dri™ The Brief Case: DRI Committee News
May 2022 | Volume 1 Issue 3

SEC Climate Rules: Increasing D&O Risk May Accompany Enhanced Disclosures

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On March 21, 2022, the Securities and Exchange Commission (SEC) proposed climate-focused disclosure requirements that, if they become effective, will make public companies' assessment of climate risk mandatory and force an examination of their environmental impact. The proposed requirements, titled The Enhancement and Standardization of Climate-Related Disclosures for Investors, would significantly increase the information public companies must include in their filings, creating a new and heavy disclosure burden on many companies, while also potentially increasing their exposure to activist securities litigation and director and officer liability.

Informed by existing frameworks such as the Task Force on Climate-related Financial Disclosures (TCFD) and the GHG Protocol, the proposal is intended to standardize reporting of climate-change risks, as well as enhance the comparability and reliability of information being made public. However, the effort to eliminate uncertainty in standards and measurement of company statements regarding climate-change risks, itself uncertain, may have the unintended effect of prompting new claims targeting climate-related policies and disclosures and GHG reduction efforts.

Overview

Under a **proposal** the Securities and Exchange Commission (SEC) issued for public comment on March 21, 2022, publicly traded companies would have to provide detailed information about climate-related financial risks and greenhouse gas (GHG) emissions. The disclosure requirements vary depending upon a company's status and size, but generally represent a significant expansion of public company obligations in this area.

Specifically, the proposal would require disclosure of information about how climate change could impact a business's strategy, business model and outlook, processes for managing climate-related risks, and the impact of climate-related events on the company's business and financial statements over the short, medium and long term. The proposal requires disclosure of direct GHG emissions (i.e., "Scope 1"), indirect GHG emissions from the purchase of electricity or other energy sources consumed by the company (i.e., "Scope 2").

In some situations, the rule will also require disclosure of indirect GHG emissions from both upstream and downstream sources (i.e., "Scope 3"). The reach of Scope 3 disclosure is potentially very large, but proponents of Scope 3 disclosures assert that such a broad

reach is important to capture a company's true carbon impact and, although a company may not control the activities in its value chain that produce Scope 3 emissions, it nevertheless may influence those activities, for example, by working with its suppliers and downstream distributors to take steps to reduce those entities' direct GHG emissions. Scope 3 may range from activities that relate to the initial stages of producing a good or service, such as materials sourcing, materials processing, and supplier activities (upstream), to activities that relate to delivering a finished product or providing a service to the end user, such as packaging, transportation and distribution, use of sold products, end of life treatment of sold products, and investments (downstream). See proposed 17 CFR 229.1500(t). Scope 3 disclosures are required only if the emissions are material or if the company has laid out targets for them.

The information required to disclose direct emissions and indirect GHG emissions from the purchase of electricity or other energy sources (Scope 1 and 2 disclosures) can be reasonably expected to be within the company's control, but disclosure of indirect emissions from upstream and downstream sources (Scope 3 disclosures) would necessitate reliance on others. Because they may rely on external information sources -- such as emissions reported by parties in the company's value chain, or data derived from economic studies, published databases, government statistics, industry associations, or other third-party sources -- Scope 3 disclosures present unique issues in data collection and measurement.

Disclosure Concerns

The SEC disclosure requirements, if adopted, will present challenges and potential for additional risk for disclosing companies. Information accuracy may be a challenge, and the disclosure rule will place a cost burden on companies, potentially forcing them to hire and rely on third-party consultants.

While many large public companies have already been measuring their climate risk, this isn't the case for all public companies. Every public company will now need to assess the climate-related information they collect and whether additional data will be needed to meet the SEC disclosure requirements. Surveys suggest that many companies do not have adequate ESG data, in particular data from their supply chain partners.

Further, accuracy and consistency in disclosures will be very important. Under the proposed rule, registrants would need to, for example, disclose the financial impact of climate events, track and disclose climate-related expenditures, and measure, disclose, and track GHG emissions. These disclosures must be made in a consistent and defensible way. And companies will need an independent third party to attest to their GHG emission disclosures.

Another significant question is how to assess the materiality of climate-related risks to determine what information must be disclosed. The proposed rule compares the materiality determination of climate-related risks to the materiality assessment for

purposes of preparing the management discussion and analysis ("MD&A") section in a registration statement or annual report, i.e., known material events and uncertainties that are reasonably likely to cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. For climate disclosures, the Commission is emphasizing an approach to materiality that considers the magnitude and probability of the risk materializing over the short, medium, and long term. The Commission also proposes that public companies disclose impacts on specific categories, including business operations, products or services, suppliers and other value chain parties, climate-risk mitigation efforts, such as adopting new technologies, and expenditures on research and development.

The effect of the rule on public companies is obvious, but the proposed rule may also have an indirect effect on non-public companies, which will likely face increased pressure to evaluate their own GHG emissions from activists and even from public companies that are their business partners, who will need their suppliers to provide data on GHG emissions.

The SEC does plan to phase in the new obligations. The proposed transition periods for existing accelerated filers and large accelerated filers is one fiscal year to transition to providing limited assurance, and two additional fiscal years to transition to providing reasonable assurance, starting with the respective compliance dates for Scopes 1 and 2 disclosure. Assuming the proposed rules go into effect in December 2022, then large accelerated filers would have to comply beginning with fiscal year 2023 (filed in 2024). All registrants, regardless of size, will have an additional year beyond the applicable compliance dates for Scopes 1 and 2 before Scope 3 disclosures are required.

Derivative Suits and Securities Litigation Battles

Once the disclosure requirements are in place, companies will face the prospect of increased risk of securities litigation and derivative claims due to inaccurate or incomplete disclosures. The complexity and expense of the required disclosures may also lead to more complex and pricey litigation over an allegedly materially misleading statement.

Activist groups and investors are already attempting to leverage derivative litigation to advance climate goals. Recently, the environmental group ClientEarth sent a **pre-action letter** to the board of directors of Shell detailing claims it intends to bring based on the company's alleged failure to implement a climate strategy that is consistent with the Paris Agreement. The suit would be filed under the UK Companies Act, which includes a requirement that directors include in decision-making the impact the company's operations have on the environment; the proposed SEC rules, if implemented, could provide a U.S. foundation for similar claims.

The newly required disclosures could give rise to direct claims under U.S. securities laws. For example, while Scope 3 disclosures are accompanied by a safe-harbor provision (i.e.,

protection from liability) in the proposed rules, the information derived from them could be used by activist shareholders or enterprising plaintiffs' lawyers to argue that other, prior disclosures were inadequate or misleading. Even accurate information presents a risk: with this new trove of far more encompassing data and disclosure to mine, would-be securities plaintiffs may identify inconsistencies with prior disclosures or allegedly misleading omissions based on prior disclosure gaps. The safe-harbor provision for Scope 3 disclosures thus may prove cold comfort to companies tasked with the burden and expense of gathering the information, in particular if these disclosures result in increased risk of derivative claims and claims against public company directors and officers.

Greenwashing Focus

The proposed rules also reflect in several places the Commission's intensifying focus on greenwashing. Announced 2022 examinations **priorities** included ESG as the second priority, in particular promising to look at whether companies are "accurately disclosing their ESG investing approaches" and "overstating or misrepresenting the ESG factors considered or incorporated into portfolio selection (e.g., greenwashing)." This focus is not entirely new; earlier in March 2022, the SEC had announced the formation of a **Climate and ESG Task Force** to identify gaps in disclosure or misstatements related to climate change and financial risks and to proactively identify ESG misconduct.

Consistent with this focus, the proposal would also require that, if a registrant has identified a GHG emission-reduction goal, it disclose information about how it intends to reach that goal and report on its progress. Similarly, if a company makes a claim about the sustainability of its operations or products, such as a "net-zero" target, it also must explain to investors how it is attempting to achieve those targets, on what time horizon, and whether it is using carbon offsets to do so, among other information.

The SEC's focus on "greenwashing" is poised to become a source of litigation and reputational risk for companies. Sustainability commitments have been a common target of "greenwashing" claims, which take aim at companies that overstate their environmental progress. Examples include: oil and gas companies pledging to achieve net-zero emissions **yet failing** to invest in renewable energy sources, or **misleading claims** that certain products are recyclable. These kinds of "greenwashing" claims can be expected to continue, if not proliferate, if the new SEC climate risk disclosure rule goes into effect.

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