Marsh

Directors and officers liability insurance cover considerations

Environmental, social, and governance

June 2022

This is the second article in our series exploring how environmental, social, and governance (ESG) risks can be mitigated by insurance coverage.

We will consider the risks posed by environmental issues, the transition to a more sustainable economy and society, social and governance, and how this impacts management liability insurance generally and directors and officers (D&O) insurance in particular.

ESG IS A FRAMEWORK TO MAP OUT A COMPANY'S IMPACT ON THE WORLD, AND WHAT IT IS DOING ABOUT IT

E

Environmental captures climate change, energy efficiencies, carbon footprints, greenhouse gas emissions, deforestation, biodiversity, and other environmentally sensitive issues.

S

Social covers labor standards, wages and benefits, diversity, human rights, community relations, privacy and data protection, health and safety, supply chain, and other social justice issues.

G

Governance captures the governing of the "E" and the "S" categories plus corporate governance considerations.

Highlights

There are few more high-profile issues for directors and officers than those relating to ESG concerns. With ESG-related claims rising in a number of jurisdictions, company boards are increasingly looking to their D&O insurance to mitigate the risk.

ESG cover considerations for D&O liability insurance outlined in this report include:

Regulatory investigations and fines

- The risk of regulatory action arising from ESG-related issues is a key concern for directors.
- Where a regulator, such as the Financial Conduct Authority, Health and Safety Executive, or the Competition and Markets Authority, investigates a director or officer in relation to a breach of regulations, the D&O policy should respond, subject to its terms and conditions.
- Notably, fines and penalties are not usually recoverable where they have been levied due to a criminal or "morally reprehensible" act by the insured person. The policy, however, will generally cover defence costs until such conduct has been finally established by legal process.
- Government oversight and regulation will put pressure on boards to ensure that their businesses are complying with environmental legislation.
- The Task Force on Climate-related Financial Disclosures (TCFD) has developed a set of recommendations that are changing the way organisations manage climate risks and opportunities. A number of countries, including the UK, have taken steps to encourage or enforce TCFD implementation and reporting.
- In the US, the Securities Exchange Commission (SEC) made proposals for broader disclosure obligations in March 2022; these include the requirement for greater attention to reporting on climate- and emission-related exposures, including on Scope 3 aspects like companies' supply chains and customer bases.

Activists and investor action

- In addition to domestic laws and regulations, companies are facing increasing litigation risk from environmental groups and activist investors.
- With environmental accountability being a cornerstone of corporate responsibility, it is likely that we will see an increase in claims relating to compliance with international agreements, such as the Paris Climate Accords, driven by activist action — particularly in the US.
- Failure by a board of directors to consider and mitigate the impact of climate change on their business, and to take advantage of the opportunities it might create, could also lead to claims that they are breaching their duty of care to the company.
- Depending on the policy wording, cover may be available under D&O Side A or B for the costs associated with such activist action in the form of crisis response cover.

Employee claims

- Employees who feel that they have been discriminated against or constructively dismissed may pursue individuals in senior management, as well as the entity, for losses suffered.
- Where directors and officers have not taken action to stamp out such discrimination, arguably perpetuating a culture where such behaviour is tolerated, or can be shown to have participated in it themselves, they may find themselves exposed to litigation.
- Regulators are also increasingly interested in the action companies are taking to diversify their leadership.
- Directors and officers should consider whether cover for employment practices violations are included in their D&O cover, and if so whether they will be covered for allegations of wrongdoing related to employment issues, including social and diversity and inclusion issues.

Greenwashing

- Activist investors are increasingly pursuing listed companies for allegedly misrepresenting their climate credentials or failing to take action in accordance with their stated climate goals.
- Companies and boards found to be making false representations about the “eco” status of their products could face both regulatory action and litigation, which could result in long-term reputational damage.
- Shareholders who have lost money following revelations of greenwashing could bring claims against the company and its directors and officers, which could fall under Side C in the case of the company and Sides A or B in the case of directors.

Derivative actions

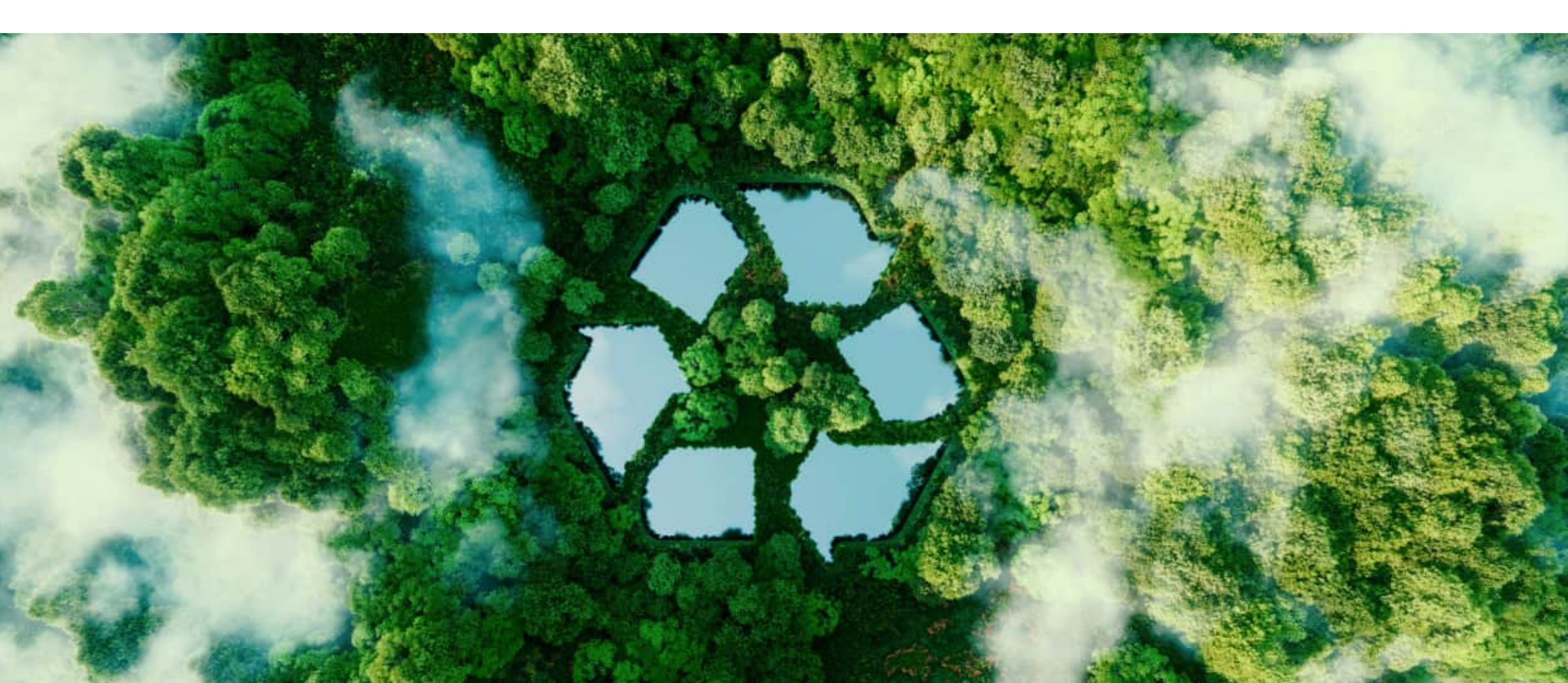
- There is a risk that directors who do not consider and take action on environmental and societal issues — and how their company’s operations impact these issues — could be exposed to claims of breach of duty.
- Breach of this duty exposes them to allegations of wrongdoing and the risk of derivative actions brought by shareholders on behalf of companies.

Governance

- The significant risks from litigation, regulation, and activism mean that boards of directors should be considering how best to oversee their company’s ESG agenda and its progress.

Supply chain

- Companies keen to evidence their ESG credentials to insurers must look not only to their own activities but also to those of their supply chain, stakeholders, and subsidiaries.
- The supply chain, and the often-labyrinth web of subsidiaries and their suppliers in a large international company, is very difficult to oversee, but can nonetheless leave companies exposed to allegations of a failure of oversight and good governance by the board of directors.



Introduction

At present, there are few more high-profile issues for directors and officers than those relating to ESG concerns. ESG is right at the top of the agenda for many official bodies and interested parties including: governments, regulators, investors (increasingly activist shareholders), customers, suppliers, and employees.

The complexity of these issues and the risks that arise from them, are arguably compounded by the fact that there is no generally accepted definition of, or indeed way of measuring, ESG and its associated risks. Rather, it is an umbrella term covering a host of different exposures measured with an array of different metrics.

It is fair to say that much of what is encompassed within the ESG umbrella is not new; environmental issues, corporate governance, and the emphasis upon human capital reflect long-standing concerns. Concerns that the recent pandemic, and the subsequent emphasis on social justice, have pushed to the forefront. The increased focus on ESG — in particular by governments and regulators — have made this a priority issue.

ESG-related risks of concern to directors can include: risk to corporate reputation, risks (including litigation risk) arising from a lack of diversity and inclusion, and those arising from regulatory scrutiny of environmental activities. This, however, is just the tip of the iceberg given the range of issues encapsulated by ESG. Further, the number of ESG-related claims are rising in a number of jurisdictions. Given this emphasis on ESG and its exposures, it is perhaps unsurprising that company boards are increasingly looking to their D&O insurance to mitigate that risk. So how are insurers dealing with this changing regulatory and risk landscape?

Insurers are beginning to change the way they invest and underwrite in response to the climate emergency as part of the broader repurposing of the financial services sector to support the transition to a greener economy. Some insurers no longer invest in companies that derive more than 30% of their revenue from coal mining, power generation from thermal coal, or the oil sands industry, unless it will help the transition to a net zero economy. Others are rebalancing the risks they underwrite in favour of renewable energy production. Many insurers, along with other financial institutions, signed up to 2050 net zero goals during COP26 and will now be looking at ways to reduce their carbon footprint both in their investment portfolio, their client list, and supply chains. This means that insureds are increasingly required to evidence their "green" credentials when seeking insurance cover.

Within the global D&O market, underwriters are increasingly focusing on questions regarding a company's ESG policies as part of the renewal submission, and are looking to see how such policies are embedded in the corporate culture of their insureds. A company with a good ESG profile is likely to be a better risk from a management liability perspective; as well as this, it enables insurers to evidence their own "green" credentials. By way of example, companies that can show that they are embracing the drive to net zero and have a plan to achieve it, and that are taking active steps to support biodiversity and sustainability goals, will find their risk more attractive to insurers.

With the above in mind, this article will highlight some of the key areas of focus in relation to ESG from a D&O perspective. Good governance and strong corporate social responsibility both go to the very heart of D&O cover, where a well-run company with good oversight and controls at board level and a responsible approach to its workforce and community, is less likely to face claims of wrongdoing against its directors.

Policy coverage — Types of cover

The coverage within a D&O policy is generally divided into the three sections, known as sides, though they are just different insuring clauses in the policy:

Side A

Protects the personal assets of directors and officers in the event of a claim for any wrongful act, where the company cannot or will not indemnify them for their legal fees, expenses or other loss (for example, if the company is insolvent).

Side B

Where the insured director or officer has been accused of committing a wrongful act, the company will in many instances indemnify them and pay their legal fees and other expenses incurred in investigating and defending the allegations. Side B protection seeks to insure the company against these losses.

Side C (where purchased)

Protects the company (primarily public listed companies) against losses in the event of any securities claim that names the company — including a derivative shareholder action — as well as investigations by regulators.

ESG cover considerations for D&O liability insurance

REGULATORY INVESTIGATIONS AND FINES

One of the main concerns for directors will be the risk of regulatory action arising from ESG-related issues. Helpfully, D&O policies already typically cover defence and investigation costs, as well as fines or penalties (where insurable at law), arising from regulatory action. This means that where a regulator, such as the Financial Conduct Authority, Health and Safety Executive, or Competition and Markets Authority, investigates a director or officer in relation to a breach of regulations, the policy should respond, subject to its terms and conditions.

These sorts of investigations can incur significant defence costs, which should be covered by the D&O policy. However, it should be borne in mind that fines and penalties are not usually recoverable where they have been levied due to a criminal or "morally reprehensible" act by the insured person, although the policy will generally cover defence costs until such conduct has been finally established by legal process. The proliferation of regulations regarding environmental compliance and reporting therefore heighten the risk of a corresponding increase in claims.

So how significant could the exposure be? In 2021 the UK Environment Agency issued a record fine of £90 million for illegal sewage discharges into waterways in breach of UK environmental laws.

This fine was against the company so would not be covered by a D&O policy, but the Judge called out the "flagrant disregard for the law by the Defendant's Board of Directors, and/or a deliberate failure by the Board of Directors" to prevent the offences.[1]

This judgment should act as a warning to directors that they need to ensure that their company policies are effective. The costs of investigating and defending individual directors for breach of environmental law should be covered by a D&O policy, subject to policy terms and conditions, although any subsequent finding of criminal liability might mean that these costs are repayable under the policy terms.

The Judge also hoped that the substantial fine, which will come out of the company's profits, would encourage institutional investors to take a more active role in ensuring companies comply with the law. Such investor action could well pursue directors deemed responsible for the failings.

1| Environment Agency v Southern Water Services Limited, Sentencing Remarks of Mr Justice Johnson, 9 July 2021.

Increased government oversight and regulation will also put pressure on boards to ensure that their businesses are complying with environmental legislation.

In this context, the TCFD has developed a set of recommendations that are changing the way organisations manage climate risks and opportunities. A number of countries, including the UK, have taken steps to encourage or enforce TCFD implementation and reporting.

The TCFD disclosure requirements are part of the UK Government's broader Sustainable Disclosure Requirements and its policy on sustainable investing; these were announced in July 2021. Since April 2022, most large and listed companies in the UK have been required to state in their annual report, whether their disclosures are consistent with TCFD recommendations or to explain why not. This includes many of the UK's largest traded companies, banks, and insurers, as well as private companies with more than 500 employees and £500 million in turnover. The TCFD disclosures are designed to embed climate change into the governance, strategy, and risk management of a company. They provide a metric to enable investors and insurers to establish the resilience of the organisation in the face of climate-related risks.

Failure to provide TCFD disclosures will leave companies and their directors exposed to the risk of regulatory action by the FCA or other bodies. The costs of responding to such investigations may fall to be covered by D&O policies so insurers are keen to ensure that their insureds are taking steps to address and mitigate this new risk area as well as accurately comply with any disclosure obligations. However, research by Marsh shows that less than a third of FTSE 100 companies are reporting climate change risk in line with TCFD recommendations.[2] Inaccurate reporting may also leave companies vulnerable to accusations of misleading investors or greenwashing, such as making environmental claims that are false, misleading, or exaggerated.

Companies will also be required to report against the Green Taxonomy. This is the UK Government's common standard to measure which investments can be defined as environmentally sustainable, to reduce greenwashing and make it easier for investors and consumers to understand a firm's impact on the environment. The Green Taxonomy covers such things as climate change mitigation and adaption, transition to a circular economy, pollution prevention and control, and biodiversity. We expect to see more developments in this area throughout the course of 2022.

The increase in regulatory requirements and intervention highlights the importance of insureds' awareness of the extent of the available investigations cover in their policy. Insureds should also review their coverage for internal investigations including the "triggers" for such coverage. Will cover only be available after a self-report has been made to an official body, or can a claim be made at an earlier stage, for example, when the insured person decides whether or not to self-report? Consideration should also be given to whether the cover requires the repayment of defence and investigation costs in the event of a fine or conviction, and if any exclusions or definitions limit cover for such losses.

ACTIVISTS AND INVESTOR ACTION

In addition to domestic laws and regulations, companies are facing increasing litigation risk from environmental groups and activist investors.

In May 2021, a court in the Netherlands ordered a large energy company to comply with the Paris Climate Accords, previously thought to be binding solely on nation states. The activist claimants succeeded in arguing that the energy company was obliged to cut its, and its suppliers', CO2 emissions by 45% compared to 2019 levels in accordance with the Paris Agreement. This is the first time a corporation has been held responsible for its failure to comply with these international agreements, and it seems possible that climate activists will be emboldened by this judgment and seek new targets in the future, including pursuing individuals who are perceived to be failing to take sufficient action to combat the climate emergency.

With environmental accountability being a cornerstone of corporate responsibility, it is likely that there will be an increase in claims of this nature, particularly in the US. Environmental activism presents lucrative opportunities for the US plaintiff bar to bring action against both companies and their directors. For example, late last year, a US company in the chemical manufacturing industry was faced with a class action suit in the State of Delaware following the leak of ethylene oxide into the surrounding atmosphere. A resident subsequently brought a class action on behalf of her neighbours, alleging strict liability, public and private nuisance, negligence, and wilful misconduct. Although none of the plaintiffs had been diagnosed with cancer or illness, it was argued that they were all suffering with "an increased risk of illness". In that case, the motion to dismiss the claim was accepted on the grounds that Delaware law applied and it did not recognise an increased likelihood of an illness or injury as a tort; however, other jurisdictions may not be so favourable to defendants.

Failure by a board of directors to consider and mitigate the impact of climate change on their business, and to take advantage of the opportunities it might create, could also lead to claims that they are breaching their duty of care to the company. It also leads to the risk that activist investors may seek to win seats on the board in order to more directly influence the direction of the company in this regard. While this may seem far-fetched, it is not without precedent.

In 2021, activist investors won three seats on the 12-member board of a large energy company. Shareholders were not satisfied with the company's performance or their transition towards renewable energy and a more sustainable business model. Although this was this particular investor's first activist position, it was supported by large institutional investors. Future activism may garner shareholder support unless boards can show that they are taking action to develop sufficiently aggressive responses to climate change and other relevant ESG risks and opportunities.

Again, it is important to be cognisant of the available coverage in the D&O policy. Depending on the policy wording, cover may be available under D&O Side A or B for the costs associated with such activist action in the form of crisis response cover. If properly worded, this can specifically include activism as a covered peril and pay for public relations and crisis management firms as well as legal advice to try and head off possible securities class actions (important for US-traded firms in particular).

While Side C cover protects the company itself against shareholder claims and costs (depending on the wording provided), much will depend on the precise wording of this cover as to whether it will respond to shareholder or activist action that falls short of a demand for payment or litigation.

EMPLOYEE CLAIMS

Employees can take action on a wide range of social issues. This is particularly relevant in the United States where the plaintiff bar is more advanced. Recent examples in the technology space involved claims of a discriminatory, sexist culture at software companies and gaming firms where sexual discrimination is alleged to have been pervasive. Where directors and officers have not taken action to stamp out such discrimination — arguably perpetuating a culture where such behaviour is tolerated — or can be shown to have participated in it themselves, they may find themselves exposed to litigation. This in turn leads to the risk of incurring very significant defence costs and, possibly, settlements or adverse judgments that would fall to be covered by a D&O policy that includes cover for employment practices violations.

In another recent example from the UK, a major bank had to pay £2 million in compensation to a female banker for years of sexual discrimination. The case named senior managers who had been involved in the behaviour. With the increased focus on gender pay gap discrimination in the UK and the EU, it is anticipated that claims by employees against companies and directors are likely to increase.

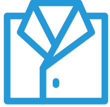
Regulators are also increasingly interested in the action companies are taking to diversify their leadership. For example, the FCA recently consulted on whether to require certain listed companies to disclose gender and ethnic minority representation on their boards and executive management teams, and whether they have met certain targets on a "comply or explain" basis.[3] This means that underwriters will be reviewing such disclosures when considering a risk.

There are other risks to consider in this context. Though the COVID-19 pandemic has so far not led to the rush of employment-related claims that underwriters expected, concerns remain regarding claims related to insolvency caused by the disruption to businesses. Furthermore, social issues such as mental health problems, challenges arising from working from home, or vaccine mandates may also lead to claims. Employees who feel that they have been discriminated against or constructively dismissed may pursue individuals in senior management, as well as the entity, for losses suffered.

Directors and officers should consider whether cover for employment practices violations are included in their D&O cover, and if so whether they will be covered for allegations of wrongdoing related to employment issues, including the social and diversity and inclusion issues mentioned above (where otherwise covered by the policy terms). Alternatively, cover for such claims may be provided by employment practices liability insurance, which protects the company as well as the individual.

Some companies may themselves take action against their own directors if they consider there has been wrongdoing; it is worth individual insureds checking their cover to see if there is an exclusion for claims brought by their own company which would prevent them from recovering under the policy for losses arising from such an action.

3| CP21/24, July 2021.



GREENWASHING

As referred to earlier in this report, activist investors are increasingly pursuing listed companies for allegedly misrepresenting their climate credentials or failing to take action in accordance with their stated climate goals. Governments are also stepping up their demands on companies to accurately report on their resilience to climate change and preparedness for the transition to a net-zero economy. The twin threats of increased regulatory disclosure requirements and activists and investors willing to take action against directors and companies where misrepresentations are made, means that greenwashing is considered one of the most likely sources of ESG claims under D&O policies. For example, in 2020 an airline had its adverts banned by the UK's advertising standards watchdog after it falsely described itself as the lowest carbon airline, based on evidence that was eight years out of date.

The Competition and Markets Authority (CMA) recently launched an investigation into high-street fashion brands that may be guilty of greenwashing in their claims of sustainability. Representations that items are recycled, made from sustainable or biodegradable material, or carbon-neutral will be investigated as retail becomes the first sector to be examined on misleading green claims.

High-street brands are increasingly turning to recycled plastic as an alternative material. However, a recent study found that clothing made from recycled bottles is actually creating more plastic waste because polyester and other materials created from plastic bottles cannot be recycled and are ending up in landfill. The CMA is looking to protect consumers who are increasingly aware of the negative environmental effect of the fashion industry. In 2019, British consumers spent £41 billion on ethical products, therefore there is a financial incentive for businesses to market themselves as environmentally positive.

Companies and boards found to be making false representations about the eco status of their products could face the risk of both regulatory action and litigation, which can result in long-term reputational damage for the business.

Another risk associated with greenwashing is shareholder action arising from alleged misstatements, perhaps overstating green credentials, or making commitments on sustainability that then are not met. Shareholders who have lost money following revelations of greenwashing could bring claims against the company and its directors and officers, which could fall under Side C in the case of the company and Sides A or B in the case of directors. It would be wise to check coverage to ensure that exclusions of cover for environmental or climate change losses are not drafted so widely as to exclude such claims.

DERIVATIVE ACTIONS

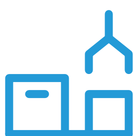
Directors owe their companies a duty to promote the success of the company for the benefit of its shareholders, but in doing so must have regard to the impact of the company's operations on the community and the environment.[4] Breach of this duty exposes them to allegations of wrongdoing and the risk of derivative actions brought by shareholders on behalf of companies. Directors therefore have a legal and regulatory obligation not only to comply with the range of regulatory duties and disclosure requirements set out above, and to avoid committing civil or criminal wrongs under the various environmental regulations, but also to consider, as a broader duty, the impact of their business on the wider community and the environment.

There is therefore a risk that directors who do not consider and take action on environmental and societal issues and how their company's operations impact those, could be exposed to claims of breach of duty. Further, directors and senior managers need to ensure that they are taking advantage of the opportunities that the transition to a greener economy offer, otherwise they could be accused of not fulfilling their obligations to the company's shareholders. Underwriters will therefore be looking for evidence of board level awareness of these obligations and opportunities when assessing D&O risk.

GOVERNANCE

The significant risks from litigation, regulation, and activism mean that boards of directors should be considering how best to oversee their company's ESG agenda and its progress. Good governance has always been a cornerstone of D&O, and underwriters will want to see evidence that boards have either assumed responsibility for ESG issues themselves or allocated this role to a committee or other senior manager with sufficient seniority and authority to ensure that the company is taking these issues seriously, and who reports regularly to the board.

Whether it is the full board or a sub-committee, or another function such as Audit or Risk, oversight of ESG issues should consider risks and opportunities at a strategic level and alignment of ESG with the corporate strategy. Because of the risk of greenwashing allegations if promises are made but not delivered, the board should be able to monitor themselves, or through their committees, if ESG goals are being met — and if not, why not. As with all good governance, "if it isn't written down, it didn't happen", so these ESG strategies, goals, and processes should be documented in ESG policy documents or incorporated into wider corporate policies or guidelines.

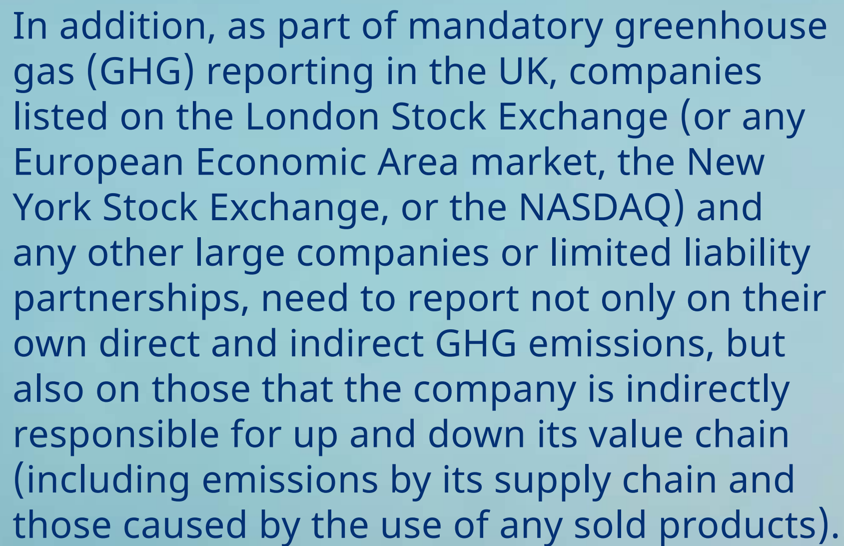


SUPPLY CHAIN

Companies keen to evidence their ESG credentials to insurers must look not only to their own activities but also to those of their supply chain, stakeholders, and subsidiaries. The recent case of a major fashion retailer using "sweat shops" and slave labour in the north of England is an example of the reputational damage that can be caused when a company does not have sufficient oversight and control over its supply chain.

An example from the environmental sphere is the case in which a Dutch court found a large energy company liable for the environmental damage caused by its overseas subsidiary, outlining that it had a duty of care to the people living in the vicinity of its overseas subsidiary. These risks can lead to D&O claims when businesses face regulatory or criminal investigations into their social and environmental impact, as well as public relations costs (where these are covered by the policy) in managing the fallout if these allegations become public.

4| Companies Act 2006, Section 172.



In addition, as part of mandatory greenhouse gas (GHG) reporting in the UK, companies listed on the London Stock Exchange (or any European Economic Area market, the New York Stock Exchange, or the NASDAQ) and any other large companies or limited liability partnerships, need to report not only on their own direct and indirect GHG emissions, but also on those that the company is indirectly responsible for up and down its value chain (including emissions by its supply chain and those caused by the use of any sold products).

This information must be included in the company's annual Directors' Report. These Scope 3 emissions will account for the vast majority of almost every company's GHG emissions and will also be the most difficult to monitor and quantify, making this a significant risk area for misrepresentation allegations and enforcement action. There will be a grace period before Scope 3 disclosures become obligatory — as things stand, the SEC proposals relating to these disclosures for US companies are yet to be confirmed.

ESG is a wide ranging and complex topic. This is exacerbated by the fact that each organisation has its own unique ESG profile. Against this backdrop, we have sought to set out some of the ways that ESG claims may fall to be covered by D&O policies and what insureds should consider in seeking to mitigate the emerging risks associated with ESG for companies and their boards.

Marsh is helping policyholders understand the coverage implications relevant to their insurance requirements as they navigate the changes brought about by their own sustainability journey. Please look out for future articles in this series, which will evaluate ESG implications for other classes of insurance.

For further information, please contact your Marsh representative or visit the Marsh website **www.marsh.com.**

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