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Insurance in the Time of ESG

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In a previous article (*What We Talk About When We Talk About ESG*) we discussed some of the ambiguities surrounding discussions about ESG. Those ambiguities were centered around questions about the definition and scope of ESG; what makes a corporation successful from an ESG perspective; how material progress toward the achievement of ESG principles is measured; and whether there is any correlation between successful engagement in ESG initiatives and profitability or reduced corporate risk. We also reviewed some of the emerging regulatory and litigation risks associated with ESG. Given the ambiguities and uncertainties that are inherent in any discussion of ESG, even with the best of intentions it may well be impossible to satisfy every regulatory body or interested set of stakeholders. Nonetheless, doing nothing is not a viable option for business leaders and directors: ignoring stakeholders, investors, and regulators who urge that corporations engage in ESG initiatives is itself a way of taking a position concerning ESG programs and opens a corporation to a particular category of potential regulatory scrutiny and stakeholder claims.

Where there is uncertainty and the possibility of regulatory investigations or stakeholder dissatisfaction, litigation frequently follows. Litigation risk is ameliorated through the tools of mitigation and risk transfer. In the previous article we discussed how adhering to good governance and decision-making practices can be used to mitigate ESG-related litigation risk. But given the ambiguity and controversy associated with ESG, even best practices likely will not eliminate the risk of ESG- related litigation. One of the essential tools in the risk-transfer toolbox is insurance. How are the available types of commercial insurance likely to respond to the still-developing risks associated with ESG initiatives?

As a general matter, insurance underwriters have tended to reward “good” ESG practices, viewing enterprises with robust ESG practices that are compliant with ESG goals as being good management liability risks. Similarly, at least in some segments of the investing and management world, it is taken as an accepted truth that ESG practices are an appropriate benchmark for investment and rating decisions. But as we discussed, the reality is a good deal more nuanced. ESG practices that are embraced by some investors likely will be viewed as counterproductive by others. Moreover, it is far easier to set high-sounding ESG goals than it may be to meet those goals. We are starting to see some of the emerging tendencies in ESG-related regulatory and litigation risk both in support of ESG principles and in backlash to ESG initiatives. It is far too early to predict whether ESG-related litigation and regulatory scrutiny is going to be a ripple, a tidal wave, or something in between. But it is possible to make predictions about how commercial insurance is likely to respond to some of the categories of

emerging ESG-related liability. As with any coverage discussion, the particular facts and circumstances matter, as does the type of coverage at issue. In addition, where a particular enterprise in in its ESG journey will have a substantial determinative effect on our discussion.

In the Labyrinth of Insurance

Litigation and regulatory investigations arising from or concerning ESG-related issues have the potential to involve multiple categories of commercial insurance coverage. The type of injury alleged, whether the allegations against an insured are brought in a litigation or a formal regulatory proceeding, the nature of the conduct that is alleged to have caused an injury, the nature of the relief sought, and the identity of the alleged perpetrator of an alleged injury are all relevant to identifying the potentially applicable insurance coverage. Potentially relevant categories of coverage include the following:

Directors and Officers Insurance: In the most general of terms, D&O insurance provides coverage for claims against insured persons and the insured business alleging that some wrongful act (an error or omission that constitutes a breach of duty) resulting in an injury was committed in the course of managing the business. These policies typically provide coverage for claims brought against individual insured persons in their insured capacity if they are not indemnified by the insured business, claims brought against insured persons in their insured capacity if they are indemnified by the insured business, and claims brought against the insured business. For public companies, the business itself is covered only for claims involving company securities—such as shareholder derivative actions, securities litigation, and securities-related investigations. D&O coverage for private companies is not restricted to securities claims. As is relevant to this discussion, D&O policies typically include exclusions or limitations to coverage for: criminal or fraudulent conduct; claims by insureds against other insureds; claims that are related to prior claims; claims involving circumstances that were known at the time the pol- icy was purchased; claims involving circumstances that were known but not disclosed on the policy application; claims arising out of the provision of professional services or other specialized services; and claims arising out of actions taken outside of an insured person's insured capacity. The circumstances under which these exclusions and limitations are applicable may vary depending on the terms of the relevant insurance policies, and small variations in wording can have substantial consequences.

Errors & Omissions/Professional Liability Insurance: To oversimplify, this broad category of insurance policies provides coverage for claims against insured persons and an insured business alleging that some wrongful act (an error or omission that constitutes a breach of some particular duty or standard of care) committed while acting in an insured capacity that resulted in an injury. This category of insurance coverage includes more than policies directed to specific professions such as lawyers, medical practitioners, engineers, and architects. E&O coverage is also written for business

activities that require a particular standard of care such as banking, fund management, investment advice, and technology services. E&O policies contain exclusions and limitations on coverage similar to the corresponding exclusions and limitations in D&O insurance policies: crime and fraud, conduct outside an insured's capacity as an insured, prior claims, and prior knowledge.

Fiduciary Liability: This is a specialized category of E&O insurance applying to claims for alleged breaches of duty against insureds acting in a fiduciary capacity. Although certainly not limited to such, fiduciary liability insurance is typically thought of as covering the managers of pension and benefit plans in ERISA claim. The exclusions and limitations pertinent to fiduciary liability insurance policies are consistent with the general contours of the exclusions and limitations discussed above.

Employment Practices Liability: This category of commercial insurance coverage applies to claims for alleged wrongful acts in connection with employment practices. This type of coverage applies to claims for discrimination based on membership in a protected class or other improper employment-related policies. This type of policy typically covers claims brought by current and former employees as well as claims brought by employment applicants. This category of insurance policies may not provide coverage or may only provide limited coverage for wage and hour claims or claims involving errors in calculating pay or benefits.

General Liability: Commercial general liability (CGL) insurance covers an insured for claims brought by third parties for bodily injury, personal injury, and property damage. These policies are largely written on an "occurrence" basis, which means that coverage can reach back to policies that were in effect when the event that allegedly resulted in the relevant bodily injury or property damage to place. In the case of claims involving property damage or bodily injury alleged caused by emissions or toxic materials, it is possible that responsive coverage may reach back decades. However, CGL policies have contained "absolute" exclusions for bodily injury or property damage resulting from the exposure to pollutants/toxic chemicals since the mid-1980s and contained partial pollution exclusions for several decades before the institution of the "absolute" exclusions. As such, CGL policies are not likely to address remedial measures intended to prevent future carbon emissions or the dispersal of toxic materials. Nor are CGL policies likely to cover "voluntary" actions to remedy existing conditions. The personal injury component of CGL policies covers claims for alleged invasions of privacy, libel and slander, and similar injuries. However, CGL policies also contain broad exclusions for some of the common categories of commercial personal injury violations such as junk faxes and similar improper solicitations, inadequate privacy protections in processing credit card transactions, media publication, and injuries involving the disclosure of electronic data. Claims concerning the allegedly inappropriate use of biometric data are currently a topic of considerable dispute.

Other Specialized Insurance: Under the correct circum- stances, it is possible that additional types of commercial insurance coverage may respond to ESG-related litigation or in- volve issues pertinent to ESG priorities. Among the potentially relevant categories of coverage are kidnap and ransom (which generally covers losses resulting from adverse events involving executives traveling abroad), media liability (covers claims for personal injuries including invasions of privacy and libel and slander for media companies subject to industry limitations under CGL coverage), and cyber risk (covers a mix of first-party loss and third-party liability coverage that may include technology professional liability, data and privacy liability, and data breach response costs).

This list of potentially responsible categories of insurance coverage is wide-ranging. This is because of the still-developing risks of liability that might result from ESG initiatives. Just as the concept of ESG encompasses an extremely broad, ambiguous, imprecisely defined cloud of environmental, social, and governance issues, the types of claims that can arise out of ESG efforts are similarly broad. Given the breadth of potential exposures, it will be important for businesses to survey their entire insurance portfolio when faced with ESG-related litigation.

Chronicle of Coverage Disputes Foretold

There are recurring patterns of facts and circumstances that give rise to ESG regulatory scrutiny and litigation. Given the challenges related to identifying ESG priorities, carrying out those priorities, and resolving the tensions between competing interests, there are a number of identifiable issues around which the challenges in instituting and managing a successful ESG program tend to coalesce. These recurring issues tend to result in particular kinds of ESG-related claims. We will attempt to identify some of the recurring issues that arise in relation to ESG programs and the types of claims that are associated with those issues and then attempt to map those claim types against the categories of insurance coverage that might respond to those claim types.

Nature of the Substantive ESG Goals: The breadth and diversity of issues that can be characterized as ESG priorities present a host of pitfalls for corporate boards trying to determine how to respond effectively to the call for greater ESG compliance. There is something to offend everyone in the bundle of environmental, social, and governance priorities that are grouped together in the ESG basket. Virtually no two lists of ESG concerns or priorities are identical. Some of the issues identified as ESG priorities are susceptible to wildly divergent interpretations. Indeed, favoring one ESG goal (e.g., phasing out of fossil fuels) may impair another ESG goal (encouraging economic development in poor but resource-rich nations). Some imprecision is inevitable when trying to identify the environmental-, social-, or governance-related value of a particular goal or activity. But due to the sensitive social and political nature of some ESG priorities, it should be no surprise if the adoption of largely symbolic social or political

ESG goals results in controversy and scrutiny from unhappy stakeholders. Disagreements about the identification of particular substantive ESG goals may take the form of so-called ESG backlash. Some of the more high-profile examples of backlash take the form of legislation or executive action expressing disapproval of making corporate decisions based on ESG criteria or pulling state or local investment or pension funds from fund managers that apply ESG considerations in making investment decisions. Even if these actions cause damage to a corporation, these are not claims or loss events that are likely to implicate commercial insurance.

However, disagreements about the identification of particular substantive ESG goals may also take the form of litigation by dissatisfied shareholders or fund beneficiaries. Mere dissatisfaction with a corporation's ESG priorities does not necessarily provide a justiciable basis for a shareholder claim or—in the case of a pension beneficiary—a viable ERISA claim. The solution to unhappiness with a corporation's prioritization of particular ESG goals is to invest with another corporation or fund manager or to move one's business elsewhere. To maintain a viable claim expressing disagreement with a corporation's selection of ESG goals, it is necessary to point to some resulting injury, most likely in the form of a drop in stock price or the frustration of some corporate purpose. A claim alleging a tangible injury, such as a drop in the price of a corporation's shares, as the result of a corporate action is the type of claim typically covered by a D&O policy. Similarly, a claim that purports to be brought for the benefit of a corporation, perhaps due to some frustration of corporate purpose, is a shareholder derivative suit that typically will be covered by a D&O policy. A claim brought by a beneficiary of a pension or benefits fund alleging that a corporate action caused a diminution in fund value typically would implicate fiduciary liability coverage.

Conceivably, if the selection of ESG goals had an adverse impact on the services provided by a corporation, E&O or professional liability coverage might be covered. In the case of an E&O claim, however, demonstrating that there is a connection between the objectionable ESG goal and the ability of the corporation to provide the relevant services that resulted in injury to the claimant may be difficult.

It also is conceivable that a claim concerning a particular ESG goal could trigger EPLI insurance if a claimant alleges that they were denied employment as a result of some quota or hiring target instituted in support of the ESG goal. Whether such a claim would be viable depends on the circumstances of the particular claim, but if an ESG goal involves hiring or employment practices, EPLI coverage should be reviewed and the availability of coverage should be taken into consideration.

As with any claim triggering D&O, fiduciary, E&O, or EPLI insurance coverage, depending on the particular facts and circumstances, the conduct and prior knowledge groups of exclusions may be relevant. If ESG-related litigation becomes commonplace,

there also is a possibility that new exclusions specific to particular subject matters for claims may be introduced.

Commitment to ESG Goals: In a related vein, it is almost never possible to "accomplish" or "achieve" ESG. There are some ESG priorities that can be expressed in terms of a fixed benchmark, such as reducing emissions or becoming carbon neutral by some fixed date. Of course, setting a fixed goal is not the same thing as achieving that goal. A corporate promise to pursue an ESG goal is empty if there is no commitment to that goal. But many, if not most, ESG priorities are process-based or self-renewing: a pledge by a financial institution to institute lending practices that encourage economic development in blighted areas is not fulfilled if there is no operational follow-through; a promise not to purchase conflict minerals is not kept if the commitment is met in 2022 but not in 2023. In sum, there is a substantial difference between setting ESG aspirations and putting those aspirations into operational practice. Success in achieving ESG goals requires corporate commitment and willingness to make that commitment institutional. The setting of lofty ESG goals without doing the hard work necessary to make those goals an institutional habit is an invitation to scrutiny and claims against the institution setting but not achieving those goals.

As regulatory requirements concerning the reporting of some categories of ESG goals (for example climate change), and progress toward those goals are adopted, the failure to provide accurate disclosures or the failure to acknowledge that a goal was not met likely will provide a basis for regulatory scrutiny. For public companies, if the relevant scrutiny involves securities, D&O coverage may be implicated. For insured persons, coverage under a D&O claim is not limited to securities-related claims.

Litigation arising from the failure to fulfill ESG goals can take the form of stock price drop claims and derivative claims. Although in connection with a set of ESG-related issues, it is likely that those types of claims would be brought by shareholders or beneficiaries who are alleging that it was the failure to fulfill ESG targets that resulted in the alleged injury. Additionally, claims arising from the failure to fulfill ESG goals may involve allegations that claimants were induced to make investment decisions in reliance on materially false or misleading statements. Such claims are most likely to trigger D&O or fiduciary coverage depending on the circumstances of the claim.

Good Faith in Setting and Performing the ESG Goals: Related closely to the preceding discussion of commitment to an ESG goal, a key factor in predicting the likelihood that a corporate ESG program will be subject to scrutiny is the intent of a corporation in setting an ESG goal. If an enterprise's ESG goals are announced merely for the sake of positive publicity or inducing investment and there is no intent to institute practices in furtherance of those goals, regulatory scrutiny and litigation become much more likely. Material misrepresentations, whether they are about ESG goals or financial performance, will always be a source of claims against a corporation.

This coverage analysis for claims involving this obstacle to successful ESG implementation has much in common with the foregoing analysis involving claims arising from less than complete commitment to meeting ESG targets. In this context, however, the conduct and prior knowledge exclusions come to the forefront. It is particularly important to pay close attention to the conditions for the triggering of these exclusions.

This consideration also highlights some of the coverage issues that might arise for regulatory investigations. Not all regulatory investigations trigger insurance coverage, many management liability or E&O insurance policies distinguish between formal investigations (that typically are covered) and informal inquiries or investigations (that may not be covered). Particular attention should be paid to what constitutes a covered regulatory investigation. Coverage disputes also arise frequently concerning what constitutes covered damages. As a general matter, remedies such as a regulatory order directing corrective or remedial action, the adoption of internal controls, disgorgement, or the payment of fines or penalties are not likely to be treated as covered damages.

The Economic Impact of ESG Goals: Because we are discussing ESG priorities in a commercial context, either in connection with corporations setting environmental-, social-, or governance-related operational priorities and goals, or investment vehicles establishing environmental-, social-, or governance-related standards for investment decisions, the economic impact of ESG practices is a significant factor in assessing the risk associated with a particular set of ESG goals.

Disputes concerning the economic impact of ESG goals are likely to take the form of stock price drop or shareholder derivative claims for alleged breaches of fiduciary duties. As such, this category of claims has the potential to trigger D&O and fiduciary liability insurance.

Balancing Duties to Stakeholders and ESG Goals: Advocates of ESG initiatives often claim that enterprises that are committed to ESG practices are a good investment, have responsible management, and behave in a responsible manner that reduces corporate risk. The argument assumes that being a responsible corporate citizen by supporting and acting consistently with some set of environmental, social, and governance principles is an indicator of responsible and capable management. However, to some shareholders, fund beneficiaries, investors, and other stakeholders, the primary hallmark of responsible management is acting in the interests of stakeholders. ESG may be a nice feel-good activity, but the interest of many stakeholders is the return on investment. Traditionally, the responsibility of a fund manager toward the beneficiaries of a pension or benefit plan is to achieve a return on investment that allows for the maintenance of the fund and the payment of the targeted benefit. When there is tension between, whether real or perceived, the duties owed to

stakeholders and the accomplishment of ESG goals, there is a heightened risk of stakeholder scrutiny and litigation.

Stakeholder objections that ESG programs are inconsistent with a corporation's obligations to its shareholders are likely to take the form of shareholder derivative claims or stock price drop claims. Depending on the identity of the claimant, such claims are likely to implicate either D&O or fiduciary liability insurance.

Wait and See

It is impossible to know if ESG initiatives will result in a substantial wave of litigation. Certainly, ESG initiatives pose substantial performance challenges for corporate insureds. ESG initiatives should not be launched solely for the sake of doing something. The assumption that companies that are launching ESG initiatives are good risks assumes that the corporate embrace of ESG is an indicator of corporate success and reduced liability and regulatory risk. Ultimately, that assumption may yet prove to be accurate. But ESG initiatives also may prove to be a magnet for litigation due to controversial choices or unmet goals. The failure to follow through on ESG goals or the inadequate commitment to stated goals are invitations to regulatory scrutiny and stakeholder litigation. Similarly, the selection of particularly controversial ESG goals or the selection of ESG goals that are disconnected from a corporation's business may be invitations to regulatory and stakeholder scrutiny. The prudent selection of ESG goals and diligent efforts in meeting those goals are the best means of preventing regulatory scrutiny and litigation. But if litigation is inevitable, barring some change in coverage terms, existing management and E&O liability insurance should be taken into consideration. In the near term, ESG initiatives may invite litigation, but ultimately, the responsible selection of ESG priorities and diligent efforts to achieve those priorities may yet prove to be a good indicator of corporate responsibility.

Companies eager to demonstrate their ESG bona fides have to beware of exposing themselves to accusations that they are exaggerating their ESG accomplishments. Optimistic goals to reduce emissions may be viewed as a material misstatement by regulators or investors if goals are not met. ESG should not just be a marketing tool. If a corporation or fund presents itself as ESG oriented, it is necessary to actually be ESG oriented.

The process of making ESG decisions, the complexity of evaluating the level of commitment to ESG initiatives, and the risks that are associated with ESG initiatives may be more challenging and nuanced than often is assumed. A clear-eyed approach and careful analysis in adopting appropriate ESG goals, as well the commitment to fulfill stated goals, are the bare minimum of a successful ESG program. There is no guarantee that there will be immediate payoffs or that realistic accomplishments will be viewed favorably by analysists or the investment market. If there is a payoff to ESG

initiatives, it most likely will come in the form of leaving an entity better prepared to meet future challenges as the byproduct of careful planning and the commitment to continual improvement. In other words, an ESG-friendly culture is not much different than the kind of corporate culture that responsible and healthy boards always have fostered. It may be difficult to define or measure ESG precisely. The definitional and methodological sloppiness associated with much of the current discussion is unfortunate, but a board that is prepared to adopt to ESG demands is one that is prepared for the vicissitudes and changing circumstances that face any business enterprise.

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