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Climate Change: D&O Issues for Policyholders

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In boardrooms across the country, directors and officers are developing strategies to address the business impact of climate change and the potential financial impact of current and future greenhouse gas ("GHG") regulation. Among the challenges they face are how to address disclosure obligations related to these financial risks and how to maximize potential insurance coverage under directors' and officers' liability insurance policies should climate-related claims be asserted.

Disclosure Concerns

Several significant developments evidence the increase in investor interest in climate change risks. Since its inception in 2003, the Investor Network on Climate Risk ("INCR") has facilitated investor involvement in initiatives designed to encourage corporate disclosure about the business risks associated with climate change. *See* Investor Network on Climate Risk — About INCR, *www.incr.com* (last visited Nov. 12, 2007). These efforts include calling on Congress to enact federal legislation regulating GHG emissions and publishing research reports to help investors understand the financial impact of global warming.

The Carbon Disclosure Project ("CDP") facilitates investor scrutiny of public companies by conducting annual surveys of corporations on their business approaches to climate change and making those responses publicly available on its Web site free of charge. *See* The Carbon Disclosure Project, *www.cdproject.net* (last visited Nov. 12, 2007). For a different view of how corporations should address shareholder concerns about climate change, *see* The Free Enterprise Action Fund Web site, *http://freeenterpriseactionfund.com* (last visited Nov. 12, 2007) (criticizing self-styled "socially responsible" investor groups as anti-business).

Certain shareholders have been increasingly active in seeking corporate responses to climate change. In 2007, more than 43 climate-related shareholder resolutions were filed with U.S. companies. For example, shareholders of ConocoPhillips submitted a resolution, which was withdrawn once the oil company agreed to support an aggressive federal policy for reducing GHG emissions, committed to improve energy efficiency at its U.S. refineries by 2012, and agreed to set a GHG emissions reduction target. *See ConocoPhillips Supports Mandatory National Framework to Reduce Greenhouse Gas Emissions*, Apr. 11, 2007, *www.conocophillips.com/newsroom/news_releases/2007news/04-11-2007.htm*. In the insurance sector, a resolution proposed to Hartford Financial Services Group was withdrawn after the company committed to respond to a CDP survey. *See* Baljit Wadwha, *Insurance Companies Commit to Climate Change Disclosure*, Apr. 10, 2007, *http://www.calvert.com/news_6681.html*. Additionally, 15 of the resolutions went to a vote at corporate annual meetings where shareholder support averaged 21.6%. *See Investors Achieve Record Results in 2007 in Spurring Corporate Action on Climate Change*, Aug. 13, 2007, *www.incr.com/NETCOMMUNITY/Page.aspx?pid=286&srcid=330*.

In recent years, groups representing investors also have sought guidance from the SEC. In 2004 and 2006, the INCR submitted letters to the SEC demanding change to corporate disclosure requirements applicable to climate change risks. In September 2007, the INCR submitted a rulemaking petition that identified current SEC regulations that arguably already require disclosure of material information about climate change risk, and demanded specific guidance from the SEC on how to apply these requirements to climate change risk. *See* Petition for Interpretive Guidance on Climate Risk Disclosure, Sept. 18, 2007, *available at:www.sec.gov/rules/petitions/2007/petn4-547.pdf*. The SEC is not expected to act on the petition.

Congress also is focusing on corporate disclosure of climate change risks. On Oct. 18, 2007, Senators Joseph Lieberman (ID-CT) and John Warner (R-VA) co-sponsored a bill titled America's Climate Security Act of 2007. S. 2191, 110th Cong. (2007). This bill would implement a carbon emissions cap-and-trade program and direct the SEC to

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confirm that under Items 101 and 303 of Regulation S-K, "the commitments of the United States to reduce emissions of global warming pollution under the United Nations Framework Convention on Climate Change ... are considered to be a material effect" and "global warming constitutes a known trend." S. 2191 §9002. The Committee on Environment and Public Works held its third hearing on the bill on Nov. 15, 2007.

Duties under U.S. Securities Laws

The disclosure obligations imposed by the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") are designed to ensure that a public company fully discloses all information that would be material to a shareholder's investment decision regarding the company's securities. A fact is material if "there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976). The recent focus on the financial risks associated with climate change suggests that an increasing number of investor groups may begin to argue that such risks are "material" to their investment decisions.

The federal securities laws require companies to disclose material information in registration statements for the offerings of securities, and in periodic and current reports that are filed with the SEC. Material misstatements or omissions in any of these documents could subject a company, its directors, and its executive officers to potential liability under various provisions of the federal securities laws and related regulations. Regulation S-K serves as the central repository of the regulatory requirements governing disclosure in registration statements, periodic reports, and current reports. 17 C.F.R. §229 (2007). *See also* Adoption of Integrated Disclosure System, 47 Fed. Reg. 11,380 (Mar. 16, 1982). Four provisions of Regulation S-K are potentially relevant to climate risk disclosures: Items 101, 103, 303, and 503.

Item 101: Description of Business

Item 101 requires a description of certain enumerated aspects of a company's business to the extent that such information is "material to an understanding of the general development of the business." 17 C.F.R. §229.101(a)(1). This Item requires companies to disclose:

> 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. 17 C.F.R. §229.101(c)(xii).

Thus, companies operating in U.S. or foreign jurisdictions where GHG regulations have been enacted may be already required to disclose the financial effects of complying with these regulations where those effects are material. *See* Air Products and Chemicals, Inc., SEC No-Action Letter, 1973 LEXIS 3112 (June 11, 1973) ("[I]t is our view that to the extent any foreign [environmental] provisions may have a material impact upon the company's financial condition or business that such matters should be disclosed.").

Item 103: Legal Proceedings

Item 103 requires a narrative description of material pending legal proceedings "other than ordinary routine litigation incidental to the business," to which the registrant (or any of its subsidiaries) is a party. *See* 17 C.F.R. §229.103. While generally unsuccessful to date, lawsuits have been filed against various companies in an effort to hold them legally responsible for climate change-related consequences. *See, e.g., California v. Gen. Motors Corp.*, 2007 WL 2726871 (N.D. Cal. Sept 17, 2007) (dismissed under political question doctrine); *Comer v. Murphy Oil*, No. 1:05-cv-436 (S.D. Miss. Aug. 30, 2007) (dismissed with prejudice). Such lawsuits could trigger disclosure obligations pursuant to Item 103.

Item 103 also explicitly requires disclosure regarding environmental matters. Specifically, it requires disclosure of any administrative or judicial proceeding arising under any federal, state or local provisions "that have been enacted or adopted regulating the discharge of materials into the environment or primary for the purpose of protecting the environment." 17 C.F.R. §229.103 at Instruction 5.

Such proceedings must be described if they are material to the company's financial condition, or involve potential monetary sanctions, damages claims, or other significant costs. *See Id.*

Item 303: Management's Discussion And Analysis of Financial Condition And Results of Operations

Item 303 requires disclosure of a company's "financial condition, changes in its financial condition and results of operation." 17 C.F.R. §229.303(a). In particular, under Item 303, a company is required to disclose known "trends or uncertainties" that might have a material impact on the liquidity, capital resources, sales, revenues, or income of the company. *Id.* Thus, to the extent climate change is a known trend, material projected costs of planning for and adapting to climate change could be subject to disclosure. Further, where a company anticipates a material increase in expenditures to address the physical consequences of climate change, disclosure of such potential expenditures might be necessary. It bears noting that the SEC has adopted a safe harbor for forward-looking statements and projections disclosed in response to Item 303. 17 C.F.R. §229.303(a) at Instruction 7. As a result, a company generally cannot be held liable for forward-looking statements that it makes in response to Item 303.

Item 503(c): Risk Factors

Item 503 of Regulation S-K outlines specific information that a company must provide in its prospectus. Among other disclosures, Item 503 explicitly requires a discussion "of the most significant factors that make the offering speculative or risky." 17 C.F.R. §229.503(c). A company must not simply present generalized risks that could apply to any issuer or offering, but instead must specifically identify the

risks that affect that company or the securities being offered in the prospectus. Depending on the registrant's business, climate-related risks could be significant such that inclusion might be required.

Coverage Issues

Companies buy D&O insurance to protect individual directors and officers from liability arising from their service in those capacities, including losses resulting from shareholder derivative suits and securities class actions. D&O policies generally have three coverages, typically referred to as Side A, Side B, and Side C. Side A provides direct cover to individual directors and officers of a company where the corporation is legally or financially unable to indemnify them. Under some policies providing Side A coverage, coverage also is provided in situations where a company is legally permitted to indemnify its officers but chooses not to do so. Side B coverage reimburses the corporation for payments it makes to indemnify its directors and officers. Side C coverage, also called entity coverage, protects the corporation from its own direct liability as a defendant and typically is limited to securities claims.

To date, no shareholder suit has been filed alleging that a failure to disclose climate-related risks had a negative financial impact harming shareholders nor has there been any lawsuit attempting to hold directors and officers liable for climate-related consequences. Most D&O policies do not explicitly address climate change, although some D&O insurers are beginning to address the issue in the application process. If climate-related claims are asserted, policyholders should expect D&O insurers to assert one or more coverage defenses based on existing policy language, including those noted below.

Pollution Exclusion

The expected focus of disputes arising from climate-related claims under D&O policies is the "pollution exclusion" found in many — but not all — D&O policies. A typical pollution exclusion provision excludes coverage for losses:

> for, based upon, arising from, or in any way related to: 1) the actual, alleged or threatened discharge, dispersal, release or escape of pollutants; or 2) any direction, request or voluntary decision to test for, abate, monitor, clean up, remove, contain, treat, detoxify or neutralize pollutants, nuclear material or nuclear waste ...

The Hartford, Directors, Officers and Company Liability Policy, Form DO 00 R292 00 0696 (hereinafter "Hartford D&O Form") *available at www.hfpinsurance.com/forms/nj85.pdf*.

A typical definition of "pollutants" includes: "any solid, liquid, gaseous or thermal irritant or contaminant, including without limitation smoke, vapor, soot, fumes, acids, alkalis, chemicals, odors, noise, lead, oil or oil products, radiation, asbestos or asbestos-containing products, waste and any electric, magnetic or electromagnetic field of any frequency." *Id*. Insurers undoubtedly will argue that GHGs are "pollutants" under this definition and therefore are encompassed by the pollution exclusion. The U.S. Supreme Court recently held in *Massachusetts v. EPA*, 127 S. Ct. 1438 (2007), that GHGs are pollutants for purposes of the Clean Air Act, *Id*. at 1459-60, but this does not compel the conclusion that GHGs are "pollutants" for purposes of a D&O policy exclusion.

There is a body of opinion that the core purpose of such exclusions is to bar coverage for actions against directors and officers for environmental remediation or damages lawsuits, not shareholder lawsuits seeking damages for inadequate disclosures and the like. A few courts have interpreted D&O pollution exclusions and similarly worded asbestos exclusions where coverage was sought for securities actions alleging failure to disclose financial risks. In *Owens Corning v. Nat'l Union Fire Ins. Co.*, 1998 WL 774109 (6th Cir. 1998), the Sixth Circuit held that an asbestos exclusion did not exclude coverage of shareholder claims related to the company's alleged misrepresentations of its financial exposure to asbestos claims. 1998 WL 774109 at *2. The court reasoned that misleading statements, rather than the use of asbestos, were the gravamen of the shareholder litigation and that those claims were not subject to an asbestos exclusion. *Id*.

In contrast, the court in *Nat'l Union Fire Ins. Co. v. U.S. Liquids, Inc.*, 88 Fed. Appx. 725 (5th Cir. 2004) held that a pollution exclusion barred coverage under the company's D&O policy. *Id*. U.S. Liquids allegedly had engaged in the illegal transport and disposal of hazardous waste. A criminal investigation revealed that the company's directors and officers had concealed these activities from investors and the public. *Id*. at 727. The Fifth Circuit found that the pollution exclusion in the insurer's policy barred coverage of subsequent shareholder suits because the disclosure violations of the directors and officers were "inextricably intertwined" with the polluting activity. *Id*. at 730. In interpreting the relevant exclusions, both the Fifth and Sixth Circuits focused on the precise language of the exclusion at issue and on the causal connection between the underlying activity and the related disclosures.

Finally, even if GHGs were found to fall within the pollution exclusion, many D&O insurance policies include an express carve-out that preserves coverage for securities and other shareholder claims, as defined by the policy. To make sure this carve-out is sufficient to preserve coverage, one commentator notes that global companies should take care to ensure that both the carve-out and the definition of "Securities Claim" are broad enough to protect the insured from claims filed in both foreign and domestic jurisdictions. *See* Kevin LaCroix, *Global Climate Change and D&O Insurance*, 2 InSights 4 (Aug. 2007) available at *www.oakbridgeins.com/insights.htm*. Where no carve-out is included, at a minimum, policyholders should seek coverage for non-indemnifiable claims against individual directors and officers. *Id*.

Bodily Injury and Property Damage Exclusion

Most D&O policies also contain some form of bodily injury and property damage exclusion. A typical bodily injury and property damage exclusion bars coverage:

> *for* bodily injury, sickness, disease,

emotional distress, mental anguish, outrage, humiliation, death ... or for damage to or destruction of any tangible property, including loss of use thereof. *See* Hartford D&O Form.

Note that the lead-in is "for," rather than a phrase such as "based upon, arising out of or in any way relating to" pollution. Although there are court decisions preventing insurers from exploiting the "arising out of" language, most insurers would acknowledge that the word "for" limits the exclusion to those claims brought by the party who allegedly suffered bodily injury or property damage and should not be read to exclude alleged harm asserted by shareholders in connection with third-party injury or property damage claims against the company.

Insurability of Section 11 And 12 Claims

Section 11 of the Securities Act imposes civil liability on particular individuals for material misstatements or omissions in a registration statement and generally allows purchasers of securities to seek recovery of the difference between the amount paid for the security and the value of the security at the time of suit or the sale price of the security if it was sold in the market before the suit was filed. 15 U.S.C. §77k(e). Section 12 of the Securities Act enables purchasers of securities to "recover the consideration paid for such security" where the seller made a material misrepresentation in connection with offering to sell the security. 15 U.S.C. §77l(a). These statutory provisions do not address disclosures that affect after-market transactions, and unlike actions under Rule 10b-5, plaintiffs need not establish fraud or wrongful intent to succeed under these provisions.

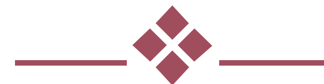
Recently, some D&O insurers have denied coverage for settlements of securities class actions pursuant to §§11 and 12, arguing that such payments represent the disgorgement of an "ill-gotten gain" and therefore constitute an uninsurable loss. *See* Peter M. Gillon & Tab R. Torano, *Securities Claims Coverage Under Your Company's Director's and Officer's Liability Policy — Less Than Meets the Eye?*, Mealey's Emerging Insurance Disputes, December 2006. *Cf. Level 3 Communs., Inc. v. Fed. Ins. Co.*, 272 F.3d 908, 910 (7th Cir. 2001) (J. Posner) (articulating theory that claims seeking relief that is "restitutionary in character" involving "ill-gotten gains" do not constitute "loss"). To date, only one federal court has upheld an insurer's denial of coverage for a §11 settlement on these grounds. *See CNL Hotels & Resorts, Inc. v. Houston Cas. Co.*, 505 F. Supp. 2d 1317 (M.D. Fla. 2007), *appeal docketed*, No. 07-12706 (11th Cir. June 13, 2007). *See also Conseco, Inc. v. Nat'l Union Fire Ins. Co.*, 2002 WL 31961447 (Ind. App. 2002) (finding §11 settlement an uninsurable loss). In its decision however, the *CNL* court commented that "Section 11 claims are not *per se* uninsurable." *CNL Hotels & Resorts, Inc.*, 505 F. Supp. 2d. at 1324-25. These cases, which seem to run counter to the purpose of D&O insurance, bear watching by policyholders. Increasingly, policyholders are seeking and receiving clarifying endorsements to preclude coverage-defeating arguments such as those raised in the *CNL* case. *See* Kevin LaCroix, *Section 11 Settlement Held Not Insurable Loss*, The D&O Diary, Mar. 18, 2007, *http://dandodiary.blogspot.com/2007/03/section-11-settlement-held-not.html*.

Rescission

If a climate-related claim is asserted against a D&O insurer, that insurer might seek to rescind the policy altogether rather than litigate the question of how specific policy language applies to the claim in question. To rescind an insurance contract, an insurer must show that the misrepresentation was material and that the insurer relied on the misrepresentation in issuing the policy. *See* 45 C.J.S. *Insurance* §533 (2007). Some states further require the insurance company to prove that the misrepresentation was made with the intent to deceive. *See, e.g.*, Wash. Rev. Code §48.18.090. Rescission also has been raised as a defense to coverage where the insurer demonstrates that the company made material misrepresentations in its financial statements and the insurer successfully argued that such statements were incorporated into the insured's D&O policy application. *See, e.g., ClearOne Communications, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, 494 F.3d 1238, 1245 (10th Cir. 2007) (finding rescission appropriate where 10-K form was a "part of the factual predicate of the application, serving to induce issuance of the policy."); *Cutter & Buck, Inc. v. Genesis Ins. Co.*, 306 F. Supp. 2d 988 (W.D. Wash. 2004), *aff'd*, 144 Fed. Appx. 600 (9th Cir. 2005) (upholding rescission of D&O policy where insured made material misrepresentations in SEC filings incorporated in its renewal application). The more aggressive underwriting of climate change exposures by D&O insurers might be designed, in part, to facilitate rescission claims. For example, Swiss Re has introduced questions on climate change in its renewal notices for its D&O liability policies. *See* Case Study-Swiss Re, *www.theclimategroup.org/reducing_emissions/case_study/swiss_re/*.

Conclusion

Climate change is receiving increased attention from policyholders and insurers. Both investor groups and insurers are likely to continue seeking greater disclosure about climate change-related risks. Companies will need to focus on the accuracy and completeness of their climate-related disclosures to regulators, the public, investors, and insurers to minimize the potential for liability and maximize the potential for D&O insurance coverage.



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