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California Passes New ESG Disclosure Laws Ahead of SEC, Triggering Increased Regulatory and Litigation Risk for Companies Doing Business in California

By Kenneth Herzinger, Jon Drimmer, Tara Giunta, Erin Zatlin & Paige Rinderer

On October 7, 2023, Governor Gavin Newsom signed Senate Bill 253[1] into law, which imposes climate-related disclosure requirements for companies with revenues over $1 billion annually that do business in California. On the same day, Governor Newsom also signed into law SB 261, the Climate-Related Financial Risk Act ("CFRA"),[2] as well as AB 1305, governing voluntary carbon market disclosures and aimed at combatting greenwashing.[3] While the new laws are aimed at increasing transparency regarding the impact of big businesses on the environment, they also create increased Securities and Exchange Commission ("SEC") enforcement risk and private securities class action litigation risk for large publicly traded companies doing business in California, as discussed further below.

SB 253

The new California law requires public and private companies operating in California and earning more than $1 billion a year to measure and publicly disclose three types of greenhouse gas emissions.[4]

- **Scope 1:** All direct greenhouse gas emissions that stem from sources that a reporting entity owns or directly controls, regardless of location, including, but not limited to, fuel combustion activities.
- **Scope 2:** All indirect greenhouse gas emissions from consumed electricity, steam, heating, or cooling purchased or acquired by a reporting entity, regardless of location.
- **Scope 3:** All indirect upstream and downstream greenhouse gas emissions, other than scope 2 emissions, from sources that the reporting entity does not own or directly control and may include, but are not limited to, purchased goods and services, business travel, employee commutes, and processing and use of sold products.

These disclosures are in accordance with the Greenhouse Gas Protocol, the world's most widely used climate disclosure framework.[5] Companies will have to start disclosing emissions from their direct operations and energy use (Scope 1 and 2) by 2026. Emissions reporting from supply chains and other indirect sources (Scope 3) is required by 2027.[6]

Many companies pushed back against the new law, saying it will create significant new costs as they work to build systems and infrastructure to track and report the data. Even though many companies already have some level of internal tracking in place for direct greenhouse gas emissions (Scope 1 and Scope 2), and some provide related disclosures, they may face substantial hurdles to track and report Scope 3 emissions, which are linked to supply chains and end users. These Scope 3 emissions are particularly difficult to track, as they require companies to coordinate with suppliers, contractors, and other third parties up and down their supply chain.[7] Though they are challenging to track, they are not insignificant. According to the Environmental Protection Agency (EPA), supply chain emissions account for more than 90% of a company's greenhouse gas emissions.[8]

However, under the law, companies have time to grapple with these tracking challenges, as misstatements regarding Scope 3 emissions do not give rise to penalties until 2030. The law also provides a safe harbor thereafter for good faith disclosures.

SB 261

SB 261 will require public and private companies with total annual revenues exceeding US$500 million that do business in California to prepare a biennial climate-related financial risk report and publish a copy of the report publicly on the company website.

The report must disclose the company's climate-related financial risk based on the framework provided in the Final Report of Recommendations of the Task Force on Climate-related Financial Disclosures ("TCFD").[9] Alternatively, compliance can be achieved by preparing a climate-related risk disclosure report pursuant to another comparable law, regulation, or listing requirement issued by a regulated exchange or government which incorporates consistent disclosure requirements. That reciprocity provision recognizes that several governments around the world have adopted or are contemplating disclosures aligned with the TCFD. Companies may also voluntarily use a framework that meets the requirements of the International Financial Reporting Standards Sustainability Disclosure Standard.[10]

These disclosure requirements begin on January 1, 2026. Failure to publish such a report can result in penalties up to $50,000 per year.

AB 1305

AB 1305 is primarily focused on implementing disclosure requirements applicable to business entities operating in California and marketing, selling, purchasing, and/or using voluntary carbon offsets.[11] Companies will need to disclose on their websites information pertaining to the applicable carbon offset project including location, timeline, relevant standards, durability, independent third-party verification, and emissions reduced or removed. AB 1305 also requires that companies disclose accountability measures that apply if a carbon offset project is not completed or does not meet projected emission reduction or removal goals.

However, even some companies not engaged in voluntary carbon offset activity will have disclosure requirements imposed by AB 1305. Specifically, a company that operates within California or makes the following claims in California will now be required to disclose on its website specified information documenting the support and accuracy of such claims:

1. the achievement of net zero emissions,

2. claims that the company or a product is "carbon neutral," or

3. other claims implying the company or a product does not add net carbon dioxide or greenhouse gases to the climate, or has made significant reductions to its carbon dioxide or greenhouse gas emissions.

These disclosure requirements go into effect January 1, 2024. Failure to comply may result in a civil penalty of not more than $2,500 per day for each day the information is not available or accurate on the company website, not to exceed $500,000.

SEC's Proposed Climate Disclosure Rules

The SEC has been making similar efforts toward increased regulation around corporate climate disclosures. Last year, the SEC proposed regulations to require publicly traded companies to disclose various climate-related metrics including greenhouse gas emissions, spending, and risks.[12] The proposed rule is narrower than the new California law, as it currently only requires disclosure of Scope 3 emissions if they are material or if the company has set its own Scope 3 emissions targets. Because of the significant overlap, public companies who come into compliance with California's new law will face less of a financial and logistical burden if they are also eventually required to comply with the SEC's rule as currently proposed.[13]

The SEC rule was proposed in March 2022 and appears to be nearing finalization. Democratic lawmakers recently penned a letter to SEC Chair Gary Gensler, urging him to "expeditiously release a final, strong climate disclosure rule that results in detailed disclosure of . . . Scope 1, 2, and 3 greenhouse gas emissions, details around energy transition plans, and capital expenditures related to the transition."[14] California House Democrats also weighed in to "strongly urge" the SEC to "include robust greenhouse gas (GHG) emissions disclosure requirements in its final climate disclosure rulemaking, particularly in light of California's anticipated Scope 3 disclosure requirement."[15]

As we explained last year, critics have questioned whether the SEC has the statutory authority to regulate in the climate space. Although two statutes grant the SEC the authority to compel disclosure "necessary or appropriate in the public interest or for the protection of investors,"[16] some critics argued that the proposed rule interpreted this authority too broadly and failed to account for the statutory context, which limited the agency to regulating the disclosure of information linked to companies' financial results. Others similarly argued that there is no causal link between climate risk and financial performance, which limits the agency's power to compel this type of disclosure. Proponents of the rule argue that Congress, which has amended the securities laws numerous times since their inception, could easily have constrained the SEC's ability to compel disclosures on new topics. Its failure to do so, according to these proponents, is evidence of Congress's intent to leave these issues to agency discretion, giving the SEC the flexibility to respond to the changing investment environment.

In addition to the proposed rule, the SEC has also previously demonstrated its focus on climate-related disclosures by initiating enforcement actions against companies for alleged misstatements and omissions regarding environmental, social, and governance ("ESG") policies.[17] However, after three years as a stated priority of the SEC's Division of Examination, ESG fell off the list for 2024.[18] There are differing views on whether this change actually represents a shift away from ESG, as some think the SEC will continue to focus on ESG-related risk areas. Despite this pivot, companies must ensure their actions align with any public ESG statements or policies they present to investors.

Implications for the Duty to Disclose

The increased disclosure requirements on both the state and federal level raise questions regarding the duty to disclose, an issue currently before the Supreme Court. The Supreme Court recently agreed to hear a case on the scope of the duty to disclose under Item 303, concerning management's discussion and analysis of financial condition and results of operations, and its impact on potential securities litigation under Section 10(b) of the Securities Exchange Act. The objective of Item 303 "is to provide material information relevant to an assessment of the financial condition and results of operations of the registrant including an evaluation of the amounts and certainty of cash flows from operations and from outside sources."[19] There is a circuit split regarding whether Item 303 creates a duty to disclose a material fact that can give rise to a Section 10(b) securities fraud claim. The case[20] centers around allegations that the defendant failed to disclose the fact that its financials would be negatively impacted by a regulation aimed at phasing out high-sulfur fuel oil. The plaintiff alleged that the impact of the regulation caused disappointing earnings, leading to a stock price drop, and that the defendant should have known and disclosed the extent of the potential impact of the regulation on its financials. Three circuits—the Third Circuit,[21] Ninth Circuit,[22] and Eleventh Circuit[23]—have ruled that a public company's failure to make a disclosure required under Item 303 cannot, in and of itself, support a Section 10(b) claim without otherwise materially false or misleading affirmative misstatements. By contrast, the Second Circuit held that a Section 10(b) fraud claim can be based solely on a company's omissions in its Item 303 disclosures, as opposed to affirmative false statements. This distinction is an important one, especially in light of the new climate disclosure rules. If the Supreme Court rules that Item 303 creates a duty to disclose and can serve as the basis for a Section 10(b) claim, climate disclosures will need to be drafted with a focus on breadth and comprehensiveness to avoid any possibility of liability for omitting a material fact.

Because the California law goes further than the SEC's proposed rules in requiring disclosure of Scope 3 emissions regardless of materiality, companies cannot omit information about Scope 3 emissions from their SEC filings if they earn more than $1 billion and are doing business in California. This increased disclosure opens companies up to further litigation risk where there otherwise would be no duty to disclose.

Preparing for Compliance

While Governor Newsom has directed his administration to work with the authors of SB 253 and the Legislature in 2024 to address issues in the laws, including potentially infeasible deadlines and cost impact,[24] affected companies should assess how best to come into compliance with at least the new California laws, if not the SEC's proposed rule as well. Companies should evaluate their current reporting practices to ensure they have the appropriate systems in place to measure, collect, aggregate, validate, and report data, consistent with established climate accounting frameworks. Companies also need to ensure they have a system in place for tracking Scope 3 data from their supply chain partners. In addition to preparing for compliance with the reporting requirements, companies need to be more intentional in setting climate-related goals, making statements or claims related to such goals, and ensuring they are prepared to meet those self-imposed targets in order to avoid SEC enforcement actions and private securities class action claims. Importantly, companies subject to AB 1305 will need to disclose the required information by January 1, 2024 or be subject to civil penalties.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

San Francisco

Kenneth P. Herzinger
1.415.856.7040
kennethherzinger@paulhastings.com

Erin Zatlin
1.415.856.7029
erinzatlin@paulhastings.com

Washington, D.C.

Jonathan C. Drimmer
1.202.551.1870
jondrimmer@paulhastings.com

Tara K. Giunta
1.202.551.1791
taragiunta@paulhastings.com

Paige Rinderer
1.202.551.1812
paigerinderer@paulhastings.com

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[1] https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202320240SB253.

[2] https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202320240SB261.

[3] https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=202320240AB1305.

[4] The statute does not provide guidance on how revenues will be calculated or define "doing business" in California.

[5] https://ghgprotocol.org/.

[6] "This bill would require the state board, on or before January 1, 2025, to develop and adopt regulations requiring specified partnerships, corporations, limited liability companies, and other business entities with total annual revenues in excess of $1,000,000,000 and that do business in California, defined as "reporting entities," to publicly disclose to the emissions reporting organization, as defined, and obtain an assurance engagement on, starting in 2026 on a date to be determined by the state board, and annually thereafter, their scope 1 and scope 2 greenhouse gas emissions, as defined, and, starting in 2027 and annually thereafter, their scope 3 greenhouse gas emissions, as defined, from the reporting entity's prior fiscal year, as provided." https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202320240SB253.

[7] The Greenhouse Gas Protocol provides technical guidance for calculating Scope 3 emissions that companies can use as a starting point. *See* https://ghgprotocol.org/sites/default/files/2023-03/Scope3_Calculation_Guidance_0%5B1%5D.pdf.

[8] https://www.epa.gov/climateleadership/supply-chain-guidance.

[9] https://www.fsb-tcfd.org/recommendations/.

[10] https://www.ifrs.org/content/dam/ifrs/publications/pdf-standards-issb/english/2023/issued/part-a/issb-2023-a-ifrs-s2-climate-related-disclosures.pdf?bypass=on.

[11] https://legiscan.com/CA/text/AB1305/id/2841701.

[12] https://www.sec.gov/files/rules/proposed/2022/33-11042.pdf.

[13] If the SEC's final climate rule is less comprehensive than the California law, it may present questions regarding federal preemption.

[14] https://www.warren.senate.gov/imo/media/doc/2023.09.26%20Letter%20to%20SEC%20on%20Climate%20Risk%20Disclosure%20Rule.pdf.

[15] https://vargas.house.gov/imo/media/doc/letter_urging_sec_to_include_stricter_greenhouse_gas_emissions_disclosures_for_the_biggest_corporations.pdf.

[16] Securities Act of 1933, §§ 7, 10, 19(a); Securities Exchange Act of 1934, §§ 3(b), 12, 13, 14, 15(d), 23(a).

[17] https://www.sec.gov/securities-topics/enforcement-task-force-focused-climate-esg-issues.

[18] https://www.sec.gov/news/press-release/2023-222.

[19] https://www.law.cornell.edu/cfr/text/17/229.303.

[20] *Moab Partners, L.P. v. Macquarie Infrastructure Corporation*, No. 21-2524, 2022 WL 17815767 (2d Cir. Dec. 20, 2022).

[21] *Oran v. Stafford*, 226 F.3d 275, 286 n.6 (3d Cir. 2000).

[22] *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046, 1054, 1056 (9th Cir. 2014).

[23] *Carvelli v. Ocwen Fin. Corp.*, 934 F.3d 1307, 1331 (11th Cir. 2019).

[24] https://www.gov.ca.gov/wp-content/uploads/2023/10/SB-253-Signing.pdf.

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