

Green Building Representations and the Emerging Potential for Securities Fraud Liability

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INTRODUCTION

IN THE PAST TEN YEARS, THE NOTION OF “GREEN” or high-performance building has moved from an isolated concept discussed among small groups of idealists to become a key element of any credible discussion regarding public or private investment in the built world.

However, that growth has been accompanied by a penumbra of oft-repeated but misunderstood or exaggerated claims regarding green building practices and certification. Unfortunately, it appears that some of those claims are being made by public companies in their securities disclosures.

In order to understand how this has occurred, it is important to understand the fervent growth of green building as a kind of social “movement”¹ in the United States. In part due to the threat of global warming and the precipitous rise of fuel costs, the green building movement has gained considerable urgency and legions of committed followers.

While environmental concerns and energy costs both factor into the growth of green building, much of the credit is due to the United States Green Building Council (USGBC) and the development and marketing of its Leadership in Energy and Environmental Design (LEED®) green building certification products. Where similar movements to encourage environmental practices (i.e., organic foods) have been mired in competing and misunderstood definitions or certification regimes, LEED has

managed to succeed. Although rating systems exist that are similar to LEED, the USGBC has virtually cornered the market on the rating of green commercial buildings.

USGBC’s cornering of the market arose from four fundamental issues: 1) LEED provides a clear definition of green that references existing, third-party standards, codes and calculation methods; 2) LEED provides an easily understood points system that seems to appeal to the competitive nature in all of us; 3) the USGBC rolled out LEED by first getting a foothold of acceptance among key federal government agencies; and 4) increasing levels of LEED certification are awarded on an appealing, highly-



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compliance with LEED requirements, creating green development covenants for neighborhoods, advising corporations and public authorities regarding green building portfolio disclosures and certification strategies, and counseling building owners, manufacturers, design professionals and others regarding construction contracts and the applicability of various certification regimes and tax incentives.

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marketable Olympic-medal-like recognition ranging from Certified to Silver, Gold, and finally, Platinum.

The success of the USGBC is reflected in the growth of its membership and in the number of buildings registered with the USGBC for potential LEED certification. Over the past five years, the non-profit USGBC has doubled its membership to more than 16,000.² At about the same time, commercial LEED registered projects have grown from approximately 2,000 to now more than 13,000 nationwide.³

Just as astonishing is the success of the USGBC's annual Greenbuild conference (recently purchased by McGraw-Hill) where the number of attendees last year (22,835⁴) was more than six times the number in attendance at the inaugural 2002 conference.⁵ This year's Greenbuild, set for November 19 in Boston, will feature Nobel Peace laureate Archbishop Desmond Tutu as its keynote speaker.

LEED's popularity has not escaped the attention of lawmakers, who have written the LEED point system into various tax⁶, building⁷ and zoning⁸ codes, and even into settlement orders in environmental litigation at nearly every level of government.⁹ Whether or not this was the design of LEED's progenitors, what started as an attempt to add a set of environmental options to a set of building practices and materials has become a national and international phenomenon.¹⁰

While its current LEED products have caught on around the world, the USGBC continues to make changes to them. At present, the USGBC offers nine LEED products. They are: New Construction & Major Renovations, Existing Buildings: Operations & Maintenance, Commercial Interiors, Core & Shell, Schools, Retail, Healthcare, Homes, and Neighborhood Development.¹¹

In addition to developing LEED products, the USGBC sells educational materials and seminars, and until recently, administered an accreditation program for design professionals and others (including lawyers) interested in earning the LEED-Accredited Professional (LEED-AP) designation in the application of LEED standards. As of September 2008, the USGBC claims to have accredited 60,000 LEED-APs.¹² The USGBC also certifies projects as LEED-compliant by obtaining written certifications from project architects stating that design elements meet LEED requirements. Beginning in 2009, the certification process will move to the Green Building Certification Institute, a 501c6 non-profit organization established by the USGBC. The following certification

organizations will work with the new GBCI:

- ABS Quality Evaluations, Inc. (<http://www.abs-qe.com>)
- BSI Management Systems America, Inc. (<http://www.bsi-global.com>)
- Bureau Veritas North America, Inc. (<http://www.us.bureauveritas.com>)
- DNV Certification (<http://www.dnvcert.com>)
- Intertek (www.intertek-sc.com)
- KEMA-Registered Quality, Inc. (<http://www.kema.com>)
- Lloyd's Register Quality Assurance Inc. (www.lrqausa.com)
- NSF-International Strategic Registrations (<http://www.nsf.org>)
- SRI Quality System Registrar, Inc. (<http://www.sri-i.com>)
- Underwriters Laboratories-DQS Inc. (<http://www.ul.com/mss>)

A number of the largest public corporations, investment funds and public institutions in the U.S. have begun to certify their buildings with the USGBC under LEED.¹³ This trend appears ready to increase dramatically as the USGBC unveils its portfolio certification program, which enables an owner to simultaneously certify its entire building stock. Currently in pilot form with the USGBC, the portfolio program includes 40 participating companies and institutions and covers 1,700 buildings and approximately 135 million square feet of building space. Pilot participants include institutional investors, financial institutions, hoteliers, retailers, universities and public corporations.

In July 2008, Office Depot joined a number of other retailers in opening its first LEED-prototype certified store in Austin, Texas.¹⁴ According to the USGBC, "...the most aggressive at pursuing green building..." appears to be Kohl's Department Stores, which last November announced that it would aim to obtain "...LEED certification for every store to break ground in 2008—or more than 80 locations."¹⁵ Other portfolio program participants include Wal-Mart, Starbucks, McDonald's, Target, Home Depot, REI and Whole Foods.¹⁶

FEDERAL SECURITIES LAWS

The Securities Act of 1933 ('33 Act) was enacted by the

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U.S. Congress as a means to restore trust in the U.S. financial system in the wake of the stock market crash of 1929 and the Great Depression. In general, it requires registration with the U.S. Securities and Exchange Commission (SEC) of any securities offered to the public. The registration process requires that the offeror provide the Commission with detailed information on the company, its management, its proposed use of funds raised, and its financial statements. Registration statements and prospectuses become available to the public shortly after filing via the Commission's online EDGAR database.

Whereas the '33 Act governs the primary market, the Securities Exchange Act of 1934 ('34 Act) targets the secondary market, requiring, among other things, ongoing disclosures by public companies to the SEC. Registered companies and those with more than \$10 million in assets whose securities are held by more than 500 owners must file annual and other periodic reports. These reports are also available to the public through the SEC's online EDGAR database.

Both the '33 Act and the '34 Act were intended to provide "shareholders and [the] marketplace with sufficient information to make relevant decisions and to be apprised of significant developments."¹⁷ Both Acts also prohibit manipulative and deceptive practices and provide the SEC with broad powers to punish any attempt to manipulate the market.

As described in the '33 Act and '34 Act and subsequent legislation, the SEC plays a magisterial role in identifying and enforcing the civil and criminal provisions of the '33 Act and '34 Act barring fraudulent practices. The agency scrutinizes, among other things, registration statements for newly offered securities, annual and quarterly filings (Forms 10-K and 10-Q), proxy materials sent to shareholders before an annual meeting, and annual reports to shareholders. The SEC also has the authority to seek an injunction prohibiting further violations, require an audit or commence ongoing supervisory arrangements. In addition, the SEC can seek civil monetary penalties or the return of illegal profits.

Private securities litigation also plays a central and often controversial role in enforcing the anti-fraud provisions of the securities laws. According to a report released by Cornerstone Research in cooperation with Stanford Law School's Securities Class Action Clearinghouse, 217 securities class actions were filed in the 12 months ending June 2008.¹⁸

In pursuing allegedly fraudulent activity, the SEC and shareholders commonly rely upon Section 10b of the '34 Act and Rule 10b-5 promulgated under the '34 Act. Rule 10b-5, breathtaking in its unqualified breadth and simplicity, makes it illegal to:

“. . . by the use of any means or instrumentality of interstate commerce. . . employ any device, scheme, or artifice to defraud. . . [or] make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”

In short, anybody who uses a deceptive device or makes a false statement or omission of material fact in connection with the purchase or sale of securities may be criminally or civilly liable under Rule 10b-5.¹⁹ Since the enactment of Rule 10b-5, there have been myriad court decisions and legislative enactments and Supreme Court decisions regarding the plaintiff's burdens of Rule 10b-5, most aimed at making it harder for a plaintiff to initiate suit and thus reducing the burden of class action suits on public companies.²⁰

To succeed on a civil claim for securities fraud under Rule 10b-5, a plaintiff must show that the defendant made (1) a misstatement or omission (2) of material fact (3) with knowledge (4) in connection with the purchase or the sale of a security (5) upon which the plaintiff reasonably relied, and (6) that the plaintiff's reliance proximately caused his or her injury.

Criminal prosecution under section 10(b) of the '34 Act and Rule 10b-5 does require proof of elements similar to those required to maintain a Rule 10b-5 civil action. In order for criminal liability to attach, however, there must be a showing that the defendant acted "willfully" in violating the federal securities laws.²¹

Section 11 of the '33 Act provides additional targets for shareholders who have purchased a security in reliance on a company's false or misleading statements contained in its initial registration statement. Under this provision, any person who purchased that company's securities may sue: 1) every person who signed the registration statement; 2) every director of the company; 3) every accountant, engineer, appraiser or any other person whose profession

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gives authority to a statement made by him and who has prepared or certified any part of the registration statement; and 4) every underwriter of the security. The plaintiff must show that he or she relied upon the false or misleading statement but need not prove that he actually read the registration statement. Other provisions of the securities laws provide mechanisms to sue persons in positions of authority over anyone liable under Section 11.²²

Securities class actions can result in costly settlements. The average settlement paid to resolve a shareholder class action suit during 2002–2007 was \$24.4 million. The average rose to a peak of \$33.2 million in 2007. Though lower than the average settlement, the median settlement increased to a new high in 2007 of nearly \$10 million.²³

PENUMBRA OF EXAGGERATED CLAIMS

There is some dispute over a set of oft-repeated claims regarding the benefits of green buildings and LEED certification. Those claims commonly assert that LEED-certified buildings yield greater occupant health and productivity, save more energy, use less water, achieve higher lease-up rates, produce greater higher overall valuation or are cost-neutral compared to comparable buildings.

Unfortunately, there is considerable controversy and little dependable data surrounding each of these claims. In fact, some authorities have asserted that, for example, LEED-certified buildings actually consume more energy than comparable buildings.²⁴ However, it is not the intent of this paper to evaluate the merits of such performance claims but only to point out that such controversy exists.

Many of the extraordinary claims regarding LEED and the nature of LEED-certified buildings seem to result from a misunderstanding of the way LEED actually works. Though the uninitiated might consider LEED to be strictly synonymous with low energy/water use and high energy/water efficiency, this is not the case. To obtain certification under the point system for LEED for New Construction, for example, there are 28 possible points for indoor environmental quality, materials and resources, and only 22 possible points for water and energy efficiency.

Moreover, many observers fail to understand that the USGBC does not conduct site investigations, that LEED does not require buildings to actually perform as promised as a condition of certification, and that LEED does not provide a comprehensive scientific basis or overarching objective (e.g., a net carbon footprint reduc-

tion) justifying its allocation of points. Also, because each project owner or architect can independently select the points they wish to pursue on a particular project (as long as they achieve certain required points), applicable green features can vary greatly from one LEED-certified project to another, making it extremely difficult to defend any generalized statements or comparisons regarding the features or performance of LEED-certified buildings.²⁵

As discussed above, misstatements made in connection with the sale of securities can trigger the potential for substantial liability under the anti-fraud provisions of federal securities laws. Fear of such liabilities has taught securities lawyers to strive for extreme caution and accuracy in connection with any disclosure provided to the SEC. However, a recent review of disclosures filed with respect to LEED and green building reveals some evidence of a lack of such caution and accuracy regarding the mechanics of and terminology associated with green buildings and LEED.

SAMPLE DISCLOSURES AND ANALYSIS

A search on the SEC EDGAR full-text searchable database (containing records from the past four years only) using the terms “LEED” and “Green Building” yielded 194 documents. One of those documents, a company’s 10-K filing, contained the following disclosure:

The Company is dedicated to excellence, leadership, and stewardship in matters of protecting the environment and communities in which the Company has operations. Reinforcing the Company’s commitment to the environment, five of the Company’s showrooms have been designed under the guidelines of the U.S. Green Building Council’s LEED (Leadership in Energy and Environmental Design) for Commercial Interiors program. The Company believes that continued compliance with foreign, federal, state, and local laws and regulations which have been enacted relating to the protection of the environment will not have a material effect on its capital expenditures, earnings or competitive position. Management believes capital expenditures for environmental control equipment during the two fiscal years ending June 30, 2010, will not represent a material portion of total capital expenditures during those years.²⁶

This disclosure states that the Company’s showrooms have been “designed under the guidelines of the USGBC.” Unfortunately, LEED does not provide guidelines per se, but is a checklist of building materials and practices.

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Though unlikely, the referenced “guidelines” could conceivably refer to points awarded under LEED-CI Credit 3.2 in exchange for providing bicycle storage and changing rooms. In addition, no reference is made to an actual attempt to certify the showrooms. Arguably, and depending on the facts involved, this disclosure could give the average investor the potentially misleading impression that the company is taking dramatic strides to position itself in an emerging green economy.

Another disclosure, a 10-A registration form, discovered in the above-described search of the EDGAR site contained the following:

Receiving LEED certification can provide building project owners with a number of benefits, including:

- higher lease rates;

- enhanced resale values;

- potential federal, state and local tax credits and incentives; and

- the ability to offer financial benefits to tenants, such as operating cost savings, improved worker productivity and health, and insurance and risk management benefits.²⁷

As discussed above, the above claims are often repeated but are actually subject to considerable debate. This statement presents the clearest example of a potentially misleading statement upon which a shareholder could rely in deciding to purchase the security in question and later bring a securities fraud suit if the investment soured.

Another disclosure, an S-11 registration form for a REIT, discovered in the above-described search of the EDGAR site contained the following:

In connection with our assessment and selection of investment partners, property managers, development managers and other service providers, we will consider their experience and reputation in the areas of environmental sustainability, including experience in the development and operation of buildings certified under the LEED (Leadership in Energy and Environmental Design) Green Building Rating System promulgated by the U.S. Green Building Council. The Investment Advisor will evaluate the sustainability of a prospective investment property by assessing its ENERGY STAR® score, its preliminary LEED score, and sustainability measures that have been or can be implemented, such as recycling,

water conservation and green cleaning methods.²⁸

This statement seems to suggest that knowledge of LEED is an effective tool in assessing and selecting investment partners, property managers and development managers. In addition, this statement appears to suggest that a “preliminary LEED score” (as determined by an unnamed person) is a meaningful measure of the desirability of an investment property. Again, claims related to the energy performance of LEED-certified buildings are subject to an ongoing debate, and LEED is not designed with energy performance as its primary objective.

Another disclosure, a 10-K annual report, discovered in the above-described search of the Commission’s EDGAR site contained the following:

In February 2008, we signed a development agreement for our first “solar community” project, a 47-unit condominium project co-sited with a Whole Foods store and other mixed retail outlets in San Diego, California. The project is a LEED-certified “green” development scheduled for construction commencing during the summer of 2008.²⁹

This disclosure appears to state that the project has been certified but that construction has not yet begun. Ordinarily, LEED projects are not certified prior to construction. This appears to be a misstatement of fact based on a misunderstanding of the mechanics of LEED certification.

CONCLUSION

Public companies involved in green building and LEED certification should be cognizant of the risks involved in making unsupported or misleading claims regarding the performance of green buildings or the relevance of LEED certification. Disclosures should avoid making unqualified or unsupported generalizations regarding the performance of buildings or of the perceived benefits of certification under LEED. Any such disclosures should be reviewed by professionals with knowledge of the mechanics of the certification process, applicable law and the defensibility of certain claims related to green building performance, based upon available data. More generally, in order to deliver true value to shareholders, a company’s building portfolio managers should negotiate its building contracts and LEED point selections with a focus on delivering meaningful energy performance and any other green features specific to the company’s sustainability goals and marketing objectives. ■

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ENDNOTES

1. See, e.g., National Public Radio story at <http://www.npr.org/templates/story/story.php?storyId=5528063> or <http://www.greenerbuildings.com/feature/2008/03/26/sustainable-solutions-the-impact-green-building-movement>, or <http://archrecord.construction.com/news/daily/archives/060807green.asp>, each describing green building's popularity in the language of a social "movement."
2. See USGBC website "About LEED" presentation at: <http://www.usgbc.org/DisplayPage.aspx?CMSPageID=1720>.
3. Id.
4. See USGBC memorandum available at: <http://www.usgbc.org/ShowFile.aspx?DocumentID=3340>.
5. "Q&A on Green Buildings With Rick Fedrizzi," Rebecca J. Bell, Boston Globe, 9/20/2008.
6. See, e.g., tax incentives listed on US EPA website: <http://www.epa.gov/greenbuilding/tools/funding.htm>.
7. See, e.g., announcement of California green building code: http://www.scsa.ca.gov/news/pdf/Press_Release_071708.pdf.
8. See, e.g., the Seattle program described here: <http://www.seattle.gov/dpd/GreenBuilding/OurProgram/PublicPolicyInitiatives/DevelopmentIncentives/default.asp>. or the Boston program described here: <http://www.cityofboston.gov/bra/gbtf/documents/Boston%20Zoning%20Code%20Green%20Bldg%20Amendments.pdf>.
9. See, e.g., Consent Decree in U.S. v. Amer. Elect. Power Serv., available at http://www.epa.gov/Region4/foiapg/readingroom/amerelcpower/aep_cd.pdf.
10. See, e.g., "Leadership in Energy and Environmental Design is Emerging as the Preferred Method for Certifying Sustainable Buildings in China," available at <http://www.joneslanglasalle.com.cn/en-gb/news/2007/leedchina.htm>.
11. See <http://www.usgbc.org/DisplayPage.aspx?CMSPageID=222>.
12. See USGBC memorandum available at <http://www.usgbc.org/ShowFile.aspx?DocumentID=3340>.
13. See, e.g., Sandra Zaragoza, "Wal-Mart to Open First 'Green' Store in McKinney," *Dallas Business Journal*, available at: <http://www.bizjournals.com/dallas/stories/2005/05/30/newscolumn6.html> and a description of the Target green building initiative at: <http://sites.target.com/site/en/corporate/page.jsp?contentId=PRD03-002348>.
14. <http://www.usgbc.org/News/USGBCInTheNewsDetails.aspx?ID=3786>.
15. Id.
16. Id.
17. *Securities Regulation*, Marc I. Steinberg, 1998, at 1.
18. http://securities.stanford.edu/scac_press/20070728_YIR08mid_Press_Release.pdf.
19. "Securities Fraud." Twenty-Third Annual Survey of White Collar Crime, Zathrina Perez, Eric Cochran, Christopher Sousa, *American Criminal Law Review*, 22-MAR-08, available at http://www.accessmylibrary.com/coms2/summary_0286-34495177_ITM.
20. See, e.g., the Private Securities Litigation Reform Act of 1995, (PSLRA), 15 U.S.C. § 78u-4(b). Among other things, it contains provisions that increase the burden of proof placed upon potential class-action securities plaintiffs at the outset of litigation, making it easier for a court to dismiss the entire litigation at an early stage.
21. Id.
22. Section 15, Liability of Controlling Persons, Securities Act of 1933 and Section 20, Liabilities of Controlling Persons and Persons Who Aid and Abet Violations, Securities Exchange Act of 1934.
23. "Recent Trends in Shareholder Class Actions: Filings Return to 2005 Levels as Subprime Cases Take Off; Average Settlements Hit New High," Stephanie Plancich, Ph.D., Brian Saxton, and Svetlana Starykh, available at http://www.nera.com/image/PUB_Recent_Trends_Dec2007_FINAL.pdf.
24. See, e.g., "A Better Way to Rate Green Building," Henry Gifford, available at: <http://869789182725854870-a-energysavingscience-com-sites.googlegroups.com/a/energysavingscience.com/www/articles/henrysaarticles/BuildingRatingSystems.pdf?attredirects=0> and "Uncertified Green Building Claims," Charles Kibert, available at <http://kibert.blogspot.com/2007/04/uncertified-green-building-claims.html>.
25. It should be stated that the USGBC is fully aware of such shortcomings and is working steadfastly to amend its products to better address these issues. See, e.g., USGBC's description of LEED 2009 available at <http://www.usgbc.org/DisplayPage.aspx?CMSPageID=1849>. Despite its shortcomings, LEED remains an important innovator and driver of meaningful change in the construction, building maintenance and building products industries, helping to create the much anticipated green economy.
26. 10-K of Kimball International, Inc. available at: <http://www.sec.gov/Archives/edgar/data/55772/000005577208000010/k08.htm>.
27. 10-A of Pure Earth, Inc., available at: <http://www.sec.gov/Archives/edgar/data/1436351/000136231008004306/c74106e10v12gza.htm>.
28. S-11 of CB RICHARD ELLIS REALTY TRUST, available at: <http://www.sec.gov/Archives/edgar/data/1297587/000119312508161521/ds11.htm>.
29. 10-K of Open Energy Corporation, available at: http://www.sec.gov/Archives/edgar/data/1176193/000110465908058717/a08-22717_210k.htm.