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Frequently
Asked Questions
About Climate
Change &
Sustainability

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Although the subject of climate change has roared into everyday political and economic discourse, few businesses feel confident they can gauge the likely impact of climate change on their operations. Even more uncertain are the laws and regulations being considered to mitigate its effects. Just as the ascendancy of the Internet and the globalization of labor have created massive challenges and opportunities, so will society's response to the challenge of climate change alter—in some cases, radically—the legal obligations and liabilities of companies worldwide.

To prepare our clients for the potential impact of climate change on policy, law and regulation, Pillsbury established a cross-disciplinary team dedicated to climate change and sustainability. This team now assists clients across industries on this complex set of issues to develop legal strategies that both protect their interests and expand their opportunities. While public opinion is morphing rapidly as scientists reach consensus on the subject and political leaders adjust their thinking, Pillsbury's Climate Change & Sustainability team is keeping clients informed and prepared for critical actions ahead.

The challenge

The worldwide scientific consensus is that air and water temperatures have risen significantly over the course of the Industrial Revolution, especially in recent decades. Continued increases in temperatures are predicted to change the air-ocean system in ways that will significantly affect mankind. In 2007, the United Nations panel on climate concluded that most of the increase in temperatures since the mid-1900s is likely due to man-made emissions of greenhouse gases, notably carbon dioxide, methane and nitrous oxide.

The climate change issue has penetrated the business domain, presenting new challenges and opportunities. New taxes on carbon emissions, the advent of climate-change-related nuisance lawsuits and the sheer complexity of regulations all translate the macro issue of climate change into the pressing arena of business operations.

It's one thing to speculate on the nature and causes of global warming. But, beyond speculation, there is an immediate need to respond to heightened legislative and regulatory measures already in place or on the drawing board. The pressing question is: What should a company know and consider when building a strategic plan for dealing with the issues of climate change?

The following brief discussion provides a review of salient questions and the outline of a serious action plan.

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1

What do businesses need to know about the actions of the international community?

As concern for climate change has intensified worldwide, the international community has adopted a range of initiatives, from promoting research to committing to reduce greenhouse gases to signing treaties for the reduction of greenhouse gas emissions.

Though the U.S. did not sign the Kyoto Protocol, it previously joined 189 nations in a treaty to prevent “dangerous” human interference in the climate system and establish the Framework Convention on Climate Change (FCCC). The Kyoto Protocol, an annex to the FCCC made effective in 2005 by 175 of the FCCC parties, committed thirty-six industrialized nations to reduce their emissions of certain gases to about 5 percent below 1990 levels by 2012.

Of key importance to future policymaking was that the protocol allows industrialized countries to satisfy their obligations, in part, through reductions achieved in other countries. This led to a system for stimulating and certifying greenhouse gas reduction in the Third World, eventually generating a lively world market in emission reduction credits.



Key takeaway: Irrespective of specific debates on the reality, causes and consequences of climate change, businesses need to know that the global community is firmly committed to serious initiatives and is increasingly acting in concert to reduce the emissions of greenhouse gases.

In this way, the Kyoto Protocol encouraged global consideration of emission credit trading as an efficient way to reduce emissions. This market-driven dimension of climate change policy holds promise and challenges for businesses worldwide.

Since Kyoto, multinational initiatives continue. Last year in Bali, 180 countries agreed to discuss deep cuts in emissions and to take steps to halt tropical rainforest destruction, which generates 20 percent of heat-trapping emissions every year.

2

What is the cap-and-trade approach to reducing greenhouse gas emissions?

As policymakers worldwide experiment with a dizzying array of approaches, one of the most widely accepted is known as “cap-and-trade.” Successfully used in the U.S. Acid Rain Program of the 1990s, cap-and-trade programs have proven to be effective in lowering emissions at minimum cost. In recognition of this fact, the European Union has instituted a region-wide cap-and-trade effort of its own to address greenhouse gas emissions.

The basic elements of a cap-and-trade program are:

- defining the universe of sources that are to be subject to the emissions cap
- setting the cap level and any rate of future cap reductions
- creating a system of enforceable, marketable “allowances” that correspond in number to the cap



Key takeaway: Worldwide multinational cap-and-trade programs are a profound development in the design of regulatory programs, since they entail government oversight with a significant market-based mechanism.

- distributing the allowances initially to the sources
- establishing a transparent system for tracking transactions in allowances and source-by- source compliance
- forming a potential “safety valve” (e.g., a mechanism for controlling the supply of allowances so as to manage price) and exploring the use of external offsets and a banking system.

For the system to work, it is critical to monitor emissions continuously, reliably and inexpensively. A well-designed cap-and-trade program gives the regulated sources the widest latitude in achieving reductions and in finding the lowest-cost solutions.

3

Should business be bracing for possible carbon taxes?

In the realm of policymaking, one alternative to a cap-and-trade approach is the carbon tax.

Any carbon tax is essentially a fee on the importation, production or use of energy sources (such as coal, petroleum and natural gas), proportional to that source's carbon content. The rationale is that carbon tax-inflated energy prices for end-users will encourage conservation and cut emissions. Similarly, raising the price on carbon-rich fuels would presumably make carbon-free (and so tax-free) alternative energy sources more competitive.

Unlike an emissions trading system, carbon tax payments would be made directly to governments rather than to a market actor, and the tax would be fixed for a time rather than fluctuate with demand.

Two principal proposals for carbon pricing have been introduced in the U.S. House of Representatives. One sets an initial price of \$10 per ton of carbon and raises the price \$10 every year until U.S. emissions drop to 80 percent of 1990 levels. The other sets an initial price of \$15 per ton. As with most tax measures, however, such proposals are difficult to pass and have been eclipsed by cap-and-trade approaches in the congressional debate.



Key takeaway: While no one can predict the course of tax policy—especially with regard to climate change—it is likely that a carbon tax will continue to take a back seat to cap-and-trade in the minds of congressional policymakers.

4

How is the federal government actively addressing climate change?

On the international scene, the U.S. has already taken part in multilateral initiatives, including an Asia-Pacific partnership to transfer clean energy technologies to less developed nations. The U.S. also organized a carbon forum to facilitate geologic carbon sequestration and joined other nations and states to create a “climate action partnership” to design and harmonize cap-and-trade programs worldwide.

Here at home, the U.S. Department of Energy is running large-scale R&D programs to promote clean coal technology and other initiatives. The Environmental Protection Agency launched voluntary programs aimed at energy conservation and greenhouse gas reductions. Both the National Environmental Policy Act and Endangered Species Act draw upon emerging scientific and policy dimensions of climate change.

According to the U.S. Supreme Court, the federal Clean Air Act confers on the EPA the core authority to regulate CO₂ from auto tailpipe emissions. Due to a subsequent decision by the DC Circuit, the EPA will also face the climate change issue in the context of steam-generating units such as boilers. Parallel language in other sections of the Act may prompt the EPA to advance standards related to air quality and greenhouse gas emissions.



Key takeaway: Even as Congress and the nation debate climate change, the federal government is already active abroad and at home in establishing its obligations and implementing actions to address the climate change challenge. It is using existing authorities where possible to address climate change issues.

5

What do we need to know about action at the state level?

State governments are not idly waiting for federal action. About 30 states have completed or are working on action plans that seek cost-effective reduction of greenhouse gas emissions. These plans include initiatives to conduct emissions inventories, project future emissions based on population and economic growth, identify areas where emissions can be reduced and develop reduction goals.

In 2003, the governors of Connecticut, Delaware, Maine, New Hampshire, New Jersey, New York and Vermont formed a regional coalition that, two years later, issued a memorandum outlining a cap-and-trade program to reduce emissions from large power plants. Since then, the District of Columbia, Pennsylvania, and the provinces of Ontario, Quebec and New Brunswick have declared themselves to be observers of the coalition. Other coalitions have sprung up, including a West Coast governors' global warming initiative, a Western governors' group on clean and diversified energy and a conference of New England governors in concert with Eastern Canadian premiers.

California is the first state to take comprehensive action. California established a greenhouse gas registry in 2001 and, in 2006, became the first state to mandate the creation of an emissions regulatory program. The Global Warming Solutions Act, also known as "AB32," sets out the broad contours of California's climate change program. Under the law, the state will adopt regulations to reduce statewide greenhouse gas emissions back to 1990 levels by the year 2020, this reduction to be achieved through an anticipated mix of control technology requirements, offsets and conservation.



Key takeaway: States and regions are very active in promulgating legislation and taking decisive, discrete actions to curtail the effects of greenhouse gas emissions.

Moreover, greenhouse gas emissions must be reported annually, and emitters will be allowed to adhere to “discrete early action reduction measures.” All adopted control measures must be technologically feasible and cost-effective, and market-based mechanisms are authorized.

Other states are pushing forward, as well. In 2007, Hawaii and New Jersey enacted climate change legislation, including mandatory greenhouse gas reductions.

Finally, individual states are starting to factor in the effects of carbon emissions as part of their environmental reviews. Kansas recently denied an air permit for a massive coal-fired power plant based on the concern that such power substantially contributes to global warming. Florida rejected a large coal plant, citing the significant future costs of the effects of carbon dioxide emissions. In Oklahoma, a request for the pre-approval of a massive coal-fired power plant was rejected on the basis that the applicant had not sufficiently explored alternative forms of energy. And in California, the state attorney general is actively commenting on the adequacy of greenhouse gas analyses in environmental review documents. We believe that the trend will continue and that the potential effects of greenhouse gases will be considered in a wide variety of proposed projects.

6

Is the U.S. Congress just debating—or doing?

Responding to public concern, the U.S. Congress has become more and more active in taking up the climate change challenge. It has passed legislation relating to renewable energy forms such as ethanol, and it is considering bills pertaining to energy policy, greenhouse gas regulation, cap-and-trade programs, carbon taxes and incentives for carbon sequestration.

In fact, roughly 50 bills targeting climate change were introduced in early 2007, though only one received serious consideration. This bill—reported to the full Senate in late 2007—would cap emissions of CO₂ and other greenhouse gases and ratchet down those caps for a 38-year period. This would result in 2050 emission levels at 70 percent below 2005 levels. It also sets up a system of tradable emissions credits that would be both allocated and auctioned to facilities emitting greenhouse gases. The market for such emissions credits is expected to allow emitters of gases to choose the best way to reduce emissions, whether through pollution control technology or the purchase of emissions credits to cover excess emissions.

Meanwhile, committees in the House of Representatives focused on energy legislation in 2007, slowing their consideration of climate change bills. One bill that will affect emissions of greenhouse gases passed Congress and was signed by the president near the end of 2007.



Key takeaway: The U.S. Congress is seriously debating passing legislation spurred by climate change concerns. It will likely enact comprehensive legislation in the first 12 to 24 months of the next presidency.

This brand-new piece of legislation has many components. For one thing, it mandates improved fuel economy by raising current standards of 27.5 mpg for cars and 22.5 mpg for trucks to 35 mpg for both types of vehicles by 2020. The legislation offers assistance to manufacturing plants that make fuel-efficient cars and auto parts, and provides funding for automakers to upgrade plants for building advanced-technology vehicles.

In addition, to reduce emissions while decreasing U.S. dependence on foreign oil, the new bill supports increased use of renewable fuels. The previous national mandate required the consumption of 7.5 billion gallons of renewable fuels by 2012. The new renewable fuel mandate requires the use of 36 billion gallons by 2022, including 15 billion gallons of corn-based ethanol and 21 billion gallons of advanced biofuels, such as cellulosic ethanol.

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How has climate change policy created specific business opportunities?

Last year, venture capital funds made record levels of investment in energy, environmental, specialty chemical and materials science companies pursuing opportunities in clean technology. In the U.S., climate change policy is helping to create markets for these new products. President Bush recently committed \$2 billion over the next three years to create an international clean energy technology fund. The fund will accelerate the deployment of new technologies in developing nations and, in doing so, make private-sector investment more financially attractive. Likewise, tax incentives and trade policy are being managed to encourage investment in climate change technologies.

The opportunities in clean tech are too numerous to catalog here; developments in financial markets, however, deserve some explanation. For instance, new markets are emerging to trade carbon credits created by cap-and-trade programs. Cap-and-trade programs are designed to create valuable, tradable commodities—that is, intangible emission rights, typically expressed in terms of tons of a pollutant for a particular (“vintage”) year. To date, all such programs issue tradable “allowances” in an amount corresponding to the cap for a particular year, and then require emitting units to cover their actual emissions with allowances each year. Typically, allowances can be banked, with surpluses in one year used to cover emissions in a later year.

Some cap-and-trade programs provide another set of rights: credits granted for qualified emission reduction outside of the cap-and-trade program. To be creditable, such reductions typically must be



Key takeaway: Even as climate change policies impose new obligations on business, they are creating opportunities, such as a lively market in carbon credits.

real, permanent, quantifiable, enforceable, sustainable and supplemental. These so-called “offset” credits can then be used to cover actual emissions. In the climate change community, allowances and offset credits are grouped under the heading “carbon credits.”

The EU Emissions Trading Scheme is a prime example. Emitting units receive allowances they can trade. In addition, they may use offset credits from the Kyoto Protocol’s Clean Development Mechanism (CDM) and Joint Implementation Mechanism to achieve compliance, under conditions still being developed. This has injected value into these allowances and offset credits, and has given birth to a market for trading them. Indeed, any qualified person, in addition to emitters, may hold allowances and credits, and take part in the market in pursuit of investment gain.

Businesses can benefit from these emerging commodity markets. They offer investors new opportunities for profitable trading, and give emitting units a tool to minimize compliance risks and costs. A U.S. electric utility, for example, might want to invest in creating or purchasing CDM credits for use in a later U.S. cap-and-trade program. Similarly, an investment bank might want to purchase and hold allowances for use in later years in the hope that allowance prices might rise as a particular cap might drop. Another example might be the creation of an investment fund by a segment of manufacturing companies to buy and hold a variety of carbon credits for later use by each for compliance.

In the absence of a cap-and-trade program or Kyoto mechanism, there are now markets in the U.S. for credits granted for voluntary GHG emission reduction. But demand for voluntary credits—including those traded on the principal market, the Chicago Climate Exchange—is likely to wane as mandatory cap-and-trade programs come into existence.

8

Are there also benefits to the real estate industry?

Many cities, such as Washington, DC, and San Francisco, now mandate that new buildings and major renovations observe “green building requirements.” These are intended to increase efficiency, promote occupant health and minimize impact on the natural environment. These requirements, which seem to impose costs in the short term, actually entail significant business benefits. First, there are tax advantages to building green. The Energy Policy Act of 2005 provides a federal tax deduction of between \$0.03 and \$1.80 per square foot through 2008 for commercial buildings placed in service after January 1, 2006, that meet certain efficiency standards. Many local and state jurisdictions have similar tax incentives. There are 12 federal initiatives for green buildings, including the Department of Agriculture’s requirement that new construction or major renovation of covered facilities meet certain “Leadership in Energy and Environmental Design” (LEED) standards and the EPA’s mandate that buildings of 20,000 square feet or more meet an even higher LEED standard.

Second, recent studies show no significant difference in average construction and/or renovation costs for green buildings as compared with non-green buildings. Furthermore, operational costs for green buildings are substantially lower over their lifetimes.

The nonprofit U.S. Green Building Council has developed standards for LEED, which are the most widely accepted standards for the design, construction, operation and certification of green buildings. LEED standards help localities create uniform codes, and LEED certification independently verifies that a building project meets the specified performance standards.



Key takeaway: Concern over climate change is leading to stringent new building requirements, but these often enable real estate participants to enjoy operational and tax advantages.

Consideration of green building issues should come early in a project's life, since it can be expensive to incorporate LEED certification after the site selection and design phases. Many architects, consultants, engineers, product marketers and environmentalists have shown knowledge of green building techniques, but not all are fully qualified, and developers should take care in identifying an appropriate team for each project. A good professional team can suggest ways to earn LEED credits without extra cost, find ways to offset certain expenses with savings in other areas, and spot opportunities for synergies.

9

What legal liability might lurk in the growing concern over climate change?

For businesses, climate change litigation and its uncertainties have affected investment planning, as well as relations with shareholders, employees, vendors and customers. Plans for meeting demands for power are particularly affected, but no activity or business sector can be considered immune. Regulatory agencies, such as the U.S. Securities and Exchange Commission, as well as the offices of state attorneys general, are evaluating the adequacy of the disclosures made by public companies concerning the costs and liabilities associated with carbon emissions and other climate change issues.

The potential for a wide liability web is illustrated in one pending case in which victims of Hurricane Katrina sued energy and chemical companies for creating greenhouse gas emissions that contributed to climate change that, in turn, increased the severity of the storm Katrina. Even mortgage lenders and insurance companies were originally drawn in, although these were later dismissed.

In another case, California's attorney general (AG) sued GM and other auto manufacturers for allegedly creating a nuisance through greenhouse gas emissions from cars. The AG sought damages for harm allegedly caused by past, present and future emissions, such as reduced snowpack, beach erosion, ozone pollution and seawater intrusion on drinking water. The U.S.



Key takeaway: Although some nuisance suits have been deemed ill-founded, there can be no question that businesses must be alert to potential far-reaching liability related to climate change.

District Court for the Northern District of California dismissed the case on the basis that the complaint presented a nonjusticiable political question. The state has filed an appeal with the Ninth Circuit Court of Appeals.

Related cases include one claim that the Tennessee Valley Authority is creating a nuisance with its emissions and another claim against the EPA, New York State and New York City for creating a public nuisance via emission of greenhouse gases.

So far, the courts have not been friendly to such actions. The TVA and New York cases were dismissed. The trial court in the Katrina case warned of “daunting evidentiary problems” for anyone attempting to connect an individual company’s operations to the 150-mile-per-hour winds churned up by a hurricane. The California AG’s suit was dismissed on grounds that adjudication “would require the court to balance the competing interests of reducing global warming emissions and the interests of advancing and preserving economic and industrial development,” which are policy and technical judgments left to Congress and the president.

10

What are the implications of the climate change issue for companies conducting transaction-related due diligence?

Greenhouse gas emissions present risks that companies conducting due diligence need to examine with care. Legislative and regulatory efforts to address greenhouse gas emissions are prompting buyers, sellers, lenders and investors to gauge how deeply climate change issues may affect their transactions. Naturally, the potential impact depends on the nature of the transaction.

Until recently, due diligence has focused mainly on identifying risks tied to contaminated property and violations of environmental laws. In the U.S., the federal rules and industry standards that form the basis for environmental diligence revolve around identifying signs of contaminated property and violations of hazardous substance laws. As such, the scope of a typical early site assessment excludes any potential impacts related to emissions and climate change.

Now, however, those pursuing transactions may need legal and technical experts to design a due diligence plan that includes climate change, and then act on its findings. This means that in most transactions, the process should include consideration of questions such as: Is the company or are



Key takeaway: The point is obvious and critically important: The issue of climate change has made due diligence much more complex and demanding.

its products subject to emissions reporting, control requirements or energy efficiency standards? Are climate change issues likely to generate new regulations, market risks or opportunities? Are significant assets located in areas that could be harmed by rising ocean levels or other climate-generated changes? Is there a process for quantifying and reporting the company's greenhouse gas emissions? Has the company tried to reduce emissions, to document and value reductions, or to secure emission reduction credits?

Some institutional investors use even more detailed due diligence systems to investigate greenhouse gas emissions and other climate change issues before making a decision. All companies generally must conduct a screening review, with more detailed studies possibly being required in certain sectors (e.g., energy, chemical, transportation) and for certain specialized transactions (e.g., carbon market). A prominent example is the Carbon Disclosure Project "Greenhouse Gas Emission Questionnaire."

A more recent development was the establishment of The Carbon Principles, announced on February 4, 2008, by three of the world's leading financial institutions. The principles were established by Citi, JPMorgan Chase and Morgan Stanley and are intended as guidelines for advisors and lenders to power companies in the United States. These principles were developed in consultation with various domestic power companies, as well as some of the leading domestic environmental public interest groups.

11

What are the legal issues surrounding “carbon sequestration”?

Fossil fuels will remain part of the energy picture for years to come. One approach to managing the continued use of fossil fuels is the concept of “carbon sequestration,” (i.e., processes that prevent an increase in the total atmospheric concentration of greenhouse gases).

One promising method is carbon capture and underground storage, whereby CO₂ is captured at the point of generation, transported to another site and injected into deep geological voids such as depleted oil and gas reservoirs. Studies suggest that with proper management, 99 percent of the injected CO₂ can remain stored in reservoirs for more than 1,000 years. The technique, according to an MIT report, could reduce CO₂ emissions significantly, while also allowing coal to meet the world’s pressing energy needs.

Achieving these benefits will require technological breakthroughs and some forms of tax, investment or related government support, as the cost of capturing CO₂ from existing power plants is high.

Success also will demand dealing with many legal questions: Will a ton of CO₂ sequestered count as much for credits, taxes or penalties as a ton of CO₂ foregone by demand reduction or renewable generation? Which agencies will regulate these projects? Is CO₂ a “waste” or a “commodity” having value? How can CO₂ producers or injectors acquire rights to the property required for transport and storage? Will eminent domain powers be available? What liabilities might result from sequestering operations, and who will bear them?



Key takeaway: Whatever approaches society adopts, the legal ramifications of climate change programs such as carbon sequestration will be unavoidably complex and far-reaching.

Managing carbon sequestration is just one of the thorny new nests of legal issues spawned by society's quest for solutions to climate change. In the future, governments may cover certain risks, while industry participants and project owners will shoulder others, possibly under regulatory frameworks yet to be drafted.

Pillsbury is working with trade associations, generators, emission credits traders, and oil and gas field operators to achieve the potentially dramatic environmental and economic benefits of carbon sequestration.

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How should a company go about building a strategic plan for dealing with climate change issues?

Preparing for climate change should be on every company's agenda. Pillsbury's climate change team is advising clients to take the following steps:

Taking a greenhouse gas inventory

Decide early in the planning process whether to inventory your emissions and, if so, what accounting standards to use. Without a sound inventory, it is hard to know where you stand and what you face. Use existing detailed and generally accepted accounting methods.

Mapping the formation of law

As governments are engaged in considering and adopting new regulatory systems, consider mapping and seeking to influence the process of law formation on emissions.

Internalizing the cost of carbon

Develop a default value—expressed in dollars per ton of CO₂ equivalence—for the cost of reducing greenhouse gas emissions. With emerging regulations, it may be unwise to calculate precise return on investment for projects involving significant energy consumption without factoring the likely eventual cost of emissions management.



Key takeaway: Preparing for the consequences of climate change and new climate change initiatives is a multidimensional endeavor, well worth the focused attention of senior people across the organization.

Future energy supply

Ensure that your company's long-range plans secure an adequate supply of energy for business requirements, accounting for projections of future regulation, energy supply and greenhouse gas reduction.

Adaptation and opportunity

The potential effects of global warming, such as sea level rise and flooding, could affect your operations catastrophically. By the same token, regulation, shifts in energy supply and global warming could present your company with promising opportunities.

Internal sustainability

To enhance efficiencies, cost savings and stakeholder relations, your company may want to seek improvements to the environmental sustainability of its operations—e.g., through energy efficiency improvements, waste reduction, environmental offset programs and the securing of external carbon credits.

Mitigation

For similar reasons, your company may want to reduce its carbon footprint directly or to otherwise compensate for perceived global warming effects.

Litigation risks

Assess your company's vulnerability to nuisance or product liability lawsuits tied to its own generation of greenhouse gas emissions or the capacity of its products to generate these emissions.

Corporate governance

Evaluate your company's disclosure obligations regarding the generation of greenhouse gases. Climate change's rapid emergence as a public policy issue has raised questions about disclosure obligations of publicly traded companies in SEC filings, and about duties and liabilities of directors and officers.

Public relations

Evaluate how these same public policy factors may impact your company's relations with shareholders, investors, customers, employees and the public, and develop strategies to communicate your position proactively.

Brand strategy

Consider creating a cross-disciplinary brand council charged with evaluating the long-term alignment of your corporate brand image with operations that might impact climate change technologies.

About Our Climate Change & Sustainability Team

Our attorneys come from different legal disciplines but have in common national and international reputations for their work on the most critical issues driving climate change policy in the U.S. and around the world. They have served as top officials in the Environmental Protection Agency (EPA), the Department of Justice (DOJ), the National Oceanic and Atmospheric Administration (NOAA) and the Department of the Interior (DOI), and have negotiated international climate treaties, served in Congress and forged relationships as lobbyists. The team also includes leading transactional and regulatory energy attorneys, as well as members of the firm's nationally recognized environmental and real estate practices.

About Our Firm

Pillsbury is a full-service law firm with market-leading strengths in the energy, financial services, real estate and technology sectors. With offices in the world's major financial and technology centers, we counsel clients on all aspects of global business and litigation. Our multidisciplinary teams allow us to anticipate trends and offer a 360-degree perspective on complex business and legal issues—helping clients take greater advantage of opportunities and better mitigate risk.

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