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# Officers and Directors-- Liability Risks

## Second Annual Legal Dimensions of Climate Change

November 8, 2006

# Agenda

- Fiduciary Duty Overview
  - corporate officers and directors
  - financial trustees
- Implications of Sarbanes-Oxley
  - expanded MD&A – more discussion of known trends, uncertainties
  - disclosure controls and procedures
- Personal Risks
  - the insurance gap

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# Overview of Fiduciary Duties

- Outside/Non-Officer Directors
  - Duty of care – to discharge duties in good faith, with the care an ordinary prudent person in a like position would exercise (Fletcher Cy Corp § 1029)
  - Duty of loyalty – must act on behalf of the company and its shareholders, and refrain from self-dealing (Fletcher Cy Corp § 837.60)
  - "Business judgment" rule – presumption or safe harbor that protects directors against claims of breach if they act on an informed basis with the honest belief that such action is in the best interest of the corporation (Fletcher Cy Corp § 1036)

# Overview of Fiduciary Duties

- Officers/Inside Directors
  - General rule – owe the same duties as an outside director – duty of care, duty of loyalty (Fletcher Cy Corp § 1029)
  - Implied obligation to keep the company's board "informed"
    - can be inferred in that directors are statutorily authorized to rely on information provided by such insiders (*see, e.g.* Del. Code Ann. title 8, sections 141(a) and (c))
  - May be subject to a higher level of scrutiny given greater accessibility to company information and knowledge of day-to-day operations (Model Business Corp. Act § 8.42)
  - Some courts have questioned availability of "business judgment" rule to officers, but generally recognized as applicable (Fletcher Cy Corp § 1036)

# Overview of Fiduciary Duties

- Financial Trustees (investing for others)
  - Duty of care is comparable to inside officers/directors
  - Duty of loyalty translates to acting solely in the interest of their beneficiaries (ERISA, 29 CFR § 1104)

# Implications of Climate Change Debate

- For Corporate Directors and Officers
  - CERES and other “responsible investing” advocates argue that impact of climate change is sufficiently broad that all company boards, encompassing virtually all economic sectors, need to respond
  - this perspective is spreading – Swiss Re is suggesting that D&O insurance applications should require a demonstration of corporate governance related to climate change
  - at minimum, given the current level of public discourse, ignoring the topic altogether could run afoul of the Business Judgment obligation of operating on an “informed” basis

# SOX Implications

- Certain established SEC requirements, such as S-K 303 (disclosure of trends, demands and uncertainties), invite at least serious consideration of impacts and potential materiality
- SOX overlay on expanded discussion of “critical accounting estimates” – where substantial uncertainties exist may also force expanded treatment, at least for Kyoto-impacted companies

# SOX Implications

- Disclosure controls and procedures – does your system address climate change related risks
- Officers have to certify –what level of diligence does that entail?
- Days of rubber-stamping by the Board are long gone – what questions should the directors be asking?

# CERES' Approach

"Corporate Governance and Climate Change," June 2003

- Board Level Components
  - Designated special committee
  - Board-level review
- Management Level
  - Make environmental a direct report to the CEO
  - Set greenhouse gas targets, make a compensation factor
  - Public commitment by CEO
- Reporting
  - Express statement of risks and opportunities in public filings
  - Adopt GRI, issue sustainability reports
- Others
  - Develop emissions data sufficient to set baseline and measure progress, including third party verification
  - Participate in trading/renewable energy programs

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# Possible Corporate Governance Responses

- CERES approach generally follows corporate governance programs covering EHS management more generally
- But, may not fit all companies
  - For a company on the low end of GHG issue (in terms of emissions/use) with exclusively US operations, the board may reasonably feel that anything beyond acknowledgement of the uncertainties could be misleading to investors given the current uncertainties

# Possible Corporate Governance Responses

- Current activity is probably somewhere in between:
  - For Kyoto-impacted entities, carbon control costs or measures may fit within traditionally mandated environmental disclosures

***From BP p.l.c. 2004 20F***

*Market mechanisms to allow optimum utilization of resources to meet the national Kyoto targets are being considered, developed or implemented by the individual countries and also internationally throughout the European Union. The relative success of these systems will determine the extent to which alternative fiscal or regulatory measures may be applied.*

# Possible Corporate Governance Responses

- Current activity is probably somewhere in between:
  - For major emitters or significant energy consumers not directly impacted by Kyoto, some impact is likely and may warrant disclosure under "known trends, events and uncertainties" under MD&A

*From AEP 2004 10k*

*"There are new environmental control requirements that we expect will result in substantial capital investments and operational costs. The sources of these future requirements include: …*

*- Possible future requirements to reduce carbon dioxide emissions to address concerns about global climate change."*

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# Possible Corporate Governance Responses

- Current activity is probably somewhere in between:
  - Some industries, such as the insurance industry, face unique dollar impacts from natural disasters. Even absent a "buy-in" on the science issues, the undisputed increase in severity of weather events in recent years has had some measurable consequences
  - CERES' most recent look at insurance company efforts in this regard shows that there has been some progress – *see From Risk to Opportunity: How Insurers Can Proactively and Profitably Manage Climate Change - CERES, August 2006*

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# Possible Corporate Governance Responses

- Some industries may have an upside – construction, emergency response providers may benefit from increase in natural disaster recovery efforts
- Climate change reporting proponents do stress that disclosures should focus on opportunities, as well as risks

# Possible Corporate Governance Responses

- For the Financial Trustee
  - Type of investment placement response that climate change considerations trigger may well turn on whether climate change represents:
    - A financial or economic risk, which must be taken into account to satisfy fiduciary duty; or
    - A social/environmental goal, which can be considered, but not to the detriment of financial performance

# Risk of Guessing Wrong Could Turn Personal

- Directors and Officers Insurance
  - Traditionally protects against personal liability for shareholder/third party claims alleging malfeasance
  - Like most casualty policies, D&O Policies generally contain a “pollution exclusion”
    - Insurance industry’s position: it is an absolute exclusion for any claims arising out of environmental matters
  - State-law based legal issue – courts look to relevant state law in determining coverage, scope of exclusion

# Risk of Guessing Wrong Could Turn Personal

- Directors and Officers Insurance
  - Impact of Pollution Exclusion not heavily litigated to date
    - 5th Circuit, applying Texas law, held that pollution exclusion bars coverage with respect to any matter "arising out of pollution," *National Union Fire Insurance Co. v. U.S. Liquids (5th Cir. 2004)*
    - Contrary holding in 6th Circuit, holding that an asbestos exclusion in a D&O policy did not negate coverage for alleged disclosure-related liabilities relating to asbestos *Owens Corning v. National Union (6th Cir. 2001)*

# Risk of Guessing Wrong Could Turn Personal

- Reality is that insurance industry has been moving toward issue-specific policies
  - they offer specific policies to cover “gaps” in general commercial liability or property casualty policy that result from the growing number of exclusions
  - Pollution Exclusion gap is now addressed through specific environmental policies:
    - pollution legal liability
    - cleanup/cost cap
    - mold coverage
  - Insurance industry says that is the only way to properly underwrite such risks
  - Skeptic say just another way to secure additional premium for issues that had always been part of a larger policy

# Risk of Guessing Wrong Could Turn Personal

- Climate change issues not limited to emitters – not necessarily directly pollution-related.
- High-risk industries may need to tackle the insurance gap issue head-on and secure specific environmentally-related coverage that includes D&O
- The Swiss Re suggestion of excluding climate change from D&O policies unless the risk is specifically acknowledged and managed is just one more variation on this theme