

A Changing Climate: The Rising Tide of ESG Liability and Implications for D&O Coverage

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The latest legal buzzword, ESG, represents the environmental, social and governance factors that many corporations are now required to consider and disclose alongside traditional financial information such as operating results and management compensation. Environmental concerns may involve carbon footprints, greenhouse gas emissions, deforestation, biodiversity, climate change and pollution mitigation, and waste management. Social concerns may include labor standards, wages and benefits, workplace and board diversity, racial justice, pay equity, and other human capital and social justice issues. Finally, governance concerns may involve corporate board composition and structure, strategic sustainability oversight and compliance, and lobbying.

With a step-up in enforcement activity at the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ), and an increase in litigation by shareholders, a company's affirmative ESG strategies and disclosures are creating liability issues for publicly-traded companies and their directors and senior management. For instance, corporate directors and officers (D&Os) face increased investor and regulatory scrutiny when it comes to corporate policies and disclosures on climate-related risks. In 2021, the SEC launched the Climate and ESG Task Force within the Division of Enforcement to develop initiatives to proactively identify ESG-related misconduct consistent with increased investor reliance on climate and ESG-related disclosures and investment. Then, in March 2022, the SEC proposed rule amendments that would require a domestic or foreign registrant to include certain climate-related information in its registration statements and periodic reports, such as on Form 10-K, including climate-related risks and their actual or likely material impacts on the registrant's business. In May 2022, the SEC proposed a rule for registered investment companies, business development companies, registered investment advisers and certain unregistered advisers, that would require funds and advisers engaged in ESG investing to provide more specific disclosures related to their ESG strategies in fund prospectuses, annual reports and adviser brochures. At the same time, the SEC also proposed a rule to prevent misleading or deceptive fund names, part of the SEC's campaign against "greenwashing," that would require a fund to invest 80% of its assets in the ESG factor suggested by its name.

We still do not know to what extent the SEC will scale back its proposed rules to avoid or diffuse constitutional challenges based on the "major questions" doctrine, *i.e.*, that questions of "vast economic or political significance" cannot be regulated by agencies without a clear statement of approval for such measures by Congress. This doctrine, of course, was recently the basis upon which the United States Supreme Court struck down Environmental Protection Agency regulations regarding power plant emissions. *See West Virginia v. EPA*, 142 S. Ct. 2587 (2022).

Institutional and activist investors are proactively challenging corporate conduct regarding ESG policies and reporting. Given the high level of public interest, we highlight herein some of the recent ESG lawsuits, and then consider some of the D&O insurance policy language worth examining before and as ESG-related risks materialize into shareholder or regulatory actions.

1.

Recent ESG Litigation That Could Implicate D&O Coverage Issues

The following cases highlight the variety of actions that may be pursued against companies by governmental entities, shareholders and interest groups scrutinizing ESG policies and disclosures. The allegations in these suits include claims of fraud, breaches of fiduciary duties and violations of securities laws.

1.

Exxon and Climate Change

In *Commonwealth v. Exxon Mobil Corp.*, Nos. 146626, 1984CV03333-BLS1, 2021 Mass. Super. LEXIS 377, at *1 (June 22, 2021), the Commonwealth of Massachusetts initiated an enforcement action alleging that Exxon's communications with investors and consumers related to climate change constituted unfair and deceptive practices. The Commonwealth specifically alleged that Exxon misled consumers by representing that its motor oil products were clean, greenhouse-gas reducing and beneficial to the environment. The Commonwealth's three counts alleged that Exxon violated the Massachusetts Consumer Protection Act by (1) misrepresenting and failing to disclose material facts regarding systemic climate change risks to Massachusetts investors (Count I); (2) misrepresenting the purported environmental benefit of using Exxon's products and failing to disclose the risks of climate change caused by its fossil fuel products to Massachusetts consumers (Count II); and (3) promoting false and misleading "greenwashing" campaigns to Massachusetts consumers (Count III).

This suit raises interesting coverage issues in that it involves allegations regarding the failure to disclose (Exxon's impact on climate change historically), as well as misrepresentations concerning future actions (Exxon's plans to take action to reduce carbon emissions and solve climate change).

2.

Tyson Foods and Environmental Impacts

In 2019, two consumer advocacy nonprofits sued Tyson Foods, Inc. in Washington, D.C. Superior Court for allegedly misleading consumers with false statements claiming their chicken products are produced in an environmentally responsible way. *Organic Consumers Ass'n v. Tyson Foods, Inc.*, 2021 D.C. Super. LEXIS 7 (D.C. Super. Ct. Mar. 31, 2021). The nonprofit plaintiffs alleged Tyson Foods marketed its company as "stewards of the planet," dedicated to "environmental leadership," when, in reality, Tyson pollutes the environment and treats animals cruelly.

Tyson Foods moved to dismiss alleging its statements were merely opinion and puffery, protected by the First Amendment. The D.C. Superior Court denied Tyson Foods' motion, holding that its statements that its products were a humane choice and that it was committed to excellence in animal welfare were detailed and concrete enough to be actionable under the D.C. Consumer Protection Procedures Act.

3.

Wells Fargo and Diversity Hiring

On June 28, 2022, a plaintiff shareholder filed a securities class action in the Northern District of California against Wells Fargo and certain of its directors and officers. *Ardalan v. Wells Fargo et al.*, 22-3811 (N.D. Cal.). In 2020, Wells Fargo expanded its "Diverse Search Requirement" policy, by requiring that at least 50% of interview candidates must represent a historically underrepresented group with respect to at least one diversity dimension (including race/ethnicity, gender, LGBTQ, veterans, and people with disabilities) for most posted roles in the U.S. with total direct compensation greater than \$100,000 per year. In addition, Wells Fargo also required that at least one interviewer on the hiring panel must represent a historically underrepresented group with respect to at least one diversity dimension. Two years later, on May 19, 2022, the New York Times reported that

former Wells Fargo executives disclosed that “[f]or many open positions, employees would interview a ‘diverse’ candidate”, but “that often, the so-called diverse candidate would be interviewed for a job that had already been promised to someone else.” The complaint alleges that, during the class period, the defendants made false or misleading statements or failed to disclose that: “(i) Wells Fargo had misrepresented its commitment to diversity in the Company’s workplace; (ii) Wells Fargo conducted fake job interviews in order to meet its Diverse Search Requirement; (iii) the foregoing conduct subjected Wells Fargo to an increased risk of regulatory and/or governmental scrutiny and enforcement action, including criminal charges; (iv) all of the foregoing, once revealed, was likely to negatively impact Wells Fargo’s reputation; and (v) as a result, the Company’s public statements were materially false and misleading at all relevant times.”

2.

The Potential for ESG Claims Under D&O Coverage

D&O insurance protects corporate directors and officers from third-party claims made against them in their capacity as directors and officers for breaches of their fiduciary duties to their corporations and its shareholders. A D&O policy typically provides three types of coverage: (1) a Side A insuring agreement for loss directly incurred by the directors and officers that the corporation is unable to indemnify; (2) a Side B insuring agreement for loss the corporation reimburses by indemnification to its directors and officers; and (3) a Side C insuring agreement for loss incurred by the corporation for its wrongful acts, an entity-insuring agreement typically limited in public-company D&O policies to “Securities Claims.”

D&O policies typically cover “wrongful acts,” frequently defined as “any actual or alleged error, misstatement, misleading statement, act, omission, neglect, or breach of duty” by the director or officer in their capacity as such. D&O policies are highly variable and they are often subject to negotiation with companies for manuscript policy provisions.

In ESG claims recently filed against U.S. corporations, the companies’ shareholders, their regulators, public interest groups and/or company employees have asserted that the corporations’ directors and officers acted improperly in making certain disclosures or adopting certain ESG policies. Whether these allegations will be considered a “wrongful act” and covered under a D&O policy will depend on the policy language, of course, but we discuss below potential policy terms and exclusions that should be considered in any coverage review.

1.

Interrelated Wrongful Acts / Prior Policies

D&O policies require, as a prerequisite to coverage, that a claim be *first* made during the applicable policy period. If a claim involves wrongful acts that are “related” or “interrelated” to wrongful acts that were the subject of an earlier claim, policy language is likely to consider the two claims as a single claim first made at the time the earliest such claim was made. If that occurred prior to a policy’s inception date, the later claim will not be covered under the policy even though it had been served on an insured during that policy period. Similarly, D&O policies often contain an exclusion for claims arising out of acts for which notice has been given under prior policies.

For these reasons, while purported misstatements identified in the ESG-related litigation may have been recently uttered, the complaint itself may suggest the possibility that the conduct in question had a long history. In those circumstances, it would be appropriate to investigate and request additional information about when the company policy was instituted and whether it was

the subject of an earlier claim. For example, the suit may involve company policies, approaches and practices that continued for years and resulted in claims that predated the policy period in question, such that the current claim could be said to arise out of the same or "interrelated" wrongful acts.

2.

Fines, Penalties, Punitive Damages and Disgorgement

D&O policies often define "Loss" to exclude certain forms of relief, such as punitive damages or other matters that are uninsurable under the law pursuant to which the policy would be construed. Accordingly, the definition of "Loss" itself requires consideration of choice of law questions and the governing substantive law on those public policy topics. The extent of whether recovery for disgorgement, for example, is uninsurable will require close examination of the claim, the record, and the law of the jurisdiction in question. Enforcement actions may seek, and perhaps solely involve, fines and penalties. Consumer and derivative actions may demand various forms of injunctive relief, such as training, changes in policy, or changes in the board. In *Tyson*, for example, plaintiffs sought an end to the deceptive marketing. The policy may specifically indicate that the costs of compliance with such forms of non-monetary relief do not fall within the definition of "Loss."

3.

Potentially Applicable Exclusions

The specific exclusions in D&O policies often contain prefatory language that dictates the scope and applicability of the exclusion. This prefatory language is often broad, such that coverage is excluded if the claim is "arising out of, based upon, attributable to or as a consequence of" a certain excluded risk. Coverage litigation may focus on whether a particular claim comes within the scope of the exclusion, with the policyholder arguing that a broad interpretation of the exclusion renders the coverage illusory.

In the context of ESG claims involving the "E" in ESG, disputes will likely arise regarding whether the alleged misrepresentations about a company's environmental policy are sufficiently causally connected to actual pollution to trigger the terms of a pollution exclusion. For example, some exclusions employ environmental terms of art, or fail to define the term "pollutants" broadly or at all. In those circumstances, a court may construe the exclusion narrowly and apply a context-based definition supplied by the case law. On the other hand, a policy pollution exclusion may be more broadly worded and apply to voluntary decisions to abate, misstatements, and reporting obligations.

Where the purported ESG policy involves statements regarding diversity, equity and inclusion policies, the D&O policy review should examine the scope of exclusions for employment practices and discrimination claims as well as the possibility that Employment Practices coverage may be implicated. In both the "E" and the "S" context, the exclusions for bodily injury and property damage, if any, should be reviewed.

In these instances, because ESG-based claims focus generally on the accuracy of statements about corporate policies, courts are likely to consider whether the nexus between the claim and the excluded conduct is strong enough to implicate the exclusion, and whether absent the excluded liabilities there would be standing to bring the claims.

In *Sealed Air Corp. v. Royal Indem. Co.*, 404 N.J. Super. 363 (App. Div. 2008), shareholders alleged that the company and its directors and officers misrepresented the company's environmental exposure. The insurance company denied coverage under the D&O policy on the basis of a pollution exclusion. The New Jersey Appellate Division disagreed that the pollution exclusion applied, reasoning that, while the exclusion applied where a company's directors and officers were sued for polluting, there were too many intervening events to find the requisite "substantial nexus" between the pollution and the alleged securities holders' damages in the case before it.

On the other hand, an Ohio appellate court found that claims of negligent misrepresentation, fraudulent transfers, and false statements about the assets and liabilities of a corporation or its ability to financial perform all were based on an obligation for pollution cleanup and, thus, were not independent of the original pollution settlements. *Danis v. Great Am. Ins. Co.*, 159 Ohio App. 3d 119, 135 (Ohio Ct. App. 2004). There, it was alleged that, while Danis agreed to pay for cleanup of a contaminated site, it had restructured its assets to avoid liability for the cleanup. The pollution exclusion applied to claims directly or indirectly related to pollution, except shareholder derivative suits that are instigated independently of the company, its officers, or its directors. The court reasoned that only one loss occurred, and that was the damage caused by the polluted site, and that the alleged wrongful acts of the Danis companies and their directors and officers were an attempt to avoid paying for the loss.

D&O policies will often exclude losses "based upon, arising out of or attributable to ... any deliberately ... fraudulent act," but many of those exclusions do not apply to defense costs and/or incorporate a final adjudication requirement, such that, for example, the exclusion would not apply unless fraud was "established by a final and non-appealable adjudication adverse to such Insured in the underlying action." Coverage issues arise when there has been no "final adjudication" or when the proceedings do not establish a specific intent to defraud. In the ESG context, "greenwashing" claims may include allegations of fraud, though evidence of a specific intent to defraud may be lacking. For instance, directors that overpromise an ambitious environmental policy may never be judged to have acted fraudulently.

Many states have public policies that prohibit insuring liability arising from an insured's intentional or willful wrongs, especially in instances where the insured is the one to recover the insurance proceeds, and, thus, in those states, ESG claims alleging fraud will not be covered. Some states, however, do not prohibit, on public policy grounds, insuring damages to a third party based on an insured's fraudulent conduct. One example is Delaware, as evidenced by the Delaware Supreme Court's decision last year in *Rsui Indem. Co. v. Murdock*, 248 A.3d 887, 902 (Del. 2021).

3.

Conclusion Litigation regarding ESG disclosures and policies is expected to increase in the coming years and there can be little doubt that insurers will receive a proportionate increase in claims under D&O policies. Courts have yet to tackle questions of D&O insurance coverage in recent filings of ESG claims; thus, for now, policyholders and insurers will have to resolve their disputes over policy language with guidance from earlier jurisprudence. One area where they are likely to agree is where "Loss," by definition, does not include the cost of compliance with non-monetary relief, though those forms of relief would appear to be critically important in the ESG context. As is the case with other underlying claims, however, disputes will arise on questions involving exclusions and the insurability of disgorgement. Given the novelty of lawsuits regarding ESG disclosures and policies, coverage litigation will surely follow.

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