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BNA Insights: Securities Litigation Canary in the Coal Mine: Investigation of Peabody Energy Corporation by the New York State Attorney General

BY TIMOTHY Q. PURDON AND NICOLE S. FRANK

According to the Mine Safety and Health Administration:

> Carbon monoxide, a potentially deadly gas devoid of color, taste or smell, can form underground during a mine fire or after a mine explosion . . . . [B]efore the availability of modern detection devices . . .[c]anaries. . .were used to alert miners to the presence of the poisonous gas. . . . . Any sign of distress from the canary was a clear signal that the conditions underground were unsafe, prompting a hasty return to the surface.[1]

Timothy Q. Purdon is partner and co-chair of the Government and Internal Investigations group at Robins Kaplan LLP. Tim is the former United States Attorney for the District of North Dakota and has spent his career leading complex criminal investigations and high stakes civil litigation from both the plaintiff and defense sides. He can be reached at TPurdon@RobinsKaplan.com.

Nicole S. Frank is an associate in the Business Litigation group at Robins Kaplan LLP. She has represented Fortune 100 corporations, start-up companies, and individuals in complex legal and business matters. She can be reached at NFrank@RobinsKaplan.com.

Like a caged canary in distress in a coal mine, the conclusion of the New York State Attorney General's investigation of Peabody Energy Corporation's securities disclosures in November 2015 should serve as an early warning to both coal producers and energy producers who rely on coal that there is danger in the air and that hasty efforts to reduce risk associated with past and future securities disclosure statements are necessary to avoid catastrophic results.

New York Attorney General's Investigation of Peabody Energy Corporation's Securities Disclosures

In February 2010, the Securities Exchange Commission (SEC) released interpretive guidance regarding disclosure requirements around climate change and its potential impact.[2] This new guidance on disclosures re-

[1] United States Dep't of Labor, Mine Safety and Health Administration — MSHA, *A Pictoral Walk Through the 20th Century: Canaries, available at* http://www.msha.gov/ century/canary/canary.asp.

[2] Commission Guidance Regarding Disclosure Related to Climate Change, *available at* http://www.sec.gov/rules/interp/2010/33-9106.pdf.

lated to carbon emissions immediately posed challenges to coal-mining companies, although the aftermath of where to draw the line in disclosing the impact of climate change has taken some years to surface. Selective disclosure of the adverse impact of climate-change legislation and regulation in public statements, or misleading by omission, may expose a coal company to risk. And with a rising collective consciousness around climate change, energy companies of all stripes should be on alert.

Any question as to the reality of this risk was answered on November 8, 2015, when Peabody Energy Corporation (Peabody)—the world's largest publicly traded coal company—entered into an Assurance of Discontinuance with the New York Attorney General (NYAG), marking the beginning of a new wave in securities litigation.[3] The Assurance of Discontinuance was the result of a two-year investigation by the NYAG's Office into Peabody's statements to the public and investors, including statements its shareholder disclosures filed with the SEC. While Peabody did not admit to any of the allegations made by the NYAG, this impact of the investigation and Assurance of Discontinuance on the company and its shareholders is clear.

Among the findings by the NYAG was that Peabody omitted less favorable scenarios by the International Energy Agency (IEA) on the world's future demand for coal and that Peabody outright denied its ability to predict the impact that potential regulation of climate change pollution (often focused on carbon emissions) may have on its business. The IEA, founded in 1974, is an organization, comprised of 29 member countries operating with the goal of promoting reliable and affordable clean energy. The IEA is considered the world's leading authority on global energy developments; it makes projections about energy, including the global coal demand, based on three ''scenarios.'' These scenarios include: (1) the New Policies Scenario, or the midline scenario, that incorporates into its projections already adopted policies and measures that affect the companies in the energy sector; (2) the Current Policies Scenario, which is the most favorable to the coal industry, does not account for recent commitments that do not yet have legislation supporting them and assumes continued global energy usage that ''would likely result in a global temperature rise of about six degrees Celsius''[4]; and (3) the 450 Scenario, or the low case for coal demand and usage, which considers and incorporates government policies that would, if enacted, restrict the global temperature rise to the desired two degrees Celsius.[5]

According to the investigation, Peabody denied this predictive ability in its public SEC financial filings while internally, hiring consultants for that very purpose and learning from consultants that regulations would have a significant impact on the coal business. Indeed, the Assurance at Paragraph 4 states that, ''in March 2014, Peabody hired an outside consulting firm, which projected that enactment of a $20 per ton carbon tax would reduce the demand for coal as a fuel source in electric power generation in the United States in 2020 by between 38% and 53% compared to 2013 levels.'' If accurate, the rate of decline predicted by Peabody's consulting firm over seven years would be devastating to the industry.

The Assurance requires Peabody to make significant additions to its shareholder disclosures, however, to reflect findings and projections by the IEA under both its New Policies Scenario and its 450 Scenario. In addition, Peabody may not represent that ''it cannot reasonably project or predict the range of impacts that any future laws, regulations, and policies relating to climate change or coal would have on Peabody's markets, operations, financial condition or cash flow'' in any public statement.[6] This result essentially strips Peabody from any non-committal statement about the adverse financial impacts of climate change and requires the company to accompany any statement about the difficulty of projecting the impact with ''a statement that Peabody has made projections of the impact of scenarios involving certain potential laws and regulations relating to climate change or coal, which could result in *materially adverse effects* on its market, operations, financial condition or cash flow''[7]—a stark departure from the company's past disclosures.

The NYAG had commenced its investigation two years prior pursuant to Article 23-A, Section 352 *et seq.* of the New York General Business Law (the ''Martin Act''), and Section 63(12) of the New York Executive Law. While the Assurance of Discontinuance between the NYAG and Peabody arose from New York state law, climate-change related legislation and regulation, which often has the potential to significantly impact an energy company's business, can originate from local, state, national, and even international governing bodies.

What the Investigation of Peabody Means for the Coal Industry

Coal remains the biggest generator of electricity in the U.S.[8] but its future amidst the growing aversion to high-carbon energy sources, combined with the risk that coal reserves may not much longer be profitably mined,[9] raises questions about the future of the coal industry. To compound the troubles faced by coal compa-

[3] *In the Matter of Investigation by Eric T. Schneiderman, Attorney General of the State of New York, of Peabody Energy Corporation*, Assurance No. 15-242, *available at* http://ag.ny.gov/pdfs/Peabody-Energy-Assurance-signed.pdf.

[4] *In the Matter of Investigation by Eric T. Schneiderman, Attorney General of the State of New York, of Peabody Energy Corporation*, Assurance No. 15-242, at ¶ 11, *available at* http://ag.ny.gov/pdfs/Peabody-Energy-Assurance-signed.pdf.

[5] *Id.* at ¶ 12.

[6] *In the Matter of Investigation by Eric T. Schneiderman, Attorney General of the State of New York, of Peabody Energy Corporation*, Assurance No. 15-242, at Agreement 1(c), page 9, *available at* http://ag.ny.gov/pdfs/Peabody-Energy-Assurance-signed.pdf.

[7] *Id.* (emphasis added).

[8] Alexander C. Kaufman, *This is the Beginning of the End of the Fossil Fuel Industry: Oil and coal companies are either going to have to invest in renewables, or perish*, The Huffington Post, December 2, 2015, *available at* http://www.huffingtonpost.com/entry/end-of-fossil-fuels_564f7457e4b0258edb316faf.

[9] Zane Selvans, *Warning: Faulty Reporting on US Coal Supplies, October 30, 2015: Peak Coal Report: U.S. Coal ''Reserves'' Are Incorrectly Calculated, Supposed 200-Year Supply Could Run Out In 20 Years Or Less*, Clean Energy Action, October 30, 2013, *available at* http://cleanenergyaction.org/2013/10/30/warning-faulty-reporting-on-us-coal-supplies/.

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nies, banks are beginning to adopt policies against providing lending and underwriting services to coal mining companies. As recently as early October 2015, Citigroup released a policy to cut lending to the coal mining industry, joining Bank of America and Crédit Agricole to become the third major bank to end its financing of coal.[10] Morgan Stanley and Wells Fargo were not far behind—at the end of November 2015, both announced a commitment to reduce lending for coal mining and for mountaintop removal mining in particular.[11] Morgan Stanley's policy applies not only to lending and underwriting for coal mining but also extends to coal-fired power plant construction in developed countries. No doubt, Peabody, Alpha Natural Resources, and other giants in the coal industry will need to tread carefully in determining how to thoughtfully disclose these threats to viability to investors. This is because, while these threats are mounting, global demand for coal will not disappear anytime soon. "A future dominated by natural gas and renewables is unrealistic and unwise, the executives [at the Wells Fargo Securities Energy Symposium] said, pointing to a lack of sufficient gas infrastructure to support a total backing out of coal."[12] The world will likely require continued use of at least some coal during a transition to more renewable energy options.

Some coal producing companies, such as Alpha Natural Resources, are taking more of a maintain-calm-in-the-storm approach, and "will use bankruptcy to keep downsizing and prepare for the future . . . estimating that coal-fired plants will continue to supply 30 percent to 40 percent of U.S. electricity 'for the foreseeable future,' even as utilities opt for more renewable energy and natural gas."[13] Other companies like Duke Energy are opting to diversify and expand into alternatives to coal-fired power plants.[14] "If Duke can successfully diversify its product offering into solar, then the company can effectively rebound from increased regulations on coal power plants."[15]

[10] Rainforest Action Network, *Citigroup Becomes Third Major Bank to Cut Financing to Coal Industry, Rainforest Action Network*, Eco Watch, October 5, 2015, *available at* http://ecowatch.com/2015/10/05/citigroup-cut-coal-financing/.

[11] Juan Carlos Rodriguez, *Morgan Stanley, Wells Fargo Cut Back On Coal Financing*, Law360, November 30, 2015, *available at* http://www.law360.com/articles/732186/.
morgan-stanley-wells-fargo-cut-back-on-coal-financing.

[12] Richard Nemec, *Fuel Diversification Key to Power Sector's Future, Execs Say*, Natural Gas Intelligence, December 12, 2014, *available at* http://www.naturalgasintel.com/articles/100713-fuel-diversification-key-to-power-sectors-future-execs-say.

[13] Linda Sandler, Tim Loh, Jodi Xu Klein and Laura J. Keller, *Coal Miner Alpha Natural Resources Files for Bankruptcy*, Bloomberg Business, August 3, 2015, *available at* http://www.bloomberg.com/news/articles/2015-08-03/coal-miner-alpha-natural-resources-files-for-bankruptcy.

[14] Brandon Dempster, *Duke Energy Is Diversifying And Expanding*, Seeking Alpha, August 8, 2015, *available at* http://seekingalpha.com/article/3418346-duke-energy-is-diversifying-and-expanding.

[15] *Id.*

What the Peabody Investigation Could Mean for Energy Companies and Electricity Producers Who Rely on Coal

The focus of climate change regulation is shifting away from attempting to reduce carbon emissions through restricting fossil fuel *demand* by limiting countries' overall greenhouse gas emissions, toward a new strategy to restrict the fossil fuel *supply*.[16] With Peabody and the coal-mining industry in general serving as the first "canary in the coal mine," shareholders of companies in the other sectors of energy downstream from the coal mining companies, like those generating electric power from coal, may soon be asking hard questions about disclosures by these companies. They may review public statements and 10-Ks for nondisclosure of the impact on future or pending legislation and regulations on coal supply and/or on the viability of aging coal-fired power plants. For example, they may inquire into the efforts those companies have made since 2010 to disclose the risk that their primary fuel source for electricity (coal) will drastically decrease due to coal companies' poor financial performance and inability to obtain financing because of heightened carbon emission regulations. Shareholders may also ask about how effectively energy companies are diversifying their investments to arrange for alternative fuel sources such as natural gas, solar, wind, and clean coal technology. Given that the path forward is "a diversity of fuel supplies beyond natural gas and renewables, recognizing that this means technology advancements will be needed to make clean coal commercially viable."[17] Investors may ask whether diversification efforts begin early enough and whether these risk and efforts have been properly disclosed.

One might additionally expect investors and shareholders to argue that fiduciary duties of corporate directors require that risks arising from heightened carbon emission regulations or climate change generally be considered, managed and disclosed. Fiduciary duty obligations generally arose from the state law of incorporation and may be conceptually applied to myriad conduct or nonfeasance. But such law is beginning to develop in the federal courts, particularly in the context of securities litigation. *See, e.g.*, *AP Services, LLP v. Lobell et al.*, No. 651613/12, 2015 N.Y. Misc. LEXIS 2314, 2015 NY Slip Op 31115(U), at *19 (N.Y. Sup. Ct. June 19, 2015) (motion to dismiss by directors denied for breach of fiduciary duty of care by disregarding issues "visible from the face of key transaction documents.").

What's Next?

The NYAG's investigation into Peabody's projections of the adverse impacts to its coal-centered business

[16] Luke Kemp, *The Paris Agreement won't stop coal, but future climate talks might*, The Conversation, December 12, 2015, *available at* http://theconversation.com/the-paris-agreement-wont-stop-coal-but-future-climate-talks-might-51241.

[17] Richard Nemec, *Fuel Diversification Key to Power Sector's Future, Execs Say*, Natural Gas Intelligence, December 12, 2014 (reporting on the consensus arrived at by a panel of three members with stakes in coal-fired generation and another member with a renewable energy company), *available at* http://www.naturalgasintel.com/articles/100713-fuel-diversification-key-to-power-sectors-future-execs-say.

from the potential regulation of climate change focused on its Form 10-K Annual Reports from 2011 to 2014. That first of its kind investigation is only the beginning for the energy sector. Always lurking around the corner from investigations by state Attorneys General are private securities lawsuits. Damages from such suits could be just as daunting as the hostile market for fuel sources with a high percentage of greenhouse gas emissions.

Securities class action plaintiffs have used the Private Securities Litigation Reform Act of 1995 (PSLRA) as a means of suing for damages associated with statements in public filings, including a company's future projections. PSLRA allows for a ''safe harbor'' for non-historical, forward-looking statements that are subject to risks and uncertainties that could cause the actual future events to materially differ.[18] These risks and uncertainties include uncertainties over projections generally.

In securities law litigation, calculating damages can be a challenging exercise wherein experts opine as to the securities' true value at different periods of time. A theory advanced by plaintiffs (investors) in securities litigation is that a security may be inflated over its true value, based on reactions of shareholders and investors to misleading public statements. One might expect a plaintiff under those circumstances to argue that damages arose as a result of various disclosures or nondisclosures in public statements, such as SEC filings or earnings calls, which value assets or liabilities or future prospects of the company. The typical response to similar allegations has been reliance by defendants in the ''safe harbor'' language used in investor meetings or company filings. Whether such language would adequately suffice to avoid such damages depends upon the specific language and context of the material misstatement.

Conclusion

As the world begins quantifying the changes necessary to limit global warming, the landscape for energy is changing. Peabody's example is the first in what will likely be a domino as first coal companies and then energy producers reliant on coal face scrutiny over disclosures to shareholders related to the impact of climate-change legislation and regulation on their business. The Peabody canary was just the first to succumb to what could be a gas cloud of litigation as investors begin to carefully consider what has or has not been disclosed about these risks by coal companies and electricity producers. On one side, institutional investors will require additional guidance from experienced securities litigators as more precedent is established as to what constitutes adequate and inadequate disclosure of this risk. On the other, coal companies and electricity producers will also need access to experienced securities litigators to discuss how to minimize their risks going forward.

[18] *See* Securities Act § § 27A(c)(1)(A)(i), 27A(c)(1)(B); Exchange Act § § 21E(c)(1)(A)(i), 21E(c)(1)(B).

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