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ESG — what directors and officers need to know about insurance

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As Environmental, Social, and Governance (ESG) issues become increasingly important to corporate investors and other stakeholders, ESG risks have likewise attracted the attention of plaintiff's lawyers. Directors and officers may find themselves defending shareholder class actions, derivative lawsuits, and other claims relating to ESG.

Before that happens, they would be well-served to understand how their company's directors and officers liability (D&O) insurance might protect their personal assets and to consider whether the company's D&O insurance policies include appropriate provisions to address ESG risks.

D&O insurance basics

When considering how D&O insurance might respond to ESG claims, it is useful for directors and officers to understand the types of insurance coverage that D&O policies may provide. Typical D&O insurance programs provide (subject to policy terms and conditions) direct protection of directors and officers' assets (Side A coverage), coverage for the company's costs of indemnifying directors and officers (Side B), and coverage for certain claims against the company itself (Side C).

D&O policies may contain express coverages for various specific categories of costs, such as derivative demand investigation costs and costs of responding to governmental investigations. Many companies carry a "tower" of primary and excess "Side A-B-C" coverage, as well as an additional "Side A-only" insurance program, providing supplemental and often broader coverage for individual directors and officers.

Why is D&O insurance relevant to ESG?

Generally speaking, D&O insurance provides coverage against claims alleging "wrongful acts" by a company's directors or officers. A typical definition of "wrongful acts" includes, in relevant part, "any error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed, attempted, or allegedly committed or attempted." Given the broad definition of covered "wrongful acts," it is readily apparent that D&O insurance is likely to be implicated in the event of a shareholder ESG lawsuit.

Timing plays an important role. D&O coverage is typically issued on a "claims made" basis. That means a D&O policy will insure claims first asserted within the policy period — and perhaps also within a further "extended reporting" or "discovery" period — regardless of when the conduct or harm at issue occurred.

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There are at least two important implications:

- First, a warning: Directors and officers should be aware that a "claim" may not be limited to lawsuits. Rather, "claim" is typically defined to include any "written demand for **monetary or non-monetary relief**" (emphasis added). An ESG matter might become a "claim" for insurance coverage purposes — potentially triggering an obligation to provide timely notice to D&O insurers — before it matures into a lawsuit.
- Second, an opportunity: Since D&O insurance is based on the timing of "claims" rather than of conduct or harm, directors and officers contemplating the types of ESG claims that may be asserted against them in the future may have the opportunity to seek appropriate enhancements to the company's D&O policies in view of the company's risk profile.

Indeed, unlike certain other types of insurance policies, D&O policies do not typically consist of widely used, standardized policy forms. The variation in language across policies (which often include numerous endorsements) and insurers may present traps for the unwary. But that variation may also present a canny policyholder with the ability to purchase or negotiate for coverage tailored to its potential exposures, including ESG-related risks.

Exclusions

Directors and officers should be aware of policy exclusions that insurers may rely upon to deny coverage for ESG claims and seek opportunities to negotiate for more favorable wordings. Although insurers may assert that other exclusions apply to any given claim, the following exclusions will most commonly be implicated in ESG claims.

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Bodily injury/property damage

D&O policies typically include exclusions applicable to bodily injury and property damage. Insurers may argue aggressively that ESG claims bearing any remote relation to bodily injury or property damage are excluded. Policyholders often have strong arguments that the exclusion was not intended to sweep so broadly as to reach securities or derivative claims (which may even be expressly carved out from the exclusion).

In reviewing the exclusion wording, policyholders can note that it is generally preferable for these exclusions to be worded as exclusions "for" bodily injury or property damage, rather than "arising out of." The "for" wording tends to support a proper, narrow interpretation of the exclusion as not reaching alleged wrongful acts by the directors or officers (e.g., governance issues).

Conduct

D&O policies may contain so-called "conduct" exclusions precluding coverage for claims based on, for example, "deliberate fraud, any deliberate criminal act, or any knowing and willful violation of any United States law … established by a final, non-appealable adjudication in the underlying action or proceeding."

While an insurer might attempt to rely on such exclusions to avoid covering ESG claims, it is important to note: (1) the "deliberate" wording places a significant burden on the insurer to show something beyond a "mere" fraud or criminal act, and (2) the exclusion ***only*** applies in the rare event of a final, non-appealable adjudication of such deliberate conduct.

While a typical ESG claim is unlikely to trigger such a "conduct" exclusion, directors and officers should be aware of the risks presented by an ultimate determination of deliberate wrongful conduct. Further, if their current D&O policies do not limit the "conduct" exclusion to "deliberate" conduct as established in an underlying adjudication, policyholders should consider requesting changed wording.

Pollution

Many D&O policies include exclusions relating to pollution. Some pollution exclusions purport to apply to all claims arising out of or attributable to "pollution," broadly defined. Other pollution exclusions are drafted more narrowly and specifically allow coverage for securities claims relating to pollution, such as lawsuits alleging public misstatements regarding pollution-related liabilities. Nonetheless, pollution exclusions may have an impact on the environmental component of certain ESG claims.

While there may be strong arguments against application of pollution exclusions to many ESG claims (e.g., that contemporary climate-change litigation does not implicate exclusions aimed at traditional "pollution"), policyholders would benefit from narrowing the scope of the exclusion during underwriting, focusing in particular on seeking a carve-out for securities-related claims.

Misrepresentation

In some instances, insurers respond to ESG claims by seeking to rescind a D&O insurance policy, or otherwise avoid coverage, based upon alleged misrepresentations made in underwriting submissions. This can present a particular challenge where an ESG claim relies on allegedly false or misleading corporate statements — made in financial statements, public filings, and press releases — as the purported basis for shareholders' ESG claims. An insurer presented with such a claim might take the position that those very same documents (which often are part of the underwriting application for D&O policies) that allegedly support the shareholders' ESG claims likewise give rise to a coverage defense based on misrepresentation in the application.

Moreover, some D&O insurers are inviting policyholders to participate in ESG-specific underwriting exercises, soliciting various information about the company's ESG-related practices and potential sources of liability. If statements provided to insurers about ESG turn out not to be true, then insurers may seek to avoid their coverage obligations based on such alleged misstatements.

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While these risks should be noted, it should also be noted that policyholders may have strong arguments to push back against a misrepresentation or rescission defense, and the policy wording and law of relevant jurisdictions may place heavy burdens on insurers asserting such defenses.

Perhaps the best safeguard against a possible misrepresentation argument is to make sure that a company's underwriting submission does not include false or misleading statements, including with respect to ESG. Beyond that, policyholders can seek to have a "severability clause" inserted into their D&O policies. Such provisions typically state that the knowledge or intent of any one individual insured shall not be imputed to others. Consequently, even in the rare circumstance in which an insurer may overcome the significant hurdle of establishing that one insured intentionally misled during underwriting, coverage may still be available for the other directors and officers.

Parting thoughts

D&O insurance can provide a critical resource for directors and officers facing potential ESG claims that threaten their personal assets. D&O insurance policies can vary widely in the coverage provided and in the language used. Corporate policyholders,

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including individual directors and officers, who are concerned about ESG-related risks, should seek to maximize their available D&O coverage at the time of underwriting, including by limiting the scope of policy exclusions.

Furthermore, to prevent insurer arguments based on alleged misrepresentations in the underwriting process, policyholders should ensure that their underwriting submissions (e.g., financial statements, public filings, and press releases) contain no false or misleading statements, which should have the double-benefit of helping to protect against ESG claims being asserted in the first place.

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