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GLOBAL WARMING – ARE D&Os IN THE HOT SEAT?

Even to a casual observer, it seems increasingly likely that profound changes to global climate patterns are occurring. Record high temperatures, drought conditions and catastrophic weather events seem almost common today. Divergent interest groups all recognize something very disturbing is taking place:

- Governments around the world are enacting laws designed to reduce so-called greenhouse gas emissions and to require greater disclosure of climate-change information by companies. The U.S. Congress reportedly has more than 80 bills introduced relating to climate issues.

- The insurance industry, which must fund many of the damages caused by climate change, is sounding alarms. According to the chair of Lloyd's of London, "the insurance industry must start actively adjusting in response to greenhouse gas trends if it is to survive."

- A Nobel prize and Academy award were given to Al Gore for his efforts to educate the world regarding global warming.

- An increasing number of shareholder resolutions are being proposed at corporate annual meetings to improve climate-changing activities.

- The United Nations and the Intergovernmental Panel on Climate Change each released reports in 2007 which express alarm regarding global warming causes and effects.

To date, directors and officers have largely escaped the regulatory, legislative, shareholder and environmental activists' ire relating to global warming issues. But as the debate intensifies and the related costs to many corporations inevitably escalate, scrutiny of directors and officers will almost certainly follow. The most likely potential sources of D&O claims and some of the D&O insurance implications relating to climate change allegations are addressed below.

I. Potential D&O Claims

If claims relating to climate change are made against directors and officers, those claims potentially could be brought by (i) third parties who are allegedly harmed by climate change, (ii) shareholders of a company which allegedly contributed to the global warming, and (iii) regulators. Each of those types of potential D&O claims is summarized below.

1. Third Party Claims

Because directors and officers generally do not owe fiduciary duties to third parties such as customers or the public in general, it is unlikely viable claims will be brought by third parties against directors and officers of a company relating to global warming issues. Although third parties may bring various types of claims against the company itself, there is very little precedent suggesting that such claims would also be brought against directors and officers. Similar to the asbestos litigation experience, mass tort claims against companies rarely include claims against directors and officers.

Despite the unlikelihood of third-party claims against directors and officers, third-party claims against companies are both likely and potentially huge. For example, numerous states and environmental groups in recent years have brought suits against various utilities, alleging the defendants' power plants emitted large quantities of carbon dioxide and other pollutants which contributed to so-called acid rain and climate change. One of those suits against American Electric Power settled in 2007 for a reported $4.6 billion, consisting primarily of the costs to install equipment in 46 coal-fired power plants to reduce emissions plus a $15 million civil penalty and $60 million in cleanup and mitigation costs.

The U.S. Supreme Court recognized the potential viability of these types of claims by states in April 2007 when the Court ruled, among other things, that the State of Massachusetts' interest in global climate change was sufficiently particularized that the State had standing to bring a claim against the EPA seeking to force greater regulatory involvement in climate change causes. Massachusetts v. EPA, 127 S.Ct. 1438 (2007). The Court found that the harms associated with climate change are "serious and well recognized," and that greenhouse gas emissions present an "actual and imminent risk" to Massachusetts.

2. Shareholder Claims

A more likely source of D&O claims is from shareholders of companies that incur large losses due to climate change. Although no such suits have been filed to date, there are indications that shareholders are already becoming active on this topic. In addition, to dozens of climate-related shareholder resolutions being proposed in the last couple of years, a coalition of investors, institutional investors, environmental groups, and other public interest organizations released a report in late 2006 which analyzed the sufficiency of climate change risk disclosures by S&P 500 companies. According to the report, most of the corporate disclosures analyzed in the study failed to comply with the "Global Framework for Climate Risk Disclosure," which is a standard developed by the Investor Network on Climate Risk ("INCR"), a group of institutional investors affiliated with the coalition. The INCR's proposed disclosure framework consists of four elements: (1) disclosure of historic, current, and projected greenhouse gas emissions, (2) strategic analysis of climate risk and emissions management, (3) assessment of physical risks of climate change, and (4) analysis of risk related to the regulation of greenhouse gas emissions. These proposed climate-change disclosure guidelines appear to contemplate greater disclosures than currently required under U.S. securities laws to some extent, and evidence the types of disclosures at least some investors want to see from companies and their D&Os.

It is far from clear that directors and officers have meaningful liability exposure to shareholders under existing securities laws regarding climate change disclosures. Climate risks are inherently difficult to evaluate and quantify, and there are not any disclosure requirements specifically addressing these risks. For example, absent a more compelling record, there is significant doubt whether companies are required to disclose projected carbon dioxide emissions from their current and proposed plants or to evaluate or quantify in public disclosures the possible effects of future greenhouse gas regulations. Even if such disclosures are ultimately found to be required, it is questionable whether failure to comply with those disclosure requirements will result in significant liability to directors and officers in securities class action lawsuits. Among other things, plaintiffs in such a lawsuit must prove loss causation by identifying a large stock drop immediately following the corrective disclosure. A large and immediate stock drop following a climate-change disclosure seems unlikely in most instances.

Perhaps more likely, shareholder derivative suits may be filed against directors and officers for breaching their fiduciary duties to the company with respect to climate change issues. If the company incurs large losses, unexpected expenses or significant penalties, shareholders may allege the directors and officers mismanaged the company by failing to properly anticipate, plan for or react to the underlying cause. In some circumstances, the directors and officers could be personally liable to the company for the resulting damage. The increasing publicity and regulatory focus on climate change issues may aggravate those mismanagement claims against the directors and officers since shareholders will be able to cite plenty of warning signs, which one could argue should have caused the directors and officers to address these issues more aggressively.

3. Regulator Claims

The SEC, state attorneys generally, the EPA and other regulators could potentially bring claims against both the company and its directors and officers relating to global warming issues. Two recent developments demonstrate the nature of some of these potential claims.

a. SEC Initiative. On September 18, 2007, a coalition of environmental groups, state governments and institutional investors (the "Coalition") filed with the SEC a 116-page document entitled "Petition for Interpretive Guidance on Climate Risk Disclosure," which requests the SEC to require increased disclosures by companies of their "climate risks." The members of the Coalition include Ceres (an environmental advocacy group based in Boston), the Environmental Defense Fund, California Public Employees' Retirement System, the New York Attorney General and 11 state governments (including New York, California and Florida). The Petition defines "climate risk" to include (i) physical risks associated with climate change, such as potential damages to facilities caused by increases in storm intensity, sea-level rise and temperature extremes, (ii) financial risks associated with present and probable regulation of greenhouse gas emissions, (iii) legal proceedings relating to climate change and (iv) shifts in the market for products and services related to climate change.

The Petition asserts that current disclosures by companies regarding climate risk are inadequate and inconsistent. As a result, the Coalition requests the SEC to issue interpretive guidance clarifying a company's obligations under existing securities laws and regulations to assess risks related to climate change and to disclose material risks and related information. The Petition suggests that the SEC set forth the process by which companies should make this assessment and the types of information most likely to be relevant to the assessment. For example, in order to assess the potential risks associated with regulatory requirements concerning greenhouse gases, the Petition asserts that companies should (a) determine their current and projected emissions levels and examine their corporate policies and governance structures relating to climate change matters, and (b) make appropriate disclosures regarding the same.

The Coalition contends that it is not proposing a change in existing substantive legal standards, but merely guidance on how existing regulations should be applied to corporate climate risks. The Petition states that certain companies likely are now required to accrue climate related contingent liabilities on their balance sheets but are not doing so. Examples of such contingent liabilities, which must be disclosed if material, probable and reasonably estimable, include costs related to compliance with greenhouse gas emission regulations, major capital investments related to climate risks, and hazards to physical operations due to developments such as melting permafrost or storm damage.

Concurrently with the filing of the Petition, the Coalition submitted a letter to the Director of the SEC Division of Corporation Finance urging the SEC to devote close attention to the adequacy of disclosures by companies concerning climate risk, particularly by companies in industry sectors that emit high levels of greenhouse gases and those that are subject to regulation of greenhouse gas emissions. The letter notes that climate change is affecting the business environment in numerous ways that can have material effects on a company's performance and operations. For example, the Coalition contends that compliance with new and anticipated regulations limiting greenhouse gas emissions will have significant financial implications for many companies, and those companies should disclose the effects of such regulations upon their capital expenditures, earnings and competitive position.

By filing the Petition, the Coalition appears to have achieved its primary goal of bringing further attention to the issue of climate change. Even in the absence of SEC action in response to the Petition, companies must recognize that the adequacy of their climate-related disclosures will be subject to increasing scrutiny in the future.

b. New York Attorney General Initiative. On September 14, 2007, the Office of the New York Attorney General sent subpoenas and accompanying letters to five large electric utility companies, expressing concern that the companies have not adequately disclosed to their shareholders the financial risks relating to their greenhouse gas emissions. The letters state that the companies have failed to disclose projected carbon dioxide emissions from their current and proposed plants, have failed to evaluate or quantify the possible effects of future greenhouse gas regulations or discuss their impact on the companies, and have not presented any strategies to reduce carbon dioxide emissions. The New York Attorney General asserts that these omissions make it difficult for investors to make informed investment decisions, and therefore the Attorney General has opened an investigation into whether or not the companies have violated the securities laws by failing to make required disclosures regarding climate risks.

Although neither these SEC and New York Attorney General initiatives target directors and officers, they do focus on one of the areas of greatest exposure for directors and officers—disclosure of material information to investors. As the standards for disclosures in this area increase, the potential liability of D&Os also increases.

II. D&O Insurance Issues

Any claim against directors and officers related to climate change could implicate several potential coverage issues under the D&O insurance policy, including the conduct exclusions relating to fraud, intentional violation of law or illegal personal profits; Application misrepresentations; and notice under a prior policy. The potential applicability of those coverage defenses will be dependent upon facts which are not likely to be unique to the climate change claims. In any event, it seems likely those coverage defenses will rarely apply to most climate change claims. However, other standard exclusions are more likely to be potentially implicated by a climate change claim and are discussed below.

4. Pollution Exclusion

Almost all standard D&O insurance policies contain a broad pollution exclusion which eliminates coverage for all Loss resulting from a Claim which is based upon, arising out of or in any way related to the discharge, dispersal, release or escape of pollutants. The policies typically define "pollutants" to include, among other things, "air emissions" or "contaminants." It seems highly likely that any climate change Claim would arise out of or relate to the discharge or release of air emissions or contaminants, and therefore the standard pollution exclusion in the D&O insurance policy will likely apply to any climate change Claim.

This conclusion is reinforced by the U.S. Supreme Court's 2007 decision in Massachusetts v. EPA, supra. In that case, the Supreme Court held that the Clean Air Act requires the EPA to prescribe standards for the emission of carbon dioxide and other greenhouse gases as "air pollutants." Specifically, the Court ruled that carbon dioxide and other greenhouse gases were "substances" emitted into the air and therefore were included within the definition of "air pollutants" within the Clean Air Act. That same conclusion seems likely when interpreting the definition of "pollutants" in the D&O policy's pollution exclusion.

Since the standard pollution exclusion will likely apply to most climate change D&O Claims, companies should seek to negotiate "carve-outs" within the pollution exclusion where possible. For example, some D&O policies state that the pollution exclusion does not apply to director and officer losses which are not indemnified by the Company and therefore covered under Side A of the policy. That type of carve-out could create coverage for a settlement or judgment in a shareholder derivative lawsuit, which is not indemnifiable under most state laws. Alternatively, some pollution exclusions in D&O policies contain a carve-out for any Securities Claims. This type of carve-out is generally considered broader (i.e., affords broader coverage) than the Side A carve-out, particularly if "Securities Claims" are broadly defined within the policy to include any claim by or on behalf of any securities holder of the Company. Such a broad carve-out would create coverage for both securities class action and shareholder derivative lawsuits, whether or not the company indemnifies the defendant D&O.

Ideally for Insureds, the D&O policy would contain no pollution exclusion at all. Several of the broadest Side A policies delete the pollution exclusion in its entirety, thereby eliminating the need to evaluate and negotiate carve-outs to the exclusion. When issued as an excess policy, a Side A policy also contains a difference-in-conditions ("DIC") provision which requires the broad Side A policy to drop down and fill in gaps in coverage which exist in the underlying program. As a result, if a pollution claim is not indemnified by the Company, a broad excess DIC Side A policy would cover any defendant director and officer in a pollution-related claim as primary insurance with no deductible, absent the applicability of some other coverage defense.

5. Bodily Injury/Property Damage

Even if the pollution exclusion does not apply to a climate change Claim, coverage may still be excluded for certain types of climate change Claims which seek recovery for bodily injury or property damage due to the climate change. Virtually all D&O policies contain an exclusion applicable to claims for bodily injury or property damage. Because this exclusion typically does not apply to claims "based upon, arising out of or related to" bodily injury or property damage, but only to claims "for" bodily injury or property damage, the exclusion should not apply to a shareholder derivative lawsuit or securities class action suit in which the plaintiff is seeking damages incurred by the company or shareholders. Instead, the exclusion is limited only to Claims brought by third parties who suffer the bodily injury or property damage and who are seeking damages directly for that bodily injury or property damage. As discussed above, those types of third party claims are not likely to be successful against directors and officers (as opposed to the Company itself).

A few Side A policies afford extraordinary pollution-related coverage by not only omitting the pollution exclusion, but by also stating that the bodily injury/property damage exclusion does not apply to a pollution claim. This unusual carve-out to the bodily injury/property damage exclusion affords to directors and officers important "back stop" insurance coverage for non-indemnified losses incurred in any climate-change or other pollution Claim even if the Claim is for bodily injury or property damage.

6. Prior Proceedings

As regulators and other activists become more critical of corporate behavior and disclosures relating to climate change, the seeds for future D&O insurance coverage disputes may be sown. For example, a 2007 SEC formal investigation or proceeding against the company in connection with disclosures of greenhouse gas emissions may trigger a "pending and prior litigation exclusion" contained within the company's 2010 D&O policy, thereby eliminating coverage for a 2010 climate-change Claim against directors and officers of that company. Alternatively, even in the absence of a pending and prior litigation exclusion, a 2007 investigation or proceeding involving only the company could result in a climate change D&O Claim filed several years later relating back to the 2007 investigation or proceeding against the company. In that case, the subsequent D&O Claim would be deemed first made during the 2007 policy, which may not have various important coverage enhancements.

Particularly for companies in industries which are obvious targets for emission allegations, negotiating favorable global warming terms and conditions in their D&O policy should begin now since future climate change D&O Claims may relate back to the D&O policy now in effect.

III. Conclusions

Some industries, such as the utilities, automotive, energy and insurance industries, are obvious potential targets for climate-change claims. However, a wide variety of other industries and companies may also be targeted. Unless companies in virtually every industry conduct a comprehensive assessment of climate-related exposures, one should not assume the exposure is minimal.

Although much is currently unknown about climate change, one thing is clear—the focus on climate change issues will only intensify in the coming years. As a result, directors and officers of any potentially affected company should begin now to assess their risks and costs, to formulate appropriate strategies, to make reasonable disclosures and to arrange a quality financial protection program tailored to these exposures. Among other things, a comprehensive record should be created which demonstrates the directors' and officers' continuing and thorough attention to these issues and reliance on qualified experts.

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