

ARE D&O POLICIES AT RISK OF CLIMATE CHANGE?

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As private companies and governmental bodies struggle to get a handle on global warming, or "climate change," officers and directors face an uncertain future, fraught with potential – though not clearly defined – liabilities. This article considers a few such risks facing officers and directors, focusing on issues likely to arise as they seek defense costs or indemnity under their insurance policies. Such risks require careful attention to policy terms, which can spell the difference between protection and catastrophe.

I. CLIMATE CHANGE CONCERNS

A. Science

The past several years have brought an exponential increase in activity related to climate change, exemplified by the increasing certainty expressed by the U.N. Intergovernmental Panel on Climate Change ("IPCC") that global warming is caused by human activity. The IPCC recently concluded that "[m]ost of the observed increase in globally averaged temperatures since the mid-20th century is *very likely* due to the observed increase in anthropogenic greenhouse gas concentrations," where *very likely* is used to indicate that the assessed likelihood, using expert judgment, exceeds 95%.²

According to the IPCC, infrared radiation that ordinarily passes from the earth's surface through the atmosphere is being trapped by man-made greenhouse gases (GHGs), causing additional heating of the earth beyond that normally caused by solar radiation. Carbon dioxide (CO₂) is considered the most important GHG, although others, such as methane released from landfills, may have greater propensity to heat the earth. Once emitted, GHGs remain in the atmosphere for a long time and travel the globe. The vast majority of man-made CO₂ results from combustion of fossil fuels. Consequently, the effort to minimize global warming is focused on energy conservation, energy efficiency, alternative energy resources, and carbon sequestration.³

B. Litigation

Although the U.S. government actively promotes voluntary reductions in GHGs, it has not imposed mandatory reductions. This lack of federal controls is one of the forces driving action by states, local governments, and plaintiffs' lawyers. The most significant case is *Massachusetts v. EPA*,⁴ in which Massachusetts and others complained about the EPA's refusal to regulate motor vehicle GHG emissions under the Clean Air Act ("CAA"). The Supreme Court found Massachusetts had standing partly because the harms caused to Massachusetts by rising sea levels could be redressed by requiring the EPA to regulate GHG emissions from motor vehicles.⁵ The Court further held that the CAA's definition of "air pollutant" encompasses GHGs, including CO₂, and, therefore, the EPA has authority to regulate GHG emission under the CAA.⁶ The CAA mandates regulation of air pollutants emitted from new motor vehicles where EPA makes a finding that an air pollutant "cause[s], or contribute[s] to, air pollution . . . reasonably . . . anticipated to endanger public health or welfare."⁷ Consequently, the Court concluded the EPA must regulate GHG emissions from motor vehicles unless it determines GHGs do not contribute to global warming or it provides some reasonable basis why it cannot or will not exercise its discretion to determine whether they do.⁸

Most other climate change litigation falls into a few categories: (i) nuisance and other tort cases, (ii) National Environmental Policy Act ("NEPA") cases, (iii) state NEPA-like cases, (iv) Endangered Species Act cases, and (v)

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2 U.N. Intergovernmental Panel on Climate Change, Working Group I, *Climate Change 2007: The Physical Science Basis, Summary for Policymakers, Contribution to Fourth Assessment Report* [hereinafter *Fourth Assessment Report*], 10.

3 Carbon sequestration may involve enhancing plant life to take up CO₂ through photosynthesis, carbon capture, or storage in reservoirs such as depleted oil and gas fields.

4 127 S. Ct. 1438 (2007).

5 *Id.* at 1455–58.

6 *Id.* at 1462.

7 42 U.S.C. § 7521(a)(1).

8 *Massachusetts*, 127 S. Ct. at 1462.

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CAA preemption cases. With the exception of the tort cases, the litigation has primarily involved claims against governmental agencies, which are beyond the scope of this article. One exception is *Northwest Environmental Defense Center v. Owens Corning Corp.*,⁹ which involved claims that a planned foam insulation plant would emit GHGs and should be enjoined unless the company secured a permit required under the CAA. This case was settled after the magistrate judge held the plaintiffs had standing and rejected the defense's argument that the issues were non-justiciable political questions.¹⁰ Tort claims have been asserted primarily against oil companies, refineries, power plants, other energy-related companies, and automobile manufacturers.¹¹ Most of these cases have been dismissed on the grounds they presented non-justiciable questions, the plaintiffs lacked standing, or both. The *Owens Corning* case, however, reflects the tenuous and unpredictable nature of these judicial doctrines. A recent federal case filed in San Francisco, *Native Village of Kivalina v. ExxonMobil Corp.*, alleges, among other things, nuisance and conspiracy.¹² It seeks damages from the energy company defendants for their contribution to global warming, which plaintiffs allege is destroying Kivalina through the melting of Arctic ice that formerly protected the village from winter storms.¹³ Future litigation may not be limited to the "usual suspects," but may involve claims against owners and developers of offices, industrial facilities, delivery fleets, and other significant contributors to CO₂ generation and release.

C. Regulations And The Market

Not only may our physical environment be changing, but it is clear the business environment is dramatically changing as well. The IPCC predicts increased frequency of heat waves over most land areas, more frequent heavy precipitation events, greater areas affected by droughts, intense tropical cyclone activity increases, and increased incidences of extreme high sea levels.¹⁴ Consequently, many businesses, including agriculture, tourism, operations near shorelines, businesses dependent on large volumes of water, and others, may be directly and adversely impacted by increased global temperatures.

9 434 F. Supp. 2d 957 (D. Or. 2006).

10 *Id.* at 970-71; Rita Cicero, *Green Groups Reach Deal with Owens Corning in Global Warming-Suit*, FINDLAW, June 15, 2006, <http://news.findlaw.com/andrews/en/haz/20060615/20060615northwest.html>.

11 See, e.g., *California v. General Motors*, 2007 U.S. Dist. LEXIS 68547 (N.D. Cal. Sept. 17, 2007); *Comer v. Murphy Oil U.S.A., Inc.*, No. 1:05-CV-436-LG-RHW (S.D. Miss. August 30, 2007); *Connecticut v. Am. Elec. Power Co.*, 406 F. Supp. 2d 265 (S.D.N.Y. 2005).

12 Complaint at 1, No. CV-08-1138-SBA (N.D. Cal., filed Feb. 26, 2008).

13 *Id.*

14 *Fourth Assessment Report*, p. 9.

As of this writing, the EPA has not responded to the Court's directive in *Massachusetts v. EPA*, but the case may ultimately have far-reaching effects not only on the regulation of emissions from motor vehicles, but also on other CAA programs, including regulation of fuels, new or modified stationary sources (potentially including large office buildings), aircraft, and ocean-going vessels. Moreover, Congress is actively working on legislation to limit and manage GHG emissions. In December 2007, the U.S. Senate Environment and Public Works Committee passed the Lieberman-Warner Climate Security Act of 2007, which would create an enormous market, estimated to be as large as \$150 billion, for trading GHG emissions.¹⁵ This is the first of several cap-and-trade bills to emerge from committee and, like other pending bills, it provides financial incentives for businesses that take early actions to document reductions in GHG emissions, with disproportionately favorable bonuses for those taking such actions prior to enactment of the legislation.¹⁶

In the absence of federal legislation, several states have banded together to establish local and regional cap-and-trade schemes.¹⁷ Most states are collaborating on The Climate Registry, a system aimed at developing and managing a common GHG reporting system capable of supporting various GHG reporting and reduction policies, and some have set emission reduction targets.¹⁸ Local governments are addressing climate change through limits on sprawling development (to reduce transportation emissions) and "green building" requirements.¹⁹ Many lenders and investors have also begun to focus on green standards. For example, Bank of America announced a policy that includes targeted reductions in GHG emissions in both its operations and investments, suggesting that evaluation of a property's or project's carbon footprint may become an increasingly common element of due diligence.²⁰

Even without regulations requiring businesses to implement energy saving tactics, the market is beginning to require it. Perhaps largely due to increased fuel prices, we have seen an explosion in "green" advertising, greater interest in renewable fuels, renewed interest in energy-efficient vehicles, increased use of public transportation, and an up-turn in energy-efficient building construction. Although it may be several years before federal legislation will mandate limits on GHG emissions, the failure of some companies to inventory their emissions and implement verifiable GHG reduction programs could significantly hurt their bottom line.

II. HOW ARE DIRECTORS AND OFFICERS AFFECTED?

Officers and directors of companies may have duties (enforceable by shareholders or government regulators) to monitor what is happening in this arena, evaluate how climate change risks may impact their business, and take steps to minimize these risks. Losses may result from many sources, include those directly related to increasing global temperatures and changes in weather patterns, defending climate-related litigation, failure to effectively plan for and manage increases in regulations or to take advantage of the benefits of early actions to address GHG emissions, or challenges to a company's advertising of its own "green" initiatives.

Federal disclosure obligations may be triggered by a public company's increasing costs of regulatory compliance or exposure to potential losses or liabilities attributed to climate change. Under Regulation S-K, item 101(c)(1)(xii), a company must disclose current and anticipated material effects of compliance with environmental regulations.²¹ Likewise, item 303(a)(3)(ii) mandates a description of "known trends or uncertainties" reasonably expected to materially affect net income.²² In 2006 and 2007, the SEC settled at least two actions against major corporations (Ashland, Inc. and ConAgra Foods) which involved alleged improper reporting or accounting treatment of legal and environmental reserves. In September 2007, twenty-two petitioners (including environmental organizations, state officials, and pension fund managers) asked the SEC to issue an "Interpretative Guidance" concerning disclosure obligations arising from "climate risk."²³ The petitioners asked the SEC to "clarify" that

15 S. 2191, 110th Cong. (2007); Robert L. Graham et al., *Cap and Trade: Early Action "Bonuses" Under the Lieberman-Warner Bill*, 39 Env't Rep. (BNA) 286 (Feb. 8, 2008).

16 Graham, *supra* note 15, at 287.

17 See, e.g., the Regional Greenhouse Gas Initiative, <http://www.rggi.org>; the Western Climate Initiative, and the Midwestern Greenhouse Gas Reduction Accord, http://www.pew-climate.org/what_s_being_done/in_the_states/regional_initiatives.cfm?.

18 Pew Center on Global Climate Change, www.pewclimate.org/what_s_being_done/targets.

19 See Mayors Climate Protection Center, <http://www.usmayors.org/uscm/home.asp>; U.S. Mayors' Climate Protection Agreement, <http://www.usmayors.org/climateprotection/agreement.htm>; Order Regarding Settlement, *State of California v. County of San Bernardino*, No. CIVSS 0700329 (Super. Ct., San Bernardino County filed Aug. 28, 2007).

20 Bank of America Climate Change Position, http://www.bankofamerica.com/environment/index.cfm?template=env_climatechange.

21 17 C.F.R. § 229.101(c)(1)(xii). See also *id.* § 229.103 (requiring disclosure of material legal proceedings "known to be contemplated by governmental entities").

22 17 C.F.R. § 229.303(a)(3)(ii).

23 *Petition for Interpretive Guidance on Climate Risk Disclosure*, www.incr.com/NETcommunity/Document.doc?id=187.

existing regulations require registrants to “review the adequacy of their internal mechanisms for gathering information about, and assessing, climate risk, and . . . establish institutional mechanisms necessary to ensure careful and well-informed review of potential climate risks.”²⁴ As of this writing, the SEC has not formally responded to the petition.

III. HOW IS D&O INSURANCE COVERAGE AFFECTED?

Many of the risks outlined in the previous sections trigger issues under CGL or property policies, which have been discussed in a number of recent publications.²⁵ The questions posed here are limited to the implications for D&O coverage.

A. Current Policy Issues

Action (or inaction) by corporate management in the face of climate-related concerns, as well as the scope and content of a company’s disclosures concerning potential environmental liabilities or related costs, could be important to insurance coverage for such liabilities or costs. Some insurers have begun to inquire about a company’s strategy for addressing climate change as part of the underwriting process.

Faced with claims by shareholders, regulators, or others, directors and officers expect D&O carriers to indemnify them for covered losses, including defense costs. Although the terms of D&O policies vary considerably, they generally cover “loss” arising out of a “claim” based on a “wrongful act” by the insured in an “insured capacity.” In climate change matters, issues may arise under any or all of these critical terms, as well as a number of potential exclusions. While a detailed discussion of such issues is beyond the scope of this article, insurance protection in such matters is likely to turn on certain policy terms, including:

- definition of the application,
- severability clause(s),
- pollution exclusion, and
- coverage territory.

The definition of the “application” is important because it may encompass an unlimited number of previously filed public documents, in addition to the material submitted with the actual application or request for coverage. Those public documents may inadequately disclose or omit information that companies are arguably required to disseminate under SEC regulations. The documents deemed part of the application may impact the insurer’s ability to rescind the policy, as discussed in the next section. A severability clause can also impact rescission, as well as certain “conduct” exclusions.

A pollution exclusion is common in D&O policies. This exclusion is a carryover from CGL policies and its application has not been fully tested in the context of D&O liability.²⁶ From the standpoint of insured directors and officers, a pollution exclusion should contain a non-indemnifiable (or Side A) carve out, a securities claim carve out, or both. Many Side A, Differences-in-Conditions (DIC) policies, which are gaining favor as a D&O risk management tool, do not contain pollution exclusions and typically respond to pollution-related claims for which the company may be unable to indemnify a director or officer.

The coverage territory may be very important, especially if the company is operating in foreign countries. Many countries are changing their laws concerning how insurance can be placed within their borders. U.S. companies operating through subsidiaries in foreign countries may not have the coverage they think they have due to these changing laws. While worldwide coverage is the favored language in a D&O policy, it may not be able to respond in a particular country. Worse, the U.S. parent company may be in violation of foreign laws by having a “non-admitted” policy instead of a locally “admitted” policy in place.

B. Rescission Risks And Protections

Directors and officers charged with inadequate or misleading SEC disclosures may be confronted with another obstacle they might not have foreseen: rescission of their D&O policy on the grounds that it was procured by false

²⁴ *Id.* at 52.

²⁵ *E.g.*, Adam M. Cole et al., *Insurance Coverage for Global Warming Liability*, 42 TORT TRIAL & INS. PRAC. L.J. 969 (2007).


²⁶ *See id.* at 973–82 (discussing issues arising under CGL pollution exclusions).

information. Insurance policies may be void *ab initio* if they are premised on concealed information or false representations by the insured.²⁷ Rescission may impact policyholders besides those responsible for the representations or omissions, with devastating consequences. In *Homestore*, liability coverage was rescinded as to the company and all officers and directors because of false statements made in insurance applications and a Form 10-Q submitted by three former officers.²⁸

The circumstances justifying rescission, and whether it affects everyone covered by the policy, are determined by policy terms and applicable state law. In some states, an insurer may avoid a policy for misrepresentation only by establishing reliance on a false material representation made with deceptive intent.²⁹ In many other states, however, even an innocent misrepresentation may void a policy.³⁰ Materiality is essential,³¹ but typically not difficult to establish.³²

Even where rescission is justified by the conduct of one or more co-insureds, an “innocent” policyholder may sustain coverage if the policy includes an effective severability clause.³³ A severability clause has two primary components: (1) each insured is viewed as a separate insured, and (2) one insured’s statement or knowledge is not imputed to another insured. A non-imputation provision may negate rescission based on innocent misrepresentations, even if state law or the policy might otherwise allow rescission on that basis.³⁴ A severability clause may also limit the type of information on which an insurer may rely to rescind a policy.³⁵ A more direct protection against rescission is an explicit “nonrescindable” clause, *e.g.*, “Under no circumstances shall the Insurer be entitled to rescind this Policy.”³⁶ Such provisions are increasingly available.

C. Conclusion

With shareholder activists, politicians, and the legal community propagating the awareness, global warming might be the next business risk keeping directors and officers awake at night. D&O liability policies must anticipate developing trends and exposures, which underscores the necessity of engaging talented, forward-thinking D&O insurance professionals. 

27 See, *e.g.*, *TIG Ins. Co. of Mich. v. Homestore, Inc.*, 40 Cal. Rptr. 3d 528, 532 (Cal. Ct. App. 2006).

28 *Id.* at 534.

29 See *Cutter & Buck, Inc. v. Genesis Ins. Co.*, 306 F. Supp. 2d 988, 997 (W.D. Wash. 2004) (Washington statute bars rescission unless misrepresentation made with deceptive intent), *aff’d*, 144 F. Appx. 600 (9th Cir. 2005); *Mayes v. Mass. Mut. Life Ins. Co.*, 608 S.W.2d 612, 616 (Tex. 1980) (Texas common law imposes intent element).

30 See *Homestore*, 40 Cal. Rptr. 3d at 532 (California statute states “Concealment, whether intentional or unintentional, entitles the injured party to rescind.”); *In re HealthSouth Ins. Litig.*, 308 F. Supp. 2d 1253, 1270 (N.D. Ala. 2004) (Alabama law permits rescission based on misrepresentations that are fraudulent, material to risk acceptance, or affect policy terms or rates).

31 See, *e.g.*, TEX. INS. CODE ANN. § 705.004 (Vernon 2007).

32 *E.g.*, *Cutter & Buck*, 306 F. Supp. 2d at 1003 (information requested by insurer is presumed material).

33 See, *e.g.*, *Wedtech Corp. v. Fed. Ins. Co.*, 740 F. Supp. 214, 218 (S.D.N.Y. 1990).

34 *HealthSouth*, 308 F. Supp. 2d at 1280-81.

35 See, *e.g.*, *id.* at 1281 (insurer may not rely on statements outside insurance application to negate a severability clause).

36 The Hartford, Priority Protection Plus Policy, Form PX 00 H202 00 0806.