REAL ESTATE CAPITAL MARKETS

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DEAR CLIENTS AND FRIENDS,

We are pleased to present our quarterly *Hunton Andrews Kurth Real Estate Capital Markets Newsletter* for the first quarter of 2022. The first quarter was an exciting time for our practice, and we made a number of announcements related to our lawyers. First, **Kate Saltz** was admitted as a partner in April 2022, a well-deserved promotion. We are thrilled for Kate, who has been a member of our practice since graduating from law school (Learn more about Kate on page six in our "Lawyer Spotlight" column). Second, **Rob Smith** was named co-head of the firm's Real Estate Capital Markets team, which he will fit into his busy REIT capital markets practice. Our long standing leader, **David Wright**, will continue to be involved in the management of our practice as co-head, and we look forward to his continued guidance. Finally, REIT tax partner **Kendal Sibley** spoke at firm sponsored REITwise 2022: Nareit's Law, Accounting & Finance Conference in March 2022 on tax issues in REIT M&A deals.

In terms of transactional activity, markets turned quite choppy during the first quarter, as volatility and uncertainty returned to the industry. Nevertheless, in addition to assisting clients with significant M&A activity and navigating annual 10-K and proxy statement requirements, we actively advised clients on potential deal structures to implement when markets calm. One transaction of particular note is our representation of Healthcare Realty Trust Incorporated in its planned combination with Healthcare Trust of America, an $18 billion deal that will create one of the nation's largest owners of medical office buildings, led by partners **Jim Kennedy** and **Jim Davidson**. The transaction is expected to close later in 2022, and is the most recent example of a string of REIT M&A transactions we have handled in the last year.

We are hopeful for renewed activity in the second quarter. We are also pleased to share some highlights of our activity during the first quarter of 2022, as well as some thought leadership and information about our team. Thank you again for your continued confidence in the work we do together.

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DEAL SPOTLIGHT: SUMMIT HOTEL PROPERTIES ACQUIRES PORTFOLIO FROM NEWCRESTIMAGE

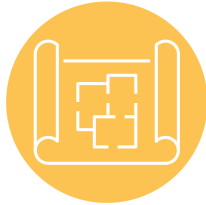
The firm recently represented Summit Hotel Properties (NYSE: INN) in the acquisition of a 27-hotel portfolio totaling 3,709 guestrooms, two parking structures and various financial incentives for a total consideration of $822 million from affiliates of NewcrestImage. The hotels became part of an existing joint venture between Summit and GIC, a Singapore-based sovereign wealth fund. This transaction, which closed in the first quarter of 2022, increased Summit's total room count by nearly 35% to more than 15,000 keys across 100 hotels in 42 markets across the country.

Summit's mission is to be the most respected owner of high-quality lodging assets that deliver superior risk-adjusted returns to its shareholders, while providing guests with an experience that exceeds expectations.

Hunton Andrews Kurth has represented Summit in more than 15 capital markets transactions totaling more than $2 billion, including its initial public offering in 2011.

The team representing Summit in the acquisition was led by partner **Rori Malech** with assistance from partners **David Wright**, **Mark Wickersham**, **Kendal Sibley**, **Kate Saltz**, **Eric Nedell** and **Ellis Butler**; counsels **Joshua Milgrom**, **Carter Clements** and **John Schronce**; associates **Rebecca Hoffman**, **Angela Jun**, **Patrick Tricker** and **Elizabeth White**, and real estate specialist **Tracy Allen**.

MARKET DATA: TOP 5 REIT INDUSTRIES IN 2022 TO DATE



DIVERSIFIED REITS

RETAIL REITS

MORTGAGE REITS

RESIDENTIAL REITS

SPECIALTY REITS

Our capital markets practice figured prominently in Bloomberg's Q1 2022 Global Legal Adviser league tables, ranking among the **top 20** law firms across 15 capital markets categories, finishing within the **top 10** in five of those categories.

TEAM MEMBER SPOTLIGHT: KATE SALTZ

Partner | Richmond | ksaltz@HuntonAK.com | +1 804 788 8642

Kate is a partner on the firm's Real Estate Capital Markets team, focusing on REITs and other real estate related specialty finance companies. Her practice also focuses on corporate finance, public and private securities offerings (as both issuers' and underwriters' counsel), M&A and other corporate matters.

Kate has provided key counsel on many institutional client relationships and cutting edge transactions including an IPO for cannabis REIT NewLake Capital Partners in August 2021, an IPO in 2019 and subsequent public offerings for Postal Realty Trust (the first ever postal REIT), a variety of offerings (including $2.2 billion in aggregate in 2021 alone) for retail property REIT Agree Realty Corporation, more than $1.3 billion in offerings (in 2021 alone) for hotel and hospitality REITs such as Pebblebrook Hotel Trust and Summit Hotel Properties, and work for mortgage REITs such as Arlington Asset Investment Corp. and Annaly Capital Management.

> *"What I enjoy most about this job is the people, including our clients and all of my Hunton Andrews Kurth colleagues. The highlight of my day is helping a client think of a new way of seeing and understanding the challenges facing their business."*

THE SEC'S PROPOSED CLIMATE CHANGE RULES AND SOME IMPLICATIONS FOR REITS

In March 2022, the US Securities and Exchange Commission (SEC) proposed new rules[1] that would require US public companies to disclose climate-related information in annual reports and registration statements. This article discusses the SEC's proposal and, in particular, some implications for real estate investment trusts (REITs).

The proposed rules are open for public comment, until June 17, 2022 and there will be significant comments from a wide range of supporters and detractors. If the proposed rules become effective, the impact on public company reporting would be profound: standing business and financial disclosures developed pursuant to SEC rules and market practice guided by a standard of materiality would be supplemented with an almost stand-alone new set of complex and extensive climate-related disclosures, much of which would be required without regard to management's judgment as to whether such disclosures are material or useful to investors. Among other things, the proposed rules would require reporting companies to include climate-related financial statement metrics in their annual financial statements that would be subject to audit and disclose historic greenhouse gas (GHG) emissions data that would ultimately be subject to external assurance at a level equivalent to the annual financial statements audit.

Given the potential ramifications of the proposed rules, we recommend that companies monitor developments closely and begin preparations for compliance as soon as practicable, as discussed in more detail in the concluding section of this article.

[1] https://www.sec.gov/rules/proposed/2022/33-11042.pdf

SUMMARY OF THE PROPOSED RULES

The proposed rules generally would apply to all SEC-registered reporting companies (including foreign private issuers) and comprise:

- a new Article 14 to Regulation S-X requiring climate-related financial statement metrics and related disclosure in a note to the annual audited financial statements; and
- a new Subpart 1500 to Regulation S-K mandating a separate, appropriately captioned section of registration statements and annual reports for climate-related disclosures, including:
  - climate-related risks, their actual and potential impacts and related discussion and analysis;
  - Scope 1 and Scope 2 GHG emissions subject, for all companies except non-accelerated filers (e.g., non-traded REITs and IPO companies), to attestation;
  - for all companies except smaller reporting companies, Scope 3 GHG emissions not subject to attestation but only if Scope 3 emissions are material or if the company has set a target or goal to reduce Scope 3 emissions;
  - climate-related targets, goals and transition plans;
  - climate-related governance and risk management; and
  - a variety of other related disclosures.

As described in more detail in the annex at the end of this article, the proposed rules would be subject to phase-in periods:

- large accelerated filers would be required to begin making the new disclosures as early as annual reports for 2023 to be filed with the SEC in early 2024;
- one year later, large accelerated filers would be required to provide Scope 3 emissions disclosure and attestation of Scope 1 and Scope 2 emissions at a "limited assurance level" (i.e., equivalent to the level of review applied to unaudited quarterly financial statements);
- after an additional year, attestation of Scope 1 and Scope 2 emissions would be required at a "reasonable assurance level" (i.e., equivalent to the level of review applied to audited annual financial statements); and
- smaller companies would have additional time to comply with applicable requirements.

There are many details, nuances and uncertainties associated with the proposed rules. Companies, including REITs, should consult with counsel regarding the potential effects of the proposed rules and the implications of any final rules that are adopted.

BACKGROUND

The formal title of the SEC's proposal is "The Enhancement and Standardization of Climate-Related Disclosures for Investors," which underscores that the intent of the proposed rules is to provide consistent, comparable and reliable—and therefore decision-useful—information to investors to enable them to make informed judgments about the impact of climate-related matters on current and potential investments. Many (but certainly not all) public companies, including many (but certainly not all) REITs, have already been making disclosures about climate-related matters in response to existing SEC rules and on a voluntary basis, usually in stand-alone reports that address all environmental, social and governance (ESG) matters published on company websites. The proposed rules reflect the SEC's concern that the existing disclosures are not as robust, balanced, widespread and standardized as they need to be to serve as a critical input in many investors' decisions to buy, sell and vote securities.

Another important objective of the proposed rules is to harmonize the US climate-related disclosure regime with international efforts. The proposed rules are modeled on the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD),[2] an international framework for climate-related disclosures which serves as a guide for many existing voluntary climate-related disclosures in ESG reports and for mandatory climate-related disclosure regimes in other jurisdictions, such as the European Union and the United Kingdom. The TCFD is also the model for ongoing international climate-related disclosure standard-setting initiatives, most notably the draft general standard recently proposed by the recently established International Sustainability Standards Board to set a "global baseline" for climate-related disclosure and reporting that is materially consistent with the TCFD recommendations.[3]

Not all REITs that make voluntary climate-related disclosures do so in alignment with the TCFD but many do,[4] not least because TCFD-alignment is viewed favorably by many investors and serves a central plank of many policies of institutional asset managers designed to compel more robust

[2] A description of the structure, purpose and activities of the TCFD and its published recommendations and related guidance are available at its website: https://www.fsb-tcfd.org.

[3] https://www.ifrs.org/news-and-events/news/2022/03/issb-delivers-proposals-that-create-comprehensive-global-baseline-of-sustainability-disclosures/

[4] According to the most recent National Association of REITs (Nareit) REIT ESG Dashboard (available at https://www.reit.com/investing/reits-sustainability/reit-esg-dashboard), all of the 100 largest US equity REITs by market capitalization reported publicly on their ESG efforts in 2021, up from 98 in 2020 and 60 in 2017, the first year Nareit gathered the data. In 2021, 80 of those REITs issued a stand-alone sustainability report as part of this public reporting, up from 66 REITs in 2020 and 28 REITs in 2017. However, for both 2020 and 2021, only 23% of these REITs by equity market capitalization reported publicly in alignment with TCFD. REITs also report climate-related information in response to surveys by organizations that report industry benchmarking data to companies, investors and other global stakeholders. The Carbon Disclosure Project (CDP) and The Global Real Estate Sustainability Benchmark (GRESB) are two of the most prominent of these types of organization, and their surveys are intended to elicit disclosures that align with the TCFD recommendations. Nareit found that 58% of the top-100 equity REITs by market capitalization reported under GRESB for 2021 (up from 50% for 2020) and 53% reported under CDP for 2021 (up from 45% for 2020). Supplementary research as to the ESG disclosure practices of mortgage REITs and smaller REITs (which were not included in NAREIT's analysis) reveals that, in 2021, 21.4% of mortgage REITs made public ESG disclosures (in a stand-alone report or on a website), but only 2% made disclosures aligned with TCFD. Of the "second-100" largest REITs (including mortgage REITs), 35% made public ESG disclosures (in a stand-alone report or on a website), but only 6% made disclosures aligned with TCFD.

climate-related disclosures.[5] The SEC believes that companies that currently align their voluntary disclosures with the TCFD will find it easier to comply with the proposed rules. There are, however, significant differences between aligning with the voluntary recommendations of a private organization and complying with the mandatory rules of a government regulator. The degree of any potential head start on compliance with the proposed rules a company may gain from its existing climate-related disclosure practices will vary by company and may not be significant. Surveying the current landscape of TCFD-aligned disclosure reveals significant variations, as companies pick and choose the elements of the TCFD recommendations they follow and the level and depth of the detail and analysis they provide. Some companies tend to focus on their achievements and aspirations without addressing matters they are less eager to highlight. This phenomenon is occasionally referred to as "greenwashing." Moreover, even though an ESG report that is not filed with the SEC is subject to the same potential liability under the general anti-fraud provisions of the federal securities laws as any other public statement by a public company, the level of rigor applied to the preparation and review of ESG disclosures by companies, their auditors and investors is often substantially less stringent than that applied to disclosures in SEC filings.

THE PROPOSED RULES: IDENTIFICATION, CATEGORIZATION AND DESCRIPTION OF CLIMATE-RELATED RISKS

The proposed rules would require companies to identify the actual or potential negative impacts reasonably likely to have a material impact on the company which may manifest over the short, medium, and long term. Whether an impact would be "material" for these purposes is based on the standard long-ago articulated by the Supreme Court: whether there is a substantial likelihood that a reasonable investor would consider the matter important when determining whether to buy or sell securities or how to vote, which can entail an assessment of both the probability that an event may occur and its potential magnitude, or significance to the company.[6] The SEC has chosen not to define what it means by "short, medium, and long term" but, rather, to require companies to choose and disclose their own definitions of the relevant time horizons as part of the broader narrative discussion.

In the required disclosure, all identified risks would need to be divided into "physical risks" and "transition risks." As a general matter, physical risks relate to natural phenomena that have occurred or may occur as the planet warms and must be further subdivided into "acute" and "chronic" risks. "Acute risks" are event-driven risks related to shorter-term extreme weather events, such as hurricanes, floods and tornadoes. "Chronic risks" are risks that may result from longer term weather patterns and related effects, such as sustained higher temperatures, sea-level rise, drought and increased wildfires, as well as related effects such as decreased arability of farmland, decreased habitability of land and decreased availability of fresh water.

A clear example of a physical risk would be when properties owned by a REIT or serving as collateral for loans by a REIT are located in areas exposed to a high risk of increased flooding. As a result, these properties could experience lower rental rates and occupancy as well as higher

[5] For example, under BlackRock's policy, where corporate disclosures are not adequately aligned with the recommendations of the TCFD or a company has not provided scope 1 and 2 emissions disclosures and meaningful short -, medium -, and long- term targets, BlackRock is unlikely to support directors considered responsible for climate risk oversight. However, while BlackRock encourages companies to disclose their scope 3 emissions and targets where material to their business model, BlackRock does not consider such scope 3 disclosures and commitments essential to its support for directors. *See* https://www.blackrock.com/corporate/literature/publication/blk-commentary-climate-risk-and-energy-transition.pdf.

[6] *See TSC Industries, Inc. v. Northway, Inc.*, 426 U. S. 438 (1977) and *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

Market Data: Industry wide, **134** REIT capital markets deals worth **$28.1 billion** completed thus far in 2022

costs, such as expenditures required to protect against (or clean up after) flood damage or more expensive property insurance, to the extent insurance remains available. Along these lines, properties also may not be worth as much in the future as a result of issues specific to the particular properties or declines in the overall market in which they are located. With these types of risks in mind, the proposed rules contemplate, without regard to materiality, disclosure of the location, down to the ZIP code, of any properties subject to the identified physical risk, as well as the percentage of those assets (square meters or acres) that are located in flood hazard areas.

Transition risks relate to the ongoing and anticipated transition the world is making towards a warmer, potentially carbon-neutral future and other human responses to climate change. A clear example of a transition risk is the potential for legislation intended to achieve emissions reductions which could include “net zero” requirements or carbon taxes. While federal legislation of this nature does not yet appear imminent, many REITs are already directly confronting the potential costs arising from state laws, such as New York City’s Local Law 97, which requires large commercial real estate assets in New York City to meet energy efficiency and emissions standards starting in 2024 or suffer financial penalties.[7] However, the category is extremely broad and any regulatory, technological and market changes to address the mitigation of, or adaptation to, climate-related risks should be categorized as a transition risk, including changing tenant preferences for energy efficiency, potential reputational harms from actual or perceived poor environmental performance relative to peers or targets and potential changes in the availability and terms of financing given the increased incorporation of climate-related considerations into the investment decisions of many debt and equity investors.

THE PROPOSED RULES: DISCUSSION AND ANALYSIS OF ACTUAL AND POTENTIAL IMPACTS OF IDENTIFIED RISKS AND RELATED MATTERS AND RISK MANAGEMENT

The proposed rules would require companies to describe the actual and potential impacts of the identified climate-related risks on the company’s strategy, business model and outlook. This requirement, unlike the requirement to identify risks, is not subject to any materiality standard. Moreover, the range of impacts to be identified is non-exclusive and broad, covering not only the direct impacts on the company but also impacts on the company’s entire value chain (which includes all the company’s upstream suppliers and downstream customers, such as the tenants of equity REITs and the borrowers of mortgage REITs) and any of the company’s activities to mitigate or adapt to climate-related risks, including the adoption of new technologies.

Companies also would be required to discuss whether and how these identified actual and potential impacts are considered as part of the company’s business strategy, financial planning and capital allocation, followed by (or integrated with) a discussion of whether and how any of the identified risks have affected or are reasonably likely to affect the company’s consolidated financial statements and a description of the “resilience” of the company’s business strategy. This discussion must also address information required in response to other elements of the proposed rules:

- the climate-related financial statement metrics required by proposed new Article 14 of Regulation S-X;
- GHG emissions; and
- climate-related targets and goals, such as “net zero” targets.

As part of this discussion, companies are required to provide both current and forward-looking disclosures that facilitate an understanding of whether the implications of the identified climate-related risks have been integrated into the company’s business model or strategy, including how any resources are being

[7] *See After Pandemic, New York’s Buildings Face Daunting Decarbonization Mandate*, by Justin Gerdes (April 23, 2020), available at https://www.greentechmedia.com/articles/read/new-york-citys-ambitious-building-emissions-law-turns-one (noting that, June 2019, the Urban Green Council found that retrofitting all 50,000 buildings covered by the law could cost up to $24.3 billion through 2030).

used to mitigate climate-related risks. For REITs, this could include a discussion of the expected costs and characteristics of, as well as the anticipated source and terms of funding for, capital expenditures needed to enhance the emissions efficiency of existing buildings. Such investments could also lead to a "green premium," where net operating income and asset value increase as a property becomes more desirable to emissions-conscious tenants and cheaper to operate due to lower energy consumption, not to mention less subject to potential future costs associated with emissions reduction regulations. On the other hand, the discussion could also cover any "brown discount" associated with buildings where energy efficient improvements cannot be implemented on acceptable terms, or at all, raising the possibility not only of declining net operating income, but also asset impairments.

This discussion could also cover the role and effect of sustainable financing instruments, such as green bonds, in a company's current and anticipated capital structure. The use of green bonds by REITs has increased in recent years, both in absolute terms and as a relative portion of all bonds issued by REITs.[8]

- The discussion would also be required to include, if applicable but whether or not material, discussions and descriptions (including certain specified information) regarding:
- the role that carbon offsets or renewable energy credits (RECs) play in the company's climate-related business strategy;
- any internal carbon price maintained by the company; and
- any analytical tools, such as scenario analysis, that the company uses to assess the impact of climate-related risks on its business.

Finally, a company would be required to discuss any processes it has for identifying, assessing and managing climate-related risks, as well as the degree to which any such processes are integrated into the company's overall risk management system or processes and how any separate board or management committee that is responsible for assessing and managing climate-related risks interacts with the company's board or management committee governing risks. The proposed rules would also require, in this context, a description of any transition plan adopted by the company together with related information and analysis.

THE PROPOSED RULES: CLIMATE-RELATED FINANCIAL STATEMENT METRICS

The proposed rules would require addition of a new note to the company's audited annual financial statements that would reflect quantified climate-related metrics on a line-item, by line-item disaggregated basis for each year covered by the financial statements and qualitative contextual information about how such quantitative metrics were derived. These quantitative and qualitative disclosures would be required without regard to materiality, although, if the *aggregate* impact of all required climate-related metrics does not exceed 1% of a particular line-item, no disclosure would be required. This requirement would not be subject to any additional phase-in period and so would immediately be subject to audit and within the scope of companies' internal control over financial reporting when the general disclosure requirements became effective.

The required climate-related financial statements metrics would relate to the impacts (positive and negative) of severe weather events and other natural conditions (such as sea-level rise), transition activities, and any identified climate-related risks or climate-related opportunities. A REIT, for example, might need to address the cost of damages from flooding that occurred due to sea-level rise or the interest cost effects from achieving an emissions target that results in a step-down in the interest rate for a sustainability-linked loan.

The proposed rules would also require companies to provide qualitative information about how climate-related risks have affected the estimates and assumptions underlying the financial statements, such as impairment analyses, that, for a REIT, might reflect the anticipated impact of physical risks, such as rising sea levels or increased flooding, on asset values.

THE PROPOSED RULES: GHG EMISSIONS AND ATTESTATION

Reducing GHG emissions is the key focal point of many governmental and market-driven efforts to address climate change. The construction and operation of buildings contributes 38% of worldwide GHG emissions,[9] and, for most REITs, their level of GHG emissions is relevant for their exposure to transition risk.

Under the proposed rules, all companies would be required to disclose, for each completed fiscal year covered by the annual financial statements, their Scope 1 GHG emissions (representing direct company emissions) and their Scope 2 GHG emissions (representing indirect company emissions from the generation of purchased electricity, steam, heat or cooling). Scope 1 and Scope 2 emissions would be required whether or

[8] *S&P Global Market Intelligence, Green bond issuance by US REITs grew in 2021*, by Chris Hudgins (January 31, 2022), available at https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/green-bond-issuance-by-us-reits-grew-in-2021-68335451.

[9] *United Nations Environment Programme, 2020 Global Status Report for Buildings and Construction*, available at https://globalabc.org/sites/default/files/inline-files/2020%20Buildings%20GSR_FULL%20REPORT.pdf.

not they are material and would be subject to attestation on a phased-in basis for all companies except non-accelerated filers as described in the annex at the end of this article. The proposed rules would not require the attestation provider to be a registered public accounting firm but would require the attestation provider to be independent and to have sufficient expertise to do the work.

Scope 3 emissions, which are described in more detail below, represent all indirect emissions from the company's upstream (e.g., suppliers) and downstream (e.g., customers) value chain, subject to a few important exceptions and accommodations also described below.

The definitions of Scope 1, 2 and 3 emissions are intended to be substantially similar to the corresponding definitions provided in the GHG Protocol.[10] The GHG Protocol is an international GHG accounting standard that is widely used for multiple regulatory and other purposes, including GHG emissions data provided pursuant to the TCFD.

GHG emissions data that would be required under the proposed rules must be reported disaggregated on a gas-by-gas basis (there are seven) and in the aggregate on a CO_2 equivalent basis. This GHG emissions data must exclude purchased and generated offsets, even if any such offsets are part of the company's GHG emissions reduction target or goal. Intensity metrics (i.e., GHG emissions per unit of economic value, such as revenue, or per unit of production, such as rentable square feet) are also required.

There are a variety of assumptions, estimates, judgments and external data associated with GHG emissions calculation, and the SEC has proposed a number of requirements and provisions to help investors to see through the accompanying disclosure how the company derived and calculated the GHG emissions amounts it is reporting. These requirements[11] also help highlight some of the many challenges in reporting and interpreting GHG emissions data and give some sense of how voluminous and intricate the accompanying caveats and explanatory footnotes may become.

In practice, some of the data and documentation necessary to verify, attest and report GHG emissions data may not be ready on the same schedule as a company's annual report on Form 10-K becomes due. Accordingly, the proposed rules provide that, to the extent actual reported data is not reasonably available when the related disclosure is due for the full fiscal year, a company may use a reasonable estimate of its GHG emissions for its fourth fiscal quarter, together with actual, determined GHG emissions data for the first three fiscal quarters, as long as the company promptly discloses in a subsequent filing any material difference between the estimate used and the actual, determined GHG emissions data for the fourth fiscal quarter. Moreover, data for historical periods can be omitted if not reasonably available. This should be particularly helpful for companies that have not historically calculated GHG emissions data prior to the effectiveness of the SEC mandate.[12]

THE PROPOSED RULES: SCOPE 3 EMISSIONS

Given the wide and diffuse range of activities up and down a company's value chain that can generate Scope 3 emissions,[13] they are likely the largest emissions source for many companies. Unfortunately, they are also the most difficult to calculate for a variety of reasons. Perhaps most fundamentally, the calculation depends on companies collecting and verifying data from third parties the company does not control. Moreover, the calculation methodologies contemplated by the GHG Protocol allow companies, even companies within the same industry, to decide which sources of emissions to include in (or omit from) their calculations and permit identical companies within the same industry to calculate emissions from the same source differently.[14] Total reported Scope 3 emissions may also result in some double-counting because of overlap in categories, although a company would be required to report this effect. Scope 3 emissions calculations are also based on a variety of other subjective and variable assumptions and estimates to a far greater extent, depending on the type of data, than Scope 1 and Scope 2 emissions.

In recognition of the inherent difficulties of calculating and reporting Scope 3 emissions, the disclosure requirement is qualified by a few important exceptions and accommodations:

- Scope 3 emissions only need to be disclosed if material or if the company has set a GHG emissions reduction target or goal that includes its Scope 3 emissions;

[10] See https://ghgprotocol.org for more information about the GHG Protocol, including relevant guidance.

[11] Examples include:
- a description of the methodology, significant inputs and significant assumptions used to calculate its GHG emissions, including an explanation of how the company determined which emissions and data to use;
- disclosure regarding gaps in the data required to calculate GHG emissions and how the effect of any data gaps on the accuracy or completeness of GHG emissions disclosure; and
- allowing reasonable estimates to be used as long as the company also describes the assumptions underlying, and its reasons for using, the estimates.

[12] According to the Nareit REIT ESG Dashboard, in 2021, 78% of the top-100 equity REITs by market capitalization disclosed carbon emissions, up from 66% for 2020 and 41% for 2018, and 71% disclosed energy usage, up from 66% for 2020 and 42% for 2018.

[13] The proposed rules, like the GHG Protocol, identify 15 categories of potential Scope 3 emissions sources up and down a company's full value chain, including but not limited to upstream supply chain emissions from purchased products, transport and distribution emissions, waste generation, employee commuting and business travel and downstream emissions from transport, distribution, use and disposal of products, leases and investments.

[14] As the most recently updated Corporate Value Chain (Scope 3) Accounting and Reporting Standard (available at https://ghgprotocol.org/standards/scope-3-standard) states: "Use of this standard is intended to enable comparisons of a company's GHG emissions over time. It is not designed to support comparisons between companies based on their Scope 3 GHG emissions."

- no attestation of Scope 3 emissions is required;
- smaller reporting companies are fully exempt from the Scope 3 emissions disclosure requirement;
- there is an explicit safe harbor from fraud-based liability for any statement about Scope 3 emissions that is made or reaffirmed with a reasonable basis and in good faith; and
- estimated Scope 3 emissions may be presented in terms of a range, subject to accompanying explanatory and qualifying disclosure.

Each company must determine for itself whether its Scope 3 emissions are material based on its own facts and circumstances, although the SEC has suggested in the proposal that Scope 3 emissions may be material if they make up a significant portion of a company's total GHG emissions, while noting that many companies have adopted a 40% threshold for determining what a "significant portion" of GHG emissions would be for this purpose. We also note that, as the TCFD indicated in one of its recent publications, it has been estimated that over 90% of the GHG emissions by the real estate sector are Scope 3 emissions,[15] which is consistent with the fact that most REITs are organized to have small corporate operations and own or lend to a significantly larger (relatively speaking) pool of third party tenants or borrowers.

For equity REITs, one of the biggest challenges with Scope 3 emissions disclosures arises when, as is often the case, tenants are responsible for paying utility costs, and the leases do not require tenants to report utility information to the building owned. Submetering (whereby the building owner purchases electricity in bulk and then charges tenants directly for how much they use), "green" leases (which may include provisions requiring tenant reporting of utility and other information necessary for the building owner to calculate its Scope 3 emissions and incentives for tenants to reduce emissions) and tenant engagement efforts can help, but only so much. Calculating Scope 3 emissions also requires an equity REIT to grapple with the carbon attributable to materials (steel, concrete, aluminum, glass and plastic are all significant emissions sources) and construction activities required to build, renovate, refurbish and maintain a building as well as emissions associated with building deconstruction and demolition.

For mortgage REITs, the standards and methodologies regarding "financed emissions" that are under development by financial sector participants, such as the Partnership for Carbon Accounting Financials (PCAF),[16] to help guide Scope 3 emissions calculations for the so-called "financed emissions" associated with mortgage loans and other investments should be helpful.

THE PROPOSED RULES: TARGETS, GOALS AND TRANSITION PLANS

The quest to reach "net zero" GHG emissions has become an imperative for many industries around the world, and REITs are no exception: according to the Nareit REIT ESG Dashboard, for 2021, 64% of the top-100 equity REITs by market capitalization disclosed a carbon target, up from 46% for 2020 and 30% for 2018, the first year of Nareit's data. Transition plans, which can reflect the broader strategic overlay for how a company intends to achieve a "net zero" target, are also becoming more and more prevalent.

The proposed rules include a requirement that any "net zero" target (or any other climate-related target or goal) set by a company must be disclosed, together with contextual information that clarifies the parameters of the target or goal, such as what is being measured, against what baseline and over what period. Companies that disclose targets and goals must also disclose how they intend to meet the target or goal and then provide annual

[15] *TCFD Guidance on Metrics, Targets and Transition Plans*, page 56, available at https://assets.bbhub.io/company/sites/60/2021/07/2021-Metrics_Targets_Guidance-1.pdf.
[16] *The Global GHG Accounting & Reporting Standard for the Financial Industry*, available at https://carbonaccountingfinancials.com/files/downloads/PCAF-Global-GHG-Standard.pdf.

progress updates. These disclosures could become critical as investors monitor and assess companies' pathways and progress towards their stated targets and goals relative to expectations, including with respect to potential costs and relative to peers. The role and cost of purchased carbon offsets that can be subtracted from absolute GHG emissions to achieve a "net zero" target could also be a focus of investors in this context.

The proposed rules also include similar disclosure requirements as to the characteristics and annual progress of any transition plan adopted by a company. A transition plan is defined as a company's strategy and implementation plan to reduce climate-related risks, which may include a plan to reduce its GHG emissions in line with its own commitments or commitments of jurisdictions within which it has significant operations, and companies may integrate disclosure about any targets or goals and any transition plan that encompasses or complements such targets or goals into the same narrative.

Disclosure regarding a transition plan could also include some of the climate-related initiatives and goals that REITs currently report on and track in their voluntary ESG reports, including operational energy efficiency improvements (such as switching to LED lighting or upgrading HVAC systems), green building certifications (such as LEED or BREEAM), installation of electric vehicle charging stations and use of renewable electricity.

THE PROPOSED RULES: GOVERNANCE

The proposed rules would require companies to describe the board of directors' oversight of climate-related risks and management's role in assessing and managing climate-related risks. The description would include, as applicable, a variety of specified and relatively detailed information about the inner workings of the board, such as the processes by which management reports at the board level on climate-related risks and board-level discussions, including the frequency of such reports and discussions. Companies would also be required to disclose whether any member of the board of directors has expertise in climate-related risks, accompanied by detailed disclosure describing the nature of the expertise.

While none of these proposed disclosures require any change in governance practices, they do suggest what the SEC considers to be important for comparing governance practices across companies. Boards may therefore feel pressure to increase the rigor of, or at a minimum review, their existing processes in view of future disclosure. For example, while many boards have discussed and considered which body (i.e., the full board, an ESG committee, the nominating and corporate governance committee, etc.) has responsibility for different ESG matters, including climate-related risks, and the scope and procedures associated with such responsibilities and have updated their committee charters and other governing documents accordingly, many boards may wish to revisit these matters in light of the proposed rules.

CLIMATE-RELATED OPPORTUNITIES

While not addressed specifically in the summary of the proposed rules in this article, as a general matter, wherever disclosures about climate-related risks and related information are required, the proposed rules also indicate that companies can, at their option, provide similar disclosures regarding climate-related opportunities. This is in contrast to the TCFD recommendations, which solicit information and analysis regarding risks and opportunities on an equal basis. The SEC's main rationale for providing companies this flexibility—to allay any anti-competitive concerns that might arise from a requirement to disclose a particular business opportunity—is certainly admirable, but companies will have to weigh this consideration against the countervailing imperative to give investors a more complete picture. For example, especially as technology continues to improve, REITs may increasingly install solar panels on the roofs of buildings they own, which may, in addition to reducing the cost (whether measured in dollars or GHG emissions) of purchasing electricity, generate additional income if excess generated electricity can be sold back to the grid.[17]

POTENTIAL LIABILITY

Unlike climate-related disclosures provided in formats other than an SEC filing, the climate-related disclosures required by the proposed rules will be "filed" not "furnished" and will need to be included (directly or through incorporation by reference) in registration statements. Such disclosures will therefore generally be subject to potential liability under the Securities Act of 1933 for material

[17] In pursuing any climate-related opportunities, REITs always need to be mindful of the impact on their federal income tax qualification testing. In many areas, the Internal Revenue Service has not yet issued guidance or has issued only partial guidance regarding the treatment of climate-change driven items. For example, producing electricity beyond what is needed for the REIT's building could produce nonqualifying income, certain solar equipment is treated as personal property and electric vehicle charging stations could be treated as permissible provision of utilities or impermissible tenant service. The disclosure produced by the proposed rules should help REITs in determining whether a particular climate-change item is "customary," which can be relevant to its REIT treatment. Ideally, though, the Internal Revenue Service will issue guidance (and, hopefully, favorable guidance) supporting REITs' ability to fully pursue climate-related opportunities that currently exist or that may become possible as technologies and infrastructure continue to develop.

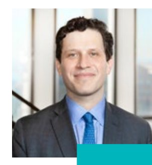
misstatements and omissions, which, unlike potential liability under Rule 10b-5 of the Securities Exchange Act of 1934 that could apply to a statement in an ESG report, does not require scienter. Given the difficulties, uncertainties and judgments entailed in preparing the mandated disclosures, which are as novel and as complex as any new rule the SEC has ever proposed, miscalibrations are inevitable, particularly when any final rules first become effective and precedents are limited. This dynamic would be further exacerbated by the prescriptive rigor of the disclosure requirements, many of which require companies to make statements about matters that are more speculative and uncertain than any other disclosures companies are currently required to make. To the extent climate-related disclosures, such as "net zero" targets, strategic aspirations and expected or potential impacts, are forward-looking, such disclosures would be protected by the safe-harbor protections under the Private Securities Litigation Reform Act of 1995 if applicable conditions are met. However, this safe harbor is limited and does not cover IPOs or limit the SEC's ability to bring enforcement actions. The proposed rules contemplate an additional new safe harbor, but its scope is narrow, protecting only statements regarding Scope 3 emissions. Moreover, safe harbors, while certainly helpful, do not prevent opportunistic plaintiff's lawyers from filing suits, which must be defended even if they do not ultimately result in any legal liability for the company. Given the potential for the proposed rules to greatly expand the number of companies making climate-related disclosures and the potential scope, breadth and depth of such disclosures, an increase in "greenwashing" lawsuits seems likely and could be accompanied by an increase in SEC enforcement actions.

OBSERVATIONS AND RECOMMENDATIONS

Comments on the proposed rule are not due until June 17, 2022, but there is still a long way to go after that before the proposed rules become final. Moreover, any final rules adopted could differ significantly from the proposed rules described above, and a legal challenge to any final rules adopted is likely inevitable. However, one thing about the future of the proposed rule is not in doubt: compliance will not be easy and it will not be cheap, particularly for smaller companies that will experience the impact of increased fixed costs proportionately greater than larger companies. Additional internal and external resources will almost certainly be needed, and demand for these resources may outstrip supply. This would not only put pressure on the overall financial cost to companies but also on their practical ability to complete the necessary work on the ambitious timeframe the SEC is demanding.

Given the scale and complexity of the endeavor, we recommend that companies begin their preparations to make SEC-compliant climate-related disclosures as soon as possible while also focusing on the influence the proposed rules may already be having on investor expectations and "best practices" with respect to any upcoming climate-related disclosures (i.e., in this year's ESG report). A few questions for companies to think about as part of this process are set forth below.

- Do we understand how each element of the proposed rules would apply to us and what we currently do (or are planning to do)?
- Is there anything we are not currently doing (or not planning to do) that we should consider doing in light of the disclosure requirements in the proposed rule?
- How do we plan to set up and implement internal procedures necessary to comply on the potential timelines?
- What additional personnel or outside resources (including external resources) do we need to prepare for and comply with the proposed rules?
- What changes may be needed to our disclosure controls and procedures and our internal control over financial reporting?
- Do our existing climate-related disclosures (if any) align with the TCFD and the GHG Protocol? What additional disclosures would be needed to comply with the proposed rules?
  - What GHG emissions data and other climate-related metrics will we disclose and how will we calculate them?
  - How will we obtain required third party assurance?
  - What climate-related risks and opportunities apply to us and what are their actual and potential impacts?
  - What are our Scope 3 emissions and are they material?
- If we are publishing climate-related disclosures while the proposed rules are still pending (i.e., in this year's ESG report), to what degree will we try to align such disclosures with what is contemplated by the proposed rules?



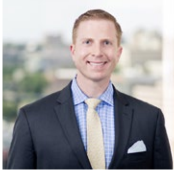
Samuel M. Kardon

ANNEX

Disclosure Requirement	Large Accelerated Filers	Accelerated Filers	Non-Accelerated Filers	Smaller Reporting Companies
All new disclosures other than Scope 3 emissions	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)	Same as Accelerated Filers	Fiscal year 2025 (filed in 2026)
Scope 3 emissions	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	Same as Accelerated Filers	Exempt
Limited Assurance for Scope 1 & 2 emissions	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	Exempt	Same as Accelerated Filers or Non-Accelerated Filers (as applicable)
Reasonable Assurance for Scope 1 & 2 emissions	Fiscal year 2026 (filed in 2027)	Fiscal year 2027 (filed in 2028)	Exempt	Same as Accelerated Filers or Non-Accelerated Filers (as applicable)

Note: Assumes a fiscal year ended December 31 and effectiveness of the proposed rules before the end of 2022.

CONTACT US



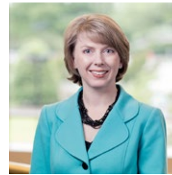
James V. Davidson
Partner, Richmond
jdavidson@HuntonAK.com
+1 804 787 8035

Anna Knecht Page
Counsel, Richmond
apage@HuntonAK.com
+1 804 788 7214

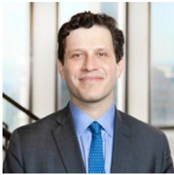
Steven M. Haas
Partner, Richmond and Washington, DC
shaas@HuntonAK.com
+1 804 788 7217 (Richmond)
+1 202 778 2220 (Washington, DC)

Kate Saltz
Partner, Richmond
ksaltz@HuntonAK.com
+1 804 788 8642

George C. Howell, III
Partner, New York and Richmond
ghowell@HuntonAK.com
+1 212 309 1228 (New York)
+1 804 788 8793 (Richmond)



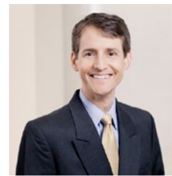
Kendal A. Sibley
Partner, Richmond
ksibley@HuntonAK.com
+1 804 788 8697



Samuel M. Kardon
Counsel, New York
skardon@HuntonAK.com
+1 212 309 1189

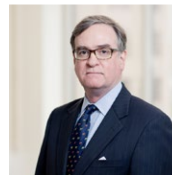
Robert K. Smith
Partner, Washington, DC
rsmith@HuntonAK.com
+1 202 955 1611

James A. Kennedy, II
Partner, Richmond
jkennedy@HuntonAK.com
+1 804 788 7302



Mark W. Wickersham
Partner, Richmond
mwickersham@HuntonAK.com
+1 804 788 7281

Joshua Milgrom
Counsel, New York
jmilgrom@HuntonAK.com
+1 212 309 1015



David C. Wright
Partner, Richmond
dwright@HuntonAK.com
+1 804 788 8638

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