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THE FLOODGATES ARE OPENING: THREE BRANCHES OF U.S. GOVERNMENT ADDRESS GREENHOUSE GAS EMISSIONS

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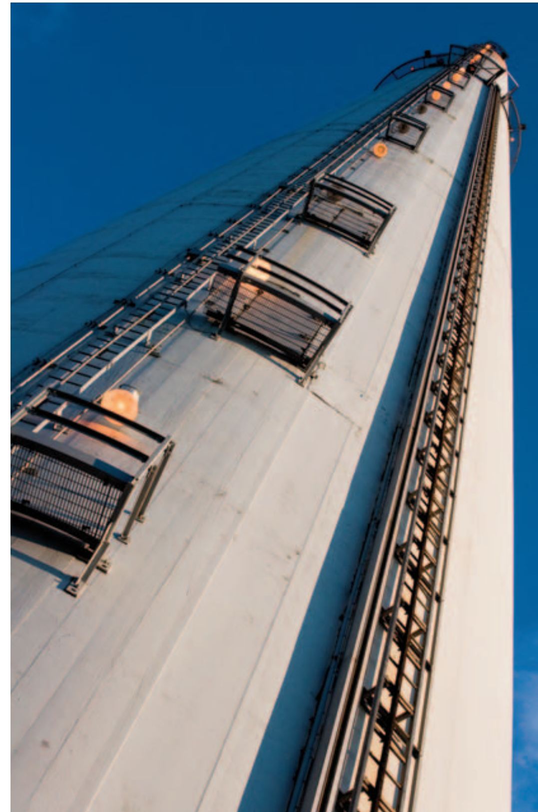
The regulation and abatement of greenhouse gas (GHG) emissions has been a prominent issue for a number of years, but late September 2009 was an extraordinarily active time in this arena. Both the executive branch and Congress appear to be moving swiftly toward policies aimed at significantly reducing emissions. Moreover, recent court decisions have allowed private parties to assert damage claims related to GHG emissions. These events increase the potential liability of GHG emitters.

One of the actions with the most immediacy has been taken by the executive branch through the U.S. Environmental Protection Agency (EPA). The EPA ruled on September 22, 2009 that it will require emitters of more than 25,000 tons of GHG emissions per year to document and report the size and scope of their emissions to a national database (See EPA rule EPA-HQ-OAR-2008-0508-2278. Additional information can also be found by clicking here.)

Noncompliance with this reporting requirement could result in fines and penalties. The reporting requirement becomes effective on December 29, 2009 for the calendar year 2010, and it will cover 85% of all emitters and roughly 10,000 facilities. This will affect a wide spectrum of industries from power generators to manufacturers. While the goal is to collect accurate emissions data to better inform future policy decisions, the EPA has said that ultimately it will require industries to use best management practices to reduce GHG emissions or face fines and penalties. This information will, of course, be publicly available, allowing for open identification of the most significant sources of GHG emissions.



In a second area, the Kerry-Boxer Cap and Trade bill, aimed at reducing GHG emissions, was introduced in the Senate. A cap and trade system would allow those that emit less than they are permitted, to sell their excess capacity to other entities that exceed their permitted allotment. The extra capacity is often referred to as a carbon credit, and the cap and trade system would create a market for carbon credits. The European Union currently uses a cap and trade system, and U.S. groups have already used regional emissions exchanges in Chicago and in the Northeast. The Kerry-Boxer bill seeks to reduce emissions to 20% below 2005 levels by 2020 and has many similarities to the Waxman-Markey bill that passed in the House earlier this year (that bill's goal was a 17% reduction in emissions by 2020). The key issue with both bills is how to equitably allocate allowances among the industries the bill regulates. However, both bills will have fines and penalties for noncompliance with the system,

and over the long term, offer fewer allowances in the pursuit of lower emissions.

Third, on the world stage there is pressure on the U.S. to move forward with other nations on this issue. In December 2009, the United Nations is holding a conference in Copenhagen on climate change. At that conference, the U.S. is scheduled to have high-level talks with China and India on efforts each country will make to reduce emissions. The integration of GHG issues into trade agreements is one component of that dialogue, and it could put political pressure on the Obama administration to deliver more regulation and green technology innovation at home.

As the determination to move ahead with regulation of GHGs has increased at the federal level and on the international stage, the courts have given plaintiffs the opening to sue for damages allegedly caused by GHG emissions. On October 22, 2009, the U.S. Court of Appeals for the Fifth Circuit, in *Ned Comer et al. v. Murphy Oil et al.*, upheld the rights of plaintiffs who claimed that they had been damaged as a result of GHG emissions. In that case, plaintiffs alleged that the defendant's energy, fossil fuels and chemical operations in the U.S. caused the emission of greenhouse gases that contributed to global warming, which caused a rise in sea levels and added to the ferocity of Hurricane Katrina, which combined to destroy the plaintiffs' private property as well as public property. The putative class action asserted claims for compensatory and punitive damages based on Mississippi common-law actions of public and private nuisance, trespass, negligence, unjust enrichment, fraudulent misrepresentation and civil conspiracy. The defendants moved to dismiss on the grounds that the plaintiffs lacked standing and that their claims presented nonjusticiable public questions. The District Court agreed. The Fifth Circuit, however, reversed, holding that plaintiffs did have standing to assert their public and private nuisance, trespass and negligence claims, and that none of those claims presented nonjusticiable political questions. Among other things, the Fifth Circuit held that the plaintiffs' complaint sufficiently "alleges that defendants' emissions caused the plaintiffs' property damage, which is redressable through monetary damages."

This decision came on the heels of a Second Circuit decision in *Connecticut vs. American Electric Power (AEP)*. In that case, a coalition of states, New York City and public interest groups sued six electric power corporations that own and operate fossil-fuel-fired power plants, seeking abatement of ongoing GHG emissions, which were allegedly contributing to the public nuisance of global warming. A public nuisance is a common-law action that alleges an interference with the public's right to the use and enjoyment of property as well as the public's health and safety. Defendants raised similar arguments to those raised in the Fifth Circuit case and argued that the public nuisance claims were preempted by the Clean Air Act and other environmental statutes and that there was no federal common law of nuisance. The Second Circuit vacated the judgment of the District Court, which had dismissed the case, holding, among other things, that plaintiffs' claims did not present nonjusticiable political questions, that plaintiffs had standing to sue, and that they could bring claims based on the federal common law of nuisance. The court also held that the public nuisance claims were not preempted by the Clean Air Act or other environmental statutes. Among other things, the Second Circuit held that plaintiffs sufficiently alleged current and potential future injury to their property. It held that they alleged that "as a result of the increase in carbon dioxide levels that has already caused the temperature to rise and change their climate, [causing] future injury to their property from the continuing, incremental increases in temperature projected over the next 10 to 100 years; and increased risk of harm from global warming including an abrupt and catastrophic change in climate..."

These decisions represent a departure from previous cases, which had generally held that nuisance actions based upon allegations of GHG-related damages were political matters not appropriate for a court and that, in any event, showing causal connections between GHG emissions and damages to public property would be too far-fetched for plaintiffs to show actual, related injury.

The heightened concern regarding GHG emissions and these cases raises the specter of increased litigation in this area. Potential defendants need to determine whether they have insurance coverage for these claims. Significantly, the claims regarding GHG emissions are generally based on the claim that GHG emissions have been emitted over a long period of time, that GHG emissions have built up in the atmosphere, and that this buildup has caused and is causing global warming, which has caused and is causing property damage. General Liability policies issued prior to the early 1970s generally did not contain any form of pollution exclusion clauses and, therefore, may potentially cover such claims. General Liability policies issued from the mid-1970s through the mid-1980s generally included a qualified pollution exclusion that only covered "sudden and accidental releases," a phrase that has generated considerable litigation over its meaning. However, depending on the jurisdiction, such policies may trigger if there were either unexpected and unintended releases of GHGs or sudden, accidental releases of GHGs. Since the 1980s, most policies have had so-called "absolute pollution exclusions," which likely bar coverage for such claims. However, insureds should carefully review their specific policies.

Since the inception of the so-called "absolute pollution exclusions," separate Environmental Liability policies have been available in the marketplace. Insureds who have purchased such policies should review them to determine whether they could provide coverage for such claims. Significantly, these policies typically provide coverage for bodily injury or property damage resulting from releases of pollutants. Greenhouse gas emissions have been defined by the courts and the EPA to be a pollutant. (See *Massachusetts v. E.P.A.* 549 U.S. 497 (2007) holding that GHGs are pollutants under the Clean Air Act.) Since, at this time, the environmental insurance industry is not generally excluding GHG emissions liability, Environmental Liability policies may therefore cover the various emerging components of liability, whether driven by regulatory requirements or by bodily injury and property damage claims under such legal actions as public nuisance. Keep in mind that other exclusions may bar coverage. Also, such policies are generally issued on a claims-made basis. Some policies have extended reporting periods or a right to report potential claims that have not yet been made. Insureds whose Environmental policies are about to expire should consider whether to report potential GHG emissions claims to their carriers in order to extend the period of coverage.

The many important components of this rapidly evolving issue now seem to be converging. Willis continues to monitor these developments and to be at the forefront of risk management considerations related to climate change and the evolving response of the insurance market.

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THE EUROPEAN ENVIRONMENTAL LIABILITY DIRECTIVE EXPANDS LIABILITIES FOR POLLUTION

"The deadly chemical cyanide and a quantity of sewage have leaked into a 30-mile stretch of the River Trent in Staffordshire"

This headline taken from the BBC website, while an extreme example, heralds the tremendous damage that can be done to an ecosystem and the extent of the costs a liable company may now be required to pay under the European Environmental Liability Directive (ELD) legislation.

As a result of the leak, thousands of fish died, the river, riverbank and surrounding areas were stripped of animal and plant life, and people were warned away from the river while the pollution was being controlled. Clearly, the ecology of the river system will be changed for quite some time.

Under the law in most E.U. member states, if this incident had occurred prior to the implementation of the ELD, the polluter could have been liable for the costs of cleaning up the damage (primary remediation) and possibly for associated fines and penalties.

Since the implementation of the ELD, the boundaries of liability for companies operating in E.U. member states have been substantially extended. Now, polluters are responsible not just for primary remediation but for *complementary remediation* and *compensatory remediation* as well. These laws have parallels to natural resource damage (NRD) restoration and compensation measures included in U.S. environmental protection legislation.

In essence, the polluter can be held liable for returning an area's biodiversity to the level it was prior to the pollution event. The assessment and monitoring costs levied by the various interested agencies will likely be substantial (all of which will fall to the polluter), let alone the complementary and compensatory remediation expenses.

What does all this mean? Simply put, the financial consequences of pollution releases will become more severe for businesses operating within the E.U., increasing the importance of having a comprehensive environmental management strategy and a supporting risk financing program.

As discussed in the last Willis *Environmental Risk Newsletter*, insurance coverage for liabilities under the ELD is typically not provided by the General Liability market. Fortunately, extensive coverage is available through a Pollution Liability policy, or partial protection may be arranged, with certain carriers, via an extension to the General Liability program.

ESTIMATING ENVIRONMENTAL LIABILITIES

Environmental liabilities can drastically change the value of a property or operation. The way potential environmental liabilities are measured and reported, therefore, can have a huge impact on perceived value of businesses and investments. How these liabilities are handled on a company's books is an ongoing issue for accounting watchdog agencies and for companies faced with environmental exposures.

In the U.S., financial accounting standards have been in flux for the past year regarding the handling of contingent environmental liabilities. In the E.U., publicly traded companies have been required since 2005 to report environmental liabilities under international reporting standards. On both sides of the pond, companies must weigh several issues in determining their environmental disclosure strategy. The emergence of new financial analytical tools that highlight the influence of management discretion in keeping environmental liabilities off the books may cause companies to reassess their approach. As corporations move towards greater transparency, the focus may continue to move from disclosure issues to the actual transfer or elimination of environmental liabilities themselves.

U.S. STANDARDS

New standards released late last year were intended to increase consistency in accounting for loss contingencies, including environmental liabilities, and improve the ability of anyone reviewing a financial statement to estimate the probability, amount and timing of future cash flows. In addition to changing the way environmental loss reserves are estimated, the changes would have required companies to recognize many previously undisclosed environmental liabilities.

As originally issued, Financial Accounting Standards Board (FASB) Statement 141-R required loss contingencies assumed in a business acquisition or merger to be recognized at their "fair value" on the acquisition date if liability arose under a contract or otherwise was strongly suspected. This standard replaced the less onerous FASB Statement 5 requirements for recognizing and estimating loss contingencies.

In accounting terminology, the fair value of a liability is the value that a market participant would charge to assume the liability. For example, the fair value of an environmental remediation liability could be based on what it would cost to transfer the liability to a third party in a liability buyout scenario. For non-cleanup liabilities, such as third-party property damages, including diminution in property value due to the presence of contamination or bodily injury, fair value

could reflect the settlement value, if one can be predicted, or the cost of an insurance policy.

Statement 141-R raised fears on the part of companies and their legal counsel that the application of fair value principles to contingent liabilities, especially pending litigation, would require the collection and disclosure of information that could work to the company's detriment. Lawyers also complained that the new standard threatened long-established evidentiary privileges for attorney-client communications and attorney work product. Auditors, on the other hand, voiced concern that they could not assure the accuracy of company estimates without full cooperation from their clients' lawyers. Under intense pressure, the FASB revised the loss contingency provisions in Statement 141-R in April 2009 to allow companies to continue using Statement 5. The future of fair value for contingent liabilities is now uncertain.

With or without the adoption of fair value for loss contingencies, intense scrutiny of environmental loss reserves will continue in the investment and regulatory communities. New methods of assessing the reliability of reported environmental loss reserves and the impact of off-balance-sheet environmental liabilities on financial performance and ultimately stock price are now in use.

INTERNATIONAL STANDARDS

International Financial Reporting Standards (IFRS) are standards and interpretations adopted by the International Accounting Standards Board (IASB). Almost 100 countries currently require, permit the use of, or in other ways support IFRS. All publicly traded E.U. companies have been required to prepare their consolidated accounts using IFRS since 2005. Many private companies also use the standards as best practice. IAS 37 – Provisions, Contingent Liabilities and Contingent Assets is the IFRS standard that covers environmental liabilities such as soil and groundwater contamination, asbestos and other legacy issues. IAS 37 describes environmental liabilities under the following headings:

- **Probable** – Financial provision required, as there is a greater than 50% likelihood of liability being realized (ongoing remediation, significant contamination)
- **Possible** – A contingent liability; no financial provision required, but nature of liability must be reported in accounts (lack of sufficient site data)
- **Remote** – An unlikely contingent liability; no provision required, does not need to be reported in accounts, e.g., remediated site, lack of site data on low-risk site

IAS 37 impacts both transactions and ongoing management of provisions. During transactions, publicly traded E.U. companies must prepare their accounts in compliance with IFRS and provide adequate provisions for environmental liabilities. Financially astute companies also use IAS 37-focused financial risk modeling to manage and minimize their balance sheet provisions on an ongoing basis. Financial risk modeling is used by companies and their consultants to provide reasonable cost assessments of liabilities rather than worst-case estimates. Provided such assessments are transparent and reasonable, they are a legitimate way of removing environmental liability provisions from the bottom line.

Contributors to this article included Greg Rogers from Advanced Environmental Dimensions, LLC

JOINING OUR TEAM

Janet Cuda joined the Willis NA Environmental Practice in 2009 as Knowledge Manager. She provides sales support and works on thought leadership material, website development and updates, broking tools, administration, communications, information management and special initiatives.

Janet has been employed in the insurance industry for the past 23 years. Prior to joining Willis, she worked for a small local insurance broker for several years and USF&G Insurance for five years.

Since joining Willis in 1994, she has served in several positions. In 1999, she was named web administrator and assisted the Willis webmaster in building web pages for the company website and intranet. She was also responsible for building the agency websites and administering various computer programs. In 2003, she moved into the role of Regional Coordinator for the Midwest Region, where she assisted the Midwest Regional Director, managed the sales tracking system, provided prospecting and marketing assistance to the producers, and trained employees on various computer systems.

Janet holds a Web Author Certificate.

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