Companies Facing Increasing Scrutiny over Environmental-Related Disclosures

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Entities that file disclosures with the Securities and Exchange Commission ("**SEC**") should be aware of recent actions by regulators and shareholders questioning the sufficiency of opinion statements made in environmental-related disclosures. Most recently, on March 31, 2016, the SEC announced a settlement with Navistar International Corp. to address charges that the company, an Illinois-based heavy duty trucking company, misled investors when it "failed to fully disclose the company's difficulties obtaining Environmental Protection Agency ("**EPA**") certification" of a particular truck engine. The SEC also filed separate charges in the Northern District of Illinois against the company's former CEO, Daniel Ustian, alleging that he aided and abetted Navistar's violations when he "engaged in a cover-up" that misled investors.

The SEC suit follows recent enforcement efforts by the New York Attorney General ("**NYAG**") and shareholder lawsuits that also alleged misstatements and omissions in corporate disclosure documents relating to (i) compliance with environmental regulations, (ii) environmental risk factors, and/or (iii) corporate governance disclosure requirements. Moreover, the U.S. Supreme Court's decision in *Omnicare Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015), has created additional uncertainty regarding liability for opinion statements made in disclosure documents. In light of these markers, a perfect storm for increased regulatory intervention is brewing.

The Navistar Enforcement Action

According to the SEC complaint, Navistar allegedly spent more than $700 million to develop an engine using exhaust gas circulation ("**EGR**") to lower nitrogen oxide emissions sufficient to meet Clean Air Act standards. An EGR-only engine would be highly competitive, as others in the industry were using EGR in addition to selective catalytic reduction ("**SCR**") technology so their engines would meet environmental limits. However, the company experienced substantial difficulties in developing and certifying a competitive EGR engine. Instead of disclosing these difficulties, Navistar allegedly misled investors in numerous SEC filings, press releases, and public conference calls regarding the status of obtaining EPA certificates for the EGR engine. Ultimately, Navistar announced that it was abandoning the development of its engine and adopting the SCR technology used by its competitors. Following this announcement, Navistar's stock price plummeted. Without admitting or denying the charges, Navistar agreed to a $7.5 million penalty to settle the SEC's allegations.

In the SEC's complaint against Ustian, the SEC accuses the CEO of a "progressively desperate and fraudulent scheme" that led investors to believe that Navistar's efforts to produce a commercially competitive EGR-only engine were proceeding without major engineering or EPA roadblocks. "When public companies and top executives discuss important regulatory developments with investors, they must tell the whole truth," said SEC director of enforcement Andrew J. Ceresney.

The New York State Attorney General

Under New York's Martin Act, the NYAG is authorized to prosecute "any device, scheme, or artifice to defraud or for obtaining money or property by means of any false pretense, representation, or promise." Pursuant to these powers, the NYAG can subpoena any document from any entity in the state, keep an investigation secret (or make it public), and file civil or criminal charges at any time. Although originally intended to combat financial fraudsters, the NYAG has employed the Martin Act since 2002 for a variety of purposes, including using the act's broad powers to enforce the NYAG's own climate change agenda.

On November 6, 2015, the NYAG issued a Martin Act subpoena to ExxonMobil seeking information related to the company's climate change research and its concurrent funding of outside groups whose purpose was to question climate change theories. ExxonMobil filed its response in December 2015.

Shortly thereafter, on November 9, 2015, Peabody Energy—the world's largest private-sector coal company—settled an eight-year dispute with the NYAG regarding allegedly false and materially incomplete statements Peabody made about climate change in its 10-K filings. This dispute stems from Martin Act subpoenas issued by the NYAG in 2007 to five companies (including Peabody) in which the NYAG alleged that the companies, among other things, did not attempt to evaluate or quantify the financial implications of greenhouse gas ("**GHG**") regulations or include any strategies to comply with reduced carbon dioxide emissions requirements. In 2008 and 2009, three of the companies reached settlements pursuant to which each company agreed to retool disclosure practices regarding financial risks associated with climate change. Peabody settled under similar terms. The investigation into the remaining company is still pending.

The Omnicare Decision

On March 24, 2015, the Supreme Court issued its decision in *Omnicare Inc. v. Laborers District Council Construction Industry Pension Fund*. The ruling addressed when an issuer may be held liable for material misstatements or omissions under Section 11 of the Securities Act of 1933 for statements of opinion in a registration statement. Among other things, the Supreme Court held that an issuer can be liable for a statement of opinion, even if honestly believed, if it fails to disclose material facts that conflict with what a reasonable investor would, in context, expect about the issuer's basis for the opinion.

The Court's holding could potentially create substantial uncertainty regarding liability for opinion statements, inevitably increasing litigation over the issue. Although addressing Section 11 liability, the *Omnicare* decision is instructive as to how courts and regulators may determine liability for opinion statements made in other types of disclosure filings—in particular, disclosures related to environmental matters. In fact, lower courts have already applied the *Omnicare* reasoning to other securities law provisions beyond Section 11.

Shareholders and the Class Action Bar

Not surprisingly, class action attorneys have filed a number of recent lawsuits against companies alleging deficiencies in environmental-related disclosures. For example, two lawsuits were recently filed in the Southern District of New York related to a November 2015 disaster in Brazil in which at least 13 people were killed and many others injured when a dam burst at a mining site. Among the allegations, the plaintiffs alleged that the company disregarded the "precarious" environmental

conditions at the mine and issued “materially false and misleading statements concerning the Company’s commitment to safety . . . at the mine sites.”

Further, in *Loritz v. Exide Technologies*, investors brought suit accusing Exide, an automotive and industrial battery maker, and its executives of falsely touting the company’s compliance with environmental regulations and failing to disclose that one of the company’s plants was releasing dangerous levels of hazardous waste. These actions prompted state regulators to shut down the plant and seek $40 million in penalties. The plaintiffs won certification of a single liability-only class in July and are currently seeking certification for a group of noteholders.

Similarly, a shareholder class action was filed against Sempra Energy alleging that a natural gas leak at the company’s storage facility caused local residents to become sick. Notably, the shareholder complaint followed on the heels of a lawsuit by local residents for damages allegedly caused by the leak. According to the shareholder complaint, Sempra, among other things, failed to publicly disclose that “an extended hazardous gas leak would constitute a serious threat to public health and safety.”

Plains All American Pipeline, L.P., was also subject to various shareholder lawsuits stemming from an oil pipeline spill along the Pacific coastline. Among the claims, the plaintiffs have alleged that the company failed to disclose a lack of internal controls relating to its pipeline operations and falsely touted compliance with federal environmental regulations. Further, the plaintiffs allege that the company issued false and misleading statements following the spill, allegedly downplaying the magnitude of the environmental damage caused by the oil spill.

Shareholder scrutiny of environmental disclosures is likely to only intensify with the promulgation of stricter greenhouse gas emissions regulations. Indeed, the Environmental Defense Fund, one of the world’s largest non-profit environmental organizations, recently published a report directed at oil and gas industry investors scrutinizing the industry’s disclosure practices with respect to GHG emissions. In particular, the report urges investors to demand better climate risk disclosure and sets out metrics to support quantitative reporting of methane gas emissions.

Federal Regulatory Scrutiny Is Ramping Up

In 2010, the SEC adopted its landmark interpretive guidance on climate change disclosure. To date, the guidance has had little effect on the breadth of companies’ environmental disclosures. But its adoption shined a spotlight on the SEC’s growing concern in this area. Importantly, the SEC’s general reporting rules require disclosure of any additional material information necessary to make required statements not misleading. In the environmental context, these rules require disclosure of “all other environmental information of which the average prudent investor might reasonably be informed.” To date, the SEC has not filed any actions concerning climate-related disclosure issues, but recently published a concept release “seek[ing] public comment on modernizing certain business and financial disclosure requirements,” including sustainability disclosures like climate change and resource scarcity.

Three recent events, moreover, have set the stage for increased regulatory scrutiny. First, in January 2016, the U.S. Government Accountability Office issued a report reviewing the effectiveness of the SEC’s guidance on climate disclosure. Among other things, the report revealed that since issuing the guidance in 2010, the SEC has taken only one of three planned actions to determine if additional action is needed on climate change disclosures. According to the report, no additional actions were taken because of shifting circumstances and evolving priorities at the SEC.

Next, on March 14, 2016, more than 30 investor groups promoting sustainable investments asked the SEC to investigate whether Enviva Partners LP—a wood pellet manufacturer—is complying with the SEC's guidance on climate change disclosures. The groups claim that the SEC's lax enforcement of the guidance can lead "to disclosures which exaggerate climate benefits" which can "lead to misguided investment decision making." Among the claims, the groups allege that Enviva "misleads investors on the environmental and climate benefits of their products." Moreover, the letter asks the SEC to more closely monitor companies' climate benefit claims; establish and enforce guidelines for those claiming climate benefits; and require companies to disclose the assumptions that underlie those claims.

Finally, on March 24, 2016, the SEC issued a letter stating that ExxonMobil must allow shareholders to vote on a proposal that would force the company to outline for investors how climate change and related legislation could affect the company's profitability. This ruling follows an earlier disclosure by the Justice Department that it had forwarded a request to the FBI to investigate whether ExxonMobil violated the Racketeer Influenced and Corrupt Organizations ("**RICO**") Act, by not disclosing the dangers of climate change to its investors. Congressman Ted Lieu of California has also asked the SEC to investigate whether the company made misstatements in its filings. Additionally, Congressman Lieu and two other Congress members asked the Justice Department to investigate whether Shell Oil violated RICO for participating in a similar "pattern of deception" as ExxonMobil. Together, they too asked the SEC to investigate whether Shell Oil "similarly violated securities laws by not disclosing climate change related material risks."

Takeaways

In light of heightened scrutiny, companies must be vigilant about disclosing environmental risks—especially risks related to climate change—in their filings and carefully consider all known and potential factors when formulating an environmental risk profile. Companies should also determine whether additional disclosures are necessary and ensure the accuracy and consistency of all information disseminated to regulators and investors. For any questions or assistance on this issue, please contact one of the Haynes Boone lawyers listed below.