

Climate Change – The Emerging Liability Risks for Directors and Officers Part 1



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Executive Summary

It is important to recognise that climate change and the effects of climate change is one of the most significant emerging risks facing the world today. Climate change and its associated risks are relevant to almost every industry globally.

Climate change is a long-term risk that requires long term planning from a corporate governance perspective. Directors and officers need to recognise their responsibilities in this regard.

The business risks that arise from climate change are many and include the physical threat to property or injuries to persons, commercial implications, regulatory compliance and litigation risks.

In this first part of Liberty's White Papers Series on Climate Change – The Emerging Liability Risks for Directors and Officers, we examine the connection between climate change and corporate governance.

In Part 2 we look at the legal framework within which directors and officers must operate in order to comply with the regulatory requirements dealing with climate change.

Introduction

As the issues of global warming and climate change gain momentum, risks associated with climate change have risen from debate at the fringes of society to being a serious issue discussed at boardroom level. Companies are under pressure to balance the interests of shareholders and stakeholders with their responsibility to the environment.

In fact, these two interests may already have become intertwined as shareholders are recognizing climate change as a business risk as well as an opportunity. Directors and officers face the need to accept that good management of environmental, social, financial and governance issues is crucial for the protection and enhancement of shareholder value of the company.

Climate change is a long-term risk and must be managed accordingly. Directors and officers need to recognise their responsibilities in this regard. This Liberty White Paper Series aims to discuss some of the important issues relating to climate change and its impact on liability risks for directors and officers. How is climate change a business risk from a corporate governance perspective? What legal requirements are currently imposed on directors and officers as far as governmental regulation on climate change is concerned? How should the board manage the business risks and opportunities that arise from climate change? What are the insurance implications for directors and officers' liability? These issues and more will be discussed in this Liberty White Paper Series on climate change and the emerging liability risks for directors and officers.

Part 1 of this White Paper Series shall focus on the connection between climate change and corporate governance. In what way is climate change a business risk as well as a business opportunity?

Is Climate Change A Priority Risk?

In the midst of global economic crisis and rising unemployment, one would expect the attention of directors and officers of companies to be focused on financial security and viability of their respective companies. We may therefore legitimately ask: should climate change risks be on the priority list of boardroom agendas given the recent financial mayhem?

There is no doubt that talks of recession and credit crunch is likely to impact adversely on the financial resources commitments given to research and development of green technology. The fact is that some companies' ability to allocate resources towards climate change mitigation efforts might be curtailed or reduced depending on the financial strength of the company.

Having said that, it is important to recognise that climate change and the effects of climate change is one of the most significant emerging risks facing the world today. It is an issue that cuts across science, risks analysis and public policies. Not only does it affect the world environment, it also has significant impacts on businesses and, ultimately, the world economy. Dealing with climate change is therefore a priority issue that should not be undermined by other concerns, including the recent global economic and financial crisis. There have been previous recessions and global financial crises in the past. In time, our economy is expected to recover. Yet climate change and what is happening and will continue to happen to our environment in the future is an issue that will not go away by ignorance or avoidance.

Extreme Weather Events

Irrespective of whether we are a believer or a skeptic in the climate change debate, it is hard to ignore the extreme weather conditions that we have seen recently. In early 2009, the scorching heat wave in South Australia that lasted for several weeks caused severe discomfort if not health risks to many whilst Victorians suffered the worst bushfires in history resulting in unprecedented devastation and human tragedy across the State.

Around the same time, we also saw the worst flooding in 30 years in the Northern parts of Queensland causing much loss and suffering to many.

In stark contrast, those in Europe experienced their coldest winter in the last decade with Britain recording its coldest winter in 20 years. Air, road and rail traffic were badly interrupted due to snowstorms, torrential rain and gusty wind.

Under these circumstances, one cannot help but consider the effects of global climate change – what is happening to the environment in which we live?

The UN Intergovernmental Panel on Climate Change released their Fourth Assessment Report in 2007, which indicated some alarming results. They predicted that temperature will increase within a range of 1 to 6 degrees celsius by 2100 with a best estimate of 2 to 4 degrees celsius. In fact, most scientists believe that there will most certainly be an increase of 2 degrees celsius. When this happens, predictions have suggested we will lose the Great Barrier Reef and 80% of the Kakadu Wetlands, not to mention 40% of the carrying capacity of pastures. A further increase will lead to a rise in sea levels and other severe weather-related phenomena.

In a similar vein, the final report of the Garnaut Climate Change Review was released to the Federal, State and Territory Governments in October 2008. This report examines the impacts of climate change on the Australian economy and the costs of adaption and mitigation. One of the key findings of this report was that climate change is accelerating at a rate faster than originally predicted and urges Australia to take urgent and leading action on climate change. It concludes that Australia's interests lie in adopting a strong and effective position on climate change mitigation.

Climate Change - A Business Risk

Climate change and its associated risks are relevant to almost every industry globally. It is relevant to utility suppliers and their consumers; those in the transport and logistics industries and their customers; forestry, agriculture, construction and mining, food industries, chemicals and pharmaceuticals; real estate, financial services, tourism and hospitality, to name just a few examples.

All industries would be either directly (eg. threats of property damage) or indirectly (eg. change in market dynamics for goods and services) affected by climate risks.

Yet, it is interesting to note that, in a recent survey compiled in 2008 by The Carbon Disclosure Project* on the Financial Times Global top 500 companies, 58 of the 383 companies who completed the survey said that they were responding to the Carbon Disclosure Project for the very first time. In effect, they were forced to consider, for the first time, questions in relation to information on greenhouse gas emissions, the potential risks and opportunities climate change present to their companies and what their strategies were for managing those risks and opportunities.

In what ways do climate change risks impact on business operations? The business risks that arise from climate change are many and include:

Property Loss or Personal Injury

The physical threat to property or injuries to persons and the consequences that follow such property loss or personal injury is clearly a primary business risk. Consider, for instance, the increasingly volatile extreme weather conditions that we have seen recently both in Australia and overseas. We have seen severe drought, hurricanes and flooding resulting in phenomenal physical loss and damage, not to mention loss of human lives. Consider the following:

1. Hurricane Katrina in 2005 caused a record US\$135 billion in property damage along the Gulf Coast in the United States. Businesses along the Gulf Coast suffered billions of dollars of infrastructure (such as oil and gas rigs and refineries) damage.
2. The 2004 Boxing Day Indian Ocean earthquake and Tsunami caused approximately 225,000 deaths. Thousands more were injured or made homeless. The approximate cost of rebuilding from the property loss amounted to US\$15 billion.

Associated with such extreme weather conditions are new health risks. An increase in temperature and extreme weather would affect the breeding and spread of disease vectors such as mosquitoes that carry, for instance, malaria. Rising temperatures may also increase air pollution which could in turn cause a rise in incidences of asthma and other respiratory illnesses.

Commercial Implications

The commercial implication flowing from these catastrophic events are also serious. We need to consider the impact on insurance markets, business resources and other financial risks flowing from such events.

The Murphy Oil case flowing from the Katrina-related flooding in the United States in 2005 is a good example of commercial implications that follow from events that many link to climate change. In that case, there was a leakage of a large quantity of oil from the Murphy Oil USA refinery in Meraux, Louisiana after a storage tank ruptured during the Katrina related flooding. Several thousand homes were damaged.

There was a class action against Murphy Oil asserting that Murphy Oil was, amongst other things, negligent in its construction or maintenance of the tank and in its alleged failure to take precautions to prevent tank rupture. The court approved a class settlement of US\$330,126,000. This amount was intended to cover acquisition of properties, remediation of damage and compensation for losses incurred by the plaintiff class members.

***Footnote**

The Carbon Disclosure Project Report 2008 is compiled by The Carbon Disclosure Project which is an independent not-for-profit organization. It commenced compiling data from 2000 and claims it holds the largest database of corporate climate change information in the world. This report also indicated that, whilst climate change is on the agendas of most boards, it is not discussed as a regular item at board level as a key performance indicator. It is discussed either twice or, at most, four times a year.

In addition to taking into account commercial implications following a catastrophic event, directors and officers also need to take into account the fact of climatic alterations in any long-term capital plans. Such consideration might require investors to factor in climate change risk into any investments if the period of the risk is, for example, between 10 and 15 years. For instance, what if there is a planned project to build an extensive gas pipeline and this pipeline is dependent on permafrost, or frozen ground, as a supportive structure? If the permafrost thaws, the long-term investments in the pipeline would be at risk. This is just one of the many issues that the consortium behind the proposed McKenzie Valley pipeline across Canada has had to manage.

The construction of this pipeline was first proposed about 30 years ago. The project was to involve 1,220 kilometres of pipeline bringing gas from natural-gas fields in Canada's far north to the oil-and-gas heartland of Alberta. This project has not yet got underway because no one in the consortium, including Imperial Oil and Shell, is willing to put in the requisite extra of \$16.2 billion or more into the project.

Regulatory Compliance

As a matter of operational compliance, there is increasing pressure on companies to ensure they comply with legislation dealing with climate change and other mandatory disclosure obligations. Regulatory risks are particularly pronounced in Europe where the European Union Emissions Trading System has been operating for a few years.

In Australia, as a matter of good corporate governance, directors and officers need to understand the implications of Australia's 2007 ratification of the Kyoto Protocol and other climate change-related regulatory requirements both nationally and in the various States. This issue shall be discussed in further detail in Part 2 of this Liberty White Paper Series.

Litigation Risks

We have discussed in our previous Liberty White Paper Series on Shareholder Class Actions that there has been and there continues to be an increasing rise in the number of class actions that are being brought in Australia by disgruntled shareholders against companies. The largest settlement of a shareholder class action to date is the action against Aristocrat which settled for approximately \$144.5 million in 2008.

Securities class actions against companies in relation to climate change and related issues could conceivably be brought under, for instance, the Corporations Act, the Trade Practices Act or the Australian Securities and Investments Commission Act.

As a matter of risk management, companies need to be conscious of potential securities class actions in the event that they are seen to have failed to have taken adequate steps to future-proof themselves against climate change risks whilst, at the same time, maximizing the opportunities these risks present. Shareholder activism is such that sophisticated shareholders and investors of companies are keeping a watchful eye on whether their companies have taken adequate measures not only to protect but also to maximize their interests in the company from climate change related events.

A useful example of such shareholder activism follows from a report that was released in May 2002 [see: "Risking Shareholder Value? An Investigation of Unnecessary Risks and Missed Opportunities, by Mark Mansley, Claros Discussion Paper, May 2002"] which criticized ExxonMobil for incurring unnecessary risks, and for missing opportunities arising from climate change-related risks. The report went on to say that this failure by ExxonMobil could result in up to \$50 billion in reputational damage and potentially more than \$100 billion in lost shareholder value resulting from litigation liability risks.

The report also said that ExxonMobil was out of step with its peers and other industries around the world because, they asserted, it had refused to:

- (i) accept the threat of global warming,
- (ii) support and establish a greenhouse gas (GHG) emission reduction target, and
- (iii) invest in renewable energy technologies.

Between 2001 and 2002, one million motorists boycotted Esso petrol stations in Britain in Greenpeace's "StopEsso" campaign. ExxonMobil was named as "environmental enemy number one". The brand name of ExxonMobil's business was seriously at risk.

At Exxonmobil's 2002 annual general meeting, 20.3% of shareholders (the equivalent of US\$55 billion worth of shares) supported a resolution demanding the corporation report back on how it could invest in clean renewable energy. The major institutional investors who supported the resolution cited the pressure on the company from the "StopEsso" campaign.

Finally, in order to protect its business and reputation, Exxonmobil announced its decision in 2002 to invest US\$100 million over 10 years in a global climate change and renewable energy project in conjunction with Stanford University.

Another recent example of litigation activism follows the decision in *Cormer v Murphy Oil* where the U.S Court of Appeals granted a group of Louisiana Gulf Coast property owners standing to sue 30 large oil and coal companies for their contribution to climate change which the plaintiffs claimed contributed to the intensity of the 2005 Hurricane Katrina. This decision is not isolated and comes a month after the decision in *Connecticut v American Electric Power* in which the U.S Court of Appeals allowed 8 states to pursue a public nuisance claim against a number of large coal burning utilities.

While these cases are based on US common law and may not have authority under other jurisdictions, one should be mindful that if such actions are successful in the US they may encourage aggrieved litigants to bring similar actions elsewhere. Global warming by its nature is a global issue without borders and therefore there is also the potential for multi-national companies to be sued in the US in relation to their carbon dioxide emissions.

Climate Change – A Business Opportunity

The process of climate change is evolutionary and is a risk that requires long term planning from a corporate governance perspective. With careful planning and management, companies can take advantage of opportunities that present themselves at appropriate times.

For instance, suppose company A decides to be proactive and voluntarily reduces its greenhouse gas emissions by 20%. And suppose subsequent legislation requires all businesses to reduce their emissions by 20%. Company A has already placed itself in a position of compliance and may be able to sell services or emission credits to companies that need to reduce their emission level in order to comply with the regulatory requirements. Company A has thus given itself a competitive advantage.

Similarly, companies that have considered the issues of climate change and their implications are in a position to answer satisfactorily questions from shareholders and investors about the company's climate change policies. If, for instance, they have already considered and put in place internal policies and procedures that:

1. assess the financial consequences of climate change risks to the company,
2. maximize shareholder and investor value in light of current and anticipated governmental regulation in relation to climate change, and
3. measure the amount of greenhouse gas emissions the company currently emits and what plans it has to reduce that level of emission,

their reputation as an environment-friendly and innovative company would be enhanced. This would in turn strengthen shareholders and investors' confidence in the company.

A good example is one that involves the Ford Motor Company. At the prompting of shareholder activists, Ford released a report at the end of 2005 which addressed the impacts of climate change on its business and detailed actions the company planned to take in order to manage the company's climate change and associated risks and opportunities.

Four years later, Ford reaped the benefits of its actions in relation to climate change. On 11 March 2009, the telecommunication giant, AT&T, announced that it would invest \$565 million over 10 years in replacing its corporate fleet with cars and other vehicles that run on alternative fuels. Ford, which has made hybrid cars and other vehicles with advanced technology power systems (eg. work vans and technician trucks that run on compressed natural gas), is a key beneficiary of this proposal.

Having assessed climate change risk as a business risk as well as a business opportunity, we shall discuss in Part 2 of this Liberty White Paper Series the legal framework within which directors and officers must operate in order to comply with the regulatory requirements dealing with climate change.

The Liberty White Paper Series

Liberty White Papers are thought leadership pieces provided to help our clients stay abreast of the latest risks and how to manage them.

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Sydney +61 2 8298 5800

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Vietnam +84 8 3827 8687

India +91 22 6143 8000

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