

The Sights

Global Climate Change and D&O Insurance

The long-running scientific debate on whether global climate change is the result of human activity may not have been conclusively resolved, but it has already prompted a string of climate change-related legislative as well as regulatory and judicial developments. These developments are threatening to increase burdens and potential liability exposures for companies and, possibly, their directors and officers. This article takes a look at the evolving legal landscape regarding global climate change, including developing areas of potential liability, and concludes with an examination of the D&O insurance implications.

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Background

The State of Current Litigation

While the debate in the scientific community over global climate change continues, some litigants have already attempted to assign blame to – and recover damages from – companies they assert are responsible for global climate change and its consequences. Perhaps the most prominent example of this kind of claim may be found in the allegations raised in the Hurricane-Katrina coverage lawsuit pending in federal court in Mississippi.¹ The plaintiffs in that case amended their initial complaint, which had named property insurers only, to add as additional defendants petrochemical companies, public utilities, power companies, and coal mining and chemical manufacturing companies. The plaintiffs allege that these companies engaged in activities that caused or exacerbated global warming, produced conditions that caused extreme weather events such as Hurricane Katrina, and are liable to the plaintiffs for the hurricane damage the plaintiffs sustained.

A separate lawsuit in San Francisco federal court alleges that six major domestic and Japanese automobile manufacturers are among the world's largest contributors to global warming, and as such have created a public nuisance, for which the defendants are liable to the people and state of California.² Significantly, for purposes of this article, California specifically alleges that the corporate defendants, "knew or should have known...that their emissions of carbon dioxide and other greenhouse gases contribute to global warming and to resulting injuries and threatened injuries."

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These and similar efforts to assign blame and impose responsibility for global climate change may have received a substantial assist from the recent decision of the United States Supreme Court in the case of *Massachusetts v. EPA*.³ In its April 2, 2007 decision, a 5-4 majority of the Supreme Court held that the EPA had violated the Clean Air Act by improperly declining to regulate new-vehicle emissions standards to control carbon dioxide emissions that contribute to global warming. The Court did not reach the question of whether or not the EPA must regulate carbon dioxide emissions in new vehicles, but merely directed that the EPA, “must ground its reasons for action or inaction in the statute.”

While the Supreme Court’s holding was narrow, there are two respects in which the decision could be potentially significant. The first is the Court’s holding that the injury of which Massachusetts complained (a receding coastline as a result of rising sea levels) was sufficiently particularized for Massachusetts to have “standing” to bring the claim. The relevance of this holding is that trial courts considering tort-based lawsuits against alleged greenhouse gas emitters generally have held that the claimants’ generalized allegations of harm are insufficiently particularized to support a justiciable controversy. The Court’s conclusion that Massachusetts had standing could affect future courts’ rulings on jurisdictional standing and justiciability criteria in climate-change based litigation. (To be sure, even cases in which plaintiffs successfully establish standing will still face formidable proof and causation hurdles, but the cases could at least go forward.)

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The second important part of the Supreme Court’s decision in the *Massachusetts v. EPA* case is its conclusion that greenhouse gas emissions (GGE) are “pollutants” under the Clean Air Act. This conclusion is broadly applicable to both mobile and stationary sources, with implications for a broad variety of industries. While the conclusion that GGE are pollutants does not in itself compel GGE regulation, the conclusion contributes significantly to the political, economic and legal forces that are coming together to make GGE regulation likelier than ever.

The Legislative and Regulatory Context

The November 2006 election dramatically changed the political landscape, and the Democratic majority in both houses of Congress has moved climate change to the top of the legislative agenda. Bills have already been introduced in both chambers to address climate change directly. In the meantime, the states are also moving forward. California’s landmark Global Warming Liabilities Act of 2006 is only one of several states’ legislative initiatives. The June 2007 G-8 Summit had as one of its primary topics the development

of cross-border solutions to global climate change. The European Union, in fact, has already adopted a GGE regulatory system based on an elaborate cap-and-trade system.

None of this has been lost on the business community. Various U. S. business groups have already come together to try to propose regulatory systems (such as a cap-and-trade approach similar to the European model) that would be more acceptable to businesses.

These political, regulatory and legal developments not only create a wide variety of current and potential operational challenges for corporate America; they also present an immediate challenge in terms of companies' disclosure obligations under SEC Regulation S-K. Two provisions of Regulation S-K are particularly relevant here, Item 101 and Item 303.

As new regulatory mandates regarding GGE and global climate change accumulate, many companies may find themselves for the first time obliged to provide Item 101 environmental impact disclosures.

Item 101(c)(1)(xii) requires companies to disclose current and anticipated "material effects" of compliance with environmental regulations:

Appropriate disclosure also shall be made as to the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries. The registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material.

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Item 303 requires companies to have "described any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales revenue or income from continuing operations." There are an increasingly large number of important trends and uncertainties surrounding

global climate change that will affect a growing number of companies, requiring that the companies adapt their Item 303 disclosures accordingly. The SEC has recently signaled a growing willingness to hold companies accountable for failure to adequately disclose material environmental risks. For example, in November 2006, the SEC settled charges against Ashland, Inc. and one of its former employees, based on allegations that the former employee had improperly reduced environmental remediation cost estimates at numerous chemical and refinery sites. The reduced estimates were reflected in the company's financial statements. The SEC found that there was no reasonable basis for the reduction, which had the effect of materially understating Ashland's environmental remediation reserves and overstating its net income in quarterly and annual reports filed from 1999 to 2001.

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Shareholders' Expectations and the Potential Exposure to Shareholder Claims

By the same token, investors have evinced a growing desire to compel full disclosure of environmental liability risks. According to a recent scholarly study, "over the last seven proxy seasons, climate change resolutions filed by shareholders have increased from six in 2001 to a record forty-two in the first months of 2007."⁴ While in the past, these kinds of shareholder resolutions would have arisen from special interest investor groups, now "some of America's most powerful institutional investors...are becoming increasingly active in environmental and social issues."

Companies could also risk shareholder litigation for their action (or lack thereof) surrounding climate change remediation efforts.

The obligation to disclose of course includes the obligation to disclose fully, accurately, and consistently. Companies can expect to face increased scrutiny of their environmental disclosures for adequacy and completeness and can anticipate significant pressure with respect to their disclosure. Indeed, the academic study cited above reports a finding that 53% of the largest publicly traded companies are doing a "poor job" describing climate change risks to investors and "are thus at risk of shareholder lawsuits."⁵

Companies could also risk shareholder litigation for their action (or lack thereof) surrounding climate change remediation efforts. The company's failure to establish standards or to take proactive measures to reduce GGE could expose companies to reputation risk and brand damage, as well as regulatory and litigation risk. Shareholder lawsuits could follow if a company's performance suffers due to negligent planning for climate change risk.

The onset of GGE regulation and the possibility of GGE regulatory enforcement actions could also present the increased likelihood of follow-on shareholder litigation. By way of analogy, there has already been a proliferation of follow-on shareholder lawsuits since the initiation of Foreign Corrupt Practices Act enforcement actions against companies. Similar follow-on shareholder litigation could ensue in the wake of GGE regulatory action, as shareholders could allege the inadequacy of disclosures of their regulatory preparedness or the effectiveness of the regulatory compliance program.

In short, the evolving regulatory landscape and public company disclosure requirements create a context within which it is prudent to assume that D&O claims will arise. To the extent that claims do arise, the wording of the applicable D&O liability insurance policies could have an enormous impact on the availability of insurance protection to defend and indemnify companies and their directors and officers.

Relevant Policy Considerations

The Pollution Exclusion. The D&O policy is not intended to respond to losses directly caused by pollution, and most D&O policies contain a pollution exclusion (although companies in the utilities and related energy sector have the option of securing coverage through a mutual insurer whose standard policy does not contain a pollution exclusion). There is no standard pollution exclusion wording among the D&O carriers. The typical wording is oriented toward one or more of the U.S. environmental statutes, although many of the standard pollution exclusions were obviously not written with greenhouse gas emissions in mind.

In any event, most carriers will agree to provide a carve-out from the pollution exclusion in order to preserve coverage for shareholder claims. Unfortunately, the carve back - or exceptions - to pollution exclusions are quite different from one policy form to the next. As such, special attention needs to be given to the pollution exclusion.

Furthermore, the wording of the shareholder claim carve back could be critically important. One minimum consideration - in light of the fact that climate change concerns are cross-jurisdictional - is that related litigation potentially could arise outside the U.S. It is crucial to make certain that the carve back does not presume through a wording bias that the future claim would only be filed in a U.S. court or by application of U.S. procedures. The carve back should also preserve coverage regardless of the legal theory under which the shareholder plaintiffs proceed. In addition, and also at a minimum, the carve back should preserve coverage for non-indemnifiable claims asserted against individual directors and officers.

BI/PD Exclusion: The typical D&O policy contains a bodily injury and property damage exclusion. The BI/PD exclusion in many policies uses the “for” wording rather than the “based upon, arising out of or in any way relating to” formulation. Exclusions with the

“for” wording presumably would preclude coverage only for a claim that is brought by the party that allegedly suffered a bodily injury or property damage. Exclusions with the “for” wording thus would not apply to preclude coverage for a lawsuit brought by a company’s shareholders alleging harm to their investment interest, even if the alleged investment harm is due to circumstances in which third-parties claim to have suffered bodily injury or property damage. Nonetheless, clarification to this extent should be sought from the Insurer. As the pollution exclusion and the BI/PD exclusion work hand in hand, it is vital that their language be in harmony.

The evolving political and legal circumstances surrounding the issue of global climate change have created an environment of uncertainty and also of potentially increased D&O risk exposure.

Application Issues: If climate change litigation becomes more prevalent in the months and years ahead - as now seems likely - D&O underwriters will become increasingly focused on environmental and climate change issues as part of their underwriting process. Companies will be called upon to provide information regarding potential exposures and about the financial burdens of evolving regulatory requirements. Applicants must take care to provide complete and accurate information on these concerns (as on all other issues). Although the severability of application language currently available in the marketplace restricts the insurer’s ability to void coverage as to insureds who made no active representations, it is still clearly in the interests of all insureds that carriers cannot later contend that they did not receive complete and accurate information.

A Side /DIC Coverage: An A Side only excess policy with difference-in-condition (DIC) coverage protection is increasingly a standard part of the complete D&O insurance program. The A Side/DIC coverage provides added excess insurance protection for individual insureds and the DIC feature provides “drop down” protection in a variety of circumstances. Many A Side/DIC policies omit the pollution exclusion, so that the A Side/DIC policy potentially could provide “drop down” protection under appropriate circumstances for an environmental claim if the traditional D&O policy is unavailable due to a coverage exclusion or other circumstances.

Conclusion

The evolving political and legal circumstances surrounding the issue of global climate change have created an environment of uncertainty and also of potentially increased D&O risk exposure. In order to increase the likelihood that their D&O policy will provide protection in the event claims do arise, it will be critical for companies to secure coverage that is calculated to respond to the needs of a changing climate and risk exposure environment.

Footnotes

¹ Comer v. Nationwide Mutual Insurance Company, Case No. 1:05-CV-00436-LG-RHW (S.D. Miss).

² California v. General Motors, Case No. 3:01-cv-05755-EMC (N.D. Cal.)

³ No. 05-1120, <http://www.supremecourtus.gov/opinions/06pdf/05-1120.pdf> (U.S. Sup. Ct. April 2, 2007).

⁴ Christine Ross, Evan Mills, Sean Hecht, "Limiting Liability in the Greenhouse: Insurance Risk-Management Strategies in the Context of Global Climate Change," *Stanford Environmental Law Journal*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=987942 (2007).

⁵ Ibid.

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A version of this article previously appeared on The D&O Diary, the author's Internet weblog. You can access the blog via our website at www.oakbridgeins.com. To monitor developments on this and other important topics relating to directors' and officers' liability, readers are encouraged to refer to The D&O Diary regularly.

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