Faced with the twin specters of imminent climate change regulation and the potential of increased litigation relating to greenhouse gas emissions, companies must revisit how their contractual relationships deal with the costs, delays and other risks posed by climate change. This e-alert addresses contractual risk allocation mechanisms that should be considered by parties in light of ongoing developments pertaining to climate change, and provides some general recommendations and practical advice that businesses should consider in preparing and negotiating contracts now to address climate change risks and liabilities.

Increased Regulatory and Litigation Risks

While climate change regulation has been looming on the horizon in the United States for over a decade, President Obama and his cabinet have made it a priority to enact new federal regulation of greenhouse gases and other emissions. The current administration has announced that it intends to pursue reductions in greenhouse gas emissions in the range of 17 percent below 2005 levels by 2020 and 83 percent by 2050. Neither the overall framework nor any particular details of upcoming regulation are currently available, but individual states and federal agencies, such as the U.S. Environmental Protection Agency, have proceeded to adopt their own greenhouse gas regulatory programs while Congress continues to debate legislation. Even companies whose activities pose little to no environmental risk may be significantly affected by climate change regulations, as demonstrated by regulations adopted recently in the United Kingdom and the European Union. Existing and proposed regulatory regimes have already begun to produce uncertainty and risks in all manner of commercial agreements, from mergers and acquisition agreements to long-term supply and services contracts.

In addition to an uncertain regulatory environment, businesses are confronting climate change pressures arising from litigation as well as increasing demands from customers, investor groups and the general public. On the litigation front, recent decisions from federal courts in the U.S. have recognized federal common law public nuisance claims challenging greenhouse gas emissions, thereby acknowledging the standing of states, private environmental groups and property owners to bring claims. See State of Connecticut, et al. v. American Electric Power Company Inc., et al., Nos. 05-5104-cv and 05-5119-cv (2d Cir. Sept. 21, 2009); Ned Comer, et al. v. Murphy Oil USA, et al., No. 07-60756 (5th Cir. Oct. 16, 2009). While these sorts of claims are not yet settled law, there is a strong consensus within the legal community that there will be a significant increase in climate change tort claims. The expected increase in litigation is linked in part to the popularization of the climate change debate, and the resulting increased public awareness of risks and potential liabilities connected to greenhouse gas emissions.
Short-Term Contract Risk Allocation

Representations and Warranties. In asset and equity purchase and sale agreements, the most common and traditional means of addressing the risks of liability is through the representations and warranties made by each party, taking into account any disclosure schedules that may supplement or qualify those representations. The parties typically represent and warrant to each other their compliance with laws in effect as of signing and closing of the transaction. Given the rapidly changing nature of climate change law, however, as evidenced by the recent sequence of federal court decisions and regulatory orders described above, it can be difficult at any time to ascertain the current state of climate change law, and therefore to assess the full implications of potentially relevant representations and warranties.

Anticipated risks, such as new environmental regulation or an expanded list of contaminants, are normally beyond the scope of representations and warranties. An exception to this general rule is when the parties have a relatively high degree of certainty as to impending events, such as when a new piece of legislation is in its final stages but is not yet in force, or when a regulation has become effective but is subject to a transition period or the issuance of guidelines or interpretive rulings from an applicable regulatory authority. In such circumstances, contractual representations may appropriately speak as to the parties’ expected compliance with proposed legislation, qualified by their current knowledge and understanding. The drawbacks of this approach are obvious: the representations will be limited to the parties’ knowledge at the time of signing and closing, and may not accurately deal with the ultimate form of the regulation.

Covenants. A typical commercial contract will also contain a number of covenants, which govern the conduct of both parties during the period between signing and closing of the transaction, as well as their conduct following the closing. The covenants relating to the period between signing and closing generally focus on maintaining the applicable business or assets in their current state until closing. Typically the parties agree to act as they would in the ordinary course of business, in a manner consistent with past practice and in accordance with “Applicable Law” as defined in the contract. For purposes of climate change regulation and risk allocation, these pre-closing period covenants raise several questions. Will the parties have the particular foresight to address climate change regulation in the definition of Applicable Law? Should the parties specifically account for costs, delays and other liabilities associated with regulatory compliance should there be a change in law between signing and closing? Will conducting a defense against greenhouse gas emissions litigation be considered to be within the ordinary course of business and consistent with past practice? Similar questions arise with respect to covenants that continue in effect after closing, such as where the parties have committed to longer-term cooperation or where payments to a seller depend upon the post-closing financial performance of the assets or business being sold. In these situations, a seller is likely to insist that the buyer has assumed the risks and liabilities associated with new climate change laws and regulations, even if those risks and liabilities may have been foreseeable as of the closing. Conversely, a buyer may well argue that seller’s right to payment should be reduced to reflect the costs and liabilities imposed by new but reasonably foreseeable climate change legal risks.

Indemnification. Contracts generally rely upon indemnification provisions to provide specific allocation of risks for breach of the contract representations, warranties and covenants. In a typical sale transaction, a seller may indemnify the buyer for a limited period of time after the closing for any claims relating to breaches of the seller’s representations, warranties or covenants, up to a specified maximum amount. Whether a seller’s indemnification will be an adequate remedy to deal with climate change compliance costs or litigation claims is an open question in the context of the currently uncertain landscape. The indemnification period for breach of representations and warranties often expires only a year or two after the closing. Depending upon the risk tolerance of the parties, the agreement could provide for a longer indemnification period (or higher caps on indemnifiable amounts) for claims relating specifically to climate change or greenhouse gas emissions lawsuits from third parties. But the effectiveness of the indemnification provisions will be predicated on the precise language of the representations, warranties, and covenants. If they
fail adequately to encompass potential changes in, or changes in the interpretation or application of, climate change laws or regulations or litigation claims, it is unlikely that any contractual duty to indemnify would apply.

Whether or not the parties will insist upon -- or even consider -- modifying their contracts to deal with the concerns outlined above will probably turn on the likelihood of the risk that new regulation or litigation pose to the parties, coupled with the likely magnitude of the liability resulting from such risk. Two internet companies signing a contract today may appear to have little need to dwell on such risks, whereas two power companies engaging in a long-term power supply agreement may find themselves embroiled with the task of predicting the likelihood of litigation or regulation as well as the potential resulting exposure.

**Long-Term Contract Risk Allocation**

Long-term agreements are typical in many contexts - especially in supply arrangements, such as sales of energy and natural resources -- as a means of ensuring a reliable supply and steady return on investment. The contractual stability and predictability that are characteristically sought by parties to a long-term arrangement are frustrated where there is a likelihood of changes in the regulatory environment or litigation landscape. Fundamentally, the parties’ exposure to climate change risk will depend in part on the extent to which their ongoing arrangements address the possibility that the original bargained-for transaction may be significantly altered by a change in circumstances. A long-term contract will typically allocate this risk through a combination of pricing, change in law and pass-through provisions.

- **Pricing Changes:** Long-term contracts often provide for the parties to revise pricing structures, many times automatically, in light of changed costs and circumstances – within certain parameters and subject to maximum and minimum thresholds. But in the context of impending climate change regulation, it is difficult to predict how the market will respond to any new regulatory framework, especially when the form and implementation of the new framework are unknown at the time of signing.

The parties risk having too much (or too little) variance in pricing, injecting a potentially unacceptable level of uncertainty and variation for a long-term contract, where stability is most favored.

- **Change in Law Provisions:** These provisions typically provide that in the event of certain changes in laws, such as changes in environmental or tax laws or regulations, the affected party (usually the seller) will have the right to require that the other party share in the increased costs. The provisions often establish cost-sharing between the parties on a pre-agreed basis, usually after some threshold in cost increases has been exceeded, but may instead require that the parties renegotiate the contract in good faith to take account of the effects of new laws or regulations. Parties should consider whether a change in greenhouse gas regulation would constitute a change in law under their agreements. A generic change of law provision may not fully address the possible business costs of a new climate change regime and attendant delays in implementation and research.

- **Cost Pass-Through:** A supplier in a long-term contract may have the ability, subject to agreed-upon thresholds and limits, to pass on its unforeseen additional costs to the purchaser. In the context of climate change, new carbon taxes or regulatory compliance costs or greenhouse gas-related litigation pose a particular challenge. Will a given pass-through provision adequately define what sorts of new technology or compliance expenses are appropriately passed on, which a typical pass-through provision would not permit? Will the provision speak as to how frequently prices may be adjusted? Will the provision require the supplier to obtain replacement sources of supply or otherwise restructure its operations to mitigate the impact of new regulation before passing on new costs? Are the costs of defending a nuisance suit the sort of expense that can be passed on to the purchaser, if the suit stems from the production of goods produced solely for the purchaser? As these provisions become
increasingly complicated, parties should be sure to include a clear and robust dispute-resolution system, providing for expert assessments and ongoing audit rights.

Parties may also consider resorting to other clauses in their agreements for potential relief should their businesses be adversely affected by climate change developments. For example, a force majeure clause typically excuses a party from performing under the contract upon the occurrence of an unforeseen and uncontrollable event that falls within the provision. While governmental acts can sometimes constitute force majeure, it is unlikely that climate change regulation (or, for that matter, climate change lawsuits) would be deemed sufficiently unforeseeable at this point to fall within the scope of a force majeure clause, unless the agreement was entered into some time ago. Similarly, a party may seek to invoke a material adverse change clause in an agreement, claiming that increased regulatory burdens, increased compliance costs, unavailability of financing, litigation costs or other costs related to climate change have resulted in a material adverse effect on its business. Depending upon the language of the applicable provision, the occurrence of a material adverse change could excuse performance or provide grounds for terminating the agreement.

What to Do Now

As a preliminary matter, companies need to determine the extent to which their operations and business arrangements are likely to be affected by climate change regulation and litigation. This assessment can be a daunting task, since the full extent of such risks and liabilities is not yet known. Companies should nevertheless attempt to identify vulnerable areas of their business and those customers and suppliers that may experience increased costs, delays or service interruptions as a result of climate change regulation and litigation. From there, companies should confer with business partners and counsel to develop preferred approaches for dealing with climate change regulatory and litigation risks in contracts. A consistent approach to the contractual provisions discussed above will be an important factor in determining ongoing levels of risk and liability. Finally, businesses should review their standard contractual terms to ensure that climate change risks and liabilities are specifically addressed to the extent possible.