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CLIMATE CHANGE RELATED D&O LIABILITY – THE COMING FLOOD?

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The Rise Of Climate Change Related Lawsuits

An increasing number of climate change related lawsuits have been filed in the last three years. Climate change related lawsuits implicating corporate conduct have generally fallen into one of two categories: (1) lawsuits against governmental entities seeking to compel those entities to promulgate and enforce regulations requiring companies to reduce emissions; and (2) lawsuits against companies alleging that their emissions caused or contributed to climate change.

The landmark case against a governmental entity is *Massachusetts, et al. v. Environmental Protection Agency, et al.*, 549 U.S. 497 (2007). In the *Massachusetts* case, several states and private organizations challenged the EPA's denial of the plaintiffs' petition for the EPA to regulate emissions from new cars pursuant to the EPA's alleged duty to promulgate emission standards for "any air pollutant" under the Clean Air Act. The EPA had denied the plaintiffs' petition based on the conclusion that the Clean Air Act did not confer the EPA with the power to issue mandatory regulations to address climate change and that in any event it would have chosen not to do so. In rejecting the EPA's position, the Supreme Court made its first ruling on climate change issues and held that greenhouse gas emissions from cars (including carbon dioxide) constituted an air pollutant under the terms of the Clean Air Act, and that the EPA had failed to support its refusal to decide whether the emissions contributed to climate change and endangered public health and welfare. In addition, the Court found that state entity plaintiffs had standing to bring the lawsuit in so far as they were able to demonstrate injury, causation, and the existence of a remedy. In December 2009, in response to the Supreme Court's ruling, the EPA issued a finding that greenhouse gas emissions "in the atmosphere threaten the public health and welfare of current and future generations."[1]

A number of climate change related lawsuits against corporations are working their way through the judicial system. The lawsuits, brought by private and state litigants, generally assert a variety of tort-based theories alleging that the defendant companies' emissions have caused or contributed to climate change with resulting environmental damage. *See e.g. Connecticut v. American Electric Power Co., Inc.*, 582 F.3d 309 (2nd Cir. 2009); *Comer v. Murphy Oil USA*, 585 F.3d 855 (5th Cir. 2009). A frequently asserted defense in these lawsuits is that they present a "nonjusticiable political question" based on the notion that "the allocation of fault—and cost—of global warming is a matter appropriately left for determination by the executive or legislative branch in the first instance." *Native Village of Kivalina v. ExxonMobil Corp.*, 663 F. Supp.2d 863 (N.D. Cal. 2009). *See also People of State of California v. General Motors Corp.*, 2007 WL 2726871 (N.D. Cal. 2007) (holding climate change related suit was nonjusticiable political question). In addition, defendants in these suits typically challenge the plaintiffs' standing based on causation – asserting that plaintiffs cannot meet the necessary standard of proof to prove the nexus between the alleged emissions and the alleged injuries. *Id.*

The decision of the United States Supreme Court in *Massachusetts*, and the subsequent EPA finding regarding the link between greenhouse gas emissions and climate change, have set the stage for increased regulation and climate change related lawsuits, not least because they represent the first Supreme Court and federal agency findings on climate change related issues, and are being used as the support for climate change related lawsuits against companies. Moreover, although corporate defendants continue to assert

[1] *See* http://www.epa.gov/climatechange/endangerment.html.

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"nonjusticiable political question" and "standing" defenses, those defenses may have been significantly undermined both by the Supreme Court 's *Massachusetts* decision and the rejection of those defenses in a number of lower courts.[2]

D&O Liability For Climate Change Related Corporate Disclosures

The first wave of lawsuits, essentially based upon tort theories, will likely only be the start. Increased regulatory activity often leads to increasing liability. Because of the likelihood of increased regulation on climate change issues, the growing number of lawsuits alleging corporate liability for climate change related damages, and the possibility of those regulations and lawsuits having a significant effect on a corporation's financial status, corporations and their D&Os are facing more risks in connection with climate change related financial disclosures, and the potential for shareholder and derivative suits based on alleged climate change related financial non-disclosures.

A variety of SEC regulations potentially require disclosure of a corporation's climate change related issues. Whether disclosure of corporate climate change related information is required under these regulations generally is determined by whether the information at issue would be considered "material"; *i.e.*, whether there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make an investment decision, or, put another way, if the information would alter the total mix of available information.[3]

Some of the SEC regulations that may trigger a requirement that a corporation disclose climate related issues are:

- Regulation S-K, Item 101 – generally requiring disclosure of "the material effects that compliance with Federal, State and local provisions that 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."[4]
- Regulation S-K43, Item 103 - generally requiring disclosure of material pending legal proceedings, including legal proceedings "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" and which is material to the business or financial condition of the registrant, or involves a government entity.[5]
- Regulation S-K46, Item 503(c) – generally requiring disclosure of the most significant factors that make an investment in the company speculative or risky.[6]
- Regulation S-K48, Item 303 ("MD&A") – generally requiring a discussion and analysis of the overall corporate financial condition to provide information about the quality of, and potential variability of, a registrant's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.[7]

In a sign that the SEC has recognized that climate change related regulations and liabilities increasingly may trigger potential corporate reporting requirements under these and other SEC rules and regulations, on February 8, 2010, the SEC issued guidance to public companies regarding the SEC's "existing disclosure requirements as they apply to climate change matters."[8] In its guidance, the SEC identified a variety of climate change related issues that might trigger corporate disclosure requirements under its rules and regulations including:

- Enacted or proposed state, federal, or international legislation that may have a material effect on a public company.[9]
- Legal, technological, political and scientific developments regarding climate change that may create risks for companies, such as decreases in demand for existing products or services, or adverse effects on a company's reputation.[10]
- The potential physical effects of climate change on weather sensitive business operations, such as the financial effects on companies with operations on coastlines or effects from disruptions to the operations of major customers or suppliers from severe weather.[11]

Although we have yet to see any significant number of governmental actions or shareholder suits against corporations or their D&Os in relation climate change related disclosure failures, the seeds for the future growth of such actions are being sown. In a sign of things potentially to come on a state level, following an investigation by the New York Attorney General into the disclosures made by three energy companies in their SEC filings regarding the material financial risks the companies faced with respect to climate change, in September 2008 and November 2009 the energy companies entered into settlements which required much greater disclosure in their filings, including: (1) their current position on climate change to the extent the companies' emissions materially affect their financial exposure, their strategies to reduce climate change

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2 *See e.g. Connecticut v. American Electric Power Co., Inc.*, 582 F.3d 309 (2d Cir. 2009); *Comer v. Murphy Oil USA*, 585 F.3d 855 (5th Cir. 2009).

3 *See TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) and *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

4 17 CFR 229.101(c)(1)(xii).

5 17 CFR 229.103.

6 17 CFR 229.503(c).

7 17 CFR 229.303.

8 Commission Guidance Regarding Disclosure Related to Climate Change, http://www.sec.gov/rules/interp/2010/33-9106.pdf, p.1.

9 *Id.* at p. 22-23.

10 *Id*. at pp. 26-27.

11 *Id*. at p. 27.

risks and any other corporate governance measures related to climate change; (2) the material financial risks associated with and any reasonably expected trends in climate change legislation or regulation; (3) the material financial risks to their operations from the possible physical impacts of climate change; and (4) any court decisions related to climate change that the companies conclude are likely to have a material financial effect on their business.[12]

The developments in climate change related litigation and regulation in the last few years are a harbinger of lawsuits against D&Os in relation to climate change related disclosures. Those lawsuits could take a variety of forms, including securities lawsuits based on shareholder losses arising out of a company's climate change related liabilities or non-disclosures, and derivative lawsuits based on allegations that D&Os failed to ensure compliance with climate change regulations and laws. The extent of those lawsuits and whether they will be successful is uncertain. Nonetheless, at a minimum the defense of such lawsuits is likely to expose D&Os and their companies to significant legal costs, even if ultimately unsuccessful.

D&O Insurance - Protection Against The Flood?

Lawsuits against D&Os alleging damages arising out of climate change related issues likely will trigger the coverage provided by D&O insurance policies for claims alleging "losses" as a result of a D&O's "wrongful acts". Insurance companies, however, have already indicated that they will likely take the position – improperly in our view — that a so-called "pollution exclusion" contained in many D&O policies would eliminate coverage for such lawsuits.

Such a "pollution" exclusion, which typically purports to exclude claims "based on, arising out of, or in any way involving 'pollution'." Insurance companies have already indicated that they will take the position that climate change related D&O claims are not covered under D&O policies based on the "pollution exclusion" and the Supreme Court's *Massachusetts* decision finding carbon dioxide and other greenhouse gas emissions to be a "pollutant" under the Clean Air Act. It is far from clear, however, whether the courts will agree with such a position. Even though the Supreme Court classified carbon dioxide as a "pollutant" for the purposes of EPA regulation under the Clean Air Act in the *Massachusetts* decision, no certainty exists that the same classification would be adopted in the context of "pollution" as that term has traditionally been interpreted in a D&O policy. Moreover, a lawsuit against D&Os asserting, for example, damages as a result of the alleged non-disclosure of climate related liabilities or issues, asserts liability based on the non-disclosure, not liability for a "pollution" related activity. In an analogous case, at least one court in recent years has agreed. In *Sealed Air Corp. v. Royal Indem. Co.* 961 A.2d 1195 (N.J. Super. 2008), the court held that a pollution exclusion in a D&O policy excluding coverage for claims "based on, arising out of, or in any way involving . . . the actual, alleged or threatened discharge, release, escape, seepage, migration or disposal of Pollutants into . . . the atmosphere" did not bar coverage for a lawsuit against D&Os based upon the D&Os' alleged misleading financial statements with respect to asbestos environmental liabilities.[13]

Accordingly, although standard D&O insurance ultimately may provide insurance for climate change related lawsuits against D&Os, those lawsuits are likely to spawn parallel disputes between policyholders and insurance companies regarding the coverage provided for such suits under standard D&O policies.[14]

Building Levees Against The Uncertain Future

The increased regulatory activity and private litigation activity surrounding the climate change issue suggests future increased liabilities. Whether D&Os will face significant climate change related lawsuits in the future is an open question. Ensuring that corporate indemnities and insurance respond is one important task. The treatment of liability for climate change related issues by the courts and governmental entities is in an early stage of evolution, and the ultimate impact may be determined by the degree to which the effects of climate change manifest themselves. In the face of such uncertainty, minimize the risk of potential liabilities by keeping abreast of the quickly gathering number of scientific developments, regulations, laws and court decisions which may potentially trigger corporate disclosure and other climate related corporate obligations.

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[12] *See In the Matter of Xcel Energy Inc.*, AOD No. 08-012, N.Y. Att'y Gen. Envtl. Prot. Bureau (Aug. 26, 2008); *In the Matter of Dynegy, Inc.*, AOD No. 08-132, N.Y. Att'y Gen. Envtl. Prot. Bureau (Oct. 23, 2008); *In the Matter of The AES Corporation*, AOD No. 09-159, N.Y. Att'y Gen. Envtl. Prot. Bureau (Nov. 19, 2009). Available at http://www.ag.ny.gov/media_center.

[13] *Sealed Air Corp. v. Royal Indem. Co.*, 961 A.2d 1195, 1201 (N.J. Super. 2008).

[14] Companies may also find that with the rise of climate change related D&O litigation, however, it may be possible to purchase D&O policies with clauses specifically carving out climate change related securities lawsuits from a policy's "pollution exclusion" or claims against D&Os for which the D&Os are not being indemnified by their corporate employer. *See* Global Warming – Are D&Os In The Hot Seat?, Directors & Officers - The ACE Report Issue No. 66, November 2007. Available at: http://www.acebermuda.com/AceBermudaRoot/AceBermuda/Media+Centre/D+and+O+Newsletter/Global+Warming++Are+DampOs+In+The+Hot+Seat.htm

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