National Association of Corporate Directors

# DIRECTORS MONTHLY

May 2003
Volume 27 Number 5
Reprinted with permission from the
National Association of Corporate Directors (NACD)

# Uninsured and Undisclosed Environmental Liabilities Pose Risks for Directors

By C. Gregory Rogers

The Sarbanes-Oxley Act of 2002 places new responsibilities on the audit committee to serve as a watchdog over management in assuring the accuracy and reliability of corporate disclosures. But along with their new responsibilities, independent directors serving on audit committees have inherited a corresponding increase in personal liability exposure. Environmental liabilities pose a special concern for audit committee members because these liabilities are often both undisclosed and uninsured.

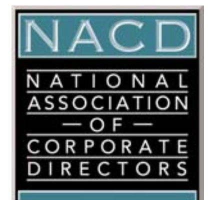
## The D&O Pollution Exclusion

Most directors and officers (D&O) policies contain a "pollution exclusion," denying coverage for any claim against a director or officer that has as its underlying cause the release or threatened release of pollutants. This includes securities claims arising from environmental matters. Insurance companies have been including pollution exclusions in commercial general liability policies since the 1980s, and have more recently added the exclusion to D&O policies.

## About NACD

**National Association of Corporate Directors (NACD)**, an independent not-for-profit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, closely held, and private firms. NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.

National Association of Corporate Directors
1828 L Street, NW
Suite 801
Washington, D.C. 20036
202-775-0509
www.nacdonline.org



Insurance companies now offer separate environmental policies to fill the coverage gap created by the pollution exclusion. Even known conditions generally can be insured against cleanup cost overruns. However, environmental insurance policies are underwritten on a site-specific, claims-made basis, and many corporate risk managers do not use them extensively. Also, for a variety of reasons discussed below, management may be reluctant to perform the investigation needed to insure the company's environmental loss exposures.

The insurance companies don't want D&O policies to substitute for environmental insurance. To emphasize this point, some D&O policies contain an exclusion for failure to maintain adequate insurance. This provision excludes coverage for any claim arising out of the failure of the company to purchase or maintain insurance coverage that would have protected it from a significant loss. The availability of environmental insurance could cause this exclusion to be triggered if the complaint alleges that insurance was available and the insured failed to investigate its advantages.

## Pollution Securities Claims

The bottom line is that most directors do not have D&O coverage for environmental claims. It is possible, albeit remote, that a director could be sued personally in a toxic tort case. Audit committee members are more likely to be sued personally in a securities claim arising from uninsured and undisclosed environmental liabilities. In insurance jargon, this is known as a "pollution securities claim."

Generally accepted accounting principles and securities laws require companies to account for and disclose environmental liabilities. However, many companies have adopted financial reporting policies and procedures that tend to understate these liabilities. The company's failure to fully disclose material environmental liabilities can give rise to pollution securities claims against the company and its leaders. Audit committees will be vulnerable to attack if they do not take steps now to ensure that appropriate systems are in place to identify, evaluate, and disclose environmental liabilities.

**Director Summary:** Independent directors can face personal liability exposure stemming from uninsured and undisclosed environmental liabilities. Directors should seek to gain the cooperation of senior management in taking steps to identify, evaluate, insure, and/or disclose environmental liabilities. Focus in the areas of accounting and disclosure policies, internal controls for financial reporting, environmental risk management, and corporate governance.

## A Gap in Internal Controls

In the absence of a government enforcement action, management may determine that the company does not have a current obligation to clean up or disclose preexisting environmental conditions, such as historical soil and groundwater contamination. While there may be no "liability" in the accounting sense of a current obligation to pay a third party, these conditions may nonetheless entail material obligations. In addition, the existence of environmental impairments creates an increased risk of third-party claims for property damage and personal injury.

While most public companies today have effective systems to ensure day-to-day operational compliance with environmental laws, many lack comparable systems to address risks related to historical conditions that are not the subject of a pending legal action. Indeed, management may intentionally choose not to investigate such risks. Actual knowledge of historical environmental conditions could trigger environmental reporting and financial disclosure requirements, as well as cleanup obligations. A lack of effective internal controls for environmental liabilities can result in management's failure to "fairly present" the financial condition of the company to shareholders and creditors.

## Financial Reporting

There are several reasons why the financial statements may not "fairly present" the financial condition of the company after considering environmental impacts. First, if management intentionally avoids investigation of suspect conditions, material impairments may go undetected. Second, management may take the position that potential losses are too speculative to estimate with reasonable certainty. If any figure is disclosed at all, it may be on the far low end of the range of possible outcomes. The effect can compound when this practice is repeated for numerous sites. Third, management may

evaluate the "materiality" of multiple environmental loss contingencies on an individual rather than an aggregate basis in order to avoid disclosure.

The existence of environmental impairments and contingent liabilities may be discovered when events call for an overall market valuation of the company—for example, in a proposed merger or in bankruptcy proceedings. If the contingent losses turn out to be material to the valuation of the company, and if these losses are uninsured, litigation against directors and officers can be expected to follow.

Members of the audit committee will be directly in the cross hairs of the ensuing lawsuits. The plaintiffs will allege that the audit committee breached its fiduciary duty of care to assure reasonably designed corporate information and reporting systems. This claim will be particularly compelling if it is found that the company routinely failed to investigate suspect environmental conditions, and indeed intentionally avoided investigation of certain types of environmental risks. Again, the D&O insurer may be entitled to deny coverage based on either the pollution exclusion or the failure to maintain adequate insurance exclusion, or both.

### Gaining Management's Support

In the past, management has faced significant disincentives to disclose contingent environmental liabilities and asset impairments. Disclosure could trigger cleanup requirements, government enforcement, and third-party litigation. Given the lack of SEC enforcement in this area, non-disclosure seemed to carry little risk. Today, the rules have changed and the motivational drivers for management are, or at least should be, vastly different.

The key to gaining their support is to inform the CEO, CFO, and the general counsel of the significant risks to the company and to themselves personally. When certifying the accuracy of the financial statements and the effectiveness of internal controls under Sarbanes-Oxley, CEOs and CFOs should realize that in the context of an SEC enforcement action, bankruptcy proceeding, or private securities litigation, every act and omission will be viewed with 20/20 hindsight.

### Managing Risk

Assuming directors are successful in gaining management's full cooperation, what actions should be taken to reduce the exposure of the audit committee to an acceptable level?

## Members of the audit committee will be directly in the cross hairs of the ensuing lawsuits.

***Accounting and disclosure policies.*** The audit committee should ensure that it is the company's policy to "fairly present" all environmental liabilities and loss contingencies in the company's periodic SEC reports. The committee should be clear that this commitment goes beyond mere conformance with generally accepted accounting principles (GAAP). The committee should further ensure that all accounting and disclosure policies are made known to the company's financial auditors. Formal policies should be defined for the following key issues:

- The procedures for determining asset impairments and asset retirement obligations.
- The means to be used to determine the "probability" of environmental loss contingencies.
- The method(s) to be used to quantify the estimated loss associated with environmental impairments and contingent liabilities.
- The procedure for determining materiality.
- The manner of disclosing contingent losses that may be offset by insurance or other rights of recovery.

***Internal controls.*** The audit committee should assure itself that appropriate internal controls are in place to ensure accurate and reliable financial reporting of environmental risks. Such internal controls may include:

- Procedures to ensure that historical environmental impairments and contingent liabilities are identified, evaluated, insured, and/or disclosed in the company's periodic financial reports.
- Procedures reasonably designed to ensure that relevant information is made known to the audit committee, the CEO, the CFO, and the company's financial auditors on a timely basis.
- Training programs to ensure that employees are aware of the company's accounting and disclosure policies and procedures.
- A baseline investigation to identify and evaluate historical environmental impairments and contingent liabilities.

## Significant education of senior corporate executives may be necessary to overcome ingrained assumptions and practices.

***Environmental risk management.*** The board of directors should periodically assure itself that management has appropriate mechanisms in place to identify, control, and finance environmental loss exposures. In addition to internal controls for financial reporting, such mechanisms may include, but are not limited to, pre-acquisition due diligence procedures, environmental management systems such as ISO 14000, environmental compliance management systems, corrective action programs, environmental loss reserves, and environmental insurance.

Because the D&O pollution exclusion makes environmental insurance so important for the protection of the company's officers and directors, the company may also want to consider the following:

- A one-time investigation of environmental coverage contained in older "occurrence-based" commercial general liability policies.
- Procedures to ensure that environmental exposures are covered by adequate environmental insurance.
- Periodic evaluation of opportunities to transfer environmentally impaired properties, and all associated liabilities, to so-called "brownfield" redevelopment companies.

***Corporate governance.*** Directors should be diligent in their efforts to provide environmental risk oversight. Here are some specific actions that seem prudent:

- Include environmental liabilities and risks as topics on the audit committee's regular meeting agenda.
- Establish internal lines of communication and reporting regarding environmental risks among appropriate personnel.
- Include internal controls for financial reporting of environmental matters on the agenda of the audit committee's quarterly internal control review meetings with the company's CEO and CFO.
- Take appropriate steps to ensure that the audit committee's decisions and actions are based on independent and objective information and advice. This should include engagement of independent legal counsel, as well as other professional advisors, as the committee deems necessary to carry out its duties. Note that Sarbanes-Oxley expressly states that the company must pay for the services of independent legal counsel and other advisors, as requested by the audit committee.

### Conclusion

Independent directors can face personal liability exposure stemming from uninsured and undisclosed environmental liabilities. Many companies appear to lack effective internal controls to identify, evaluate, insure, and/or disclose environmental liabilities, especially those related to historical conditions that are not the subject of a pending legal action. Consequently, the information needed to insure and disclose these risks often is not available. Significant education of senior corporate executives may be necessary to overcome ingrained assumptions and practices. Independent directors should seek to gain the cooperation of senior management in taking steps to reduce environmental risks to an acceptable level. These actions should focus in the areas of accounting and disclosure policies, internal controls for financial reporting, environmental risk management, and corporate governance. ■

**Greg Rogers** is an attorney with the Dallas environmental law firm Guida, Slavich & Flores, P.C. He is currently a director of a closely held oil and gas exploration company, and may be reached at rogers@gsfpc.com.