

## THE ESG POLICE HAVE ARRIVED. IS YOUR INSURANCE READY?

*Authors: ACCC Fellow [Robert Chesler](#) and Dennis Artese of Anderson Kill.*

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- The SEC has fined an investment manager for inaccurate statements concerning ESG review
- D&O insurance policies should respond to ESG liabilities
- D&O insurance companies may deploy various defenses against coverage, but in most cases such defenses should fail

The Securities and Exchange Commission (“SEC”) has just fined the investment management arm of a major U.S. bank \$1.5 million for ESG violations. Specifically, according to an SEC [statement](#), the SEC order found that the investment advisor “did not always perform the ESG quality review that it disclosed using as part of its investment selection process for certain mutual funds it advised.”

This enforcement action follows upon the SEC’s lawsuit against Vale, the Brazilian mining company whose dam collapse killed 270 people and resulted in an estimated \$4 billion in damages. Among other things, the SEC alleged that Vale misled the government and investors through its ESG disclosures.

Further, the SEC is proposing rules for investment funds that label themselves as green. It is estimated that 800 such funds exist, controlling \$3 trillion in investments. The SEC is proposing that such funds explain the basis for their assertion that they are ESG conscious in their investments.

ESG – standing for Environmental, Social and Governmental – has become a major initiative for corporate America. In particular, the environmental prong of ESG calls for companies to institute sustainability goals and to invest in environmentally friendly companies. This emphasis has both economic and popular support. Environmental sustainability will make companies more able to compete and make their business less risky. Indeed, some insurance companies are offering better insurance policies to those companies that demonstrate a commitment to ESG. Moreover, green is popular with investors and shareholders as a good in and of itself. Climate change and its risks have entered popular consciousness. People want the companies in which they invest in to be on the right side of the climate crisis.

ESG, though, is not without its risks. Companies can be too apt to label themselves as green or sustainable, and investment advisors may be too quick to accept those labels without scrutiny. This may have been the case with the sanctioned investment advisor, which may have been negligent in not checking out the ESG claims of its investment vehicles. In some cases, companies may engage in such “greenwashing” activities and proclamations with the intent to deceive investors and shareholders – or so may shareholders or regulators allege. It is easy to see how all levels of ESG liability

incurred by companies will result in claims against officers and directors. The question then becomes, do companies have insurance coverage for greenwashing liability? The answer in many cases will be “yes.”

One coverage trap for companies involved in ESG claims stems from the fact that directors and officers (“D&O”) liability insurance policies are claims-made – the insurance policy in effect when the company receives the claim is responsible, regardless of when the violation occurs. That raises the question: what exactly constitutes a claim? D&O policies define the term “claim” broadly; a claim can be far more than just a complaint filed in civil lawsuit. A typical claim definition will include “any demand for monetary or non-monetary relief.” A company that receives an actual complaint typically knows that it needs to give notice to its insurance companies. However, an SEC proceeding can be long and drawn out, commencing with a letter, without a formal complaint ever being filed. Companies should give notice to their D&O insurance companies upon receipt of the first notice from the SEC, regardless of how informal it may seem.

D&O policies also typically contain so-called “conduct exclusions,” which bar coverage for fraudulent or intentionally wrongful conduct. In most D&O policies, however, these conduct exclusions apply only if there is a final judgment of wrongful conduct against the insured. Typically, an SEC claim will resolve itself before such a final adjudication comes to pass. Indeed, in order to preserve insurance coverage against a risk of a negative final adjudication, companies and their directors and officers will often purposefully seek to settle a contested claim if they can do so while neither admitting nor denying guilt.

Companies can also expect their insurance companies to invoke the pollution exclusion as a hurdle to coverage against claims alleging ESG failures. D&O policies typically include broad exclusions for pollution, and many ESG-related actions against companies concern pollutants at their core. Policyholders, however, should be able to overcome this hurdle. A leading insurance case concerned a shareholder action against directors and officers over allegations that they understated the company’s environmental exposure. The insurance company denied coverage on the basis of a broad pollution exclusion. The court held that the proximate cause of the loss was the misrepresentation and not the pollution, and found coverage. *See Sealed Air Corp. v. Royal Indem. Co.*, 404 N.J. Super. 363 (App. Div. 2008).

Finally, depending on your company’s policy language, coverage may or may not be available for civil fines and penalties asserted in a government action. Many D&O policies used to specifically exclude civil fines and penalties within the definition of covered “loss.” While more recent D&O policies typically provide coverage for civil fines or penalties, some policies may place limitations on such coverage. For example, they will cover civil fines and penalties if based on unintentional conduct, or they will cover all fines and penalties if insurable under applicable law. Other more recent D&O policies will at least agree to reimburse defense costs in connection with claims seeking civil fines and penalties, even if they exclude fines and penalties from their definition of “loss.”

With the March 2021 creation of a Climate and ESG Task Force within the SEC's enforcement division and general increase in attention to ESG issues, heightened scrutiny related to ESG investing is expected, along with a corresponding increase in SEC enforcement actions and private litigations. Companies and their directors and officers should look to their D&O insurance for defense and indemnity coverage against such claims, and consult with experienced insurance coverage counsel at the first indication of a claim.

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**Pullout quote:** “Companies should give notice to their D&O insurance companies upon receipt of the first notice from the SEC, regardless of how informal it may seem.”

**Robert D. Chesler** is a shareholder in Anderson Kill's New Jersey office and is a member of the firm's Cyber Insurance Recovery Group. Bob represents policyholders in a broad variety of coverage claims against their insurers and advises companies with respect to their insurance programs.

**Dennis J. Artese** is a shareholder in Anderson Kill's New York office and chairs the firm's Climate Change and Disaster Recovery Group.