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Recommended Citation

Washington, Angela (2022) "“At What Cost?": The Future of Securities Enforcement in Climate Change Litigation," *Sustainable Development Law & Policy*. Vol. 21 : Iss. 1 , Article 3.
Available at: <https://digitalcommons.wcl.american.edu/sdlp/vol21/iss1/3>

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‘AT WHAT COST?’:

THE FUTURE OF SECURITIES ENFORCEMENT IN CLIMATE CHANGE LITIGATION

by Angela Washington*

PART I: ASKING WHY

Ask Why? Twenty years ago, Houston’s Enron Corporation launched its *Ask Why?* advertising campaign.¹ The television commercials featured dizzying abstract images against synthesized chamber music, and a narrator bellowing the phrase, “Ask why.”² Having transformed its image “from a staid gas pipeline company to a high-tech trading firm,” Enron curated the story that it was ‘defiant,’ a ‘nonconformist,’ and a ‘visionary’ in the energy industry, and Wall Street listened.³

The conditions that allowed Enron to flourish also gave rise to the perfect storm that led to its fall.⁴ The federal government deregulated the energy industry in the 1990s due, in part, to Enron’s lobbying efforts.⁵ With newfound liberalization and a thirst for adaptation, the trading firm led the charge into new markets, starting with futures contracts in oil, gas and electricity.⁶ It seemed that Enron was the answer to concerns surrounding the volatile market at the time, and the firm promised predictability to investors while it assumed the risks.⁷ But Enron’s rapid growth imploded amidst the bear market of 2000-02, and after the company faced mounds of allegations of corporate malfeasance, it was Senator Joseph Lieberman, Governmental Affairs Committee Chair, who said, “[a]nd we’ve got to ask the question – why?”⁸

The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) was enacted in response to the Enron scandal.⁹ The Act’s aims were to, *inter alia*, strengthen corporate governance rules and increase accountability and disclosure requirements for corporations.¹⁰ In particular, encouraging transparency from executives, accountants, and auditors with regards to their company’s financial standing.¹¹ Sarbanes-Oxley created a criminal penalty for CEOs and CFOs who knowingly certified false reports—up to a \$1 million fine, 10 years in prison, or both.¹² Some argued that the Act was an overreaction at the time, but for the victims of the Enron scandal, accurate reporting and more fulsome disclosure requirements could have shielded them from economic devastation.¹³

Today, there is a growing tide of business leaders concerned with the effects of climate change on infrastructure necessary to support the global economy.¹⁴ When the Commodity Futures Trading Commission (CFTC) issued its report, *Managing Climate Risk in the U.S. Financial System*,¹⁵ it was amidst a historic wildfire season that saw the destruction of 3.4 million acres in residential and business property and the forced migration of thousands of people across California, Washington State, and Colorado.¹⁶ The report’s findings confirmed what

business analysts have been saying for decades: climate change poses a grave, systemic threat to financial markets.¹⁷

Although mostly voluntary in the United States, the predominant narrative among the investor community has been that credible, accurate reporting of market risks in the form of sustainability disclosures can lead to a competitive advantage.¹⁸ For example, the Obama Administration, in a move to keep up with the European Union, encouraged companies to sign the American Business Act on Climate Pledge.¹⁹ In it, 154 companies agreed to act upon the Paris Agreement’s objectives to establish a long-term framework for reducing greenhouse gas (GHG) emissions and transitioning to low-carbon-based investments.²⁰

This year Larry Fink, the CEO of the world’s largest asset manager, BlackRock, made an emboldened plea to encourage companies to rethink their carbon footprints. He stated that BlackRock would begin exiting certain investments they deemed were not financially prudent and “present[ed] a high sustainability-related risk.”²¹ Perhaps he was worried that when a record 631 global investors, representing 37 trillion in assets, urged their governments to amplify efforts against climate change, American firms were noticeably absent from the table.²²

Investment firms and their clientele have sought to influence companies’ policies toward sustainable development by easing access to environmental, social, and governance (ESG) disclosures.²³ To achieve this objective, Enron and the corporate governance scandals that followed it contain important lessons about informational rights that should be applied to the legal strategies in recent climate change litigation.²⁴ Climate equity is the basis from which all other sociopolitical issues derive, and the existing tensions between companies’ interests in protecting proprietary information and the right to invest intelligently must be reconciled.

Federal and state securities enforcement and regulation is a legal area ripe to address climate change concerns.²⁵ Legal protections for investors against corporate securities mismanagement—primarily fraudulent misrepresentations and omissions that violate disclosure requirements in the purchase or sale of securities—will be essential to profitable economic activity in the fossil fuels sector.²⁶ Dually concerning, environmental degradation caused by fossil fuel industries’ short-term, opportunistic resource extraction jeopardizes the

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market economy; therefore, a company's financial health depends on forthright calculations of climate-related risks.²⁷

Sustainability disclosures occupy an important space between the seemingly opposed interests of industry and environmental protectionism. The breadth of remedies available in securities law is a critical tool that has been underutilized by federal securities regulators to date.²⁸ Furthermore, there is evidence that states' securities enforcement is also bolstering consumer protections against fraud and breaches of warranty and merchantability.²⁹ Investors (and consumers for that matter³⁰) desire to know how companies will prepare their business operations to mitigate environmental impacts through the deployment of enhanced technologies in their practices and policy directives. Here, strict securities enforcement has the potential to transform the climate change movement by advancing the rights of shareholders to understand the ESG risks associated with investment opportunities. With informed decision-making, those industries embracing the harmonious interplay between sustainability and economic development are the profitable investments for our planet.³¹ The existential threat of climate change, often masked by the "fairy tale of eternal economic growth," has raised ethical and moral issues too profound to ignore.³² Corporations have a duty to be transparent about climate change impacts, and we have a right to know what they are.

PART II: DISCLOSING WHAT THEY KNOW

Businesses have an inherent interest—as well as a functioning role—in the relationship between climate change and global anthropogenic CO₂ emissions from certain energy extractive activities, including the industrial processes involved in the burning of fossil fuels, deforestation, oil and gas drilling, and mining operations.³³ Extreme weather events are poised to devastate economic sectors and lead to dire consequences for safety, food security, and public health.³⁴ These consequences on industries and the greater economy can be referred to as climate risks. "Climate risks" are the unanticipated ways that climate change can destabilize financial markets and cause significant reductions in asset valuations.³⁵ Effects can include physical damage to facilities, influences on consumer demand, new regulatory costs and incentives, and detriments to human productivity and the supply chain.³⁶ As expected, ninety-three percent of U.S. business leaders consider climate change-related risks when making investment decisions.³⁷ Presented with the scientific and legal developments associated with climate change litigation, confronting the financial risks associated with climate change—and mitigating those impacts—is the only choice for businesses to successfully sustain operations.³⁸

In coastal regions that have been devastated by extreme weather, extractive industries have become the targets of commercial lawsuits for misleading consumers and investors in their representations—or omissions—about climate change impacts.³⁹ While an evolving area, these cases are falling into two buckets of coverage. First, to protect consumers, the

allegations against public corporations like Shell, ExxonMobil, Koch Industries, and BP are that they have known for decades about the industry's contributions to climate change, and have colluded in affirmative campaigns to deceive the public.⁴⁰ Second, with respect to supporting investor decision-making, executives may stand to face liability under securities law for not disclosing a "material" risks in financial reporting.⁴¹

While presently true that more companies are voluntarily sharing this information,⁴² there are still several statutory and regulatory hurdles to getting climate-related data and risk analysis.⁴³ How ESG or sustainability topics in businesses' operations are disclosed is anticipated to be one of the defining market valuation factors that investors remain committed to pursuing. Investors want insights into how a particular company plans to manage the risks related to ESG topics.⁴⁴ The challenge to the analysis, however, is that investors are not convinced that they are able to use existing sustainability disclosures to guide their investment decisions because unlike other Securities and Exchange Commission (SEC)-mandated financial disclosures, sustainability disclosures do not conform to a common set of standards.⁴⁵ Just as essential to understanding the upfront material costs associated with the investment, clear reporting of environmental practices and impacts across the supply chain will influence delivery of products to consumers.⁴⁶ With that knowledge, essential to the calculus is how companies plan to embed this data into their long-term business strategies. Thus, transparent and verifiable standards for reporting and disclosure allow for accurate and reliable evaluation of a company's performance.⁴⁷ Without it, investors and companies cannot prepare for the "heightened risks in an increasingly resource-constrained world."⁴⁸

Such was the argument in *New York v. ExxonMobil*,⁴⁹ in which the State of New York alleged that "ExxonMobil made various material written and oral misrepresentations and omissions that tended to mislead the public" about the way it internally priced risks related to global climate change.⁵⁰ Specifically, ExxonMobil made the alleged misrepresentations in its *Outlook for Energy*, *Managing the Risks*, and *Energy and Climate* annual publications and reports.⁵¹

The New York attorney general (AG) brought the charges under the Martin Act.⁵² This New York state law gives the AG broad authority to investigate publicly-held companies for financial fraud if the company trades securities in New York.⁵³ However, the court held that New York failed to prove by a preponderance of the evidence that ExxonMobil had *materially* misled its investors concerning how it calculated the costs of climate change.⁵⁴ The court reasoned that none of the projections of proxy costs of carbon and GHG costs would have influenced investment decisions based on those projected costs.⁵⁵

When the #ExxonKnew campaign started to gain traction, the parallels of the controversy with the Enron scandal were striking.⁵⁶ The Enron scandal raised public consciousness with respect to corporate governance principles, generating demand for more aggressive regulation of public companies and

facilitation of information sharing.⁵⁷ Similarly, the ExxonMobil case prompted thinking around how SEC's disclosure requirements can also serve to supply security holders and the securities market with materially necessary information about environmental liabilities and obligations.⁵⁸ The framework of corporate and securities law that developed after Enron can lead to a promising strategy that 1.) imposes affirmative legal duties on public companies to understand the implications of climate change; and 2.) encourage adoption of climate change policies and practices that are accountable to investors and promote transparency in the financial markets through "full and fair disclosure."⁵⁹

That the climate risk represents a "material" risk—and is thus subject to compulsory disclosure under the Securities and Exchange Act of 1934—is essential to having a claim under the Act.⁶⁰ Specifically, Rule 10b-5 (10b-5) prohibits a range of unscrupulous practices (e.g., use of deceptive devices, misleading statements, etc.) relating to fraud or misrepresentation in the purchase or sale of securities.⁶¹

Although 10b-5 does not delineate the elements of breach, the Supreme Court has identified six elements necessary to find a violation of the Act: (1) a material misrepresentation or omission; (2) intent; (3) a connection between the misrepresentation or omission involving the purchase or sale of a registered security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.⁶² Violations of the provisions of 10b-5 can result in the SEC seeking civil penalties, such as fines and injunctions, or barring a person from serving in his or her position as a corporate officer or director.⁶³ The Department of Justice (DOJ) may also file criminal charges under the Act.⁶⁴ Importantly, 10b-5 creates a private cause of action.⁶⁵

10b-5 is a formidable tool in climate liability litigation because of the breadth of its coverage.⁶⁶ First, federal enforcement authority for 10b-5, and generally the universe of federal securities acts,⁶⁷ is based in the engagement of the proscribed fraudulent act in interstate commerce. However, it has mostly been understood as a formality to create federal jurisdiction as the over-the-counter or national securities exchanges leads to the jurisdictional test being easily satisfied.⁶⁸ Even if the defendant only engaged in intrastate business, 10b-5 can reach the action because stock of any company is a "security" and is thus broadly construed.⁶⁹

Additionally, the SEC has authority to require periodic reporting of certain information by regulated entities with publicly traded securities.⁷⁰ The disclosure reporting requirement has become a legal area of ballooning interest as companies feel pressure from investment firms to accurately assess climate risks—and implement accordingly—to lessen the impact on fossil fuel industries over time.⁷¹ Among those interested, business leaders, investors, and activists, have sought for more guidance and regulation from the SEC concerning how periodic disclosure requirements⁷² should apply to climate risks and reporting of information under federal securities laws and regulations.⁷³

In 2010, the SEC addressed these requests in a pivotal guidance document articulating the disclosure known as the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).⁷⁴ The SEC's guidance was intended to have registrants and those reviewing disclosure filings on its Electronic Data Gathering, Analysis, and Retrieval system (commonly referred to as "EDGAR"⁷⁵) better understand how the impact of climate change may be relevant to the statements provided in the MD&A disclosure.⁷⁶ That is why when the SEC proposed amendments to modernize MD&A, critics felt the agency had weakened the position it took in the original guidance, and criticized the SEC for failing to take the opportunity to standardize disclosure requirements related to climate change.⁷⁷

Although the State of New York's case against *ExxonMobil* did not proceed, other state actions are being pursued against the company on similar claims. Massachusetts, for example, has adjusted its legal strategy based on the New York lawsuit's dismissal.⁷⁸ Washington, D.C. filed a lawsuit against ExxonMobil, as well as BP, Chevron, and Shell, in which it accuses the oil companies of engaging in a decades-long coordinated campaign to mislead the public by downplaying the climate change-related science to keep their businesses profitable.⁷⁹ Further, Delaware's and Minnesota's suits have named the American Petroleum Institute—the largest oil and gas trade association in the United States—as a defendant in addition to the major fossil fuel companies.⁸⁰ There is potential for such high-profile litigation in the states to generate "do the right thing" consumerism and encourage investors to proactively incentivize sustainable development in their resolutions.

PART III: LEVELING THE (CORPORATE) PLAYING FIELD

First, Prioritize Climate Deception Enforcement Efforts.

One advantage that state regulators can leverage is that they may be able to bring actions in situations where corporate actors' misstatements or omissions were merely negligent, or the law imposes strict scrutiny liability, whereas 10b-5 has a scienter requirement.⁸¹ Notably, the Martin Act (under which New York's AG brought suit) is among the blue sky laws regulating the offer, sale, and purchase of securities that does not require proof of intent to defraud.⁸²

In addition, state attorneys general's (AG's) have broad discretionary authority to issue civil investigative demands for companies' internal documentation. In Massachusetts's investigation against ExxonMobil, the amended complaint was filed on the heels of New York's dismissal.⁸³ Massachusetts's suit goes broader than New York's and alleges that ExxonMobil deceived investors *and* consumers, whereas New York's claims only concerned securities law violations.⁸⁴ However, the amended complaint also excludes one of the investor deception claims – specifically, the proxy cost of carbon allegations – that New York's state court rebuffed.⁸⁵

The Massachusetts AG wisely adjusted its legal strategy in response, but other states should take caution to not use New York

as the metric for how future climate deception cases will fare in the courts.⁸⁶ Similarities exist between these climate deception suits and what culminated in a historic settlement against tobacco giant Philip Morris.⁸⁷ Although a seemingly distant memory, the “Big Tobacco” litigation had a rocky start.⁸⁸ Essential to the broader movement is that state regulatory agencies continue to demonstrate a willingness to pull resources to pursue these claims in the first place and to continue to test legal theories in these early days of climate deception jurisprudence.

Securities litigation will continue to shape corporate social responsibility despite legal burdens and governance challenges. Indeed, as discussed in Part II and above, state regulators are playing an essential role in the securities enforcement regime⁸⁹—by bringing the cases that the SEC and DOJ cannot or will not.⁹⁰ In the absence of federal enforcement, state regulators and private litigants have been forced to rise to the challenge to target companies that fail to accurately disclose climate risks in their portfolios.

The Sierra Club is among those that have accused the SEC of shirking at their duties to shareholders and instead shifting enforcement responsibilities to state regulators.⁹¹ In its complaint, the Sierra Club alleges that the SEC has been captured by industry and refuses to produce documents under FOIA which would show their reasoning for allowing companies to omit climate-related shareholder resolutions.⁹² Sierra Club’s argument is that the SEC’s interests coincide with corporate polluters rather than defending climate-related shareholder resolutions that are aimed at reducing pollution and adopting corporate sustainability and climate goals.⁹³ With the state attorneys general’s engagement on climate deception, it is also time for the SEC to flex its regulatory authority in this area.⁹⁴

Second, Clarify Climate Change-Related Financial Disclosures. Relatedly, with the increase in climate-related litigation in the past few years, investors are searching for ways to independently equalize or level their bargaining position by adopting resolutions on a company-specific basis through the SEC’s shareholder proposal rule—Rule 14a-8 (“14a-8”).⁹⁵ This rule has allowed shareholders to introduce proposals that seek to address social policy concerns on ESG topics, so long as certain ownership and procedural requirements are met.⁹⁶ 14a-8 has received support from a number of mainstream institutional investors, despite declines in the number of ESG proposals submitted and voted on.⁹⁷ For instance, in 2017, a majority of the shareholders at Occidental Petroleum and ExxonMobil approved shareholder proposals requesting more robust disclosure on the potential effects of climate change.⁹⁸

In a different political environment, the SEC would treat sustainability disclosures as importantly as other financial disclosures, and thus, as necessary to intelligently evaluating trends, events, or uncertainties that are likely to materially impact a given corporation’s capital, sales, or revenue.⁹⁹ Only with a common set of disclosure standards can investors make meaningful decisions based on their economic interests.¹⁰⁰ Moreover, this balancing of investors’ bargaining position entails stricter enforcement of securities laws and regulations to

deter corporate malfeasance. The Volkswagen litigation offers hope in this respect.

The SEC charged Volkswagen executives under section 10(b)¹⁰¹ and defrauding U.S. investors by making deceptive claims about the environmental impact of the company’s “clean diesel” fleet after it was discovered that Volkswagen had been cheating on federal emissions tests.¹⁰² The SEC’s complaint came more than two years after Volkswagen pleaded guilty to misleading the Environmental Protection Agency and U.S. customers about whether its automobiles (e.g., VW, Audi, and Porsche) were diesel vehicles that complied with U.S. emissions standards.¹⁰³ That settlement requires Volkswagen to pay into a multibillion dollar mitigation trust fund that will replace diesel emissions sources with cleaner technology and offset the emissions of nitrogen oxides caused by Volkswagen’s violations.¹⁰⁴ If the SEC’s case is successful, Volkswagen’s former CEO could be barred from serving as an officer or a director for any SEC-registered company and participating in future stock offerings; ordered to return any “ill-gotten gains” or earnings he may have received from stock sales during the emissions scandal period; and become subject to other civil penalties.¹⁰⁵

Third, Develop Climate Risk Stress Tests. The Enron scandal changed securities and financial regulation substantially. The event demonstrated the necessity of regulations to foreclosing the prior loopholes in accounting practices found in fraudulent financial reporting.¹⁰⁶ Before Enron, the government had not done enough to protect public investors. Now, as observed in the #ExxonKnew and Volkswagen cases, this work is not done. Duties to disclose material information to investors under securities law and regulation can reject the “greed is good” framework in favor of environmental conservationism, while also protecting investors and consumers. But to disclose with integrity, the short and long-term physical and transitional risks must be calculated to give financial institutions a fighting chance to “course-correct.”¹⁰⁷

Among the recommendations in the CFTC report, the panel calls for a coordinated effort among federal and state regulators to assess the impacts of climate change on financial markets in the form of ‘stress tests.’¹⁰⁸ To effectively measure climate risks, crucially, the United States ought to oversee common data collection practices and methodologies to guide both the public and private sectors.¹⁰⁹ The report provides that standardization across definitions and classifications can help promote transparency, and better enable financial institutions to mitigate climate risks through integration into their long-term management frameworks.¹¹⁰

Economist Lord Nicholas Stern noted, “Climate change is a result of the greatest market failure the world has seen.”¹¹¹ The underenforcement of disclosure violations can erode trust by sending a message that those with the deep pockets win. The urgency of the climate crisis and its immediate economic impacts implores public companies—and the federal and state authorities that regulate them—to provide climate change information that materially relates to investment decisions. Financial disclosures

in tandem with a science-based climate change narrative in sustainability disclosures can resist the countervailing view that

accepts “business as usual” operations in favor of economic and environmental justice.



ENDNOTES

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- ¹¹ Carlson, *supra* note 9.
- ¹² 18 U.S.C.A. § 1350(c)(1) (West) (2002).
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- ²⁵ See Press Release, U.S. Sec. & Exchange Comm’n, SEC Charges Volkswagen, Former CEO with Defrauding Bond Investors During “Clean Diesel” Emissions Fraud (Mar. 14, 2019), <https://www.sec.gov/news/press-release/2019-34>, for an example of how securities enforcement can address climate change concerns.
- ²⁶ See *c.f.*, Erin Cox & Gregory S. Schneider, *Energy Companies Abandon Long-Delayed Atlantic Coast Pipeline*, WASH. POST (July 5, 2020, 7:07 PM), https://www.washingtonpost.com/local/virginia-politics/atlantic-coast-pipeline-canceled/2020/07/05/dalc0f40-bef5-11ea-b178-bb7b05b94af1_story.html (reporting that litigation linked to the Keystone XL pipeline heightened litigation risk, extended the project’s timeline, and ballooned the estimated costs by \$3 billion dollars from when the project had started).
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