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Impact of Proposed Rules on Climate-Change Related Disclosures on M&A

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January 19, 2023 - On March 21, 2022, the Securities and Exchange Commission ("SEC") proposed rules that would require public company registrants to disclose certain climate change-related information in their periodic filings and registration statements. The public comment period for such proposed rules initially expired in June 2022 but was briefly reopened in October 2022. It is now expected that new rules will be adopted in the first half of 2023. After the new rules are adopted, registrants buying other companies should consider building out their acquisition processes to evaluate, mitigate and communicate climate change-related issues related to the companies they acquire. Attention to proper post-closing disclosure will be particularly important since the SEC is expected to be increasingly aggressive in policing issues of Environmental, Social and Governance (ESG) compliance, and has recently fined Goldman Sachs $4.0 million for failing to follow its own ESG policies and procedures. This note outlines the proposed climate change-related disclosure rules and their potential impact on acquisitions.

The new rules proposed by the SEC would add a subpart to Regulation S-K requiring registrants to disclose certain climate change-related information. The information disclosed would include (i) climate change-related risks reasonably likely to have a material impact on a registrant's business or consolidated financial statements, (ii) climate change-related impacts on a registrant's strategy, business model and outlook, (iii) climate change-related risk management practices, (iv) internal carbon prices or climate change-related targets or goals and (iv) three separate scopes of greenhouse gas emissions metrics. Scope 1 and Scope 2 emissions metrics would also be subject to an attestation requirement applicable solely to accelerated and large accelerated registrants. Finally, the rules would add a new article to Regulation S-X requiring that certain climate change-related financial statement metrics and disclosures be included in notes to the registrant financial statements included in annual reports and registration statements.

Registrants buying other companies will have to ensure that their post-acquisition periodic reports properly disclose material climate change-related risks assumed in their acquisition transactions, particularly those that are material. The proposing release acknowledges that many registrants already voluntarily provide climate change-related information. It notes that the SEC's intent is to move from such existing ad hoc information, toward consistent, comparable and reliable data that is more useful to issuers, investors and other market participants. The qualitative nature of issues relating to climate change makes consistency, comparability and reliability difficult to achieve, particularly for registrants that find themselves in competitive acquisition processes. These registrants will need to quickly assess risks related to climate change that are applicable to their targets and may need to do this based on limited knowledge. Any transaction-related material risks may need to be incorporated into registrant filings shortly following consummation of the acquisition.

The proposed rules would require disclosure of physical and transition-related climate change risks that are reasonably likely to have a material impact on a registrant's business or financial statements over the short, medium and/or long term. They would also require related disclosures regarding the actual and potential impacts of such risks on the registrant's strategy, business model and outlook, as well as detail on board and management oversight. In outlining its proposed requirements, the SEC analogized to materiality concepts used in MD&A disclosure, where matters are typically material if there is a substantial likelihood that a reasonable investor would consider them important in making investment and voting decisions. Climate change-related risks, however, are long term, amorphous and of varying importance to different individual investors, making many assessments of reasonableness highly subjective and subject to challenge. Further, proposed rules that require the identification of board members with expertise in climate change-related risks may be deemed to impart out-sized responsibility for applicable errors on expert board members.

Subjectivity also impacts the proposed requirement to disclose greenhouse gas emissions metrics. The proposed rules would require reporting of emissions metrics in Scope 1, Scope 2 and Scope 3 classes. Scope 1 emissions are a registrant's direct greenhouse gas emissions from operations controlled by it and would be relatively straightforward to compile. Scope 2 emissions extend to indirect greenhouse gas emissions from electricity and other forms of energy acquired by the registrant for consumption in operations controlled by it. Scope 3 emissions are not produced by the registrant itself, but rather, by third party actors up and down the registrant's value chain, including suppliers and customers. Since Scope 3 emissions information comes from third party vendors of energy that is purchased and consumed by a registrant, no such registrant can be certain of its accuracy. Scope 1 and Scope 2 emissions data is required for the current fiscal year and any historical periods disclosed by the registrant both on a carbon-dioxide equivalent basis and on a basis that is disaggregated among seven constituent greenhouse gases. Finally, disclosure must include a breakdown of emissions per unit of revenue and production, as well as detail on related methodologies and assumptions. Evaluating what such disclosures will look like pre- and post-acquisition will be expensive and time-consuming.

Acquiror registrants will likely need to involve environmental consultants in their material transactions early and substantively if the proposed rules are adopted. Environmental due diligence is a long-standing component of the typical acquisition due diligence exercise but currently focuses on liability rather than sustainability. The proposed rules would expand the scope of the due diligence exercise in a way that inevitably would increase the costs, risks and timelines associated with buyer acquisition processes and would favor buyers (e.g., private equity) who are not registrants, since non-public auction bidders will be free of the new and burdensome disclosure requirements. This also may drive a more robust environmental consulting industry than currently exists, and the capacity of the existing industry initially may be inadequate to fully serve all filers. Law firms can address liability, compliance, target efforts and disclosure obligations but may be less well placed to address subjective risks and opportunities, or to calculate emissions metrics.

Scope 1 and Scope 2 emissions data should be reasonably available from targets but may take time to evaluate and consolidate with a buyer's own data. Buyers who are accelerated or large accelerated filers will also need to attest to the Scope 1 and Scope 2 emissions data disclosed in their annual reports and registration statements, which will require a complete and accurate understanding of target emissions in order to avoid liability. Larger registrants would be required to disclose emissions data beyond that captured by Scope 2, including emissions resulting from activities of their suppliers and customers. Such Scope 3 emissions data will be required only if material or if incorporated into the registrant's emissions goals. Registrants may also benefit from using estimates and ranges in their disclosures. Nonetheless, accelerated and large accelerated buyers vying for targets with material Scope 3 emissions may find it challenging to compile the required information within the intense pace and compressed timeframe of an acquisition auction diligence process.

The proposing release also details a new article to Regulation S-X that would require financial statements in periodic reports and registration statements to describe the impact of climate-change related risks. Such disclosure would not be limited by materiality and would be set forth in line-by-line detail, including regarding expenditures related to mitigation and transition activities. Duplication of such information found elsewhere in the applicable annual report or registration statement could be avoided by incorporating information by reference. As with the proposed amendments to Regulation S-K, the proposed changes to Regulation S-X would require buyers to evaluate how their proposed acquisition would impact the disclosures of the post-acquisition combined company. Since the applicable exercise involves overlap between environmental and accounting due diligence, it may be that such diligence is best executed by environmental consultants affiliated with a buyer's accounting due diligence specialists.

Environmental due diligence is a fundamental part of acquisition transactions but varies dramatically according to industry and depth of environmentally sensitive activities. The proposed climate change-related disclosure rules likely would require acquiring registrants to conduct near universal emission and other climate change-related due diligence. Transaction agreements may also need to include new representations and warranties confirming the accuracy and completeness of such emissions and climate change-related information, as well as compliance with applicable regulatory regimes. Interim covenants may also need to become more restrictive in areas that impact climate-change; and in private transactions, special indemnities and other protections may be required to address identified and/or potential liabilities. Transaction documents in acquisitions involving a public company buyer and/or target will generally need to address the requirements mandated by the proposed rules.

The implications of the proposed climate change-related disclosure rules on M&A may be immense. The proposed rules would extend the due diligence period for registrants buying companies and may place such buyers at a disadvantage vis-à-vis competitors. Disclosure-related risks are also amplified by the fact that significant requirements, including those related to Scope 3 emissions, require information that may not be readily available, and may also involve the application of estimates, assumptions and other subjective factors that are imprecise. Even in cases in which applicable information is available, the methodology underpinning a target's emissions information may differ substantially from that historically applied by the registrant. As a result, the post-acquisition integration of the target may require the registrant to rebuild its processes and even restate its historical disclosures for the combined company. The establishment or recognition of objective standards for climate change-related information is likely to create compliance challenges analogous to those associated with the roll-out of requirements under the Sarbanes-Oxley Act.

The SEC has long required disclosures regarding environmental matters in public filings. In 2010, the SEC clarified that climate change matters were encompassed within its existing disclosure requirements. As climate change has become increasingly important to public constituencies, investors and other market participants, issuers have provided a range of information lacking consistency, comparability or reliability. The proposed rules intend to address these shortcomings by requiring certain universal disclosures and attestations thereto. The new rules will inevitably increase both the expense and time devoted to the evaluation of target businesses by registrants, as well as imposing at least an initial learning curve and ramp-up. However, such negative impacts can be mitigated, and disclosure risks can also be addressed, by giving registrants that buy other companies a substantial grace period before mandating integration of climate-change related information from newly acquired businesses. Acquisitive issuers will be looking for such a grace period when the new rule are finally issued sometime this year.

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