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Climate Change and Oil Reserve Estimates — New Securities Litigation Risks

A Texas Federal Judge Turns Up The Heat On Oil Companies Facing Climate Change-Related Securities Class Actions

On August 14, 2018, the United States District Court for the Northern District of Texas issued a surprisingly shareholder-friendly opinion denying a motion to dismiss filed by Exxon Mobile Corp. See *Ramirez v. Exxon Mobil Corp., et al.*, Civ. No. 3:16-CV-3111-K. The shareholders alleged that Exxon and its management team (including Rex Tillerson) made material false statements concerning Exxon's oil and gas reserves to maintain its stellar credit rating and secure a \$12 billion debt offering on favorable terms. Specifically, the shareholder plaintiffs alleged that Exxon applied a proxy carbon cost when evaluating investment and business decisions that underestimated the actual costs of government policy changes on climate-related control. Plaintiffs also alleged that as the price of oil and gas declined in 2014, Exxon did not follow other oil and gas companies and reduce (or "de-book") its oil and gas reserves. Rather, Exxon falsely assured investors that it had superior investment processes and project management that allowed it to profitably extract its oil and gas assets. According to plaintiffs, the market learned the truth about these misstatements through a series of partial disclosures that concerned potential and actual reductions to Exxon's proved oil and gas reserves.

The opinion is important because it is the first climate-change related securities class action against a major oil and gas company. It is also significant because it departs from opinions of numerous federal courts that have refused to uphold securities claims based on the allegation that an oil company should have de-booked reserves sooner than it did—most courts recognize that estimating of oil and gas reserves is inherently subjective and requires a substantial amount of technical judgment.¹ The Northern District of Texas allowed these claims to proceed because plaintiffs sufficiently alleged at the pleading stage that the proxy carbon



cost that Exxon used in its public statements and disclosures was different and higher than the one the company used internally.

The district court disagreed with Exxon that its statements concerning its oil and gas reserves were statements of opinion, which under the Supreme Court's ruling in *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, -- U.S. --, 135 S. Ct. 1318, 1327 (2015), require the plaintiff to allege facts demonstrating that the defendants subjectively did not believe their opinions about reserves. Citing *Barre v. Intervoice-Brite, Inc.*, 397 F. 3d 249, 257 (5th Cir. 2005)—a case that predates *Omnicare* by 10 years—the district court held that *Omnicare* does not apply to alleged violations of GAAP. On this point, the Northern District of Texas is more shareholder friendly than the Ninth Circuit, which recently held that estimates of goodwill reserves were opinions and must satisfy *Omnicare*'s heightened "subjective knowledge" standard. See *City of Dearborn Heights Act 345 Police & Fire Retirement Sys. V. Align Tech., Inc.*, 856 F.3d 605, 618 (9th Cir. 2017).

The district court's opinion in *Ramirez v. Exxon Mobile Corp.* is also strikingly pro-shareholder in its conclusion that Exxon's forward-looking statements made in 2016 that extended low oil prices might result in a de-booking of proved oil reserves were not protected by the PSLRA safe harbor or the bespeaks caution doctrine. The Court agreed with plaintiffs that Exxon's cautionary language was inadequate and that plaintiffs sufficiently alleged facts showing that Exxon knew that a de-booking of its reserves was "all but certain." This holding is surprising because Exxon's SEC filings contained fairly detailed cautionary language of the events that could cause a reduction in reserves and expressly warned that a de-booking was possible.

The district court also rejected Exxon's argument that it was not required to update its proved oil reserves during interim periods—SEC regulations (17 C.F.R. § 229.1202(a)(2)) only requires annual updates of oil and gas reserves. The district court held that "other provisions" under GAAP (ASC 275 and 932) require companies to update proved reserves in interim financial reports when "adverse events significantly affect proved reserves." Interestingly, the district court did not identify the "adverse events" that should have caused Exxon to revise reserves during interim financial periods.

On the element of scienter, the district court concluded that plaintiffs adequately alleged a "strong inference" of fraudulent intent based on internal documents reviewed by Exxon's management committee that showed that the internal "proxy cost" for carbon regulations was much lower than what the company stated publicly. The district court, however, significantly departed from most federal courts in its analysis of plaintiffs' motive allegations. Specifically, the court concluded that Exxon's motive to maintain its high credit rating and to conduct a large debt offering was sufficient to support "a strong inference of scienter as to all defendants." This conclusion stands in sharp contrast with numerous federal courts that have concluded that such generalized motives are insufficient to plead scienter under the PSLRA.²

KEY TAKEAWAYS

Unfortunately for Exxon, and other oil and gas companies that will have to deal with this opinion as authority in other cases, a denial of a motion to dismiss is an interlocutory order and likely will not be reviewed by the Fifth Circuit. But there are some lessons that oil and gas companies can learn from this opinion to avoid future challenges by companies to oil and gas reserves.

- Oil and gas companies should explain in plain English how they calculate and use proxy costs of carbon when calculating financial projections. Exxon argued that Plaintiffs confused two separate proxy costs—one for carbon and another for greenhouse gases. But the Court held that Exxon's disclosure created the impression that it used just one proxy cost value across all business units. The takeaway here is that companies should not provide partial or incomplete disclosures of key metrics or assumptions—if there are multiple assumptions used, they should be disclosed clearly and in plain English.



- Companies should constantly update and refresh their cautionary language about factors that can adversely impact oil and gas reserves. Each quarter, companies should consider whether there have been any adverse events that significantly impact the company’s oil and gas reserves. Analyzing your public competitors’ risk factors is a good start. But a quarterly deep dive into company-specific factors, including a consultation with internal and independent petroleum engineers, is necessary.
- Although insider sales were not at issue in *Ramirez v. Exxon Mobil Corp.* (in fact, Exxon conducted a stock buy-back during the class period), insider selling can provide plaintiffs a powerful motive to pursue securities fraud claims. The best strategy to minimize risks associated with insider sales is for all company officers and directors to create insider trading plans that comply with the requirements of Rule 10b5-1. Sales made in compliance with 10b5-1 plans generally cannot be used as evidence of scienter.

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¹ See e.g., *Truk Int’l Fund LP v. Weinman*, 737 F. Supp. 2d 611, 624–25 (N.D. Tex. 2009) (dismissing the claim because “a reasonable investor would have recognized the speculative and uncertain nature of the formulation of estimates of proved reserves”); *In re China N. E. Petroleum Holdings Ltd. Sec. Litig.*, No. 10 CIV. 4577 MGC, 2014 WL 7243149, at *3 (S.D.N.Y. Dec. 11, 2014) (dismissing the claim because of a lack of scienter and recognizing the “numerous uncertainties inherent in estimating quantities of proved reserves”).

² See e.g., *Indiana Elec. Workers’ Pension Tr. Fund IBEW v. Shaw Grp., Inc.*, 537 F.3d 527, 544 (5th Cir. 2008) (“The desire to maintain a high credit rating is universally held among corporations and their executives and consequently does not contribute significantly to an inference of scienter.”) (quoting *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 664 (8th Cir. 2001)); *San Leandro Emergency Med. Grp. Profit Sharing Plan v. Philip Morris Companies, Inc.*, 75 F.3d 801, 814 (2d Cir. 1996) (“We do not agree that a company’s desire to maintain a high bond or credit rating qualifies as a sufficient motive for fraud[.]”).