THE ESG POLICE HAVE ARRIVED. IS YOUR INSURANCE READY?

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I. Government Agencies are Cracking Down on Greenwashing

This past May, the Securities and Exchange Commission ("SEC") 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 be required to explain the basis for their assertion that they are ESG conscious in their investments.

Concern over ESG greenwashing claims is not limited to the United States. In Germany, the Frankfurt public prosecutor, the German securities regulator, and the federal criminal police raided the offices of Deutsche Bank and its asset management subsidiary over greenwashing claims. The authorities expressed concern over fraudulent marketing of purportedly sustainable investment funds.

ESG – standing for Environmental, Social and Governance – 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 businesses less risky. Indeed, some insurance companies are offering better insurance policies to those companies that demonstrate a commitment to ESG. One leading insurance broker offers an independent ESG review of companies that then receive preferred terms on their D&O policies if they meet certain standards. Insurance companies are beginning to ask questions about ESG compliance as part of the application and procurement process.

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 to be on the right side of the climate crisis. Companies and funds that style themselves as green and ESG compliant believe that they can attract more investors.

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."

II. D&O Insurance for Greenwashing and Other ESG-Related Claims

A. Notice Issues

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.

As to general liability policies, in a majority of jurisdictions, late notice of a claim will only result in a forfeiture of coverage if the insurance company can prove that it has incurred prejudice as a result of the delay in providing notice. This measure of legal protection can lull companies into a false sense of security concerning notice. Claims-made policies, such as D&O policies, are completely different from occurrence-based policies as regards notice. Providing notice outside of the policy period will result in the forfeiture of coverage in every jurisdiction. Providing notice of anything that even smells like a claim must have the highest priority.

Alpine Home Inspections, LLC v. Underwriters at Lloyds, 2008 WL 4963578 (N.J. App. Div. 2008) is an example of how harsh the effects of late notice can be. There, the policyholder received a claim for $3,300, which it did not report to its insurance company because it was within the deductible. After renewing its insurance policy with the same insurance company, Alpine received an increased demand of $300,000, for which it did provide notice. The insurance company denied coverage contending that notice was late. The appellate court agreed with the insurance company, finding that the policyholder had a duty to provide notice of the demand for $3,300, and its failure to report that claim during the policy period in which it was received foreclosed coverage.

If there is any question as to whether an SEC inquiry or other communication concerning ESG compliance rises to the level of a "claim" requiring official reporting under a D&O policy, it is often best practice for policyholders to provide their D&O insurance company with a "notice of circumstance," explaining in detail the facts of which they are aware that may give rise to a claim in the future. The effect of providing such a notice of circumstance is to anchor a future claim in the policy period in which the notice of circumstance is given.

While providing notice of circumstance is discretionary, it could be beneficial in at least two respects. First, by anchoring the future claim in the policy period in which the notice of circumstance is given, it protects the policy limits of future policies. Second, given the increased attention to ESG claims, some insurers may start to limit or even exclude coverage for such claims. Indeed, there is discussion in the insurance industry press about amending the D&O policy to add a climate change exclusion. Thus, providing a notice of circumstance will have the effect of anchoring a future claim concerning ESG liability under a policy that may provide broader coverage than a later-issued policy in effect when the claim is actually asserted.

B. Conduct Exclusions

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.

C. Pollution Exclusions

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, may well 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).

The holding in *Sealed Air* has not been tested in other jurisdictions. Rules on causation differ significantly among states. Pollution exclusions remain a major coverage issue for companies confronted with ESG claims. Moreover, as mentioned above, there is discussion in the insurance industry press about amending the D&O policy to add a climate change exclusion. It is not known what such an exclusion might look like, how

broad it will be, and whether it can avoid ambiguity. A climate change exclusion in D&O policies will undoubtedly give rise to a tidal wave of coverage litigation challenging its effectiveness.

D. Civil Fines and Penalties

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."

Issues may also arise over whether a payment to the SEC constitutes a "penalty." In *J.P. Morgan v. Vigilant Insurance Co.*, the policyholder made a payment of $140,000,000 to the SEC, representing disgorged profits. The insurance company denied coverage for the payment, alleging that it was an excluded penalty, and suit ensued in New York. The trial court ruled in favor of the policyholder, finding that the payment was not an excluded penalty; however, the appellate court reversed. The New York Court of Appeals then reversed the appellate court's decision, finding that the payment was not a penalty imposed by law. This issue of what constitutes a fine or penalty for coverage purposes is highly fact sensitive, and law on the issue differs among jurisdictions.

III. Conclusion

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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