

Climate change on the corporate governance landscape





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INTRODUCTION

Climate change is no longer just an ethical environmental issue. It has fast become a matter of corporate governance, with regulators both here and abroad increasing oversight and pressure on greater corporate disclosure of climate change risks.

At the same time, litigation against companies and their boards on climate change exposures has accelerated pace.

As a result, the implications of climate change on the personal liabilities of company directors are increasingly apparent. Against this changing landscape, this paper examines what protection for climate change exposure can be offered under current directors and officers (D&O) policies, where potential gaps in cover exist, and how a policy is likely to respond in the event of a regulatory investigation, shareholder litigation or the threat of an adverse outcome.¹

D&O POLICIES – PERSONAL ASSET PROTECTION

While D&O liability insurance policies are designed to protect the personal assets of directors and officers, they might not always respond to a climate change risk in the manner expected.

In part, the issue stems from the fact that D&O insurance was established long before climate change emerged on the world's political agenda.² Consequently, climate change risks do not fit neatly within existing definitions and exclusions, leading to potential gaps in cover.



¹Paper delivered at the International Legal Symposium: Climate Change Risk and Corporate Governance Directors' Duties and Liability Exposures in a post-Paris World, 29-30 August 2016, University of Melbourne.

²D&O insurance emerged in the 1930s. Climate change emerged as a political issue in the 1990s.

³Note this coverage carries risks for the directors in that it dilutes the limit available for claims against them and also potentially exposes the policy to applications by liquidators (as the company is an insured for the purposes of the policy, the policy may be regarded as an asset of the company).

⁴See Zurich's D&O Policy, which at the time of writing this paper has an extension for Environmental Mismanagement and Pollution cover (conditions and exclusions apply). Definitions of an environmental event, greenhouse gases and clean-up costs has also been broadened by several insurers.

The breadth of D&O cover

A typical D&O policy covers individual directors for all acts, errors or omissions arising from their conduct as directors and could therefore include matters relating to climate change risks.

Some of the allegations that may trigger a D&O policy include:

- Breaching their fiduciary duties in not considering the financial risks associated with climate change.
- Failing to comply with legislative reporting requirements.
- Failing to disclose climate change liabilities.
- Disseminating false or misleading or incomplete information on climate risks.
- Mismanagement of climate related risks.
- Negligence in allowing the company to emit greenhouse gases into the atmosphere.
- Failing to protect the company's assets.

If the D&O policy contains Company Securities Cover (commonly referred to as Side C cover) coverage may also be available for the entity itself in the event of shareholder litigation.³ This is a real risk as share prices have been known to plummet following adverse news on climate change exposures.

In most D&O policies, critical definitions such as 'claim', 'loss' and 'wrongful acts' are broadly defined so far as coverage for directors and officers is concerned. In responding to the increasing visibility of climate change exposures, some D&O insurers are now expressly covering these risks both for directors and officers, as well as any securities related claims made against the company.⁴

In most D&O policies, the issue becomes about determining whether greenhouse gases are considered ‘pollutants’.

THE GAPS IN D&O COVER

Pollution exclusions

Until recently, most D&O policies contained a pollution exclusion. Some exclusions read in absolute terms, to exclude claims, for example, ‘arising out of, based upon or attributable to or in any way involving directly or indirectly pollutants’.

Others use narrower language to simply exclude claims ‘for’ pollution. As is the case with all policies, there is endless variation in wording.

The reason for the commonly featured exclusion is that pollution-related claims are addressed by a raft of other insurance products. For example, a public and products liability policy would generally respond in the event of ‘sudden and accidental’ pollution, while environmental liability policies could be triggered by ‘gradual seepage and contamination’. Coverage is also available under contractors pollution legal liability policies, site pollution legal liability policies or tailored under special purposes policies.⁵

When applying this exclusion to climate change risks, the issue becomes about determining whether greenhouse gases⁶ are considered ‘pollutants’. This is defined in most D&O policies as any solids, liquids, gaseous or thermal irritant or contaminant.

In the United States, the conclusion appears to have been drawn that carbon dioxide (along with other greenhouse emissions) falls under the classification of ‘pollutant’.⁷ Notwithstanding that carbon dioxide is a natural and necessary component of the atmosphere, the argument was made that an excessive amount of carbon dioxide poses a threat to an ecosystem and, on that basis, can be considered a pollutant or contaminant.

This finding has been recognised in various jurisdictions including in Australia.⁸

Some D&O policies remove the ambiguity by expressly defining carbon dioxide or other greenhouse gases as a pollutant.

Those D&O policies that feature a pollution exclusion typically contain write backs to the exclusion or provide extensions for shareholder pollution claims (some are limited to derivative claims only) and defence costs, the latter being typically sub-limited.

While the better D&O policies do not contain a pollution exclusion, they generally exclude clean-up costs, including the loss incurred in removing, containing, treating, detoxifying, neutralising, assessing, monitoring or testing for the effects of pollutants. Other pollution insurance policies specifically provide for this cover.

⁵ Refer to Marsh’s Environmental Practice Group for more details.

⁶ At the time of writing this paper, is defined in the Zurich D&O policy as carbon dioxide (CO₂), methane (CH₄), nitrous oxide (N₂O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs) and sulphur hexafluoride (SF₆) or any other emission or substance defined by any applicable law as a greenhouse gas.

⁷ Massachusetts v Environmental Protection Agency 529 U.S.497.

⁸ Walker v Minister for Planning [2007] NSWLEC 741.

Bodily injury and property damage exclusions

There are other exclusions commonly found in a D&O policy that may also restrict cover for climate change exposures. For example, D&O policies can contain a bodily injury and property damage exclusion on the basis that such claims are covered under public and products insurance policies or workers compensation insurance.

If couched in broad terms ('arising out of', 'based upon' etc.), the exclusion will likely capture any climate change event that leads to property damage, along with mental and emotional distress caused by associated pollution.

In the better D&O policies, this exclusion operates to exclude only those claims 'for' bodily injury or property damage, rather than 'any claims howsoever related'.

Exclusions for fines and penalties

Some D&O policies specifically exclude cover for fines and penalties. This exclusion will therefore limit any cover that a D&O policy may provide following an adverse regulatory finding into a breach concerning climate change.

Climate change exclusions

It is possible that climate change exclusions may be introduced in future D&O policies, should boards fail to demonstrate a prudent and diligent approach to climate risk governance in their proposals for insurance.

Jurisdictional and territorial limitations

Some policies limit coverage to the Australian and New Zealand jurisdictions or territories.⁹ This raises coverage issues for climate change exposures, which often have global impact and implications.

Other exclusions

There are other exclusions, such as the fraud and dishonesty exclusion and prior known matters exclusion, which can also affect policy coverage.

For example, many fraud and dishonesty exclusions deny claims for loss resulting from the wilful violation or breach of any law, regulation or by-law anywhere in the world, as well as the breach of duty imposed by any such law, regulation or by-law. While the exclusion in the better policies only applies once a final adjudication has established the proscribed conduct, if defence costs are advanced under the D&O policy, the burden of repayment will fall on the director or officer, if they are found to have willfully breached their obligations.

The better D&O policies include severability provisions preserving cover for directors and officers cleared of any wrongdoing, notwithstanding improper conduct by fellow directors and officers.

Most D&O policies exclude any matters policyholders were aware of prior to entering into the policy. Known as the prior known matters exclusion, this may also give rise to non-disclosures issues.

THIRD PARTY VS FIRST PARTY COVER

D&O policies principally cover directors and officers for third party losses, which relate to losses sustained by a third party (such as customer, client or supplier) as the result of a director's wrongful acts, errors or omissions.

In a D&O policy, loss is typically defined to include damages (such as compensation orders), judgments (including pre and post judgment interest), settlements entered into with the insurer's consent, defence costs and other associated expenses such as claimant's costs and crisis costs.

Climate change related risks however, result in a number of 'first party losses' being direct losses sustained by the company.

Damage to property, business interruption, lost market value and remediation and clean up expenses are some of the losses sustained directly by a company as a consequence of a climate change risk and these items are not typically covered by a D&O policy.

⁹ Jurisdictional limits refer to the jurisdictional region in which the insurer will respond with coverage in the event of legal action. Territorial limits refer to the geographical area from which a claim can originate.

REGULATORY INVESTIGATIONS

Globally, there is increasing regulatory pressure on companies to meet their duties and obligations associated with climate change risks. Further, regulatory investigations relating to climate change are expected to rise in line with the growing body of climate science.

Regulatory investigations are serious matters and can result in potentially severe outcomes for directors. Fortunately, most D&O policies include some form of cover for legal costs incurred by directors or officers in preparing for, responding to and attending an investigation.

The better D&O policies provide this cover to the full policy limit, contain an advance payment promise, and apply even before the allegation of a wrongful act, error or omission. This is important as the preliminary stages on investigations are routinely an evidence gathering exercise.

In a worst case scenario, the consequences of any type of regulatory breach can include:

- Criminal prosecutions against the company and its directors and officers.
- Fines and penalties against the company and its directors and officers.
- Disqualification or imprisonment of a director or officer.
- Follow-on civil proceedings.
- Significant legal costs and expenses.
- Damage to reputation and brand.
- Disruption to business.

Fortunately for directors, if a prosecution is commenced by a regulator following an investigation, a claim will likely trigger under a D&O policy (as criminal proceedings are typically covered). Consequently, directors and officers should be covered for amounts they become legally liable for in defending such a prosecution.

However, under most policies, cover for prosecutions against a company itself is not expressly covered.

Cover should also be available for any civil penalty proceedings that may be instigated by a regulator against a director for statutory breaches following an investigation.

Most D&O policies will provide some form of cover for legal costs and expenses incurred by directors in defending disqualification orders.

The better D&O policies will also cover:

- Reasonable legal costs incurred by a director or officer to bring legal proceedings (as distinct from defending proceedings) to overturn orders disqualifying them from managing a corporation.
- Reasonable costs and charges in hiring a public relations firm to mitigate the effects of any published negative statements arising out of any investigation and flow on litigation.
- Fines and penalties¹⁰ to the extent insurable at law.
- Security for 'take or pay' obligations.

For reasons of public policy, all D&O policies exclude matters uninsurable at law.¹¹ This means that a person may not benefit from his/her own wrongdoing and, by extension, may not be indemnified against the consequences of those actions.

Any insurance contract purporting to insure against such risks would be void and unenforceable. This includes any policy that purports to indemnify a person against criminal liability if the crime is committed with guilty intent. The position is less clear where the crime is one of strict liability and the conduct of the offender is morally innocent, although the majority view is that an indemnity can be given. It may depend on whether there is an element of fault or intent attributable to the person who has committed the strict liability offence. So while cover may be available for civil fines and penalties this may not extend to a fine awarded pursuant to an offence.

¹⁰ The Clean Energy Regulator is responsible for administering a number of Climate Change laws, the non-compliance of which may result in, amongst other things, civil and criminal penalties.

¹¹ This is so whether or not the wording expressly makes reference to matters uninsurable at law.



STATUTORY LIABILITY INSURANCE

Another option available to directors and officers (as well as their organisations) is statutory liability insurance. Statutory liability insurance covers ‘penalties’ that an insured becomes liable to pay following a contravention of an ‘Act of Parliament’. The policy only covers penalties as defined and associated legal costs, specifically excluding other types of loss including damages. This cover is also subject to, among others, the usual exclusions for claims arising out of deliberate, wilful, intentional or reckless wrongful breaches.

PRE-INVESTIGATIONS

Cover for pre-investigations is a recent evolution in D&O policies that is rapidly taking hold. The development addresses the costs incurred by directors in preparing formal notifications to regulatory bodies in the event of an actual or suspected material breach of a company’s legal duty. Additionally, internal investigations requested by a regulator following a company’s formal notification can also be covered.



IMPORTANCE OF NOTIFICATION

Given the myriad of factors that determine whether D&O policies respond to climate related risks, it is critical for directors and officers to take great care in the reporting of claims and circumstances.

Equally important is the need for companies to follow the notification and claims handling conditions set out in the policy so as to not prejudice cover.

The failure to notify a potential claim within the policy period can have serious consequences for the policyholder especially when the policy does not expressly provide that right.¹²

The late notification of claims or circumstances often creates unnecessary difficulties between directors and their insurers and can often require a court adjudicated outcome. To avoid complications, always notify claims or circumstances promptly and during the policy period.

¹² While section 40 of the Insurance Contracts Act 1984 provides this right a failure by an insured to exercise it will not be remedied by section 54 of the insurance Contracts Act 1984. Section 54 of the Insurance Contracts Act 1984 governs the ability to notify a claim after the policy has expired.

Directors and officers should carefully analyse their own risk profile to ensure a D&O program is structured to meet their needs.

CONCLUSION

The increasing focus on climate change exposures presents new and different challenges for directors and their companies, with the threats of class action lawsuits, significant remediation costs and irreversible damage to the corporate and personal brand growing ever more likely.

In the face of larger stakes, directors must have a thorough understanding of the risks involved and how they can be best managed. This is a sentiment echoed by regulators.

While a D&O policy provides some coverage for climate change exposures, it does not necessarily respond to all related losses and liabilities.

Adequate protection for directors and officers in today's climate essentially requires three items:

- 1) Good corporate governance practices.
- 2) Properly worded indemnification provisions and/or deeds of indemnity from the corporation.
- 3) An appropriate insurance program.

Directors and officers should carefully analyse their own risk profile to ensure a D&O program is structured to meet their needs. There are different products available today to assist. An excess side A policy, statutory liability insurance and environmental insurance are some of the specialised products that can help shield directors and officers from the ever increasing personal liabilities¹³ that attach to their positions.

While insurers provide standard form policies as a baseline, the terms and conditions can be negotiated to improve the scope of cover.

¹³ Attention is now being focused on the potential D&O claims from climate change. The world's climate is changing and this will expose businesses, governments, societies and accordingly directors and officers to new and different risks and opportunities. Refer to Marsh Update August 2006, Climate change: Risk and Opportunity for more information.



EXCESS SIDE A COVER

Excess side A cover is enhanced D&O coverage for individual directors and officers, covering them for non-indemnifiable losses. These include shareholder derivative actions and claims in bankruptcy. It acts as a safety net when the company is either not permitted or not required to provide indemnification to its directors and officers.

It may be offered on a purely excess basis or on a 'difference in conditions' (DIC) basis, dropping down to respond if the underlying insurer rescinds the policy, becomes insolvent or excludes a specific coverage grant in the side A cover. It may cover all directors or officers or only non-executive directors.

Some of the benefits of an excess side A policy include¹⁴ :

- 1) Limits dedicated to individuals and cannot be impaired by corporate liabilities.

An excess side A policy will provide dedicated and exclusive limits for claims made against directors and officers that cannot or will not be indemnified by a company, even if the rest of the D&O program has been exhausted by indemnifiable or entity losses.

- 2) Broader coverage terms.

Since the vast majority of claims covered under a D&O policy are indemnified by the company, a side A only D&O policy allows insurers to afford broader coverage terms than generally possible under a traditional D&O policy.¹⁵ Importantly, the policy contains fewer and less onerous policy exclusions. For example, there are no exclusions for alia pollution, prior litigation, defamation or other personal injury in an excess side A only policy.

- 3) Less likely to be frozen as an asset of the corporation in the event of a corporate insolvency.

Side A only policies can potentially afford more protective coverage for directors and officers in the event of a company's insolvency since the company is not an insured under the policy.

The popularity of the excess side A policy continues to increase.¹⁶ Given some of the high profile bankruptcies, notable cash settlements of D&O claims and the increase in significant shareholder class actions, side A policies have no doubt become a tool to attract and retain directors and officers. They offer additional comfort to directors and officers in carrying out their duties in today's political and regulatory environment where they face unprecedented scrutiny.

Excess side A cover offers additional comfort to directors in today's political and regulatory environment where they face unprecedented scrutiny.

¹⁴ There are a number of Side A products available. Terms and conditions vary greatly.

¹⁵ Ibid.

¹⁶ The availability of cover can be very formula driven and tied to the financial health of the applicant.

For more information, contact the colleagues below or visit our website at:
www.marsh.com.au

MELITA SIMIC

Managing Principal - FINRPO
+61 2 8864 7650
melita.a.simic@marsh.com

CRAIG CLAUGHTON

Head of FINPRO
+61 2 8864 7788
craig.claughton@marsh.com

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