

**AN INCONVENIENT SUIT:
WHY GLOBAL WARMING SHOULD
CONCERN DIRECTORS AND OFFICERS
By Peter M. Gillon & David M. Finz**

Former Vice President Al Gore's recent film An Inconvenient Truth outlines the perils of global warming, and suggests that time is running out to protect life on this planet from what many believe will prove to be the catastrophic effects of climate change. The United Nations' long-awaited report on the scientific evidence of a "greenhouse effect" would certainly appear to underscore this dire message. As captains of industry ponder how to respond to the growing clamor for sustainable development, they may also want to consider how best to protect corporate directors and officers from a possible wave of securities litigation as investors scrutinize the effect of a company's environmental track record on shareholder value.

The increasing frequency of shareholder resolutions relating to global warming and the environment (at least 70 were filed in 2005) indicates that investors are demanding action to address global climate change. Not only activist investors, but stakeholders such as pension funds and even the SEC may well initiate litigation or enforcement actions alleging a public company's inadequate disclosure of the material effects that compliance with environmental laws here and abroad may have on capital expenditures, earnings and competitive position.

Disclosure requirements relating to greenhouse gas emissions present new challenges. To begin with, U.S. multinational companies may be subject to local laws implementing the Kyoto Protocols when operating in signatory countries (of which the U.S. is not one at present). Compliance with the laws of these countries may require material capital expenditures that must be reported under U.S. securities laws. (For example, S-K Item 101 requires disclosure of material capital expenditures projected far enough out in the future so as not to make the disclosure misleading.)

In the US, Federal action has been promised by the incoming Congress, perhaps as early as mid-2007. But states haven't waited for Washington to act. Legislation has been enacted by California under Assembly Bill 32, and is under consideration by various states and regional compacts in the West and Northeast. The courts may play a role as well. Even before the ink was dry on California's law, California Attorney General Bill Lockyer filed a lawsuit against leading U.S. and Japanese auto manufacturers, alleging their vehicles' emissions have contributed significantly to global warming, harmed the resources, infrastructure and environmental health of California, and

cost the state millions of dollars to address current and future effects. (*People vs. GM*, Complaint filed Sept. 20, 2006)

Although, as of this writing, there have been no shareholder suits specifically concerning disclosure of the financial impact of climate change, shareholders and regulators are clearly demanding information and action with respect to environmental concerns. Already, institutional investors such as state pension funds have been supporting shareholder resolutions on climate change and environmental sustainability, and shareholders recently filed suit against BP for failing to disclose the financial impact of pipeline corrosion and spillage at Prudhoe Bay. The SEC, not known for being very active on environmental reporting matters, recently brought just such a case against Ashland, Inc. In a Consent Order announced on November 29, 2006, the Commission found that the oil company materially under-reported its reserves for remediation of environmental contamination at dozens of sites across the country, and thus overstated its net income over a period of three years.

Another complication in analyzing disclosure requirements relating to climate change is the sheer enormity of the potential losses. Lord Peter Levene, the Chairman of Lloyd's of London, has stated that the London market expects the increase in annual storm-related property damage in the U.S. (already up sevenfold in the past 30 years for insured losses) to spike even further due to global climate change. In a recent speech, he predicted that warmer sea surface temperatures will intensify and extend the storm season, raising the

prospect of a single storm hitting the Eastern Seaboard potentially causing as much as \$100 billion in losses.

Such developments pose a challenge for company directors and officers. For the CEO and CFO required to sign a Sarbanes-Oxley Section 302 certification that discloses "fairly present" the company's financial picture, the impact of global climate change is now a serious consideration.

The Pollution Exclusion

The concern for directors and officers is that there is some question as to whether securities claims for losses stemming from mismanagement or non-disclosure of the impact of climate change would be covered under a standard D&O policy. This is because such policies typically contain exclusions for losses associated with "pollution."

Determining whether a specific D&O policy provides coverage for climate change-related claims of course depends on the nature of the claim and the exact wording of the policy and particularly the "pollution exclusion." Some general points can be made, however. First, the pollution exclusion found in most D&O policies today is a carryover from other unrelated policy forms and is arguably ambiguous in its application to the modern D&O form; so there is a serious question whether it applies to securities lawsuits at all. Second, the principal greenhouse gas, carbon dioxide, is not presently classified by the U.S. Environmental Protection Agency as a "pollutant" under the Clean Air Act. In fact, EPA's position is under review in the Supreme Court in *Commonwealth of Massachusetts, et al v. U.S. EPA*, 05-

1120, a case brought by various state and local governments asserting that CO2 is indeed an air pollutant and that EPA therefore is obligated to issue vehicle emissions standards for CO2. Third, many forms of the D&O pollution exclusion contain a carve-back for non-indemnifiable (Side-A) loss, such as where a company is financially unable to indemnify a director or officer for a claim asserted against such director. And, fourth, certainly the pollution exclusion should be absent from increasingly popular Side-A Difference-in-Condition policies.

In any event, some D&O insurers have already vocalized their intent to incorporate language into their standard policies that would definitively exclude securities claims having their genesis in corporate mismanagement of climate change. This is an apparent attempt on the part of such insurers to remove any ambiguity that may currently exist regarding coverage for such matters. On the other hand, many insurers have readily agreed, on a case-by-case basis, to modify the pollution exclusion to limit its application to claims for violations of pollution laws, cleanup actions and the like, leaving in place coverage for securities litigation.

Not Easy Being Green, But Necessary

The challenge for businesses today is to be proactive in anticipating the types of exposures they will face as a result of the changing environment (both ecological and legal) in which they operate. While this task may be most imperative for energy producers, other industries with a heavy "carbon footprint" (e.g., airlines, trucking and shipping, agribusiness, certain manufacturing and retail operations) need to be vigilant as well.

Ultimately, *every* company will want to show it is exercising good stewardship over the Earth's resources, from using low emission vehicles in its fleet to encouraging telecommuting among its staff members.

Nevertheless, history has shown that, even with the best planning, securities claims can and do occur. In light of this reality, risk managers should review their current D&O policies and work to remove any ambiguities in coverage. Qualified brokers and legal counsel can help ensure that companies looking to address such exposures obtain the most favorable coverage terms commercially available.

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