclose before the Guidance, still have yet to disclose after the Guidance. These include: General Electric, Bank of America, Verizon, Kroger, United Health, Boeing, Kraft, and Motorola.[xxxviii]

C. Other Methods of Obtaining Disclosure

Beyond the requirements to disclose set out by the SEC and clarified in the Guidance, a number of other mandatory and voluntary disclosure requirements have been created in the past few years. Last year, California, New York, and Washington all announced the requirement that insurance companies having operations in their states are now required to disclose risks they face from climate change, and how they plan on dealing with those risks.[xxxix]

In addition, several voluntary disclosure requirements have been created. The Carbon Disclosure Project requests emissions information from corporations, and has over 3,700 companies contribute information.[xli] Also, over 1,700 corporations produce sustainability reports with the Global Reporting Initiative guidelines, which includes “risks, opportunities, strategies, and actions with respect to environmental, social, and other sustainability-related issues, including those related to the physical impacts of climate change.”[xlii]

D. Why I Believe Lawyers Need to Advise Clients to Disclose

1. Advising Disclosure is Ethically and Legally Required

The first consideration attorneys should make is that they are both ethically and legally obligated to advise their clients to disclose material risks. If climate change is a material risk to their client’s company, then their client is legally obligated to
disclose those risks, or be faced with possible civil or even criminal litigation.[xlii] Helping clients in nondisclosure of material risks violates disciplinary rules; to avoid violations the attorney must “diligently and competently advise the client on its legal obligations, using informed and independent judgment, and to make best efforts to ensure than the client meets its disclosure obligations and thereby complies with the law.”[xliii]

2. **Investors Want to be Informed**

The second reason why it is important to disclose material risks related to climate change is that investors and shareholders desire to know this information, as it can affect their decision on whether or not to invest. “Investors have been concerned about physical climate risks ... for several years and have actively pursued better climate disclosure from the companies in which they invest—engaging companies directly, sending questionnaires, and issuing statements.”[xliv] A recent study found that 75% of investors surveyed believed climate change constitutes a material risk.[xlv] Investors have the right to make a fully-informed decision before investing money in a public company.

Investors are historically largely responsible for disclosure requirements. It is predicted that “climate change disclosure will likely mature and increase as large institutional shareholders and other activists continue to exert pressure on registrants to enhance their voluntary and mandatory climate change disclosures.”[xlvi]

3. **The Importance of Climate Change Disclosure is only Going to Increase**

As mentioned in the introduction, President Obama is serious about climate change regulation. In addition to the executive’s ability to regulate, it is likely Congress will continue to legislate new climate change rules and that the SEC will return again to the issue of climate change, “as the financial crisis subsides and climate and energy policy again take center stage.”[xlvii] Therefore, it is better for companies to be prepared now and protect themselves from vulnerability to expensive litigation and possible criminal liability. Knowing the risks may also help companies capitalize on the opportunities presented with climate change.

**IV. Conclusion**

In his State of the Union Address, President Obama said: “We can choose to believe that Superstorm Sandy, and the most severe drought in decades, and the worst wildfires some states have ever seen were all just a freak coincidence. Or we can choose to believe in the overwhelming judgment of science—and act before it’s too late.”[xlviii] The time for attorneys to act in advising clients to disclose material risks related to climate change is now. Not only is it currently required by law, in the future it is likely to increase in importance, and will help save clients the costs of litigation and investor dissatisfaction.


Id.


Id.


Id.


Id.


Id. at 534


A Climate of Increasing Risk, supra note 3, at 2.

Ceres, supra note 13, at 9.


Id.


[xxii] Id. at 238.

[xxiii] See Statement by Mary Shapiro, supra note 17.


[xxviii] Id. at 6-12.


[xxxi] Id.


[xxxv] Id. at 15.

[xxxvi] Id.

[xxxvii] Id. at 9.

[xxxviii] Hansen, supra note 29, at 531.

[xli] Id. at 4.

[xlii] Id.

[xliii] Sarbanes-Oxley Act of 2002 requires company officers to disclose material information affecting financial conditions of company, false certifications may result in criminal liability. See A Climate of Increasing Risk, supra note 3, at 5.

[xliii] Id. at 11.


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