

By Louise Pennington and Tara Cummins

It's Getting Hot In Here

Potential fallout from climate change has turned up the heat in executive suites and boardrooms. The increasing call for clarity in climate risk disclosure should spur risk managers, board members, and chief financial officers to re-examine this evolving aspect of management risk exposure.

Traditional Climate Perils

Companies have long performed due diligence to determine if and how their business activities may negatively affect the environment. This strategy is moderately effective in contending with traditional risks. However, liability from direct or inadvertent pollution can be significant, if not catastrophic, as demonstrated in the case of asbestos, oil spills and ground leaching. A company can go bankrupt cleaning up a site or defending lawsuits arising from environmental torts.

On the receiving end of environmental risk, the failure to properly prepare for earthquakes, hurricanes, or similarly potential disasters could destroy a company's bottom line. An organization without sufficient financial resources or business interruption insurance can suffer catastrophic loss from severe weather events.

Traditional property, casualty and business interruption perils represent historically dominant climate risk concerns. And as the earth's climate changes, so too does the business climate. Enron and other corporate scandals have brought a paradigmatic shift to the business environment with new emphasis on company disclosure brought by activist stakeholders and regulators alike. The result is that board actions with respect to climate change are beginning to attract front-page attention, as Directors and Officers liability exposure continues to grow in the climate risk sphere.

The Push for Disclosure

In early 2008, a group of over 50 investors managing a combined \$2.3 trillion in assets sent a letter to Senate Majority Leader Harry Reid and Senate Minority Leader Mitch McConnell calling for strong national climate legislation. The letter stated, "We hope you will press the Securities and Exchange Commission (SEC) to promptly issue guidance on corporate disclosure of climate risk, or include this issue in comprehensive legislation to address climate change." The letter was signed by pension funds, state treasurers, state and city controllers, asset managers, venture capitalists, financial services firms, foundations, endowments and other institutional investors. This recent call for disclosure is similar to the 2006 push by a similar group representing \$1.5 trillion in assets that asked the SEC to require companies to disclose the risks that climate change may pose to earnings. Paralleling these lobbying efforts, activist shareholders are urging companies to address climate risks. The 2007 season saw nearly 40 shareholder proposals relating to climate change matters.

The Securities Exchange Act of 1934 requires public companies to disclose “material effects” and “trends or uncertainties” that reasonably may be expected to have impact on the financial condition of the company. Written before the advent of climate change, the Act does not specifically address precisely which climate change-related items are material and therefore must be disclosed. The recent and previous calls for change seek to clarify disclosure requirements so that companies will uniformly address present and potential impact of climate-related business factors, be they potential new legislation, regulation, litigation, or potential business disruption or change.

It is not unforeseeable that within the next decade, guidelines, if not mandatory rules concerning climate risk disclosure, will be established. The recent outcome of investigations of financial risk disclosure of energy companies by New York Attorney General Andrew Cuomo emphasizes the point. In a noteworthy settlement in August of 2008, Xcel Energy agreed, among other things, to provide disclosure on the potential impact of present and probable future climate change regulation and legislation.

Regulatory inquiry that results in an agreement to legislation that is not yet on the books is based on the assumption that such legal mandates cannot be far behind. Regulators and the SEC are feeling pressure from many constituencies. Companies must be sure to stay abreast of developments and to determine whether or not they are properly prepared for such an eventuality.

The Impact to Directors and Officers Liability Insurance

In the context of climate risk disclosure, two fundamentally likely scenarios that could give rise to claims under a D&O policy are: 1) a derivative suit might occur where failure to prepare or respond to climate risk results in considerable financial loss to the company, or 2) a shareholder class action might occur if the failure to disclose climate risk exposure or events were to cause material negative impact to the company’s share price. In these instances, directors and officers might look to the D&O policy to help with defense costs, settlement or judgments.

D&O policies typically contain broad pollution exclusions, which are designed to prevent the policy from covering physical and environmental perils. But when physical climate perils intersect with financial disclosure, the bright line of the pollution exclusion may become a bit blurry. Though a landmark 2007 U.S. Supreme Court case, *Massachusetts v. Environmental Protection Agency*, did not directly address insurance policies, it quite possibly may have a significant impact on D&O pollution exclusions going forward. In its decision, the Supreme Court acknowledged greenhouse gas emissions as “pollutants” under the Clean Air Act. Accordingly, insurers might argue that the exclusion applies to claims arising out of disclosures concerning greenhouse gas emissions or similar environmental discharges.

Currently, certain insurers will allow the insured to “buy back” some coverage within the pollution exclusion for non-indemnifiable claims, i.e., claims for which the company cannot reimburse an executive for liability or defense costs. Greater protection would be afforded whereby the exclusion would no longer apply to

securities claims of any kind (derivative or direct); a policy without any pollution exclusion would be best but is not generally available in the D&O insurance marketplace.

The near future is likely to see further growth in offerings to help risk managers grapple with environmental challenges. But before going shopping, companies should examine their climate risks, review the impact and disclosure of these risks, and refine the terms and conditions of their organization's existing directors and officers liability insurance.

The world is changing, but the change is evolutionary. The same may be said of a climate-insurance solution.

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About Integro

Integro is an insurance brokerage and risk management firm dedicated to serving the insurance and risk management needs of complex institutional risks. Integro has offices across North America, as well as in Bermuda and London. Its headquarter office is located at One State Street, 9th Floor, New York, NY 10004. Call 877-688-8701 and visit www.integrogroup.com.

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