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What's Your Environmental, Social, and Governance (ESG) IQ Score?

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This paper reviews some of the ins-and-outs of ESG, its significance to the industry, and how insurers and reinsurers are grappling with many thorny issues related to ESG. It discusses exposures and coverage issues posed by ongoing climate change litigation, D&O claims arising from missteps on diversity and inclusion, an increase in activist and investor greenwashing claims against companies for overstating their sustainability efforts, and fall out from bluewashing attempts to improve tarnished reputations.

I. Introduction:

ESG Risks and Responsibilities for Insurers and Reinsurers

ESG issues have real-world implications for business operations. Companies with strong practices have been found to deliver more sustainable returns. ESG is in the spotlight today because there is a heightened recognition of the cause and effect relationship between ESG factors and the corporate bottom line. There is increased internal and external stakeholder focus on ESG issues, and pressure for change on topics ranging from climate change, to racial injustice, to Covid-related inequities. Simultaneously, there is heightened governmental awareness of ESG as seen in the SEC's regulatory actions requiring ESG disclosures, the identification of climate change as systemic financial risk, and more.

Importantly, ESG is different from Corporate Social Responsibility. Whereas CSR focuses on 10-15% of a company's finances that are devoted to community projects, ESG focuses on the remaining 85-90% of the company's operations. ESG presents the opportunity

for companies to demonstrate industry leadership, and future-readiness. It also heightens risks by spotlighting existing financial, compliance, and reputational risks in a new realm.

For insurers, these new risks require new assessments, products, and coverage decisions. Many of these new risks are based on increased exposures of insureds. There is greater risk of damage from hurricanes, wildfires and other natural catastrophe events. There are pressures on policyholders' reliance on fossil-fuel resources (e.g., coal, oil & gas), D&O liability exposures from governance issues, and a host of citizen/shareholder suits on topics ranging from environmental cleanups to toxic torts, to greenwashing, human and civils rights, and product liability. Lawsuits have challenged policies and disclosures on climate impact, racial equity and inclusion, business ethics, dangerous workplaces, environmental impacts and more. For insurers, this means there are likely to be increased demands for defense and indemnification and greater challenge in risk quantification such as reserve-setting. It also means that insurers may be relying on inadequate modeling and tracking, facing new investor and lender pressures, juggling inconsistent, overlapping and duplicative global regulatory requirements, and managing new climate-related financial risk in their portfolios.

II. "E" = Environmental component of ESG

Corporations are facing global pressure to lead on climate change and environmental justice. Investors and advocates know there are environmental impacts of a company's supply chain and procurement activities. They take account of the success of a company's efforts (or lack thereof) to transition to renewable energy or otherwise reduce its carbon footprint (E/G).

Heightened risks associated with the "E" in ESG are self-evident: climate change is increasing threats from severe weather and natural catastrophe losses. Whether or not one believes that humans cause climate change, it is beyond reasonable scientific dispute that temperatures and sea levels *are rising* globally and this will continue. This will have profound implications, including:

- Asymmetrical changes to local weather;
- More weather emergencies (floods, fires, droughts);
- Prevention and mitigation (sea walls, air conditioning, farming changes, moving away from shores) likely to be politically difficult and too late;
- Potential global population migration; and
- The fact that the longer we wait, the more costly the implications will be.

Climate change is also spawning more litigation against policyholders. This includes more traditional environmental litigation seeking to force companies to clean up more rigorously, more expansively and in response to new contaminants, more toxic tort litigation, and slew of new litigation about climate change and sustainability. It also includes the advent of new theories of liability.

One of the more prominent emerging claims is for so-called "greenwashing." For the consumer, green claims are attractive and map onto beliefs that products are "higher quality," "more authentic," and "better for you." Similarly, investors increasingly emphasize environmental factors in their investment decisions. Employers may emphasize environmental accomplishments and sustainability in response to employee concerns, and to attract candidates to the company. These are all drivers prompting companies to make climate pledges, such as "Carbon neutral/negative by 2030," "All renewable by 2020," "Zero emissions," "Regenerative," or "X% annual reduction." Not surprisingly, these climate-related claims have become the focus of great scrutiny, challenging whether actions and accomplishments have lived up to corporations' lofty pronouncements.

A notable suit is the case brought by the Earth Institute against ten major food, beverage and consumer goods companies for the nuisance created by their plastic packaging, including polluting waterways with plastic trash and touting products as recyclable when they are not.

There is a growing mandate for more disclosure of companies' actions and their environmental impact. As there are more voluntary and required disclosures, this leads to more publicly available information about corporations' climate commitments. Greater access to data means that there is more knowledge about the potential for claims against companies for a wide variety of environmental failures, and thus there are more empowered individuals bringing suit.

III. <u>"S" = Social Component of ESG</u>

The Social component of ESG reflects a renewed focus on the lack of workforce diversity, internal inclusion efforts, and racial disparity concerns, including in the use of data and AI. There are growing demands for racial equity and civil rights audits, initially closely following pay equity litigation in seeking racial equity assessments and more recently evolving to encompass broader civil rights audits as well as racial equity issues.

An illustration is a Shareholder Proposal submitted to Goldman by SOC Investment Group, which was defeated 2021. It stated that:

> Shareholders of Goldman Sachs Group Inc. ("Goldman") urge the Board of Directors to oversee a racial equity audit analyzing Goldman's impacts on nonwhite stakeholders and communities of color. Input from civil rights organizations, employees, and customers should be considered in determining the specific matters to be analyzed. A report on the audit,

prepared at reasonable cost and omitting confidential and proprietary information, should be publicly disclosed on Goldman's website.

Similar shareholder proposals were made to JP Morgan Chase & Co., Bank of America, Citigroup Inc., Morgan Stanley, State Street Corp., Wells Fargo & Company, and BlackRock Inc.

In March 2022, a Shareholder Proposal submitted to Apple by SOC Investment Group was passed, stating:

> Resolved: That shareholders of Apple Inc. ("Apple") urge the Board of Directors to oversee a third-party audit analyzing the adverse impact of Apple's policies and practices on the civil rights of company stakeholders, above and beyond legal and regulatory matters, and to provide recommendations for improving the company's civil rights impact. Input from civil rights organizations, employees, and customers should be considered in determining the specific matters to be analyzed. A report on the audit, prepared at reasonable cost and omitting confidential or proprietary information, should be publicly disclosed on Apple's website.

The increased scrutiny of companies' performance on racial equity and civil rights can have an impact on company brand and reputation, as well as hiring and retention of talent. Moreover, the disclosures from racial equity and civil rights audits may result in increased litigation and other disputes focused on the "S" considerations in ESG. This includes:

- Individual and Class Discrimination Claims
- Race, Pay Equity, Other Protected Categories
- Shareholder Derivative Suits; and
- Anti-ESG Shareholder Proposals and Suits.

ESG's "social" component also encompasses efforts by activists and non-governmental organizations to draw attention to forced labor issues and to support workers' claims against companies under governmental legislation such as the Uyghur Forced Labor Prevention Act signed by President Biden which became effective on June 21, 2022. Human rights organizations are assisting workers in filing class actions and other cases against companies purchasing and importing commodities allegedly made with forced labor. U.S. companies sourcing minerals, commodities, and consumer goods (apparel, electronics, food products, among others) are targets.

New claims in the area of workers' rights are anticipated. For example, additional cases may be filed on behalf of workers with an increased focus on employers' alleged "knowledge" of working conditions, including forced labor in a company's supply chain. Further, failures in ensuring worker safety could expose companies to litigation. And, following the model of

"greenwashing" claims, plaintiffs' firms may mount challenges to marketing statements and companies' statements on labor practices in so-called "bluewashing" claims.

IV. "G" = Governance component of ESG

In many ways, the "G" in ESG encompasses all of the discussions above because good governance requires effective handling of regulatory disclosures on climate change, environmental justice and attendant risks, as well as key issues in "greenwashing," racial equity/civil rights audits and potential exposures, and issues posed by forced labor and dangerous working conditions. Corporations must integrate ESG into their risk management and foster a culture of good governance to protect against reputational harm and potential liability.

The governance component of ESG also encompasses issues such as executive compensation and balancing demands regarding the gap between employee and executive paychecks. It certainly includes expectations for corporate responsibility towards the environment and boardroom diversity, as well as corporate responsibility to protect against cyber risks, bribery and unethical practices, and managing financial and tax opacity, and lobbying activities. The potential for shareholder claims for mismanaging any of these governance tasks is self-evident.

V. ESG: Risks and Responsibilities for Insurers and Reinsurers

Outside activism and pressure for corporate action on ESG issues, together with regulation and legislation setting new corporate requirements on environmental and social issues, are the drivers for increased ESG risk. For insurers and reinsurers, there is both the potential for direct liability for ESG missteps, and the indirect exposure from liability and losses suffered by their policyholders.

There are also new theories for coverage, and defenses to coverage claims, involving ESG exposures. These questions are, of course, tied to the nature of the underlying claims, but there are at least two large questions that loom in ESG coverage disputes. These are: what role "accident," "occurrence" and "expected or intended" issues will play in cases alleging knowing harm to people and property; and whether broad nuisance claims that have emerged as a vehicle for attempting to force change (such as in suits alleging contributions to climate change or for plastics pollution) will prove to be the kinds of claims that can be shoehorned into general liability coverage which was written to address traditional tort claims for damages due to bodily injury or property damage suffered by a particular person.

Finally, and most significantly, ESG presents vast opportunities for insurer innovation and leadership in addressing ESG concerns. Insurers and reinsurers have taken up the challenge, leading with their own corporate sustainability efforts, and counseling and incentivizing their policyholders to advance ESG objectives. The industry also has introduced new products such as

parametric insurance for underserved populations impacted by earthquakes and hurricanes which will help to close the coverage gap. Whether the "E," "S," or "G" is at issue, insurance also responds to societal needs. Insurers and reinsurers help communities recover from catastrophic events such as wildfires, hurricanes and other severe weather events. Insurance provides a mechanism for compensation for claimants harmed by discriminatory action or improper workplace practices. And insurance backstops directors and officers who face potential exposure for governance missteps, helping policyholders attract strong talent to corporate boards and thereby advancing the good governance through which each of these issues is addressed.

VI. Conclusion

Increased attention to ESG presents an opportunity for companies to showcase their good work – but it also creates increased litigation risk. For insurers and reinsurers, an understanding of ESG risks and responsibilities is critical for their own operations, for managing their exposures to policyholder liability, and to assessing which kinds of ESG-related claims may be covered and which are not. A close look at the emerging standards and claims will increase your ESG IQ score, and help ensure you are ready for the challenges ahead.