

LOS ANGELES DAILY JOURNAL
THURSDAY, APRIL 12, 2007

Climate Change Exclusion

By Rachel S. Kronowitz

Among the many issues that the Supreme Court's ruling this week in Massachusetts v. EPA, 2007 DJDAR 4302, has raised are its effect on the availability of insurance coverage for claims against corporate directors and officers related to climate change.

So-called directors and officers insurance, purchased by companies to insulate directors and officers from the costs of lawsuits resulting from their actions in their professional capacities, generally contain broad provisions that purport to exclude coverage for claims arising from or related to pollution matters. Massachusetts v. EPA's holding that carbon dioxide emissions are "pollutants" and the court's indication of relaxed standing requirements for certain claimants making allegations related to climate change are likely to fuel mounting public and shareholder activism focused on global warming.

Shareholders increasingly are insisting that companies disclose the financial risks posed by global warming and the strategies they have in place in preparation for probable future regulatory requirements. The most significant concerns focus on how a company recognizes, analyzes and discloses environmental or climate risk.

In 2006, two dozen climate-related shareholder resolutions were filed with U.S. companies requesting financial risk disclosure and plans to reduce greenhouse gas emissions. Many of these resolutions were withdrawn after companies agreed to implement shareholder requests. The Investor Network on Climate Risk, representing \$3 trillion in assets, recently renewed its request to the Securities and Exchange Commission chairman to clarify that climate change is a material risk requiring disclosure on security filings and requesting specific guidance regarding the information companies must provide to investors on the financial risks posed by climate change.

According to a recent report by Marsh, insurers are becoming more concerned about their policyholders' potential exposure to liability risk associated with climate change. As a result, insurers are beginning to raise issues related to climate change in the underwriting process that precedes issuance and renewal of D&O policies.

Among the questions that insurers are posing to policyholders with regard to assessing climate change and D&O risk are the following: Does your company allocate responsibility for the management of climate-related risks? Are there independent board members tasked with addressing climate-related issues? What progress, if any, has your company made in quantifying, disclosing and/or reporting its emissions profile and planning for future regulatory scenarios?

Publicly traded companies will have increasing difficulty failing to consider seriously how climate change will affect their operations and financial results and failing to disclose these risks and concerns. Some insurers have indicated that they may begin to exclude coverage for all climate risks from its D&O policy if a policyholder cannot show that it is taking prudent steps to prevent the loss associated with the management of climate change. Insurers facing significant claims under D&O policies related to climate change risks also are likely to try seek to rescind D&O policies issued to corporations that failed to disclose the potential risk for such claims in the underwriting process. This approach by insurers is being used increasingly in the post-Enron era.

How can a corporation increase the probability that its directors and officers are covered for costs associated with climate change claims? Be prepared in the application and renewal process to discuss climate risk issues, the corporate governance steps that your company has taken to address these issues and any planning that the company has done to prepare for future regulatory scenarios. Advise your client to provide documentation to its insurer about the progress your company has made to quantify, disclose and report its emissions profile. A full and complete discussion of these issues will help to forestall any attempt by the insurer to rescind your client's D&O policy because of a lack of candor in the application process.

Before your client's policy is issued, work closely with its insurer to include the broadest possible coverage language in the D&O policy. Although most such policies exclude coverage for certain pollution claims, the question is whether the climate change claim against a corporation and its directors and officers will be covered or excluded under the pollution exclusion. The answer to this question depends on the nature of the allegations and the facts surrounding the work done by the corporation and its board. The answer may be different from state to state.

The probability of a positive coverage outcome will be enhanced by the negotiation of narrow contractual exclusions related to so-called pollution claims; not all D&O policies are the same, and the coverage provided should be negotiable. For example, your client should negotiate exceptions (or writebacks) to the pollution exclusion that provide that the exclusion does not apply to shareholder claims and certain types of defense costs. Your client should work with the insurer to negotiate a narrow definition of the bodily injury and property damage exclusions in the policies. Negotiate coverage to pay for certain governmental fines and penalties, and supplement that coverage with statutory liability coverage.

Options outside of traditional D&O insurance coverage are available to supplement the transfer of climate change risk for directors and officers. For example, the Bermudian insurance market offers specialized D&O policies that do not include a pollution exclusion. Dedicated limit policies are also available that provide broader coverage for a typical D&O policy and do not include a pollution exclusion.

By planning and creatively structuring the coverage purchased to protect a corporation's directors and officers, a corporation can maximize coverage, minimize risk and limit its insurance costs. Even companies with sophisticated risk management personnel can benefit from the expertise brought to bear by outside counsel, especially in the uncertain situation of the manner in which the coverage put in place will be interpreted.

Rachel S. Kronowitz is a partner in the Washington, D.C., law firm of Gilbert Randolph.