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D&O Coverage for Corporate Behaviour and Breaches of Climate Change Commitments

IN BRIEF

A panel of three experts looked at the impact of climate change issues on the potential liability of company directors and officers. The issues considered included:

- Knowledge and education
- Greenwashing
- Types of claims
- Supply chains
- Regulation
- Activist claims

This note follows a virtual event hosted by the FOIL D&O SFT on 8th November 2022 concerning D&O exposures arising from environmental risks and the role of the insurance industry in managing those risks. The event was chaired by Mark Huxley, who was joined by James Denison (Partner), Simon Colvin (Partner) and Abhay Srivastava (ESG Manager) of Weightmans LLP and a group of delegates from around the D&O insurance market.

Sources of Future Litigation

Mark Huxley observed that, as a mature class of liability insurance, D&O cover evolves with corporate behaviour, which in turn is evolving to meet regulatory requirements and climate change. Given the statement made at COP27 that 'we must have zero tolerance of net zero greenwashing', Mark asked where the panel anticipated D&O litigation arising from these issues in the future.

Referencing the Grantham Institute annual report, **Simon Colvin** noted that climate change litigation had historically been focused in the USA, but was beginning to develop in other jurisdictions, in particular Australia and Europe, and in sectors beyond fossil fuels, such as minerals and manufacturing. Moreover, a survey undertaken by PwC suggested that nearly 100% of boardroom directors had made plans for net zero, but fewer than 65% of directors at companies with a turnover of less than $1bn understand carbon emissions indicating a significant knowledge gap.

James Denison noted the importance of ClientEarth's claim against 13 directors of Shell concerning their alleged failure to progress an effective net zero strategy for the company. The outcome of that action could have serious implications for directors more broadly.

Group litigation claims concerning issues such as vehicle emissions could also result in claims against directors and increasing regulation of environmental issues, such as greenwashing as previously mentioned, also generates an ever-greater risk of liability for directors.

Abhay Srivastava added that advertising is a clear source of potential greenwashing claims. Extended producer responsibility may also result in claims arising out of commercial supply chains.

Businesses should not overlook what supplier and/or subsidiary organisations are doing. For example, activists have criticised Coca-Cola's sponsorship of COP27 despite it being a significant polluter. Holistic management of environmental risks for D&Os will require consideration of the after-sales impact of products as well as the impact of the supply chain.

Simon Colvin added that the evolution of legislation and regulatory control have taken over from voluntary action. The EU Corporate Sustainability (Due Diligence) Directive concerns both the direct activities of businesses and how those businesses engage with their supply chains, imposing formal legal requirements to ensure compliance throughout the supply chain.

The EU is also focusing on the regulation of greenwashing, notwithstanding the challenges posed by a diverse industrial landscape. The EUP may adopt a 'footprint' approach: if a company wishes to make claims about its green credentials it should do so in a certain way.

Additional Supply Chain Issues

Mark Huxley commented that supply chains have always been a major issue for the insurance industry, and he is now seeing ESG being raised in supply chain contracts.

Simon Colvin confirmed that Weightmans has responded to external audits with specific questions from clients on these issues, focusing on two areas: how the firm itself operates and how it addresses ESG issues through the services it provides. The number of marks accredited for ESG in client tenders has steadily been rising.

Insurance Industry Response

Mark Huxley sees change happening across the insurance industry but asked how quick that change is likely to be, how it can be achieved and whether the insurance industry be leading the change?

James Denison

While insurers may review their investments with reference to ESG issues, directors' liabilities arising from environmental risks will fall within the scope of D&O insurance as it stands, subject to exclusions, so no major change to cover is needed. Insurers are already heavily engaged with companies facing environmental risks and are holding their suppliers to account, as noted in the supply chain discussion.

Insurers recognise the need to engage with environmental risk. Many will be exposed to claims arising directly from climate change, so they have a clear commercial driver to act.

Simon Colvin believes that insurers need to be ready for litigation brought by activists to drive behavioural change rather than to recover damages. The insurance market can take some of the risk around these novel areas to drive change, but the market still appears fragmented regarding ESG risks, with splits between business lines.

Abhay Srivastava noted that, according to the progress reports for COP27, the net zero pledges and commitments by industries (including insurance) to divest from certain industries and categories of investment were inadequate to limit 1.5 degrees in global warming. These conclusions may encourage regulators to force insurers to revise their programmes and targets, which may help to reduce the risk of activist litigation, subject to compliance with regulatory requirements.

It should also be recognised that some organisations do not have sufficient resources to achieve science-based targets and there are competency or capacity gaps. ESG is often not properly integrated into business practices. In one poll, 82% of voters had an ESG or sustainability programme in a single department but not shared across the whole business. This appears to be a major obstacle to delivery of net zero targets.

James Denison commented that Shell has called for a global response rather than singling out any individual business. A holistic approach is required and putting the responsibility on one individual, or one department will not produce the desired outcome. It seems reasonable to assume that a coordinated approach should generate more progress over a shorter period.

<u>Who will be Pursuing Environmental Claims against Directors?</u>

Simon Colvin anticipates a combination of direct claims and stakeholder pressure. The Grantham report suggests that claims are predominantly being brought in jurisdictions with robust human rights legislation, where the courts appear willing to engage in terms of breach of human rights. Activist litigators target their claims and build a moral foundation around the impact of alleged wrongdoing on a community.

James Denison linked the point back to supply chains. Claimants may be selective in relation to the jurisdiction for a claim, but the behavioural impact of Court decisions may be of limited effect unless the broader global position can be taken into account.

<u>Generational Perspectives</u>

James Denison noted that, alongside clients, younger talent may be able to influence company culture and policy. Supporting clients that cause environmental damage may affect recruitment and retention.

Abhay Srivastava referenced a group called ‘Law Students for Climate Accountability’, which ranks the top 100 law firms globally in four categories concerning climate impact. Students are encouraged to avoid employment with those law firms with poor rankings.

Simon Colvin noted that, in his experiences of recruiting trainees and apprentices into the firm, the majority want to talk about ESG topics and want to know that the business is doing the right things.

However, the legal profession has traditionally been committed to providing representation, regardless of the nature of the claim against a client. That will not change overnight.

Open discussion

The following points were discussed on a Chatham House Rules basis:

Greater regulation of corporate behaviour might generate more D&O claims by imposing a clearer set of rules that might be broken. Alternatively, regulation leads to box-ticking with no real substance, essentially amounting to greenwashing and potentially also triggering more claims.

The insurance industry is not there to police behaviour but is in a unique position to influence behaviour. Insurers might have a greater impact working with polluting companies, rather than simply refusing to insure them.

Businesses with a significant environmental impact would need help to transition to a more sustainable model. Reinsurers could also influence the market by imposing caps.

Simon Colvin felt that Insurers might be reluctant to be 'first to market' on new ESG products as that could lead to exposure. Similarly, any move away from coverage will happen slowly, although that has been seen in flood-risk.

As with flood risks, reinsurance could be a major factor in driving future behaviour and greater collaboration, although the impact of such a change would likely be felt only in the long term.

Simon Colvin noted that we might expect to see more claims against companies, including SMEs, for making misleading statements about the environmental advantages of products or services for marketing purposes. For example, in the context of public procurement, bid winners might be challenged on grounds of greenwashing. However, the scope for such claims might be reduced by guidance and standards in relation to statements about particular types of products. The Green Technical Advisory Group in the UK is developing a 'green taxonomy' to clarify what is meant when something is claimed about the sustainability of a product or service.

In the financial industry, there is concern about the accuracy of ESG statements with regard to investment funds. Advisers need to understand the products they are recommending to their clients. HSBC has been criticised by the Advertising Standards Agency for claims concerning its position on climate change/net zero. The ASA concluded that, in making these claims, HSBC could not cherry-pick one aspect of its business but had to look at everything it did.

From a more general ESG perspective, it was noted that only 50% of delegates polled at a previous FOIL event thought that their D&I policy had affected their firm's tender process. Would it be the same for the firm's climate change policy? Are insurers not as insistent on these issues as they should be?

Simon Colvin noted that, since the professional services industry generates extremely limited direct emissions, any reduction will have little impact on an insurer client's Scope III emissions. Law firms can achieve greater impact in a societal context. Firms would be well-advised to identify their own material considerations and then concentrate on those issues.

There is no generally applicable ESG strategy, but standards set around specific tasks provide useful structure. There is a FTSE index which measures carbon emissions, fossil fuel reserves and green revenue data. Funds can subscribe to this and track and invest accordingly.

James Denison noted that a similar S&P index exists, from which Tesla had been removed, although it was thought that it was the S, rather than the E, that had led to that. It was suggested that lumping E, S and G together was not necessarily a beneficial thing to do.

Abhay Srivastava confirmed that there are various matrices and indices available that measure ESG scores but that they relate to risk rather than performance. Fossil fuel companies will rate highly on these indices, even though they are working on transitioning.

COP26 resulted in an International Sustainability Standards Code which aims to consolidate some of the existing standards and provide a single piece of guidance. This should enable ESG scores to be generated for the benefit of investors and organisations internally.

James Denison brought this all back to the question of whether Coca-Cola's sponsorship of COP27 could be considered as greenwashing. It would seem preferable for a company to engage with environmental issues rather than ignoring them. Many companies have a long way to go due to their histories.

Simon Colvin felt that the legal profession had not moved as quickly as some others, but lawyers have a part to play in education and reform and as facilitators. **James Denison** agreed that this discussion needs to be carried on and expanded to the insurance industry and even activist groups, to increase understanding. It is not right simply to say that fossil fuel companies are bad and therefore their insurers are bad. It is a much more complicated relationship than that.