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UPDATE

Litigation and Enforcement Impact of the SEC's Proposed Rules on Climate-Related Disclosure

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The Securities and Exchange Commission's Proposed Rules on Climate-Related Disclosure, released March 21, 2022, represent a significant change in public company disclosure requirements and, if adopted, will have far-reaching effects not only on all public companies but also on those within the companies' value chain. (Bracewell's summary of the SEC's proposal and related analyses can be found at Bracewell Insights.) While the short-term and long-term import of the proposed rules is still being assessed, it is important to consider the substantial impact these new requirements will have on companies' enforcement and litigation risks.

In light of the recent focus on Environmental, Social, and Governance (ESG) issues by all stakeholders, companies already face enforcement and litigation risk from multiple sources, including federal and state regulators, shareholders, consumers, activists, and even commercial counter-parties.[1] The SEC's proposed disclosure rules, if implemented, will likely increase those risks, and the extensive new requirements will provide regulators and litigants with a substantially enhanced arsenal with which to bring such actions.

Below we provide a brief overview of the enforcement and litigation environment related to climate risk and ESG issues, and then address some of the more specific risks arising out of the SEC's proposed rules.

Climate & ESG-related Enforcement and Litigation

Government regulators, investors and the public have demonstrated that they intend to hold companies accountable for their public statements regarding climate risk and other ESG factors, whether in SEC filings, sustainability reports, marketing materials or simply on the company's website.[2] If a company's actions do not match its representations—or if a company makes materially false or misleading statements or omissions—it should expect regulators, shareholders and activists to consider legal action that can have profound financial and reputational consequences.

Although not the only federal agency paying attention to climate-risk and ESG, the SEC has taken the most aggressive policy action thus far.[3] It created a Climate and ESG Task Force in its

Division of Enforcement last year, which is focused on identifying material gaps or misstatements in company disclosures of climate risks.[4] The SEC has made clear that the full and accurate disclosure of ESG-related information remains an exam priority, and has warned against "greenwashing," or overstating or misrepresenting sustainability practices and commitments.[5]

The SEC has opened several investigations into various ESG-related matters, and, notably, in the months prior to issuing the proposal, the SEC staff initiated months-long correspondence with a number of publicly-traded companies asking detailed questions about climate-related impacts on their business and the differences between climate-related disclosures in their SEC filings and those in their voluntary sustainability or corporate social responsibility reports.[6] This initiative likely informed the drafting of the proposed mandatory disclosures and also serves as a guide to potential future enforcement actions. In short, companies should expect the SEC to focus on both the disclosures in the SEC filings themselves and comparisons to other company statements.

According to SEC Chair Gary Gensler, the new comprehensive disclosure regime is intended to ensure that full, accurate, and consistent climate-related information is available to investors, so they can make sufficiently informed investing decisions.[7] There can be little doubt, and Mr. Gensler has confirmed, that the SEC will use the full extent of its enforcement powers under the securities laws to take action against non-compliance and misleading or false disclosures.[8]

State regulators have also been examining climate-related corporate disclosures. Over the last decade, New York's Attorneys General have utilized the Martin Act, the state's broad anti-fraud statute, to target companies in the energy industry. In these investigations, the AGs examined how climate risks were analyzed internally by the company and compared those analyses to the company's public-facing disclosures. Investigators focused on whether the risks that boards and management discussed behind closed doors correlated with their external communications to investors and other stakeholders. Companies should also anticipate increased scrutiny by other states based on the proposed expanded disclosure requirements.[9]

In addition to government regulators, shareholders, investors, and consumers have been devoting significant attention to companies' climate-related disclosures and practices. Securities class actions based on claims of false or misleading statements, in both SEC filings and other public statements, regarding a variety of climate and ESG issues have been on the rise, along with shareholder derivative actions that seek to implement reform through litigation. Consumer protection statutes and false advertising prohibitions have also been utilized to bring lawsuits against companies for alleged greenwashing. Examples of recent cases include claims that companies overstated the recyclability of their products and claims that companies falsely asserted the environmentally safe nature of their products or production processes.[10] Regardless of the merits of some of these claims, they are often costly, to both a company's finances and its reputation.

The comprehensive and detailed mandatory disclosures in the SEC proposal will surely intensify scrutiny of companies' disclosures and may lead to more, and more encompassing, litigation

based on purported misleading or incomplete statements. And, given litigation trends, it may be that shareholder and investor litigation takes the lead in enforcement of the new rules.

Another area of risk worth noting is commercial litigation. Whether it concerns a company's suppliers, vendors, contractual counter-parties, or joint-venture partners, ESG-related risks require companies subject to SEC disclosure rules to ensure not only that their own organizations are in compliance with their publicly stated policies and practices, but also that companies with whom they do business - or intend to do business - are as well. For example, a public company may disclose that all parts of its supply chain engage in certain sustainability practices and comply with all local environmental laws, but a major supplier's deviation from that practice could render the disclosure inaccurate. Consequences could include exposure to enforcement activity, consumer or shareholder litigation, and litigation with the third-party who has breached its contractual obligations to the company. The SEC's proposal makes this last category of litigation risk more prominent.

Increased Risk Under New SEC Proposed Climate-Related Disclosure Rules

The extensive proposed climate-related disclosures magnify the risks of enforcement and litigation outlined above. While the general scope of the rules has been described by the SEC as requiring information about "climate-related risks that are reasonably likely to have a material impact on [a company's] business, results of operations, or financial condition," the specific requirements detail what climate-related risks the SEC considers material and impose a significant obligation on companies to collect, assess, validate, manage, mitigate and report information on an unprecedented scale.[11] It remains to be seen whether the rules will be adopted as proposed or modified, but there is a general consensus that some form of mandatory climate-related disclosures is likely to be implemented. Either way, the SEC proposal provides a roadmap to regulators and private litigants alike.

As we have noted previously, the proposal requires, among other things:

- specific disclosure of greenhouse gas (GHG) emission metrics covering Scope 1 (direct emissions) and Scope 2 (indirect emissions, e.g. purchased electricity) for all companies, and Scope 3 (indirect emissions in value chain) emissions that are material, or if a company has set Scope 3 reduction targets;
- extensive and specific disclosures regarding climate-related physical risks and transition risks to a company's financial statements, business operations or third-party value chain;[12]
- specific quantitative and qualitative financial information related to climate-risk;
- specific and detailed disclosures about governance, business strategy, financial planning, risk assessment and risk management;
- disclosure of any climate-related targets or goals, transition plans, use of scenario analysis or an internal carbon price, and decision making related to targets, plans, analytical tools;

- annual updates on actions taken and progress toward achieving climate-related targets or goals; and

- attestation requirements for certain filers.

These detailed disclosure requirements, and many others in the proposed rule, presents an opportunity for regulators and litigants to attempt to identify specific misstatements or incomplete or allegedly misleading statements. And, it should be expected that there will be comparisons of a company's SEC disclosures to other public-facing statements, such as sustainability reports and website marketing, as well as greater scrutiny of a company's publicly available information regarding its relevant operations and those of the companies within its value chain.

Additionally, the disclosures mandate extraordinary exposure of the management and operations of a company, and activist shareholders may use the information to pressure company boards or direct decision-making, increasing the likelihood of shareholder derivative actions, proxy fights and board election battles.

Companies that have already released plans regarding carbon-reduction targets, achieving net-zero, or other climate-related commitments should review and assess those plans in light of the mandatory disclosures and be prepared for their investors and the SEC to do the same. Companies that have not yet set targets or goals, or have not released them, should also evaluate the risks and requirements of doing so.

Overall, as we've advised, corporate governance, including a robust and integrated risk-assessment and compliance program, is critical to both addressing the proposed rules and mitigating risk.[13] When company boards, executive management, and in-house counsel are evaluating the new disclosure requirements, their climate-related and other ESG risks, and related business strategy, they should also be including litigation and enforcement risk in the analysis.

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1. See Bracewell articles titled "*More Focus on ESG Means More Scrutiny, Litigation and Enforcement, Too*," "*ESG Regulatory Landscape Creates Commercial Pitfalls*" and "*COVID, Climate Change and ESG – The Future of Disclosures, SEC Enforcement, and Securities Litigation*."

2. *See Goldman Sachs Grp., Inc. v. Arkansas Tchr. Ret. Sys.*, 141 S. Ct. 1951, 210 L. Ed. 2d 347 (2021); *see also Ramirez v. Exxon Mobile Corporation*, 334 F. Supp. 3d 832 (N.D. Tex. 2018); *People by James v. Exxon Mobil Corporation*, 65 Misc. 3d 1233(A), 119 N.Y.S.3d 829 (N.Y. Sup. Ct. 2019); and *City of Pontiac Gen. Employees' Ret. Sys. V. Bush*, No. 20CV06651JSTTSH, 2021 WL 2588979 (N.D. Cal. 2021).

3. *See*, *e.g.*, *Consideration of Greenhouse Gas Emissions in Natural Gas Infrastructure Project Reviews*, 178 FERC ¶ 61,108 (2022) (proposed policy governing the review of greenhouse gas

emissions and climate-related impacts from interstate natural gas pipeline projects and LNG projects).

4. SEC Press Release titled "*SEC Announces Enforcement Task Force Focused on Climate and ESG Issues*," dated March 4, 2021. (https://www.sec.gov/news/press-release/2021-42)

5. SEC Press Release titled "*SEC Division of Examinations Announces 2022 Examination Priorities*," dated March 30, 2022. (https://www.sec.gov/news/press-release/2022-57)

6. SEC Press Release titled "*Sample Letter to Companies Regarding Climate Change Disclosures*," dated September 22, 2021. (https://www.sec.gov/corpfin/sample-letter-climate-change-disclosures)

7. SEC Statement titled "*Statement on Proposed Mandatory Climate Risk Disclosures*," dated March 21, 2022. (https://www.sec.gov/news/statement/gensler-climate-disclosure-20220321)

8. See Chairman Gary Gensler's remarks at a briefing (https://www.youtube.com/watch?v=Zq9G_Nhvi5M&t=1s); see also SEC Speech titled "*Building Upon a Long Tradition"* dated April 12, 2022. (https://www.sec.gov/news/speech/gensler-remarks-ceres-investor-briefing-041222)

9. Enhanced scrutiny may also come from state treasurers, who may alter state investments according to disclosures under the new rule. While such investment decisions are not enforcement or litigation, they amplify the power of states to leverage the SEC's disclosure rules to meet state policies on climate change.

10. *See Bush v. Rust-oleum Corp.*, 2020 WL 8917154 (N.D. Cal.); *see also Earth Island Institute v. Coca-Cola Co.*, 2021-CA-001846 (D.C. Super. Ct.) and *Gardner v. Starkist Co.*, 2020 WL 1531346 (N.D. Cal.).

11. See the Proposed Rule Summary on the Federal Register at 1. (https://www.federalregister.gov/documents/2022/04/11/2022-06342/the-enhancement-and-standardization-of-climate-related-disclosures-for-investors#p-3)

12. "Value chain means the upstream and downstream activities related to a registrant's operations." Proposed Rule, Subpart 229.1500.

13. See Bracewell's Insights on SEC Climate Disclosure Proposal and article titled "*More Focus on ESG Means More Scrutiny, Litigation and Enforcement, Too*."