

Disclosure, Management Practices, and Corporate Governance Relating to Climate Change Financial Risks

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Recent action by the Attorney General of the State of New York will affect how public companies disclose and address climate change financial risks. On August 27, 2008, the Attorney General announced a settlement agreement with a major public utility holding company, Xcel Energy Inc. (“Xcel Energy”), pursuant to which Xcel Energy agreed (the “Xcel Energy Agreement”) to disclose specified, detailed information about the financial risks of climate change on its business and how it is addressing those financial risks in its annual report on Form 10-K filed with the U.S. Securities and Exchange Commission (the “SEC”) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”).¹ As discussed more fully below, while the disclosures required under the Xcel Energy Agreement about financial risks resulting from climate change are consistent with existing SEC disclosure requirements, the new, detailed disclosures required about Xcel Energy’s strategic analysis of climate change financial risks and emissions management are likely to affect both management practices and corporate governance at Xcel Energy and other companies.

The New York Attorney General’s action was brought under the Martin Act, a New York state statute that grants broad powers to the Attorney General to subpoena and bring actions against all persons who buy or sell securities in New York.² Given these powers, the Xcel Energy Agreement, the Attorney General’s warning in his August 27 press release announcing the Xcel Energy Agreement that he “will continue to fight for increased transparency and full disclosure of global warming financial risks to

¹ “Cuomo Reaches Landmark Agreement with Major Energy Company, Xcel Energy, to Require Disclosure of Financial Risks of Climate Change to Investors” (August 27, 2008) (available at http://www.oag.state.ny.us/media_center/2008/aug/aug27a_08.html), announcing the execution of an “Assurance of Discontinuance Pursuant to Executive Law § 63(12)” (AOD #08-012), August 26, 2008 (available at http://www.oag.state.ny.us/media_center/2008/aug/xcel_aod.pdf), under which Xcel Energy agreed to make various disclosures about material financial risks, management practices, and corporate governance actions related to climate change financial risk, and greenhouse gas emissions.

² N.Y. Gen. Bus. Law § 352 (Consol. 2008). The Martin Act gives the New York Attorney General broad powers to conduct public and private investigations and issue subpoenas for any documents of, and bring either a civil or criminal action against, any persons that engage in fraud or deceptive practices in connection with the sale of securities in New York. Unlike the anti-fraud provisions of the federal securities laws, the Martin Act does not require a showing of a willful intent to commit misconduct (or scienter). See *State v. Rachmani Corporation*, 525 N.E. 2d 704 (N.Y. 1988). The Attorney General’s action was also brought under Executive Law § 63(12), which authorizes the Attorney General to, among other things, petition the Supreme Court of the state to enjoin fraudulent or illegal acts in the conduct of business. N.Y. Exec. § 63(12) (Consol. 2008).

investors,”³ and various other developments discussed below, public companies should ensure that they fully disclose to investors material financial risks from climate change.

In addition, if the disclosures that Xcel Energy agreed to make become the best practices for all public companies that face material financial risks from climate change, public companies that do not have strategies that (i) address the financial risks of climate change, (ii) are under the supervision of the board of directors, and (iii) are assessed as a part of management’s compensation program may need to disclose that they do not have such strategies. Finally, executive officers, directors, and other insiders of public companies should evaluate whether they are aware of any material financial risks to their respective companies, including from climate change, that have not been disclosed publicly before they sell securities, especially in New York.

Disclosures required under the Xcel Energy Agreement. Xcel Energy agreed to disclose the following information about financial risks relating to climate change in its annual report on Form 10-K:

- An analysis of material financial risks associated with existing laws and regulations relating to greenhouse gas emissions and laws and regulations relating to greenhouse gas emissions that are likely to be adopted in the future;
- An analysis of material financial risks from litigation that involves Xcel Energy and relates to climate change and any climate change–related decisions from any court in any jurisdiction in which Xcel Energy operates that may have a material financial effect on its business; and
- An analysis of material financial risks from the physical impacts associated with climate change, including any impacts from sea-level increases, extreme weather events, droughts, and changes in temperature.

In addition, Xcel Energy agreed to make the following disclosures in its Form 10-K about its strategic analysis of climate change financial risks and emissions management as long as its greenhouse gas emissions materially affect its financial exposure from climate change financial risks:

- Its current position on climate change;
- The following details regarding its emissions management:
 - Estimates (in tons) of its greenhouse gas emissions for the most recent fiscal year;
 - Estimates (in tons) of expected increases in greenhouse gas emissions from planned new coal-fired electric generation projects;
 - Strategies to reduce, offset, or limit its climate change financial risk and adapt to the physical impacts of climate change, including the steps it is taking to reduce greenhouse gas emissions, the results of strategies to date, and the expected future results of such steps, including greenhouse gas emission–reduction goals; and

³ The Xcel Energy Agreement may be the blueprint for the New York Attorney General’s negotiation of future settlements with four other energy companies to which the Attorney General sent subpoenas last year demanding information about the potential financial impacts on their businesses from climate change.

- Information about corporate governance actions concerning climate change, including the role of its board of directors, as well as a statement on whether environmental performance, including meeting climate change objectives, is incorporated into officer compensation decisions.

Disclosures that are consistent with existing SEC requirements. The required disclosures about material financial risks are consistent with various SEC requirements currently applicable to the Form 10-K, although the Xcel Energy Agreement requires specific disclosures that are not identified in the SEC's requirements.

Item 101 of SEC Regulation S-K requires disclosure about the material effects that compliance with federal, state, and local provisions regulating the discharge of materials into the environment, such as greenhouse gases, or otherwise relating to the protection of the environment, may have on the capital expenditures, earnings, and competitive position of the company. In addition, it requires disclosure of material estimated capital expenditures for environmental control facilities.

Item 103 of SEC Regulation S-K requires disclosure about material legal proceedings, including proceedings contemplated by governmental authorities.⁴ Administrative or judicial proceedings arising under laws or regulations regulating the discharge of materials into, or designed to protect, the environment are considered to be material legal proceedings required to be disclosed if the proceeding is material to the business or financial condition of the company or involves a claim for damages or potential monetary sanctions, capital expenditures, deferred charges, or charges to income in an amount that exceeds 10% of the company's current assets. However, Instruction 5(C) to Item 103 provides that, where a governmental authority is a party to a proceeding and the proceeding involves potential monetary sanctions, the proceeding must be described unless the company reasonably believes that the proceeding will result in no monetary sanctions or monetary sanctions of less than \$100,000.⁵

Item 303 of SEC Regulation S-K requires management, in its management's discussion and analysis of financial condition and results of operations, to discuss, among other things, known trends and uncertainties that are reasonably likely to have a material impact on the company's financial condition or operating performance. The SEC staff has interpreted this item to require disclosure about, among other things, critical accounting estimates, i.e., those estimates and assumptions made in connection with the preparation of financial statements that have a material impact on the company's reported financial condition and operating performance or are reasonably likely to have a material impact on the company's future financial condition or operating performance.

⁴ The quarterly report on Form 10-Q (the "10-Q") must describe any new legal proceedings and any material developments in such legal proceedings. See Instruction 1 to Item 1 of Part II of the 10-Q.

⁵ With respect to "sanctions," Question 105.01 of the SEC Division of Corporation Finance's Compliance and Disclosure Interpretations of Regulation S-K, updated on July 3, 2008 (available at <http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm>), explains that footnote 30 to the SEC's Release No. 33-6835 (May 18, 1989) and the letter to Thomas A. Cole (Jan. 17, 1989) clarify that, "while there are many ways a . . . 'potential monetary sanction' may be triggered [under the Comprehensive Environmental Response, Compensation, and Liability Act (42 U.S.C. § 9601) (otherwise known as the "Superfund" law)], including the stipulated penalty clause in a remedial agreement, the costs anticipated to be incurred under Superfund, pursuant to a remedial agreement entered into in the normal course of negotiation with the EPA, generally are not 'sanctions' within Instruction 5(C) to Item 103."

Item 503 of SEC Regulation S-X requires disclosure about factors that make an investment in a public company risky or speculative.⁶ These factors must be updated to reflect material developments, such as new evidence on the risks of climate change, new legislation or regulations relating to climate change, or new estimates of material costs to reduce greenhouse gas emissions.⁷

Some of the disclosures required by the Xcel Energy Agreement may also be required in a company's notes to its financial statements. Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" ("FAS 5"), requires disclosure of the nature of a contingency for which a loss has been accrued, the amount accrued, if material, and any additional material loss that is reasonably likely to have been incurred.⁸ The Financial Accounting Standards Board (the "FASB") recently proposed to expand the disclosures required by FAS 5 to address "constituents' concerns that the disclosures about certain loss contingencies under existing guidance do not provide sufficient information in a timely manner to assist users in assessing the likelihood, timing, and amounts of cash flows associated with loss contingencies."⁹ Others have expressed similar concern about the adequacy of disclosures about uncertainties that may affect a company's results. Given such concerns, the Final Report of the SEC's Advisory Committee on Improvements to Financial Reporting recently recommended that the:

SEC and the FASB should work together to develop a disclosure framework to

"[r]equire disclosure of the principal assumptions, estimates, and sensitivity analyses that may impact a company's business, as well as a qualitative discussion of the key risks and uncertainties that could significantly change these amounts over time. This would encompass transactions recognized and measured in the financial statements, as well as events and uncertainties that are not recorded."¹⁰

New detailed disclosures in the Xcel Energy Agreement that affect management practices and corporate governance. The additional information about management practices relating to greenhouse gas emissions and corporate governance matters, which are required by the Xcel Energy Agreement as long as Xcel Energy's greenhouse gas emissions materially affect its financial exposure from climate change financial risk, are not the types of disclosures that have generally been made on a Form 10-K.

⁶ Material changes in risks must be disclosed on the 10-Q under Item 1A of Part II of 10-Q by public companies other than smaller reporting companies (as defined in Rule 12b-2 under the Exchange Act (17 C.F.R. § 240.12b-2)).

⁷ Risk factors and other cautionary language should be updated from period to period as a company's fortunes change to enhance the company's ability to rely on the safe harbor protection in Section 27A of the Securities Act of 1933, as amended (15 U.S.C. § 77z-2), and Section 21E of the Exchange Act (15 U.S.C. § 78u-5). *See, e.g., Asher v. Baxter International Inc.*, 377 F.3d 727 (7th Cir. 2004), *cert. denied*, 544 U.S. 920 (2005).

⁸ Paragraph 8 of FAS 5, (March 1975) (available at http://www.fasb.org/pdf/aop_FAS5.pdf).

⁹ FASB, "Exposure Draft of a Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies, an amendment of FASB Statements No. 5 and 141(R)" (June 5, 2008) (available at http://www.fasb.org/draft/ed_contingencies.pdf). On September 24, 2008, the FASB decided to develop an alternative disclosure requirement that takes into account the concerns raised by certain commentators on the proposed expanded disclosures. In addition, it decided to field-test both the proposed and the alternative disclosure requirements and to delay the announced proposed effective date for the new disclosure requirements to no sooner than for fiscal years ending after December 15, 2009. *See* FASB, "Summary of Decisions Reached—FASB Board Meeting 9-24-08" (available at http://www.fasb.org/news/SDR_Contingencies_09-24-08.pdf).

¹⁰ Recommendation 1.2, "Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission" (August 1, 2008) (available at http://www.sec.gov/about/offices/oca/acifr_finalreport.pdf).

If these additional disclosures made by Xcel Energy become the best practices for disclosure, investors, analysts, and the SEC may demand robust disclosures about material financial risks from climate change from all public companies.

Disclosure about greenhouse gas emissions and strategies to reduce such emissions may become an expected part of the analysis of a company's material financial risks from climate change. Rather than having to admit that they have no strategies to analyze and address the effects of climate change, including the effects of greenhouse gas emissions, public companies that face material financial risks from climate change are likely to adopt such strategies. In addition, Xcel Energy's disclosures about the role of its board of directors concerning climate change and the relationship between officer compensation and environmental performance may lead to demands for similar information from other public companies.

Therefore, public companies should consider adopting these management practices and corporate governance measures if they face material financial risks from climate change. As is often the case, disclosure requirement changes behavior—and it can be expected that many companies may in time want to be in a position to favorably disclose their responses to material financial risks from climate change and the incorporation of environmental performance into their business practices and corporate governance approach, including officer compensation decisions.

Additional reasons why companies may decide to provide the Xcel Energy disclosures. Increasingly, investors are demanding more disclosures about climate change financial risks. In October 2006, a coalition of institutional investors, environmental groups and others released the Global Framework for Climate Risk Disclosure (the “Global Framework”), which they described as “a statement of investor expectations for comprehensive corporate disclosure.”¹¹ Similar to the disclosures required by the Xcel Energy Agreement, the Global Framework urges companies to disclose, if applicable: (i) data on their total greenhouse gas emissions; (ii) analyses of their climate risk and emissions-management practices, such as disclosure about the company's position on climate change, an explanation of significant emissions management actions taken by the company, and a description of corporate governance actions taken to address climate change financial risk, including disclosures of whether executive compensation is tied to meeting corporate climate objectives; (iii) assessments of the physical risks to their businesses from climate change; and (iv) analyses of regulatory risks relating to climate change.

In September 2007, another coalition (which includes the New York Attorney General and some of the members of the Global Framework coalition) submitted a petition to the SEC, which they supplemented in June 2008, requesting that the SEC issue interpretive guidance relating to public companies' disclosure obligations concerning climate change risks.¹² The petition suggested that the SEC's interpretive release describe how companies should evaluate whether they face risks in connection with climate change and direct companies to disclose, to the extent material, physical risks

¹¹ Available at http://www.unepfi.org/fileadmin/documents/global_framework.pdf.

¹² File No. 4-547, “Petition for Interpretive Guidance on Climate Risk Disclosure,” submitted by multiple petitioners, including the California Public Employees' Retirement System, Ceres, the Environmental Defense Fund, and officials from nine states, including the Attorney General of New York (September 18, 2007), supplemented by a Supplemental Petition (June 12, 2008) (the “Supplemental Petition”) (available at <http://www.sec.gov/rules/petitions.shtml>).

associated with climate change, financial risks associated with present or probable regulation of greenhouse gas emissions, and legal proceedings relating to climate change.¹³

The SEC has not issued guidance in response to this petition, and investors' calls for information about climate change financial risks as well as other environmental issues have persisted. Ceres, a coalition of investors, environmental organizations, and other public interest groups concerned about global climate change, reported that a record 57 climate-related shareholder proposals were submitted for inclusion in proxy statements in 2008, of which 25 were withdrawn after companies reached agreements with the proponents of the proposals.¹⁴ The proposals that were the subject of shareholder vote received an average of 23.5% of shareholder votes for approval, according to Ceres.¹⁵ In recent years, shareholder proposals on environmental issues have represented the largest category of social proposals submitted by shareholders to public companies.¹⁶

In addition, shareholder proposals requesting companies to review and report on the economic, social, and environmental impacts of their businesses, so-called "sustainability" reporting, received approval of between 40% and 46.4% of the votes at four companies in 2007.¹⁷ More than 1,500 companies worldwide publish sustainability reports that follow the Global Reporting Initiative guidelines (the "Guidelines").¹⁸ In 2007, of the half of the 100 largest publicly traded companies in the United States that issued sustainability reports, more than a third followed elements of the reporting template of the Guidelines.¹⁹ A survey of disclosures about climate change in sustainability reports issued in 2006, however, determined that companies reported much more on potential opportunities from climate change than on the financial risks from climate change.²⁰

Institutional investors have contacted companies to obtain information on greenhouse gas emissions outside the shareholder proposal process as well. The Carbon Disclosure Project, which is backed by

¹³ In July 2008, the SEC received a petition from the Free Enterprise Action Fund, which also submits shareholder proposals, seeking "interpretive guidance that would warn registrants against making potentially false and misleading statements pertaining to global warming and other environmental issues" because of its view that there is inadequate evidence of the effect of humans on global warming. File No. 4-563, "Petition for Interpretive Guidance on Public Statements Concerning Global Warming and Other Environmental Issues," submitted by Steven J. Milloy and Thomas Borelli of the Free Enterprise Action Fund (July 21, 2008) (available at <http://www.sec.gov/rules/petitions/2008/petn4-563.pdf>).

¹⁴ "Investors Achieve Major Company Commitments on Climate Change" (Aug. 20, 2008) ("Ceres") (available at <http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=928&srcid=705>).

¹⁵ *Id.*

¹⁶ As You Sow, "Proxy Season Preview 2008 – Helping Foundations Align Investment and Mission," at 4 (available at <http://www.asyousow.org/publications/proxy-preview-2008.pdf>).

¹⁷ *Id.* at 3.

¹⁸ See Global Reporting Initiative – What We Do (available at <http://www.globalreporting.org/AboutGRI/WhatWeDo>). The Global Reporting Initiative, which describes itself as a large multi-stakeholder network of experts in multiple countries worldwide, first issued the Guidelines in 2000 and has updated and improved the Guidelines periodically since then. The Guidelines are the most widely used sustainability reporting framework.

¹⁹ "SIRAN/Social Investment Forum Report Finds Strong Growth in CSR Web Sites, CSR Reports and Use of Global Reporting Initiative Guidelines" (July 17, 2008) (available at <http://www.socialinvest.org/news/releases/pressrelease.cfm?id=112>).

²⁰ Global Reporting Institute and KPMG, "Reporting the Business Implications of Climate Change in Sustainability Reports" (2007), p. 5 (available at http://www.globalreporting.org/NR/rdonlyres/C451A32E-A046-493B-9C62-7020325F1E54/0/ClimateChange_GRI_KPMG07.pdf).

385 institutional investors with \$57 trillion in assets under management, annually distributes a questionnaire to over 3,000 companies, requesting information on greenhouse gas emissions and the business risks of climate change. The Carbon Disclosure Project compiles the data it receives and publishes it in the form of an annual report.²¹

Finally, Congress has been concerned about climate change. The Lieberman-Warner Climate Security Act of 2007 would have required the Environmental Protection Agency (the “EPA”) to establish a program to decrease greenhouse gas emissions. Although it was blocked from further consideration by the Senate on June 6, 2008, Senator Joseph Lieberman believes that further work by Congress is likely, given the support of 54 senators for strong, economy-wide, cap-and-trade climate legislation.²² An earlier version of the bill²³ would have required the SEC to adopt regulations requiring disclosure of material risks relating to climate change. In addition, in a letter dated December 6, 2007, Senator Chris Dodd, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, and Senator Jack Reed, Chairman of the Subcommittee on Securities, Insurance and Investment, asked the SEC to issue guidance on climate disclosure and report on the adequacy of disclosure relating to climate change and the regulation of greenhouse gas emissions.²⁴

In the wake of the Xcel Energy Agreement and the increasing focus of shareholder activists on climate change financial risks, among other environmental issues, disclosures regarding any material financial risks of climate change and other environmental matters may be advisable for public companies to avoid future New York State action under the Martin Act and to address shareholder demands. In addition, the SEC may be influenced by the petitions, the Xcel Energy Agreement, the congressional actions, and the other initiatives discussed above when reviewing disclosures that fail to address material financial risks from climate change in a sufficiently precise and detailed manner under the existing SEC disclosure requirements discussed above.

Challenges to preparing the Xcel Energy-type disclosures. The preparation of disclosures that are consistent with the Xcel Energy Agreement may require considerable effort by some companies. To assess the financial risks of legislation and regulation, a company will have to analyze not only existing laws and regulations that apply to its business and their impact on its operations, but also proposed laws and regulations that would have a material financial effect on its business in each of the jurisdictions in which it does business if it concludes that such proposed legislation or regulations are likely to be adopted.²⁵ The requirement to describe material risks of court decisions in which the company was not a party based on the impact of such decisions on the company may require companies to monitor court decisions more closely than they have historically. An assessment of the

²¹ See, e.g., Carbon Disclosure Project Report 2008 (available at <http://www.cdproject.net/reports.asp>).

²² See “Majority of Senators Step Forward to Support Mandatory, Comprehensive Climate Legislation” (June 6, 2008) (available at <http://lieberman.senate.gov/newsroom/release.cfm?id=298862>).

²³ Available at <http://lieberman.senate.gov/documents/acsabill.pdf>.

²⁴ See Supplemental Petition, *supra* note 12, at 5.

²⁵ The decision of the Supreme Court in *Massachusetts v. Environmental Protection Agency*, 549 U.S. 497 (2007), that the EPA has the authority to regulate greenhouse gases under the Clean Air Act has led to proposed rule-making by the EPA on greenhouse gas regulations. In addition to regulatory actions by states and other jurisdictions, utility companies will have to evaluate the impact of regional agreements among states to reduce greenhouse gas emissions, as the Regional Greenhouse Gas Institute does by imposing a mandatory cap and trade program to reduce carbon dioxide emissions from power plants. See Regional Greenhouse Gas Initiation Fact Sheet (available at http://www.rggi.org/docs/RGGI_Executive_Summary.pdf). As discussed, Congress has also considered the risks of greenhouse gas emissions.

physical impacts of climate change and other environmental matters also may present challenges to companies, given the uncertainties in predicting the future effects of climate change. At a minimum, management practices and the company’s corporate governance approach may have to address the risks of climate change, affecting every part of the company’s operations from monitoring and gathering data about emissions and taking steps to reduce emissions to taking management’s success in those areas into account in making compensation decisions. Crafting disclosures about such management practices may present challenges because these management practices may involve competitively sensitive information.

Those companies that have not developed strategies to address the material financial risks of climate change will need to develop such strategies if they want to provide, or are asked by their shareholders to provide, Xcel Energy–type disclosures. Preparation of Xcel Energy–type disclosures for a Form 10-K may challenge even those companies that have developed strategies to reduce the material financial risks of climate change and adapt to the physical impacts of climate change and are accustomed to reporting emissions of different substances to environmental regulatory agencies: this is because the Form 10-K is a public document reviewed and relied upon by investors, filed under the federal securities laws with the SEC, and subject to governmental action by the SEC, the New York Attorney General, and other state agencies, as well as private plaintiffs.²⁶

Morgan Lewis can help. Morgan Lewis’s energy and environmental attorneys are working with utility and other companies on renewable energy projects, “clean” technologies, emission trading, and other strategies to manage greenhouse gas emissions and sustainability, while also closely tracking legislation, regulatory actions, and litigation involving greenhouse gas emissions.²⁷ In addition, our securities lawyers are experienced with disclosure and financial reporting issues and can help companies evaluate the extent to which they want to provide Xcel Energy–type disclosures. Finally, our corporate governance and executive benefits experts can also help companies evaluate corporate governance actions in the area of risks of climate change, including compensation decisions that drive and reward environmental stewardship.

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²⁶ The exposure to potential litigation questioning the adequacy of climate change disclosures suggests that companies should review their officer and director liability insurance policies. Such policies may include language that excludes coverage if the lawsuit relates to pollution. Given the Supreme Court’s decision in *Massachusetts v. Environmental Protection Agency* (see *infra* note 25) that greenhouse gas emissions are a “pollutant” under the Clean Air Act, companies should make sure that a case alleging inadequate disclosure about greenhouse gas emissions would be covered by their officer and director liability insurance policies. The firm has experts in the officer and director liability insurance area who can assist with that review.

²⁷ See Morgan Lewis, “White Paper—Communicate: An Overview of Climate Change Law” (May 2008) (available at http://www.morganlewis.com/pubs/LIT_ClimateChangeLaw_WhitePaper_15May08.pdf).

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