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Looking Closer At ESG's Environmental Risks For D&O

By **Daniel Tay**

Law360 (September 21, 2022, 8:37 PM EDT) -- Companies committing to environmental initiatives under the environmental, social and governance banner should be wary of "greenwashing" claims that could increase risk from a directors and officers insurance perspective, with breach of duty claims and political backlash also lurking as potential sources of risk.

An SEC task force alleges BNY Mellon Investment Adviser made misstatements about ESG considerations for some of its mutual funds. (AP Photo/Mark Lennihan, File)

More companies are taking the plunge on ESG programs, whether it be in response to investor pressure, regulatory scrutiny, altruism or some combination of those factors. Insurers have also begun paying closer attention to companies' ESG efforts as the threat of ESG-related litigation looms large.

"Failures to appreciate and mitigate ESG-related risks can adversely impact insurability, especially in lines like directors and officers liability where claims are often driven by so-called event-driven litigation that negatively impacts a company's reputation and, in turn, the company's stock price and financial performance," Geoffrey Fehling, a partner with Hunton Andrews Kurth who represents policyholders, told Law360.

While companies that do take proactive steps on such issues could reduce the risk of ESG-related litigation and potentially receive more favorable terms when applying for directors and officers insurance, compliance issues and political turbulence mean the impact of companies' ESG initiatives is **much more complicated**.

Here, Law360 takes a deeper dive into the "environmental" facet of ESG and how action in this area can contribute to additional directors and officers risk.

Failure to Follow Through on Promised Initiatives

The most prominent way in which a policyholder's public commitments to environmental initiatives can result in additional risk is the possibility of being hit with a "greenwashing" claim, or a claim that the policyholder intentionally misrepresented its environmental commitment to gain the benefits of being seen as environmentally proactive.

Greenwashing risk could take the form of a regulatory or enforcement action. In one notable action, the U.S. Securities and Exchange Commission's Climate and ESG Task Force charged BNY Mellon Investment Adviser Inc. in May with making misstatements about ESG considerations for some of its mutual funds. The company falsely represented that all investment in the disputed funds had undergone an ESG quality review, when "numerous investments held by certain funds did not have an ESG quality review score as of the time of investment," according to the SEC. The company **agreed to pay** $1.5 million in penalties to settle the charges.

In a similar vein, German governmental authorities are investigating asset management company DWS and its majority owner, Deutsche Bank, regarding allegations that DWS falsely labeled assets under its management as "ESG integrated." **German police raided** DWS' offices in May, and a lawsuit has been filed against DWS, Kevin LaCroix, executive vice president of insurance brokerage RT ProExec, told Law360.

Enforcement actions like the BNY Mellon and DWS cases could potentially result in D&O claims by themselves. Additionally, the DWS lawsuit shows how these investigations and enforcement actions could translate into shareholder litigation or other types of private civil litigation as well, LaCroix said.

In an example where a greenwashing lawsuit arose without a preceding regulatory or enforcement action, a group of consumers sued egg producer Vital Farms Inc. The class alleged that the producer's statements about its operations being "ethical" and "certified humane" were false and that the producer tricked consumers into paying a premium for sustainable and ethically sourced eggs.

The Vital Farms lawsuit demonstrates that companies "need to take care in preparing their sustainability reports and ESG disclosures, and also their outward-facing marketing statements," Emily Garrison, a partner at Honigman LLP who represents policyholders, told Law360.

The probability of increased regulatory scrutiny is likely to result in more policyholders being exposed to claims of greenwashing, or more broadly, failure to meet stated environmental goals, LaCroix told Law360. For example, the SEC's proposed climate disclosure guidelines, should they be implemented in a form close to what the agency proposed, would require companies to make disclosures about their sustainability programs as well as emission reduction targets.

"They're gonna have to make quantitative disclosures, and that's the kind of thing that claimants in future claims potentially could seize upon," LaCroix said, referring to potential scenarios in which a company makes disclosures about environmental targets that it cannot follow through with.

In such cases, it would not be surprising to see companies argue as a defense that they made their disclosures in good faith, LaCroix said. However, regardless of whether a company is actually engaged in greenwashing or if it made a good faith effort to meet its environmental goals and ultimately fell short, the risk for purposes of directors and officers insurance remains, Honigman's Garrison said.

"They could all end up in the same place, in litigation because of misrepresentation, or a securities class action," Garrison said. "However you look at this, it's important to make accurate, thoughtful disclosures."

Political Controversy and ESG Backlash

Even if a company is able to avoid greenwashing claims, the highly charged political atmosphere surrounding the topic of environmental action and ESG in general means any sort of environmental commitment by a policyholder can result in additional risk.

The latest incarnation of this is anti-ESG legislation being put forth in several states. Such legislation usually bars state agencies from investing in funds that consider ESG factors for any purpose apart from maximizing returns, or bars the state from doing business with companies that have elected to not do business with certain industries.

In the environmental sphere, Kentucky, Oklahoma, West Virginia and Texas have enacted laws prohibiting their state governments from doing business with financial institutions that "boycott" energy companies. Indiana, Louisiana, Idaho, Minnesota, South Carolina and Utah have similar legislation under consideration.

For companies that do business with state governments, such anti-ESG legislation presents yet another risk, Hunton's Fehling told Law360. Such companies may find themselves precluded from soliciting business from state pension funds and other state entities, which can often be very desirable investors due to their size, LaCroix said.

Additionally, a company that solicits business from state entities that must comply with anti-ESG laws might potentially be at risk of being accused of hiding its environmental initiatives, or "anti-greenwashing," LaCroix said.

Such anti-ESG legislation often characterizes the consideration of ESG factors as superfluous to the objective of maximizing investor returns, but the reality is more nuanced than that, Jonathan Schwartz, partner at Freeman Mathis & Gary LLP who represents insurers, told Law360. For example, an investment adviser might advise against investing in a particular industry because it is likely to be subject to expensive ESG-related litigation, or has ESG-related public perception problems, Schwartz said.

"It really is all financial at the end of the day," Schwartz said. "If the investment fund says the best thing to do is to invest in ESG-responsible companies, because that's going to provide a good rate of return, then that's great. And if they say they should be targeting fossil fuel industries or tobacco or alcohol because those are better investments, then in some ways that's what the considerations should be."

Breach of Duty

On the opposite side of the spectrum from greenwashing, a policyholder's directors and officers could face claims that their commitment to environmental objectives — and material actions undertaken in service of those objectives — was a breach of their fiduciary duties.

"[Companies] can also be subject to sort of a perverse opposite allegation that by putting those values and those aspirations first, giving that priority…they were acting contrary to shareholder interests," LaCroix said.

While there has not yet been such a lawsuit in the environmental space, LaCroix noted that a recent lawsuit had been filed against Starbucks by a conservative activist group, asserting that Starbucks' diversity, equity and inclusion commitments under the "social" prong of ESG were contrary to the interest of the company. The logic underlying that lawsuit could be applied in the environmental context as well, LaCroix said.

--Editing by Bruce Goldman.
