Managing D&O Risk in the Era of ESG and DE&I

Given that the global D&O insurance market is valued at over $20B today[1], it's remarkable to consider that there was a time when this coverage didn't exist—a time when there were few regulations surrounding the sale of securities, and little to no accountability placed on directors and officers for the actions of a business or its impact on corporate profitability and share price.

In contrast, directors and officers today need to navigate a complex minefield of statutory and regulatory responsibilities related to their fiduciary duties of care, loyalty, and obedience. They need to balance shareholder expectations of profitability with increased public demands for social responsibility. And increasingly, it's no longer enough for companies just to do the right thing: they must show how ethical behavior is ingrained in their corporate culture.

As regulations and societal expectations continue to evolve, D&O insurance is adapting, and brokers must understand these changes to best protect their clients.

CONTACT

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D&O and Corporate Conscience

To understand where the D&O market is headed, it's helpful to look back briefly at how we got where we are today.

Congress passed the first antitrust law, the Sherman Act, in 1890, and followed up in 1914 with two additional measures: the Federal Trade Commission Act (which created the FTC) and the Clayton Act. These laws—still in effect today—not only prohibited unlawful mergers but began to set the standard for what constituted unlawful business practices. Many state statues followed suit in the years ahead.

However, it took until the stock market crash of 1928 to give rise to the development of D&O insurance. Lawsuits around company failures led to directors and officers paying judgements and settlements—and the insurance industry saw an opportunity to create a product to protect them.

It took until the late 1960s to generate significant interest in coverage, with the 1968 Escott v. Barchris Const. Corp decision illustrating the personal liability faced by directors and officers. In subsequent years, the D&O insurance product underwent various changes until it arrived at its current Side A/B/C format.

In recent years, the focus of D&O liability has largely been on governance, driven by the Enron scandal of 2001 and regulations and litigation stemming from the Great Recession of 2008. Additionally, new risks continue to arise that could never have been envisioned when coverage was first developed. For instance, directors and officers are increasingly facing lawsuits related to cyber-attacks, alleging failure to implement adequate controls or disclose cyber risks to investors.

D&O underwriting has evolved as well. It's no longer simply adequate for an organization to "check the boxes" around having controls in place. Underwriters want to ensure that a company's words and deeds are a true reflection of its culture. Buyers should therefore expect lengthy discussions between underwriters and their management team and/or board.

Social Trends and D&O Evolution

Throughout the evolution of D&O insurance, the concept of corporate conscience has been a constant factor. In recent years, investors began evaluating—and board rooms began focusing on—things such as corporate responsibility, sustainability, and impact investing. Today, the emphasis of investors is increasingly on two key social trends: ESG (Environmental, Social, and Governance) and DE&I (Diversity, Equity, and Inclusion).

ESG

Until recently, the term ESG was a non-factor for investors, but today they are increasingly demanding ESG information, with the '**E**nvironmental' component garnering the most attention. Pollution has long been a risk companies have managed, but the meaning of Environmental in ESG encompasses much more than direct contamination, considering the far-reaching environmental impact (negative or positive) a company has, with that impact presumably reflected in its share value.

On a related note, climate change litigation is an increasingly lucrative avenue for plaintiffs' attorneys. Companies (and their directors) are being sued for direct or indirect contribution to climate change, including allegations of failing to disclose or mitigate risks. On the other hand, suits have also been filed for making allegedly misleading environmental responsibility claims in order to bolster a company's public image and share price, a practice often known as "greenwashing."[2]

In seeking D&O coverage for ESG risks, buyers may contend with strengthened pollution exclusions and specific climate change exclusions. Certain sectors of business may also be facing greater scrutiny by underwriters, with coal, petrochemical, and similar "socially undesirable" classes having a much more difficult time securing D&O coverage. On the other hand, buyers that have strong ESG programs in place will generally obtain much more favorable terms and pricing.

DE&I

Issues around DE&I have seen increased litigation as well. Several shareholder actions regarding diversity issues have been brought against the boards of public companies across several industry sectors[3]. Suits claim violation of fiduciary duty through failure to address diversity among officers and/or board members, making misleading statements of companies' commitments to diversity, and even allegations of violations of the Securities Exchange Act that led to shareholders' making investments as a result of diversity claims.

These actions are demanding not only monetary damages, but remedies such as diversity training, initiatives for hiring diverse employees, resignation of board members, and, of course, attorney fees.

Even if lawsuits are not filed, directors and officers know they are under the microscope when it comes to issues of diversity—not just from investors, but also from regulators, lawmakers, and the public at large. Although no D&O policy exclusions around this issue are likely to be seen, buyers can expect underwriting inquiry into their DE&I policies and practices and the expectation that diversity is not just a buzzword, but a commitment reflected in a company's culture.

Managing Risk

The history of D&O insurance demonstrates that this is a market in a constant state of evolution, impacted not just by changes in laws and regulations, but also by evolving societal expectations around what fiduciary duty and corporate conscience mean.

For businesses, managing D&O risks requires good governance, strong frameworks around emerging issues such as ESG and DE&I, as well as a program of liability protection from an insurer with the capacity and appetite to offer the broadest coverage available. For retail agents and brokers, it is important to partner with an expert who has the knowledge and market access to navigate this complex landscape, as well as the proven ability to offer programs and solutions that address changing risk.

About the Author

This article was written by Jordan Kurkowski, senior vice president, professional lines, Amwins Brokerage.

Sources

[1] https://www.prnewswire.com/news-releases/directors-and-officers-do-insurance-market-report-2022-high-penetration-of-small-and-mid-size-companies-bolsters-sector

[2] New York City filed a lawsuit in 2021 against three oil and gas companies alleging the companies advertised themselves as leaders in fighting climate change, but instead misled consumers through the promotion of "cleaner" and "emissions-reducing" fuels without disclosing their climate impacts. Earlier this year, a Canadian coffee producer was ordered to pay a $3 million fine after it made false claims about the recyclability of its packaging, while last year the UK Advertising Standards Authority ruled that Ryanair's low-emissions advertising campaign had misled consumers.

[3] i.e., Facebook, Oracle, Gap and Cisco