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The Emperor Has No Clothes: Going Naked on Environmental D&O Exposures

by Greg Rogers

The Sarbanes-Oxley Act of 2002 and other developments in the aftermath of recent accounting scandals significantly increase both the probability and severity of potential environmental claims against corporate directors for failure to exercise appropriate pollution risk oversight. "Pollution risk oversight" is the process by which board members attain reasonable assurance that the company's environmental objectives will be met. It comprises the legal responsibilities of directors to provide oversight of the corporation's compliance with environmental laws, financial reporting of environmental liabilities, and management of environmental risk. Pollution risk oversight exposure is particularly acute for audit committee members who are typically charged with responsibility for overseeing legal compliance, financial reporting and risk management.

The potential situations giving rise to director liability can vary, as injured shareholders or creditors may seek legal recourse against directors in the following circumstances:

• During the company's internal control audit under Section 404 of Sarbanes-Oxley, the auditor finds material weaknesses in internal control over financial reporting of environmental estimates and accruals. As a result, the auditor issues a qualified internal control opinion.

• The company is forced to restate its reserves for environmental liabilities when the company's auditor discovers material undisclosed asset retirement obligations for asbestos abatement and groundwater remediation.

• A series of violations of environmental regulations result in criminal prosecution of the company and certain employees. A Justice Department investigation reports the absence of an effective program to prevent and detect violations of law, specifically citing the board's failure to take appropriate remedial action in response to repeated legal violations.

• Major institutional investors begin divesting the company's stock due to the company's perceived failure to proactively address climate change risk and to fully disclose the material adverse impact of global warming on continuing operations.

• Known but undisclosed (and uninsured) loss contingencies associated with the manufacture of hazardous materials result in environmental product liability litigation that threatens the future viability of the company.

• The board authorizes distributions to shareholders at a time when the company, unbeknownst to its directors, is insolvent due to undisclosed environmental liabilities.

• Cost overruns on environmental cleanup at several former operating sites unexpectedly force the company into bankruptcy.

Insurance Protection

Like standard business insurance, most D&O policies today contain a pollution exclusion that denies coverage for any claim that has as its underlying cause the release or threatened release of pollutants. As

illustrated by recent case law, the pollution exclusion can also extend to securities claims arising from environmental matters. In the past, carriers have been willing to negotiate cutbacks on the exclusion, in effect allowing limited environmental coverage under the policy. More recently, D&O insurers are taking steps to reduce their exposure on environmental-related claims. For example, Swiss Re recently announced plans to mail questionnaires asking buyers of D&O insurance what they are doing to prepare for anticipated government restrictions on greenhouse-gas emissions. If a company isn't doing enough, Swiss Re will consider refusing to offer coverage.

In addition to the pollution exclusion, some D&O policies now contain an exclusion for failure to maintain adequate insurance. This provision excludes D&O 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 such insurance was available and the insured failed to obtain it.

Failure to fairly present the company's environmental liabilities, costs and risks in its financial statements may trigger other exclusions and cancellation provisions in the D&O policy. In response to the spate of recent accounting scandals, D&O carriers are beginning to exclude coverage for shareholder suits precipitated by restatements of the company's earnings and financial condition. Even worse, submission of inaccurate financial statements to the carrier as part of the D&O policy application may serve as grounds for rescission of the entire policy.

Director Action
For the reasons discussed above, D&O insurance alone is unlikely to be a panacea for the environmental risks facing corporate directors. Instead, directors must take affirmative action to ensure that the company effectively controls and finances the underlying risks. In doing so, the board can both (a) reduce the probability of unanticipated environmental losses to the company and its shareholders, and (b) demonstrate satisfaction of its fiduciary duty of care to provide appropriate pollution risk oversight. Directors can take the following actions to achieve these dual objectives:

1. Establish objectives for environmental risk management. For example, the overall objective could be to identify environmental risks that could have a material, adverse effect on achievement of the company's financial and strategic objectives and to take timely and appropriate action to control and finance these risks.

2. Direct management to implement a system of internal control. This needs to go beyond financial reporting designed to ensure achievement of the environmental risk management objectives established by the board.

3. Actively fulfill the board's assigned role in the implementation and ongoing operation of the internal control system. For example, the audit committee should ensure that significant environmental liabilities and risks are included as topics on its regular meeting agenda.

4. Retain an independent environmental specialist to periodically evaluate the internal control system and attest to its design and operational effectiveness. The board may not have internal expertise with regard to internal control over environmental matters. Even if it does, it is prudent for the board to obtain assurances from an independent specialist as to the adequacy of the company's internal control system.

5. Periodically assess the adequacy of environmental coverage under the company's D&O insurance policies. As underwriting practices continue to mature in this particular area of risk, boards adopting best practices for environmental risk management should be able to negotiate broader insurance coverage at more favorable premiums than other companies in the same industries with ineffective pollution risk oversight.

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