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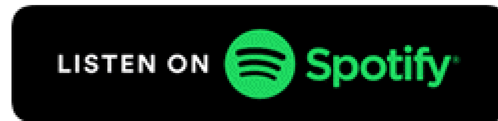
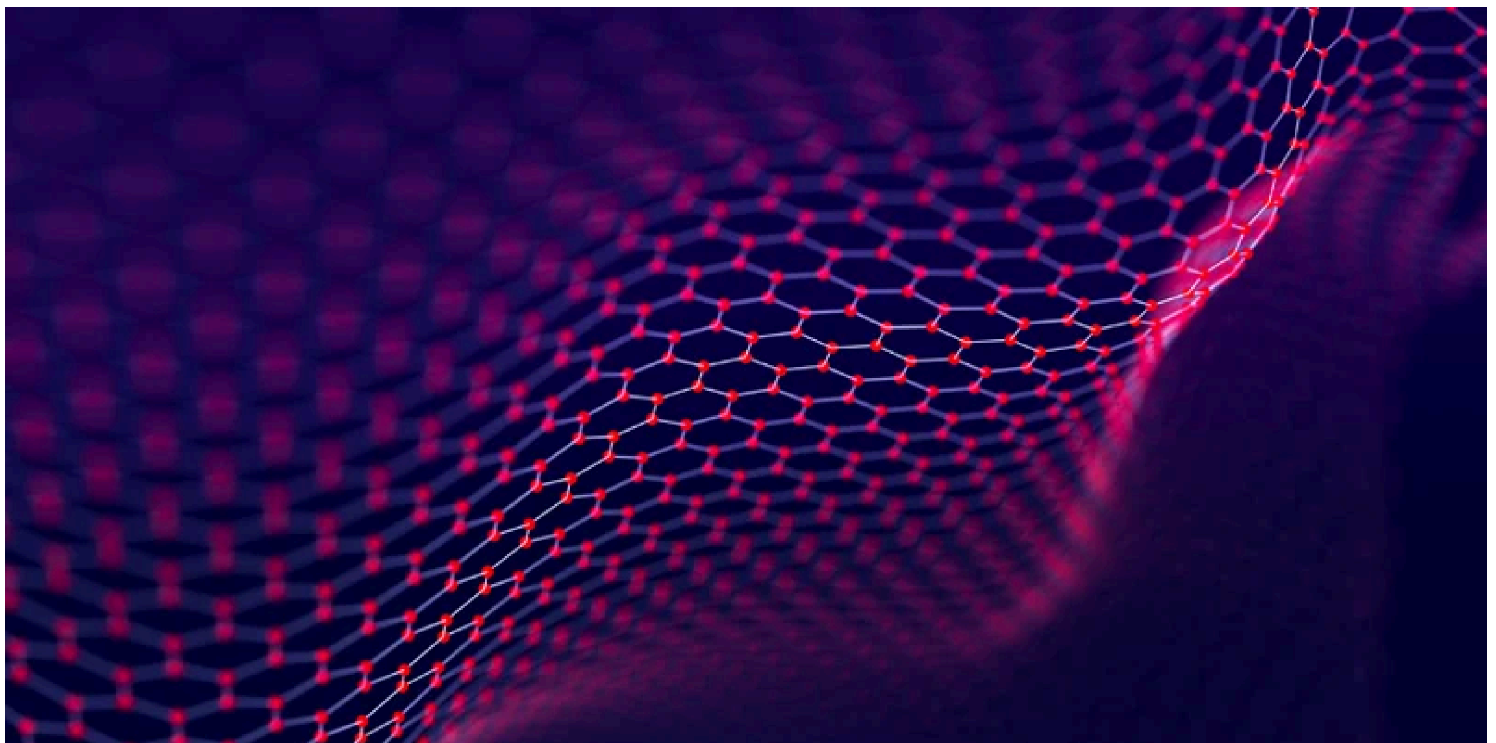


Authors: **Carolyn H. Rosenberg, Stephen T. Raptis, Jalen Brown**



Carolyn Rosenberg, Stephen Raptis and Jalen Brown explain what “bump up” exclusions in D&O insurance are, and policy considerations when considering or structuring a transaction.

Transcript:

Intro: Hello, and welcome to Insured Success, a podcast brought to you by Reed Smith's insurance recovery lawyers from around the globe. In this podcast series, we explore trends, issues, and topics of interest affecting commercial policy holders. If you have any questions about the topics discussed in this podcast, please contact our speakers at insuredsuccess@reedsmith.com. We'll be happy to assist.

Carolyn: Welcome to our Insured Success podcast, the bump-up exclusion. I'm Carolyn Rosenberg. I'm a partner in our insurance recovery group on behalf of policyholders here in Chicago. With me today are my colleagues, Jalen Brown, also in Chicago, and Steve Raptis in our Washington, DC office. We'll get right into it. We've talked about the bump-up exclusion, which is a name. Jalen, can you start us off and tell us what do we mean when we say a bump-up exclusion?

Jalen: Yes, thank you, Caroline. So bump-up exclusions have become a hot issue for D&O insurance coverage. Insurers have begun raising these issues regularly in claims involving corporate mergers and acquisitions, insurers assert these bump-up exclusion claims whenever consideration paid in an acquisition is alleged to be too low. And so while a bump-up exclusion is referred to as an exclusion, we won't find a bump-up exclusion in exclusion sections. There is a carve-out for the definition of an otherwise covered loss. And so a bump-up exclusion provisions are often found within a D&O policy's definition of loss, and attempts to exclude the amount of a settlement or judgment that represents an increase in the price paid to acquire an entity where such consideration was alleged to be inadequate. There are a few exceptions to the bump-up exclusion. Virtually all bump-up exclusions carve out coverage for defense costs and side A claims, and I know Steve is going to tell us a little bit more about what side A claims are.

Stephen: Just as a little bit of history, D&O policies were originally put into the marketplace largely to protect the directors and officers from non-indemnified claims, the kind of claims that the company will not indemnify them for or can't indemnify them for legally. Those are side A claims. Many D&O policies also include side B and side C coverage that protects the company. But the side A claims are the non-indemnified claims against the officers and the directors.

Carolyn: So, Jalen had mentioned that these come into play in acquisition situations and transactions. Steve, tell us, where do you think the bump-up exclusions come into play most? What kinds of cases or situations should you be on the lookout for?

Stephen: In my experience, I've been seeing insurers assert that bump-up exclusions apply to really all types of corporate transactions. They haven't limited it to one type. It's become sort of a go-to generic defense anytime there's an allegation in a case that inadequate consideration was paid and consideration with a

transaction. And that includes both public and private companies. And we have seen sort of a morphing of these exclusions. It used to be traditionally they would apply to, they would contain language that made them applicable to acquisitions. That was a key word, and often it would be accompanied with acquisitions of all or substantially all of the assets of some other entity, and that was where the exclusion applied. But more contemporary versions we're seeing have really gotten away from that acquisition language. We might call it a restriction. And we know that with most public company transactions, they will be challenged. It's the nature of the beast. And when I say challenged, one side, one set of shareholders or another will claim that either their side paid too much or the other side will claim that they didn't receive enough. And sometimes there are both of those allegations in a single transaction. They can't both be right, but we'll see both sides actually have to deal with those kinds of shareholder suits. The good news is if you're a public company, these are securities claims. These are exactly the kinds of claims that are likely to be covered if you have side C coverage. So that's the good news. And one other thing that policy holders should be aware of with respect to these bump up exclusions is they really are, even in the states where they've been interpreted in favor of the insurers, they are still limited to the language of the exclusion. And that is damages or loss where it is claimed that inadequate consideration was paid. So if the loss or the damages at issue are of a different nature, those should not fall under the bump-up exclusion. And that's something that we should all be mindful of when we're looking at these often long securities complaints that may be 150 pages long. You really need to separate out what falls under the exclusion and what doesn't, because if it doesn't fall under the exclusion, it should still be covered regardless of how the bump-up exclusion is interpreted.

Carolyn: And as you said, Steve, and as Jalen alluded to, even though this is in the definition of loss, it's an exception to the definition of loss, and therefore it is construed as an exclusion. And as we know, applying basic sort of black letter law principles, exclusions have to unambiguously apply, and the insurer has the burden to show that. So, you've told us sort of theoretically and practically speaking what's covered, but let's get into the nitty-gritty. Jalen, you know, who's been winning the coverage disputes in regard to the bump-up exclusion?

Jalen: At this point, Delaware seems to be the only jurisdiction that is scrutinizing these exclusions rigorously. Two examples of this is in February 2021, the Delaware court presented the Northrop Grumman decision, and in this case, the policyholder prevailed under Delaware law. Some of the key facts for this case was that both sets of shareholders voted, neither merging entity survived, and that neither entity obtained substantially all of the assets of the others. The court noted in Northrop that the shareholder claims did not allege inadequate consideration exclusively, and the court construed the bump-up provision, which the court deemed an exclusion, and narrowly and strictly under Delaware law, the court concluded that it applied to a lawsuit claim that alleges only the consideration exchanged, nothing else, as part of only one specific control transaction was inadequate. The court held that the exclusion was inapplicable to the merger because the lawsuit involves more than just inadequate consideration. And also more recently, we have the Viacom decision that just came down a few months ago in August of 2023. And. Again, the court applied Delaware law, and this case involved a merger between Viacom and CBS, and this was a transfer of all of Viacom's assets. The shareholders of

Viacom brought a claim against Viacom due to the merger. And in this case, the shareholders and Viacom ultimately settled their claim for $122.5 million, and the insurers refused to pay the settlement because of the bump-up exclusion provision. In this case, Viacom countered the insurers and stated that the bump-up exclusion applied only to acquisitions, and acquisitions was an unidentified term within the policy and was not considered a merger. The Delaware Superior Court found that the bump-up exclusion was ambiguous as it was subject to contrary but reasonable interpretations, that the exclusion applied to acquisitions that are part of a broader transaction, such as a merger, or that it only applied to acquisition transaction. As a result of this case, the court held that the bump-up exclusion had to be interpreted in favor of coverage and that it did not apply to Viacom's settlement of the CBS merger claims. Therefore, Delaware has been the only state so far that has been rigorously construing bump-up exclusions in favor of policyholders.

Carolyn: So it sounds like, Jalen, that Delaware law is favorable, at least at this point, and scrutinizing the specific language and the particular facts are critical. What about the cases where policyholders have not fared as well? What about the cases that have been lost?

Jalen: For the cases that have been lost, those have been found in jurisdictions that have not been applying Delaware law, such as Wisconsin, Virginia, and California. An example of this case would be the Komatsu Mining Corporation decision, which was a Seventh Circuit decision in January of 2023 that applied Wisconsin law. In this case, the transaction at issue was a merger, but the extent to which the merger is an acquisition was not particularly analyzed by the court. The court held that the exclusion applied solely based on the inadequate consideration language and the bump-up exclusion policy. While the court acknowledged the Northrop decision in Delaware, it noted that the exclusion at issue was different and that Delaware law applies more policyholder-friendly rules of policy construction than the Wisconsin courts.

Carolyn: I know there was one other case as well, the Towers-Watson case, right, where the appeal was recently in the Fourth circuit, and that didn't go quite as well as policyholders had hoped.

Jalen: Yes, the Towers-Watson decision came down from the fourth circuit on May 9, 2023. The fourth circuit reversed the district court's decision and applied Virginia law instead of Delaware law. The fourth circuit relied on the dictionary definitions of the term acquisition to conclude that the term applied both both to the actual acquisition of a stock and to mergers. The Fourth Circuit then remanded the case to the District Court to determine whether the bump-up exclusion applied, given these new parameters. The District Court's decision came out on March 6, 2024, and consistent with the Fourth Circuit's opinion, the District Court determined that the contract interpretation in Virginia was distinct and different from Delaware, and that under Virginia law, the bump-up exclusion applied.

Stephen: One thing that I found interesting about the Wisconsin case and the Towers-Watson case were the fact that they found the Delaware law actually applies more policyholder-friendly rules of policy interpretation than the states, Wisconsin and Virginia, whose laws they were applying. That was interesting to me because we normally think of that body of law as universal. In fact, we often refer to it as universal rules of policy

interpretation. But I thought in both cases, it was interesting that those courts distinguished the Delaware cases by saying, well, Delaware has a different set of rules of policy interpretation, which was a little bit new to me.

Carolyn: Yeah. And Delaware makes some sense because many corporations are incorporated in Delaware. Delaware seemed to have a body of law where the jurists are quite familiar with. Corporate law, indemnification, bylaws, and also the roles of directors and officers and the ability to look at transactions, look at the various damages alleged, and be able to parse through both the exclusions and elements of loss that would be covered. And although we've been talking about the cases themselves and the very helpful analysis that you both have shared, the real question too is, are there really lessons learned from either successful, partial success, or not success if you're a policyholder that could be applied when you're purchasing insurance or renewing your D&O policy or structuring a transaction or considering it. Steve, can you share some of your thoughts on those issues?

Stephen: Yeah, I guess the first thing that I would say is that this is an evolving issue because this is not an exclusion that has been interpreted in average state, or not even close to it yet, this is a book that's still being written in terms of the ability of policyholders to really effectively be able to recover under their policies with respect to transactions. But there are a few things that I think that we can take away from where we are on the current state of the law. The first thing, and just to sort of go one level higher, is that D&O policies for people who have not negotiated them, they aren't written on a standard policy form like you might have with your general liability policy or your property policy. There's not much room to negotiate those policies because the insurance industry has a form that everybody uses. D&O policies aren't like that, which means that each insurer has its own version of policy. There's a lot of similarities between those versions, but they're not the same. And as a result, depending on how the market conditions are at the time, certain provisions within your D&O policy may be negotiable. And we have no reason to believe, given that There really is no typical bump-up exclusion. That language has really evolved over time and continues to evolve over time. We don't have any reason to believe that that's not one of the provisions that may be more on the negotiable side than the non-negotiable side. But regardless, when the policyholder at renewal or if they're buying a new policy altogether, they really need to look at that language, whether it be in the specimen policy, if they're buying it from that carrier for the first time, or whether it's in their current language that they would renew. new. They really need to review that language carefully at renewal so that if adjustments need to be made, that can happen. That's the right time to do it. A couple of the things that they can look for that we've highlighted already today, if you can find, if it's still available, a version of the exclusion, it still has the traditional acquisition language in it. We mentioned earlier that that might be thought of as a limitation. That's a good thing with exclusions. If you can still get a version of that bump-up exclusion, that's a good place to start. As Jalen mentioned earlier, bump-up exclusions traditionally always carved out defense costs expressly. Now we don't always see them carved out expressly. If you can get a version of the policy that carves them out expressly, that's better than relying on certain language that may be within the exclusion that can be interpreted as carving out defense costs. We want to make sure that language is expressed. And then finally, you want to make sure that that side A carve out, which should be in every bump up exclusion, is stated very expressly. In your exclusion, maybe it says that the

side A claims are carved out. Maybe it says it only applies to side B and C coverage. Either way, you would be well advised to make sure that that carve out is in there. The final thing that I would say is that a lot of times in structuring transactions. One of the last considerations that the negotiating or the transacting parties have is insurance. What we might propose is under certain circumstances, insurance maybe should be more of a driver than an afterthought. And especially, say, for a public company, it's highly likely because of the visibility of the transaction that it will be challenged on one side or both. So maybe since you know you're going into the transaction with a high likelihood that it will be challenged, maybe D&O insurance and the recoverability of D&O insurance should really be more at the forefront of the thinking. Can you structure your transaction in a way that preserves the D&O coverage if the transaction is ultimately challenged? And as we talked about a little while ago, Jalen talked about the fact that Delaware has shown itself to be a friendly place. Two different types of burgers have been held by Delaware courts not to be subject to the exclusion. So, if all other things are equal, why not structure your transaction in a way that takes you outside the bump-up exclusion, at least arguably, by structuring it, if you're a Delaware corporation, in a way that's consistent with the case's finding coverage? Anyway, we don't want to suggest that the tail should wag the dog, but D&O proceeds in these transactions, like Jalen talked about with Viacom, $122 million in D&O insurance proceeds. That's a lot. And so it's something to take into account when potentially when you're structuring a transaction, especially if you're a public company, especially if you're a Delaware corporation.

Jalen: That's a great point that you mentioned that an insurer should really consider the language of the policy that they purchased. That's exactly what the Onyx decision focused on, where the court held that and relied on the assumption that there was more favorable policy language available in the marketplace, and that was not purchased by the policyholder when finding that the bump-up exclusion did apply.

Carolyn: And clearly, bump-up exclusions are not going away anytime soon, at least not for the short term. So it's really important to both know what jurisdiction you're in, do what you can on the negotiating front and structuring the transaction, and of course, understand where the case law is and is going and really get into the facts to be able to make the arguments that put you in the best place to overcome the exclusion if and when it is raised. I want to thank both Steve and Jalen for elucidating the topic for us today and would invite you to tune in to additional episodes of Insured Success. Thanks so much.

Stephen: Thank you, Carolyn. Thank you, Jalen.

Jalen: Yeah, thank you both. It was great talking.

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ESG - from Boardroom to Courtroom: ESG's Impact on Overpromising and Underdelivering

Avinash Poorooye

Associate

Environmental, Social, and Governance ("**ESG**") principles have quickly gained significant traction in the business world. Companies worldwide are recognising the importance of aligning their operations with ESG goals to meet societal and investor demands. As ESG becomes more mainstream, so does the scrutiny on companies that overpromise and underdeliver on their commitments. This trend has elevated ESG issues from the boardroom to the courtroom, with legal and regulatory consequences for companies that either fail to deliver on their promises or lack a compelling strategy to implement their commitments.

The Promise

To attract investment and gain a competitive edge, companies often make ambitious ESG commitments in their boardrooms. These promises can range from aggressive carbon emission reduction targets to ambitious diversity and inclusion initiatives. While such commitments may be made with good intentions, the challenge lies in the execution and actual delivery on these promises.

Companies that promote themselves as ESG champions can expose themselves to potential litigation if they fall short of their promises. Shareholders, consumers, and employees are increasingly holding companies accountable for their ESG practices. When companies make bold ESG claims in their marketing materials, annual reports, or public statements, stakeholders are quick to notice if those claims are not backed by concrete actions and results.

The Delivery

As stakeholders become more discerning, there is an increasing awareness of companies falling short on their ESG promises and stakeholders are turning to legal avenues to hold corporations accountable. Shareholders have filed lawsuits against companies for misleading ESG disclosures. These legal actions can have serious financial and reputational repercussions. Companies found guilty of overpromising and underdelivering on ESG commitments may face fines, penalties, and damage to their brand image.

One high-profile example of stakeholder capitalism is ClientEarth’s (despite having only 27 shares in Shell at the time) unsuccessful lawsuit against Shell’s Board of Directors – which was the first derivative action worldwide to seek to hold directors personally liable for climate risk mismanagement. Although the English Court of Appeal denied ClientEarth's appeal permission primarily on procedural grounds, the case underscores the importance of ensuring that ESG promises are backed with well thought out execution plans.

Increased Regulatory Scrutiny Worldwide

Staying abreast of regulatory developments is crucial for businesses to effectively manage their ESG agenda. Global regulators are ramping up their efforts to enforce compliance with ESG standards.

In the United States, the Securities and Exchange Commission (“**SEC**”) has signalled its commitment to scrutinising ESG disclosures more closely, emphasising the importance of consistent and reliable reporting. For example, on 23 September 2023, the SEC acted against DWS Investment Management Americas Inc. ("**DWS**"), a registered investment adviser and subsidiary of Deutsche Bank AG, in two separate enforcement actions. The first enforcement action addressed DWS's failure to establish a mutual fund Anti-Money Laundering program, while the second action focused on misstatements regarding its ESG investment process. To resolve these charges, DWS agreed to pay a total of $25 million in penalties. The SEC has issued several other fines on non-compliant companies. Sanjay Wadhwa, Deputy Director of the SEC’s Division of Enforcement and head of its Climate and ESG Task Force has stated:

> Whether advertising how they incorporate ESG factors into investment recommendations or making any other representation that is material to investors, investment advisers must ensure that their actions conform to their words...

The European Union established the Sustainable Finance Disclosure Regulation ("**SFDR**") which is a transparency framework. It outlines the requirements for financial market participants to disclose information related to sustainability. The SFDR is designed to enable investors to evaluate the integration of sustainability risks in the decision-making process, aligning with the EU's overarching goal of attracting private funding to accelerate the transition to a net-zero economy. The European Commission is currently conducting an evaluation of the SFDR framework to encompass considerations such as legal certainty, usability, and the role of the SFDR in addressing issues like greenwashing.

We are witnessing a similar trend in Oceania. In 2022, Australia's financial watchdog, the Australian Securities and Investments Commission ("**ASIC**"), took its first action against corporate "greenwashing". ASX-listed company, Tlou Energy, paid fines totalling $53,280 after receiving four infringement notices for alleged false or misleading sustainability-related statements made to the market in October 2021. More recently, in January 2023, ASIC imposed fines on Black Mountain Energy ("**BME**"), another ASX-listed company. BME paid A$39,960 (US$27,592.2) to comply with three infringement notices related to deceptive sustainability claims made to the stock exchange between December 2021 and September 2022. ASIC was concerned that BME's statements about its "'*net zero carbon emissions*" gas development project had either no reasonable basis or they were factually incorrect.

Proactiveness

To mitigate legal risks associated with ESG commitments, companies must prioritise transparency and accurate reporting. Comprehensive and measurable goals, coupled with regular updates on progress, can help build trust with stakeholders.

To mitigate the risk of legal action, companies must take a proactive approach to ESG. This means not only setting meaningful ESG targets but also implementing strategies to achieve them and regularly reporting on progress. Robust ESG governance structures, data collection mechanisms, and third-party audits can help ensure the accuracy and transparency of

ESG disclosures. In an earlier article, I discussed how pre-emption can be a powerful tool to avoid disputes. Read it again here.

Conclusion

ESG has evolved from a buzzword in corporate boardrooms to a significant factor in legal proceedings and regulatory enforcement. Companies that overpromise and underdeliver expose themselves to unnecessary risks and protracted courtroom battles. Companies must prioritise ESG in a meaningful and transparent manner, aligning their actions with their words. ESG is not just a matter of corporate responsibility; it is also a matter of legal liability.

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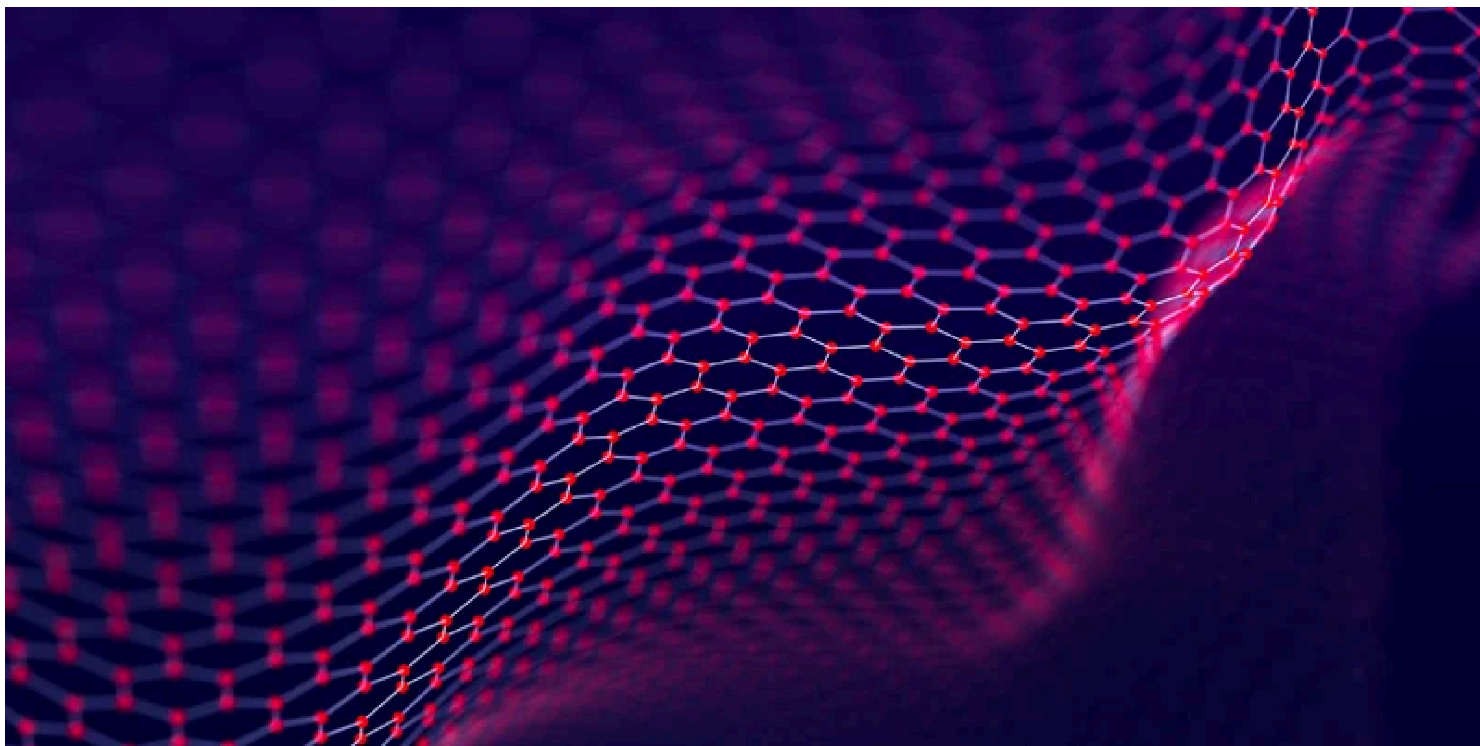
Authors: **Mark Pring, Catherine Lewis, Thomas Morgan**



Mark Pring, Catherine Lewis, and Tom Morgan break down the three pillars of ESG (environmental, social, and governance), and discuss current risks that policyholders are facing and how they should go about mitigating certain risks.

Transcript:

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Mark: Welcome back, everyone to our podcast series, Insured Success. My name is Mark Pring. I'm delighted to be joined by my insurance colleagues, Catherine Lewis and Tom Morgan to talk about some topical issues relating to ESG risks and how policyholders can try and mitigate such risks. I know you've both written quite a bit on ESG risks on our Policyholder Perspectives blog. Tom, starting with you and focusing first on the E in ESG what are some of the key risks facing Corporates at the moment?

Tom: Yeah, sure. So climate related litigation is the obvious one. So climate related disputes in the UK traditionally have focused on, you know, challenges to government decision making and policy through the judicial review mechanism. But I do think we're now seeing a change of approach focusing instead on corporate actors as, as the strategic target. I think this is in part because of increased transparency and disclosure requirements placed on corporate entities which produces more actual information and gives

claimants greater scope to target claims based on, you know, embedded international standards and settled climate knowledge.

Mark: Ok. And what types of claims are we talking about here?

Tom: Yeah, it's a pretty wide array really. Challenges are coming from investors, consumers, activists, regulators and also litigation funders are increasingly looking to back some of these claims. Strategic climate change claims like the recent client Earth action, for example, targeting off directive notably failed to get off the ground, but it's unlikely to be the end of these types of claims in the UK. This exposure is arguably higher since the UK became the first G20 country to put into practice the goals of the task force on climate-related financial disclosures by making it mandatory for the UK's largest companies and financial institutions to report on their climate change risks. Activist claimants in the UK therefore often supported by institutional investors potentially have greater ability than in other jurisdictions to hold corporates to account. They can closely scrutinize disclosed metrics and net zero transition plans with reference to the impacts on agreed international standards.

Mark: Thanks Tom. So this, this seems to be a sort of information paradox, if I can call it that. On the one hand, you have inadequate disclosure of information which may give rise to corporate liability. Yet, publication of the same data may provide a foot in the door for strategic litigation against those same corporates.

Tom: Yes, exactly. So this risk is obviously at its highest for high emitting corporates. However, prospective claimants could target any sector, particularly those directly or indirectly financing carbon intensive companies, but also a wider array of industries including for example, financial services, retail, agriculture, and transport. Many of these you know, companies in these industries will also have set 2030 reduction targets and obviously 2050 beyond that. So we could start to see the claims rack up uh in the near future.

Mark: Understood. So what about the more traditional types of claim those seeking loss and damage?

Tom: Yeah, there haven't really been many breakthroughs in the English Court yet. However, outside of the UK, there has been a growing trend of claims seeking compensatory damages, the indirect impacts of climate change. One claim I'm following particularly closely has been brought by a Peruvian farmer against RWE in Germany. He said for the cost of constructing flood protection measures in his village in Peru which he claims that emissions released by RWE in Germany contributed to. The case is ongoing. But importantly, a uh a German court of appeal has already found that in principle, a polluter can be liable for the impact of climate change.

Catherine: And we should also note that loss and damage were also again a headline issue at cop 28 with the agreement to support developing countries suffering the impacts of climate change. And I think the

acknowledgement that high emitters have a responsibility to compensate the damage caused to developing countries that are disproportionately impacted by climate change seems to align with this type of claim.

Mark: I completely agree. And um it's fair to say the English courts have always been a popular forum for international litigants assuming claimants can establish jurisdiction in the first instance. If the actions are successfully elsewhere, they may set a powerful incentive for more claims in the English courts.

Tom: Yes, completely agree. This may also be bolstered by the rapidly outstanding field of attribution science which by seeking to accurately measure the causative connection between climate change and individual environmental events will likely provide a further evidentiary basis for claimants against corporate actors. Furthermore, English courses are already dealing with complex group actions for loss and damage in relation to other environmental issues. And the overall trend is favorable towards complex actions involving questions of science attribution and quantum. So, you know, for example, last year, the court of appeal decided that the group action against BHP in relation to the Mariana dam collapse should continue despite its complexity and multijurisdictional nature. Surviving BHP's attempted strikeouts. You also have the vast Dieselgate claims going through the courts at the moment.

Mark: Yeah, I think we're we're all in agreement that class actions are likely to be a real growth area uh in terms of the types of claims that, that we're seeing in the near future around ESG. Insurers uh, will have to stay on top of, uh, what is a changing and, and growing risk profile for them. So, just shifting across and focusing now on the topical area of greenwashing, this is another risk area. If you like that we're starting to hear a lot about again with that wider access to company information and related disclosure requirements, as well as increased consumer pressure, companies appear to be at more risk than ever of greenwashing claims. Tom, did you have any thoughts?

Tom: Yeah, definitely. So, actions related to greenwashing in the UK typically require the claim to bring a claim for misrepresentation which requires reliance on misleading statements which can often be difficult to prove. However, increasing sustainability disclosure obligations for public companies as we've just discussed, offer an alternative route as claims for misstatement or publication of misleading disclosures can be brought against companies by investors.

Catherine: Absolutely right. I think it's also important to add here that whilst there have not been any notable greenwashing legal cases in the UK, regulators are wrapping up their focus on misleading and unsubstantiated claims made by companies about their environmental impact. So most recently, the CMA, the Competition and Markets Authority, has started an investigation into whether Unilever has overstated the sustainability of some of its products. And there will undoubtedly be more regulatory scrutiny of similar marketing endeavors by other companies who make climate related statements and advertisements. I'm sure you'll have seen adverts for certain international airlines have recently been banned for making misleading statements to consumers about those airlines environmental impact.

Mark: Absolutely, Catherine, we've all seen it. Just pausing here for a moment, we've been talking particularly about environmental risks and of course, this is an insurance podcast. So just for the moment, let's let's focus on uh the application of all of this to, to the insurance context. And obviously one means of mitigating the risk of direct corporate claims is through tailored insurance programs. But the sting in the tail is that the same growth in the risk of exposure to climate litigation has also resulted in increased demands for insurance coverage for such risks, then limited available capacity in terms of uh insurer appetite and also greater scrutiny from those insurers of placement and renewal of the risks. The result of all this being the further risk if you like of policy coverage disputes as and when uh a claim may arise. Catherine, do you, do you have any thoughts on this?

Catherine: Yeah. Um I completely agree with that and I think uh what we will see is that insurers will increasingly expect their insured to accurately disclose the risks that they face from climate change. And this seems to be particularly the case in light of climate litigation trends, which are expected to focus on the liability of Corporates to assess manage and disclose their vulnerability to a changing environment, changing economy and and changing customer expectations. And that is in addition to the traditional risk exposures.

Mark: I agree. And I think my personal view is that insurers are likely to focus on some key points. So first of all, the increased likelihood of insured claiming on liability policies as a consequence of claims relating to climate change. Secondly, management and governance claims in respect of climate change, where directors and officers could be held personally liable uh for failing to consider climate impacts in their decision making. And then finally, failure to properly measure and report company exposures to climate related risks as required by the TCFD that Tom mentioned earlier. For directors and officers, the new reporting obligations here in the UK and elsewhere could lead to personal accountability. So just moving on, we've talked about E, are we losing sight of uh the S and the G? Catherine, any thoughts on that?

Catherine: Absolutely right. So, whilst climate change and environmental issues are quite rightly very high on the agenda of all corporations as governments and individuals um take steps to mitigate the impact of climate change. I think it's really important that corporations don't lose sight of their obligations and consequent risks under what we call the social and governance elements of ESG.

Mark: Again, I completely agree. This is, this is obviously a rapidly developing area and insurers are gonna be under pressure to keep up with the range of judicial decisions and regulatory intervention in this context as well as the potential implications for coverage under their liability policies that they're writing. I think above all, we expect to see insurers probe policy holders at renewal in order to understand uh better uh their ESG related risks and liability policies, particularly directors. And officers liability policies even now we're seeing increased claims.

Catherine: I completely agree with that Mark. So shall we move on then to the, the S, social aspects? And this involves a corporation's interaction with its employees, customers and its stakeholders. And I think diversity and inclusion will continue to be a huge focus for various key stakeholders. In particular investors, customers

and employees, businesses are ever increasingly being held to account by stakeholders to do more than simply pay lip service to DEI policies or risk litigation, regulatory action and reputational damage. I think in the same way that greenwashing is considered a litigation and regulatory risk companies may also increasingly find themselves at risk of social washing claims if they mislead about the positive social impact they claim to have. And so, for example, I think multinational sports brands have more recently come under fire in the media for making public statements to combat racism whilst facing reports of allegations of racial discrimination by their own employees. And I think it's only there for a matter of time before we start seeing the first of these so called social washing uh legal actions to to follow.

Tom: Yeah, sure if I can jump in there as well, I think another key theme in merging in the social limit of ESG is health and safety and working conditions. One of the key pillars of ESG related policies is transparency and that's not just the transparency of the business itself but also how it operates on the international stage. A number of claims have reached the English Courts in recent years. The UK Supreme Court, for example, found that a parent company could over duty uh get in respect of operations carried out uh by an overseas subsidiary, particularly in I'm thinking of the Vedanta case. And as I mentioned earlier, the Mariana Dam case relates to BHP subsidiary company which is also being sued in Brazil.

Catherine: These are really interesting developments, Tom and I think these cases demonstrate that the English courts at least are potentially willing to acknowledge the responsibility of an apparent company towards its workers in countries where its subsidiaries operate.

Mark: Yeah, and while it's easier said than done risk in this area can be mitigated by having clear policies in place as well as fostering a culture of transparency in order to allow for incidents such as those to be investigated and and managed appropriately. Policyholders in that context should also seek be able to seek, I should say to demonstrate to insurers that they have appropriate oversight of uh not just their domestic operations but but overseas operations as well. So conscious of time. Should we then focus on the G and ESG, governance, and Catherine, do you have any initial thoughts?

Catherine: Yeah, thanks, Mark. So this aspect encompasses a business's ethical and legal management, how a company governs itself. And this is a very broad topic and it's developing in many, many areas. And currently, um I think there's a clear focus on transparency and this ties into points we've been discussing already that customers and shareholders are rightly holding businesses to account. So in terms of a business’s leadership, in mid-2022 the FCA issued policy statement 22/3, which introduced changes to the UK listing rules and imposed a new comply or explain obligation to seek to improve the diversity of the board and executive management of listed companies. Great news. A key concern for businesses as a result of these comply or explain requirements will be the extent to which claims under section 98 of this, the Financial Services and Markets Act follow alleging for example, misleading disclosures in things like the annual reports produced. So a lot to think about and I don't think it's likely to be the end of de and I policies implemented by UK regulators. I'm sure we can expect both the FCA and the PRA to continue to focus on the diversity of businesses listed in

the UK. And in addition to the makeup of a company's leadership, we are seeing increased scrutiny of supply change. It's no longer sufficient to ignore or profit from bad practices or illegal activity happening elsewhere around the globe. Um What do you think, Tom?

Tom: Yeah, I mean, I'd say that the key elements of this risk have actually existed for some time. So the modern slavery act requires companies to produce a slavery and human trafficking statement for each financial year. Assessing the modern slavery risk and supply chains in the business And looking at the bribery act, which also applies where an offensive an offense is committed overseas by a person connected with the UK. We have the EU's new deforestation regulation which came into force in June 2023 which requires companies to conduct extensive due diligence on their supply chains when dealing with certain products. I'm thinking, you know, cattle, cocoa, coffee, palm oil, soya, wood. So implementing robust policies, regular training and clear reporting lines will enable the risk to be monitored in incidents when they do arise to be managed appropriately.

Mark: That's all very practical and just thinking sweeping all of this up in terms of mitigating ESG associated risks. It's gonna appear daunting for many insured, but it is, I think possible to navigate the positive changes brought about by an increased ESG focus through implementing in particular as we've discussed already robust policies and procedures. Uh Insurers expect to be informed about a company's ESG awareness and related programs as well as the implementation of those programs and policies and indeed their monitoring. In particular I and others have noted that D&O underwriters have been eager to understand what disclosures and commitments insured have made to the public and whether there are any underlying claims relating to such disclosures. For example, whether the directors have made claims about the diversity of the company's board of directors or the company's climate change statistics. Catherine any, any sweep up thoughts here.

Catherine: Yeah, I have a few. And we've all been thinking about the steps that policyholder can be taking in this environment and I'll just run through a few that, that we've been talking about. So one of the things that um a policy holder can be doing is to implement clear sustainability and ESG frameworks that cut across all business stakeholders. So in this regard, they can also produce um environmental and social impact assessment and just as importantly as producing the original assessment, have processes in place to monitor and update any impact assessments so the risks remain relevant. A policyholder should also be starting to really ensure that controls and processes are in place internally to ensure early identification of specific threats facing the business. So specifically, for example, ensuring that the money laundering reporting officer, MLRO, and other reporting and compliance functions are connected to the areas of the business where risks might arise to ensure that there's prompt notification to the insurance and legal teams. In addition, it's helpful for all parts of the business to engage proactively with legal teams to stay abreast of rapidly changing legislative and regulatory frameworks. And we've discussed this in some detail already and it's no longer acceptable or even possible to turn a blind eye to what's happening overseas. It's also helpful for policyholders to start thinking about having dedicated ESG managers whose role it is to collect relevant data and monitor risk. Finally, from me, an organization should start putting into place clear plans for implementing targets, whether these are climate

based targets or DE&I based. And these plans should have concrete steps that can be demonstrated to insurers and regulators.

Tom: Great, thanks Catherine. And just one more point from me, policyholders should really engage with insurers and or their brokers early ahead of a policy renewal. They should when doing so expect questions in proposal forms and in discussions with the insurers about what steps are actually being taken to mitigate the risks associated with ESG.

Mark: Great points at the end there from both of you. Thank you and thank you everyone for listening to Insured success. We absolutely look forward to joining you again for another episode. Bye bye.

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ESG Ratings – the challenges of comparison and reliability

By Claude Brown & Olivia Grant on 4 July 2024

Read time: 3 minutes

Over the last few years, the consideration of Environmental, Social, and Governance (ESG) factors have grown in importance when it comes to investment decisions, with ESG ratings serving as a critical benchmark for investors seeking sustainable and ethically sound investment opportunities. However, the reliability of these ratings has come under scrutiny due to concerns around the accuracy of data used, and challenges in comparing ESG indexes compiled by different agencies. The absence of standardised reporting requirements and independent verification processes increases the financial risk for investors who make decisions based on such ratings.

Issues also arise regarding incomplete and inconsistent data used for ESG ratings. A 2023 poll by BNP Paribas of 420 investors, covering asset owners and managers, hedge funds and private equity firms, found that 71% viewed 'inconsistent and incomplete' data as the biggest barrier to ESG investing. The huge variation in data sources, methodologies, and criteria utilised by ESG rating agencies contributes increased scepticism around the usefulness of such ratings attributed to companies. This, in turn, poses challenges for investors seeking to compare ESG ratings reliably. Additionally, as the majority of companies reporting ESG metrics do so voluntarily, there are increasing concerns about the pressure to disclose only positive information. Over time this can lead to the

possibility of ‘greenwashing’, with investors at risk of making financial decisions based on misleading sustainability claims published by these companies.

There is a growing need for increased transparency around ESG data collection, regularised reporting systems, and third-party authentication of the evidence informing company ratings. There have been controversies that have demonstrated inconsistencies in rating criteria, as well as the risk of ESG rating agencies placing greater/lesser weight on particular elements of the ‘E’, ‘S’ and ‘G’, when deciding on ratings. This leads to not only to challenges in comparing scores, but also obscures the true rationales behind the ratings given, further inhibiting the ability to verify the data and information provided. The push towards legal standardisation would not only enhance the reliability of ESG ratings, but also establish a more solid and robust framework for comparability across companies and industries.

There is a responsibility on investors, at least from a legal standpoint, to exercise due diligence when interpreting ESG ratings. Understanding the often-complex methodologies used by different ESG rating agencies, authenticating data sources, and considering the legal context of a company’s operations are crucial steps in making well-informed and reliable investments. Seeking advice and input from experienced legal professionals is essential to making sensible financial decisions. It is also incumbent on the regulatory bodies involved in this area, such as the FCA in the UK, and ESMA in Europe, to set aside resource to help establish a solid legal framework that promotes accountability and transparency in the realm of ESG investing.

In conclusion, while ESG ratings play a vital role in the legal landscape of responsible investing, their reliability is currently marred by data inadequacies and a lack of comparability. To ensure that ESG ratings can be trusted, concerted efforts from a variety of stakeholders are required. Regulatory bodies must establish consistent frameworks and methodologies for ESG reporting; companies should be transparent and thorough in their evidence gathering and findings; and prospective investors must critically assess and seek second opinions on the ESG ratings they propose to rely on. Only through such collaborative efforts can the ESG landscape evolve into a trustworthy guide for responsible investing.

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How insurance can help manage global supply chain risk

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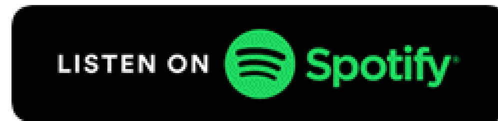
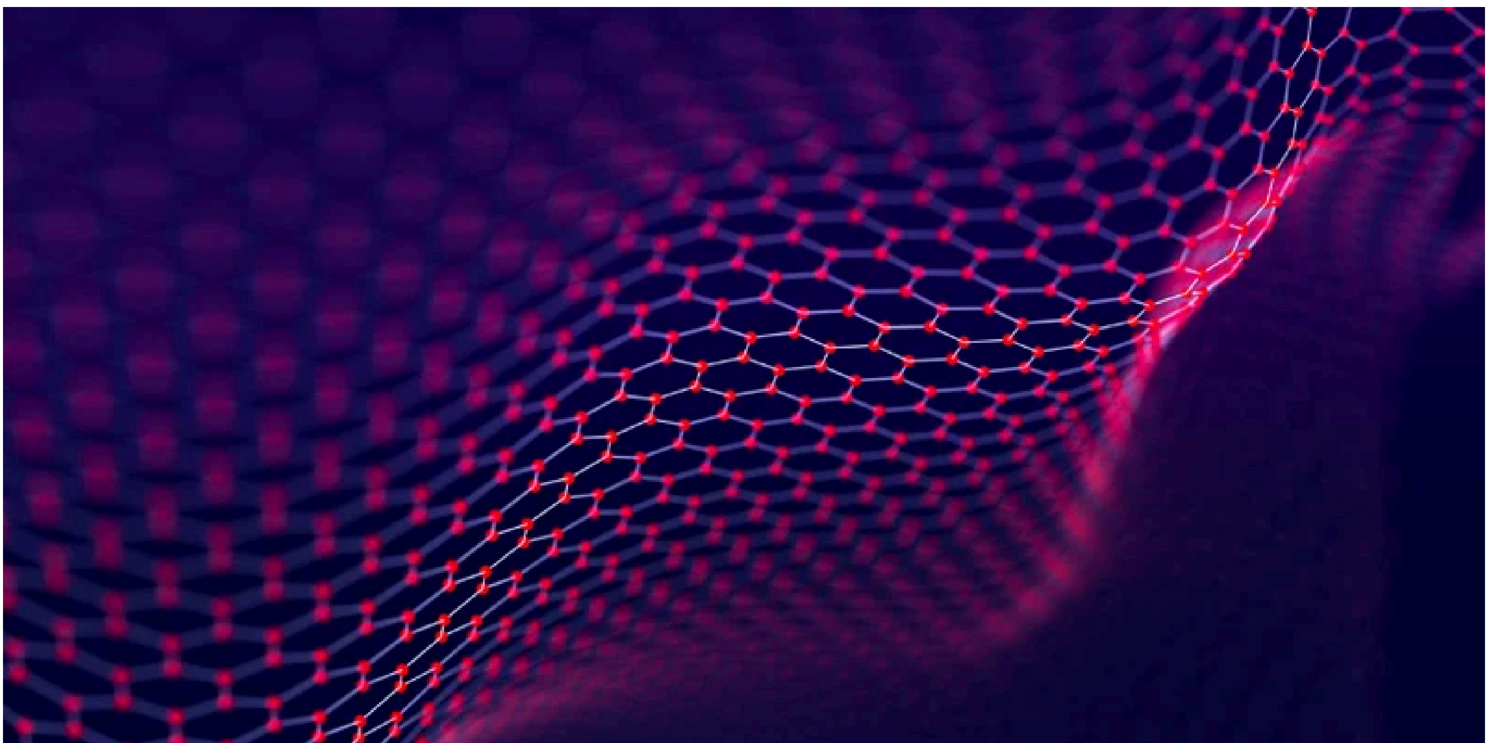


Authors: **Bert Wells, Cristina M. Shea, Adrienne N. Kitchen**



In this podcast, Bert Wells, Cristina Shea and Adrienne Kitchen of Reed Smith's Insurance Recovery Group delve into the critical topic of insurance coverage for supply chains, highlighting the significant risks and disruptions that can impact global logistics. This episode explores how events like political instability, cyberattacks and natural disasters can disrupt supply chains, and highlights the essential role insurance plays in mitigating these risks. The team shares real-world examples of supply chain disruptions and the insurance lessons learned from these cases, emphasizing the importance of understanding risks and ensuring adequate coverage.

Transcript:

Intro: Hello, and welcome to Insured Success, a podcast brought to you by Reed Smith's Insurance Recovery lawyers from around the globe. In this podcast series, we explore trends, issues, and topics of interest affecting commercial policyholders. If you have any questions about the topics discussed in this podcast, please contact our speakers at insuredsuccess@reedsmith.com. We'll be happy to assist.

Adrienne: Welcome to Insured Success. My name is Adrienne Kitchen. I am a senior associate in Reed Smith's Insurance Recovery Group. Joining me are Bert Wells, a partner from our New York office, and Cristina Shea, a partner in San Francisco. Today, we're talking coverage for supply chains. Supply chains are relationships between a seller or manufacturer of goods and the supplier of those goods or things like the materials incorporated into products, raw materials, component parts, things like that. Supply chains can be disrupted by numerous things, whether price changes, transportation or storage failures, labor shortages, political instability, man-made physical losses to plants like fires, storage facilities, stores or cyber attacks, all of which pose a significant risk to businesses. A disruption in any part of the chain can cause losses in other parts of the chain. Insurance has become central to managing risk in global supply chains and logistics, particularly as they grow increasingly complex and vulnerable to disruption. Some types of insurance that may help cover losses to supply chains are contingent business interruption, supply chain, and trade disruption or cyber insurance. Other coverage types may cover some potential gaps in these insurance types. Global supply chain risks also is a focus of national policy and security. Cristina, would you like to discuss some of those?

Cristina: Yeah, thank you, Adrienne. So focusing on the U.S. first, you know, going back about, I don't know, 12 years or so, the U.S. Department of Homeland Security really started to recognize and understand the importance of securing the global supply chain. And along with that was recognizing, you know, its vulnerabilities and how it was susceptible to external forces. So to ensure that the global supply chain continued to function smoothly, the Obama administration adopted a national strategy in 2012. And that was designed to bolster and support the efficiency, I guess, of the insecurity of the global supply chain and ensure that it was able to withstand evolving threats. And then, you know, during the pandemic, the strain on the global supply chain really, it was, you know, front and center. It was under a microscope. And following the pandemic, the Biden administration really greatly enhanced some of that implementation of that strategy. And they took that program and addressed some of the acute supply chain crisis that had arisen due to the

pandemic. And in the context of that, the Biden administration created a council on supply chain resilience and it implemented the use of the Defense Production Act that allowed U.S. Manufacturers to start creating essential medicines in the U.S. in order to mitigate some of the drug shortages. And all along throughout both the Obama and the Biden administration, the real focus has been on implementing security measures to shore up the supply chain and to protect its infrastructure. And then similarly, the European Union has been developing its own regulatory initiatives that have gone, you know, hand in glove with a lot of the U.S. initiatives as well.

Adrienne: Thank you, Cristina. Recent cyber attacks highlight the scale and vulnerabilities related to the supply chain concerns. So now let's discuss some recent examples that have hit the news. Bert, would you like to start off?

Bert: Yes, thanks, Adrienne. In fact, it's not limited to cyberattacks. In fact, disasters of various physical sorts are also very much a reason for supply chain interruptions that cause loss. And I want to speak for a moment about the tragic collapse of the Francis Scott Key Bridge in the port of Baltimore in March of this year, 2024. And as our listeners will no doubt remember, that not only shut down the bridge itself, but prevented entry and departure from the port of Baltimore by shipping traffic. So it had an obvious and an immediate and extreme impact on parties that were shipping materials into or outside the port of Baltimore, which is not only a major port on the East Coast of the United States, but as I understand it, probably the largest port in terms of handling automobile deliveries to the East Coast. So it's a very significant interruption in supply chains for those that were expecting some material to pass through the port itself or that for some reason needed to rely specifically on the Francis Scott Key Bridge, although there were other routes around the missing bridge for vehicular traffic. And in this connection, I'd like to mention two types of coverage that are often found in property insurance policies that could well relate to the Key Bridge collapse and cover losses that arose from it. I think the most obvious example is the so-called ingress / egress coverage that is found in many property policies, which is intended to protect a policyholder that can no longer enter or depart its premises. And it's triggered if there's a physical loss or damage to a property that is used to access the premises of the policyholder, preventing that access. So in the Port of Baltimore case, although this is a very obvious kind of coverage to apply, and it very directly applies, it would be a relatively limited number of policyholders that lost ingress and egress, let's say, specifically through the bridge or specifically through the port. That is, businesses that had properties actually in the port that could not get access to shipping or departing. Thinking, though, about the broader impact of the loss of the bridge on parties that transship materials through the port and don't necessarily have properties adjacent to the bridge or the port, there's another type of coverage that is found in many property insurance policies called contingent business interruption insurance. The purpose of contingent business interruption coverage is to protect the policyholder from losses that arise when there's a physical loss, that is to say, loss of or damage to physical property at the premises of someone else in the supply chain that gives rise to a loss. And an example here might be a party that was trying to ship automobiles to a dealership, let's say, through the Port of Baltimore, which could no longer gain access that way or had to wait months for access to additional inventory of automobiles. The idea of contingent business interruption is

that one of your suppliers has suffered a physical loss and therefore the type that's covered in the insurance policy and that there are ensuing losses to business income, for example. Well, an interesting facet of this is who exactly is the supplier of the services at the Port of Baltimore? And does that supplier constitute a supplier for purposes of insurance? This was a question that came up in a case by a caption, Archer-Daniels-Midland versus Phoenix Assurance several years ago, in which it was held that various authorities that managed the Mississippi River in that case were indeed suppliers for purposes of insurance. And here, we would expect that entities such as either the state of Maryland or the Port of Baltimore, which is one of its agencies, or the federal authority responsible also for keeping the port open, might be considered a service provider, therefore triggering contingent business interruption for this particular collapse of access through the port and across the bridge. Adrienne, did you want to talk about Colonial Pipeline?

Adrienne: Yes. Thank you, Bert. That was an interesting discussion and interesting issues that you might not expect. So the Colonial Pipeline attack in May 2021 was one of the first high-profile corporate cyber attacks that originated with a breached employee password as opposed to a direct attack on the company's systems. The Colonial Pipeline originates in Houston, and it carries gas and jet fuel to the southeastern U.S. and delivers about 45% of all fuel to the East Coast. In May 2021, a threat actor called DarkSide penetrated Colonial Pipeline's network security using a compromised VPN password. The threat actors stole some 100 gigabytes of data and infected Colonial's network with ransomware. In response, to contain the attack and due to fears the DarkSide might have information that would allow them to carry out further attacks on vulnerable parts of the pipeline, Colonial shut down its operations. That's a flow of more than 100 million gallons of fuel every day across thousands of miles of pipeline. It caused fuel shortages along the eastern seaboard, led to fuel prices hitting a seven-year high. The attack also led to emergency declarations by several states and the federal government and some various agencies. On May 9th, the Federal Motor Carrier Safety Administration issued a regional emergency declaration for 17 states and D.C. President Biden declared a state of emergency temporarily suspending the amount of petroleum products that could be transported by road and rail domestically. Ultimately, with FBI oversight, Colonial Pipeline did pay the ransom. It was some $4.4 million. DarkSide then provided a tool to restore the system, but it took quite a while to get everything back in working work. Six days after the initial attack, Colonial Pipeline was able to restart operations, and three days after that, operations had returned to normal. Although the DOJ recovered $2.3 million of the Bitcoin used to pay the ransom, Colonial Pipeline also suffered significant losses - investigation costs, loss of income from the multi-day shutdown, reputational damage, class actions alleging negligence and violations of consumer protection laws. One lesson learned from these attacks is the importance of various kinds of insurance, including cyber. Cristina, what are some other lessons learned from the trenches?

Cristina: So just using, you know, real world examples that we have handled here for our clients, we have a client that manages supply chains for restaurants around the world. And one of that that client's key business associates had a breach of their network systems and through that breach the threat actor was able to access our client's network system and caused a complete shutdown of its network and a shutdown of its supply chain throughout Europe and the U.S. So the client itself had a cyber policy and we filed a claim under that policy.

The problem here was that the losses were in the $13 to $14 million range, but the policy had a deductible of $15 million, meaning the client had to cover the first $15 million of its losses before coverage under the policy would kick in. So then we looked at some of the agreements between our client and its business associate or vendor. And through those agreements, the vendor was supposed to have added our client as an additional insured under its own policies. So effectively, that would have allowed the business associates policies to cover our client. But it turned out that the business associates insurer had canceled its policies the year before the incident. And the business associate either didn't realize that or realized it and didn't tell our client. But either way, our client was not able to recoup the benefits under those policies either. Long story short, our client had an interest in maintaining its business relationship with that vendor. So we ended up reaching a settlement with them, but it was a long protracted process. It really put a strain on the business relationship and it was a real distraction to both businesses. So, you know, I think that's a really good example of some lessons that we all learned from that. Number one being it's really important to understand, for every enterprise to understand where your risks lie, understand financially how much it's going to cost you if your systems are down for two days, two weeks, two months, and then determine whether your deductibles are set at the right place and whether additional policy limits are needed. You know, some companies make an intentional decision to set high deductibles and cover the first, whatever, $15 million, $20 million in the event of this type of breach. But, you know, that's fine if there's a certain logic to that for some businesses. But other businesses often buy policies straight from a broker without understanding the, you know, what the implications are and how it would look in effect if they were to have some sort of breach and disruption of their supply chain. And I think the other important lesson here to be learned is that if you are a business that has entered into these business associate agreements with vendors that require the vendor to insure you, those should be reviewed annually just to make sure that everybody still understands what is supposed to be provided under those agreements and that everything that was intended to be provided, like in this case, being an additional insured, is still intact and still effective.

Bert: That's a great point. And I would add that just, I'm sure you've seen this too, that in many business associate or counterparty relationships, you'll see requirement of notice if insurance is canceled, as well as a requirement that it be maintained. Although a breaching party in one respect might breach in another respect as well. So that's no guarantee that the insurance will remain in place.

Cristina: Yeah, you know, my recollection is, Bert, that they did have an obligation under this agreement to notify, but it wasn't entirely clear that anybody at the vendor knew that the insurance that was supposed to be provided to our client had actually been canceled. So again, it was a massive distraction and they'd wanted to maintain this business relationship. So we tried to get past it as quickly as possible.

Bert: Well, continuing with the theme of sort of lessons learned from client experiences, I'd like to briefly share the experience of a client that I won't name that is in the consumer products industry. It supplies retailers, its product is in constant demand, and it operates or leases warehouses across the country in order to be able to continually restock retailers with their requested orders. Well, this is a classic complex supply chain scenario

in which retailers are connected to the manufacturer through a distribution network passing through warehouses. And among the facets of that distribution system is something that seems very prosaic, a piece of software that tells warehouses what products to pick and what pallets to pack them on and what trucks to load them into and in what order. And my client was in the unfortunate position of having adopted an update to its picking and packing software, well having i should say having written it having designed it and having tested it extensively in what they call in the trade a sandbox to ensure that there were no glitches or bugs in that software so that it would operate properly when rolled out to numerous warehouses across the country. And lo and behold, the sandbox, I guess, wasn't big enough, didn't have enough sand. And when the software was rolled out, it froze. It offered nothing to the warehouses, no guidance at all. So warehouses across the country found themselves inundated with orders from retailers, but no capacity to fill them efficiently at all. And in some cases, just completely unable to fulfill the orders. This is a classic story of for want of a nail, the shoe was lost. For want of a shoe, the horse was lost. For this client, the consumer products manufacturer, this was an eight-figure loss, even though it took less than a week to get most of the warehouses up and running again. But fortunately, in its cyber insurance, it had selected an option, which many policyholders don't pick, in my experience, an option for a type of coverage called system failure coverage. And this is exactly the moment that system failure coverage is called for. There's no cyberattack here. There was no malicious intent. Instead, an accidental operation of the system. Indeed, an accident with the software that occurred after extensive testing, which was believed to be sufficient for the purpose, resulted in the freezing of a wide swath of operations and a big loss for the client. Anyway, as I say, fortunately, they had good coverage. They had this system failure feature in their cyber coverage. The deductibles and the waiting period, the time waiting period that also acts as a kind of deductible before such a loss can be collected, were actually rather small. So we were able to prepare a proof of loss and with a very significant demand for that client that was squarely within the scope of coverage. So the lesson learned is simply think about the options. These things cost additional money, but consider, too, the risk that you as a policyholder may face for the failure of a critical piece of software. And that additional premium you may ultimately decide is very worthwhile. Well, Adrienne, we spent a lot of time talking about examples so far. Why don't we get into some of the coverage types that are available for the many different ways that supply chain disruptions can manifest themselves? Would you like to tackle that?

Adrienne: Sure. Thank you, Bert. And thank you both. Those are great examples and demonstrate how complicated supply chain disruptions can be, the various ways insurance can be implicated, and the importance of managing risk sort of beforehand as well as after. So thank you both for those. Several policy types may provide coverage. Bert, you talked about contingent business interruption, CBI, a little bit before. You specifically mentioned that it covers suppliers, and I just wanted to add that it can also cover purchasers and properties that attract customers to the policyholder's business. There's also something called specialized broad supply chain insurance. And it is broader coverage than CBI for supply chain disruptions. Supply chain insurance is sometimes called trade disruption insurance. These are specialized named peril policies that generally cover the loss of net profits and costs caused by physical or political perils. They may also cover losses from risks such as natural disasters, industrial accidents, a bridge collapse, production issues,

employment and labor issues, infrastructure, riots, public health emergencies, a wide range of events. And cyber insurance is also a key insurance that may cover supply chains, particularly as the businesses in the supply chain rely on the internet, rely on software to make their supply chain work. Cyberattacks like denial of service attacks, extortion, and the resulting data loss can all affect the supply chain, more so because supply chains are increasingly reliant on computer systems for continuity of operations. Cyberattacks and other cyber disruptions, like the one you mentioned, Bert, can interfere with communication among those in the supply chain. So your manufacturers and your suppliers and your shippers and your warehouses, no one can talk to one another, so the supply chain shuts down in that way. Cyber insurance may cover a supply chain disruption caused by a computer virus, a malicious attack, or the resulting data loss. Third-party cyber insurance may provide some cover to businesses further down the supply chain if a cyber attack or system malfunction affects the supply chain and the policyholder is sued or has to indemnify a third party. Other coverages may help to fill some of the gaps in the more common ones that we've been discussing. Things like political risk and special contingency coverage. Political risk insurance is a specialized first party insurance that covers risks in politically risky parts of the world and may expressly insure against specified perils like nationalization of property, confiscation of assets, war, things like that. Cargo Marine covers the transportation of goods over the ocean or land, as well as any damage to the conveyance. Marine insurance may provide some indirect coverage for supply chain disruptions, things like coverage for equipment, merchandise, or goods that are in transit or being stored that may not reach their destinations on time or even at all. Port blockage, for policyholders whose supply chains depend on access to navigable waters, you may get time element coverage for a loss resulting from vessels being denied access to or egress from an insured facility or other property. They're the inability to deliver cargo from a vessel that does reach the facility if there's an issue with the cargo delivery. Civil authority and ingress / egress coverage. Bert, you mentioned ingress / egress a bit earlier. First-party property policies generally contain civil authority coverage, which covers business interruption losses and, in some cases, necessary extra expenses caused by the orders of local, state, or federal authorities, things like evacuation orders, curfews, and highway closures. There's also Directors and Officers coverage, which may protect board members, executives, directors, managers, and the companies they serve for claims and investigations of investors, third parties, and regulators. For instance, after a supply chain crisis, the officers and directors could be accused of failing to take proper measures to protect the business or third parties. Okay, so given how soon the U.S. election is now, we decided to play exit poll, in which our panelists will be asked a question that definitely has not been asked on any other poll, exit, or otherwise. Cristina and Bert, NASA launched Europa Clipper, its most expensive planetary probe ever, to explore an icy moon of Jupiter named Europa. Clipper's five-year journey will include gravitational ricochets around both Mars and Earth to slingshot it into the outer solar system, where it will eventually orbit Jupiter and repeatedly fly by Europa, but not land. NASA hopes the probe will detect chemical signatures of the contents of the water ocean under the moon's 10-mile-deep icy surface, giving clues as to whether some form of alien life may be present in that ocean. My question for you is, what type of supply chain insurance does NASA need now that this package is on its way to this distant icy moon?

Bert: Okay, well, I have some thoughts. I guess what occurs to me is that we have various suppliers here, and not just the suppliers NASA was counting on to get its probe ready in time, but I think Mars is a supplier here because Mars has to give a gravitational boost to the Clipper probe. And if Mars is a little late or a little early, that probe is not going to get exactly the gravitational boost it needs. That's the ultimate example of just-in-time supply chain strategy, if you ask me. Now, as to whether I would have insurance for that, I don't know. I think Mars' appearance is probably a pretty safe bet. If NASA's looking for insurance there, I think we should all be pretty worried.

Cristina: So I took a different approach. The way I saw this hypothetical was that if NASA is going to be navigating this ocean on the icy moon of Jupiter, then it should be looking to its marine insurer to cover the transportation and risks that are there under its supply chain.

Bert: Well, thank you. And thanks, Adrienne, for moderating this. This was everything I could have expected and hoped for.

Cristina: Yeah, thank you, Adrienne.

Adrienne: You are very welcome. And hopefully the listeners, if they have any questions, will reach out to us and they can see that we in IRG love insurance and we also have a good time in coverage disputes.

Cristina: Thanks, everyone.

Bert: Thank you.

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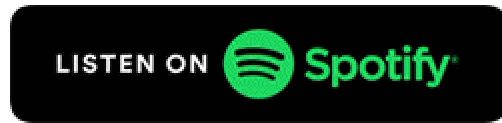
It's not easy being green: ESG claims and potential protecti…



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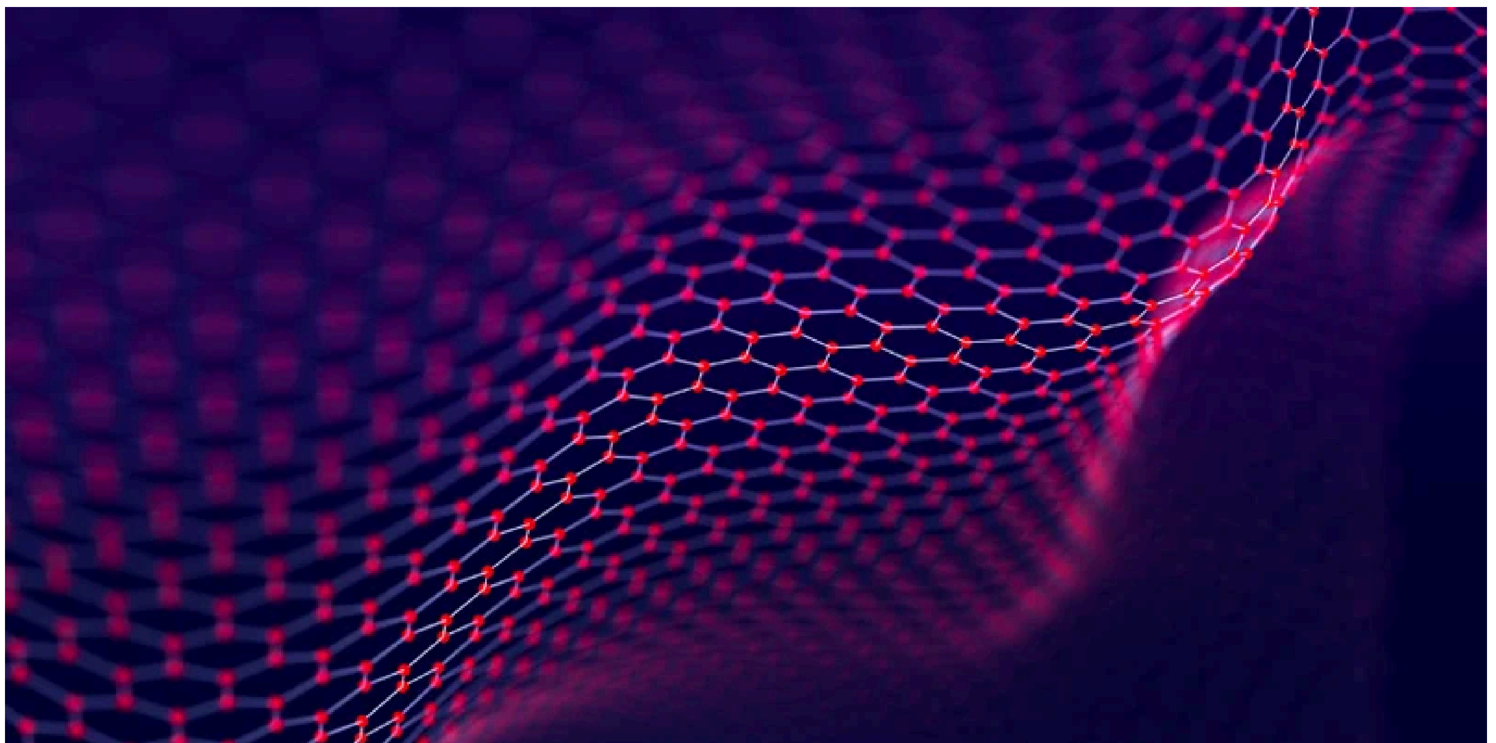

From “greenwashing” to “greenhushing,” from sustainability goals to boardroom debates, ESG exposures are fluid and formidable. Learn from Carolyn Rosenberg and Jennifer Smokelin how claims have morphed and how pro-active strategies, including insurance, can be implemented to lower the temperature.

Transcript:

Intro: Hello and welcome to Insured Success, a podcast brought to you by Reed Smith's insurance recovery lawyers from around the globe. In this podcast series, we explore trends, issues, and topics of interest affecting commercial policyholders. If you have any questions about the topics discussed in this podcast, please contact our speakers at insuredsuccess@reedsmith.com. We'll be happy to assist.

Carolyn: Hi, everybody, and welcome back to Insured Success, where today our topic is It's Not Easy Being Green, ESG Claims and Potential Protections. I'm Carolyn Rosenberg. I'm a partner in the Chicago office of Reed Smith in our insurance recovery group, where I work with policyholders in connection with insurance review, as well as handling insurance coverage disputes and all kinds of risk management and corporate governance. My partner, Jennifer Smokelin, who is a partner in Pittsburgh, is steeped in energy and ESG and related issues and is one of our leaders in our ESG initiative. We're delighted that she is here today to help inform us and discuss these important issues. We've certainly talked about all the acronyms, ESG, DEI. Most people are familiar with greenwashing claims and, of course, the newest claim of green hushing. So, Jennifer, to try to hallucinate this a little bit further, when companies are talking about ESG and green hushing, what is the landscape? What is green hushing?

Jennifer: Thanks, Carolyn. Companies are talking less these days about ESG in earning calls and marketing materials. But they are mentioning it nearly as frequently as ever in their financial reports and disclosures. The apparent disconnect here suggests that companies haven't fully shelved their sustainability-related goals. They're just talking about them less. There's a number of data points over the past year that indicate that investor interest in ESG has cooled down. Many companies in the last year have exited the Climate 100+, an initiative pushing companies to address environmental issues. However, many companies still recognize that investing in sustainability is important for long-term value creation. So they keep doing the initiatives related to sustainability, just not specifically labeling them as ESG. Companies have adjusted their terminology. As I said, they don't use ESG. They might refer to sustainability instead. We're even seeing some companies talking more in the language of clean air, clean water, and economic opportunity, effective and apparently palatable terms other than ESG. This trend, nicknamed green hushing, stems from a recent tide of ESG backlash and mounting legal considerations.

Carolyn: What are some of those mounting legal considerations?

Jennifer: In three words, Carolyn, litigation and regulation. From shareholder suits to regulatory actions to class action litigants that have lodged greenwashing claims against companies they accuse of releasing rose-tinted marketing materials. To those of you listening, we strongly recommend you talk to us or the lawyer you

regularly deal with at Reed Smith regarding how to address these litigation and regulatory risks. Let me highlight some examples of legal risks and quick upshot regarding specifics to talk to Reed Smith about. First, there is a risk regarding NGO suits. These are suits brought against public companies for allegedly misleading climate change with regard to ESG. The up shot here is that it's important to regularly act on any given ESG commitment in meaningful ways that are grounded in science, regardless of how many years away a particular deadline for an ESG goal might be. We also recommend publicly sharing clear updates on progress towards any ESG goal. From a regulatory risk standpoint, we are still seeing a risk with regard to SEC regulatory action. This despite the fact that the public company climate disclosure rules are currently stayed due to a pending litigation in the Eighth Circuit. For example, the SEC has recently brought enforcement action for allegedly inaccurate representations of recyclability. The upshot here is that recyclability, as interpreted by the SEC, is not simply a matter of the materials used. There must be a process in place to facilitate the act of recycling the item. It is important to be aware of and consider recycling practices wherever a company operates and sells to ensure statements with regard to recyclability are accurate. Another takeaway here is that the SEC is willing to go after fines and civil penalties for such representations. On the DEI side, California may require employers to report voluntary social compliance audits. If adopted, this bill, called AB3234. Would essentially mean that if an employer voluntarily conducts a social compliance audit, that employer must then publish a clear and conspicuous link on their website to a report detailing the findings related to compliance with child labor laws. The upshot here is that this bill is likely to be adopted. AB3234 has received broad bipartisan support, easily passing in both the State Assembly and the Senate at the end of August in California. Governor Newsom is expected to sign the bill soon. The final risk we want to highlight is shareholder suits. We have seen these both offensively, that is, brought by shareholders, and defensively, brought by the company, to fend off shareholder proposals with regard to ESG issues from going to vote at a company's annual meeting. The upshot here is that, ideally, there is a shared desire to better a company between both the shareholders and the leaders of the publicly traded entity. However, these legal battles illustrate that there is a tug between activist groups and company leadership that is rife with legal risk.

Carolyn: What about from a global perspective? I know we've been speaking about principally the U.S. I know there's much going on in the world. Can you tell us a little about that?

Jennifer: Carolyn, we see even more potential liability across the pond. As an example, in France, there is a criminal complaint linked to contributions to climate change filed against an energy company and its directors and officers in France, from which the upshot suggests that there is a possibility of criminal liability for major decision makers at companies. Another takeaway point from this case is using timing of shareholder suits to influence shareholder meeting outcome. This complaint was filed a few days before the energy company's annual shareholder meeting, which included a climate-focused shareholder proposal. The criminal complaint would likely influence the voting shareholders regarding that climate action. So speaking of corporate and corporate officer liability, Carolyn, how can insurance help?

Carolyn: The important thing about insurance is I think we start with the premise of looking at a director's and officer's liability insurance policy because that is typically where you would see coverage for an individual director officer's liability. And if you're a public company, D&O policies typically cover securities claims. So it depends if one of these suits led to stock drops or derivative shareholder lawsuits or claims against directors and officers in the company could very well be a house for that claim in a D&O policy. Private company D&O policies have broader coverage for the entity. And a key question to look at, which is what we do a lot of in reviewing insurance policies and negotiating for the most enhanced terms and conditions working with your in-house legal risk management and outside brokers, is that you want to also look and see whether there is potential coverage for investigations. For subpoenas, for regulatory actions against both individuals or if they're requested to provide documents, books, and records, as well as look in your policy to make sure there's no pollution exclusion. Although the claims against directors and officers are not for pollution, and therefore even if there were a pollution exclusion, it should not apply, it's best to look at your policies for any potential exclusions that could apply. Another important takeaway is that. When you are applying for insurance, typically you may be filling out a renewal application if you're renewing the insurance, but you may also be filling out longer questions and questionnaires if you're looking at insurance for the first time, or you may be looking at a broad panoply of options. And in looking at applications, you should be thinking about and being very careful about how you're answering. If there are questions asked about ESG initiatives, about DEI, about all kinds of what we would call under the rubric of environmental, social, and governance issues. That's because potentially insurance applications could be discoverable if considered part of the insurance policy. And, of course, insurers may be screening applications not just for underwriting but for purposes if there is a claim to determine whether or not there was any sort of alleged misrepresentation or omission in how the risk was presented to the insurer for purposes of the insurer turning around and using any sorts of exclusions or other terms and conditions against the policyholder. The important takeaway here is to have the insurance applications as well as the policies reviewed by knowledgeable coverage counsel. But D&O insurance is really the starting point. It's not the ending point. You could potentially have coverage for ESG-related claims under other policies, depending on how the claims are alleged and the causes of actions they're in. You could have environmental coverage claims. You could have coverage under general liability and business interruption. You could have employment-related claims and look under your employment practices liability policy. You could also potentially have coverage under a cyber or data tech and privacy policy, depending on, again, the tentacles, the allegations, the causes of actions that are alleged. The important takeaway here is to review your coverage before a claim, demand, or investigation or regulatory action occurs, and then if there is an issue, to take a look very carefully, work with knowledgeable counsel to determine when and how to report that claim, and then how to maximize coverage, not just for the defense costs of defending the action, but of course for any potential judgments or settlements. Those are some thoughts on how to access insurance in addition to good risk management reporting, regarding making sure your representations are careful and considered, as Jennifer was discussing. Jennifer, any last take away from your perspective?

Jennifer: Carolyn, I think you did an excellent job giving an overview of insurance, and we discussed green hushing and the mounting legal considerations with regard to ESG claims. So, no, I have nothing further.

Carolyn: Thank you. Well, thanks everybody for listening. Please reach out to us if you have any questions and we look forward to having you listen in on our next podcast. Thanks again.

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15 December 2023 | Reed Smith Newsletters

SEC Enforcement Newsletter: Q4 2023

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It's no secret that the U.S. Securities and Exchange Commission's (SEC or Commission) enforcement agenda is aggressive, with reports of record-breaking penalties and claims by some that the SEC is regulating by enforcement rather than providing regulated financial institutions with the clarity they need to comply with the agency's evolving standards. Navigating the regulatory landscape is complex, and it is critical for companies to understand the core areas of risk and keep up to date on key SEC enforcement trends and top priorities in order to remain compliant. In our quarterly newsletter, our cross-practice team provides short summaries of notable developments in securities enforcement and regulation.

Authors: **Daniel Z. Herbst, Hadas A. Jacobi, Ozra O. Ajizadeh, Justin W. Angotti, Caitlyn M. Holsopple**

Trends

1. Disclosures

The SEC's enforcement activity continues to highlight the agency's focus on accurate disclosures by public companies. In 2023, the SEC brought enforcement actions against public companies for disclosure deficiencies that resulted in a wide range of charges, including fraud, accounting misstatements, and deficient controls. Actions included charges against Fluor Corporation, a global construction company, for accounting errors that caused it to materially overstate its earnings; charges against Newell Brands Inc., a consumer products company, for misleading investors about its core sales growth; and charges against electric vehicle companies XL Fleet, Canoo Inc., Kandi Technologies Group, Inc., and Hyzon Motors, Inc. for making materially misleading statements regarding revenue projections, sales, or product launches.

Notably, in a November 2023 talk SEC chairperson Gary Gensler gave during DC FinTech Week, he described U.S. securities laws as having been painted by Congress with a "broad brush" in order to protect the investing public by ensuring that information material to investor decisions is made clear and available in public

disclosures. Such disclosures, Gensler stated, promote trust, which he described as foundational to the existence of capital markets, and facilitate equitable market participation.

2. ESG

Environmental, social and governance (ESG) issues continue to be an important focus for investors and the SEC. The SEC's approach to ESG enforcement has evolved in recent years. In March 2022, the SEC proposed amendments to existing rules requiring additional climate-related disclosures for publicly traded companies. That same month, the SEC released its 2022 exam priorities, in which ESG was listed as its second-highest priority.

Since then, enforcement actions on ESG issues have started to make headlines and reflect the Commission's desire to hold firms accountable for ESG-related statements that do not accurately reflect their investment process. On September 23, 2023, the SEC announced a $25 million settlement with one of the world's leading asset management companies for misstatements regarding ESG investments and greenwashing. On September 20, 2023, the Commission announced a new rule that amended the Investment Company Act "Names Rule" to include ESG and sustainable funds. The rule requires that ESG funds' investments must be in 80% alignment with the stated goals of the fund, a move that could be problematic for the viability of ESG funds.

More recent SEC actions have been more of a mixed bag. The SEC's October 2023 release of exam priorities for 2024 notably **omits** ESG where it had been front and center for 2022 and 2023. It is possible that the SEC's omission of ESG from 2024 audit priorities reflects the fact that the Commission is working to finalize ESG rules before focusing on enforcement. Indeed, Gensler recently noted that the new final rule on climate-related disclosure standards is not likely to be completed until 2024.

Notwithstanding the apparent easing off the gas pedal, ESG continues to be a highly-watched issue that remains front of mind for the Commission and certainly for investors. Public companies taking positions on ESG and funds with stated ESG strategies should remain diligent in vetting public statements and disclosure materials to avoid running afoul of the evolving body of ESG regulations and enforcement.

3. Continued focus on individual accountability

The SEC continues to reiterate that "[i]ndividual accountability remains a pillar of [its] enforcement program." The SEC's fiscal year 2023 enforcement results highlight the agency's focus on holding individuals accountable. Consistent with prior years, approximately two-thirds of the SEC's enforcement actions in FY 23 involved charges against individuals. The SEC also barred 133 individuals from serving as officers or directors of public companies – a high water mark for the past decade.

These statistics are consistent with staff comments as well. In July 2023, Paul Munter, the SEC's chief accountant, released a statement reminding accounting firms and individual accountants of their independent

obligations when auditing crypto firms and putting them on notice of heightened enforcement in this area.

A string of recent, high-profile enforcement actions, including SolarWinds, Binance, FTX, and McDonald's, further highlight the SEC's ongoing focus on individual liability. In addition to the SolarWinds and Binance cases discussed below, the SEC also continues to target both high- and low-profile individuals, often in coordination with a corporate resolution. Earlier this year, for example, the former McDonald's CEO agreed to a $400,000 civil penalty and five-year officer or director bar to resolve allegations that he violated the anti-fraud provisions of the Securities Act of 1933 and Securities Exchange Act of 1934. McDonald's terminated the former CEO without cause after he engaged in a personal relationship with another employee in violation of company policy. The SEC found that the former CEO failed to disclose similar misconduct to the company, which would have impacted McDonald's disclosure to investors about his termination and compensation.

While several of these matters involved chief executive officers, the SEC also continues to target other executives, including chief financial officers and chief information officers. Thus, it is critical that individual executives and auditors remain independent and on alert for continued enforcement initiatives.

4. Cryptocurrency ETFs

On October 19, 2023, the first U.S. Bitcoin futures-based exchange-traded fund (ETF) began trading, leading to a surge in the value of Bitcoin, which is the world's largest cryptocurrency by market capitalization. The surge reflected the widely-held view in the digital assets space that cryptocurrency ETFs could provide a vehicle to boost investment in digital assets by facilitating everyday investors' access to this complex area by allowing them to invest in such assets through a regular brokerage account or pension fund, rather than requiring them to buy and store the digital assets independently.

To date, the SEC has given the green light to ETFs that own futures contracts tied to the price of Bitcoin, but it has so far denied applications for spot cryptocurrency ETFs, which would directly purchase and hold cryptocurrency. Nevertheless, many in the industry remain hopeful that SEC approval of spot crypto ETFs is rapidly approaching. On December 4, 2023, leading asset management firm filed an amended S-1 filing with the SEC for its proposed spot Bitcoin ETF, as did Bitwise, a digital asset service provider, which could indicate the SEC's engagement in moving the applications forward.

Key cases

1. SolarWinds

On October 30, 2023, the SEC charged the Austin, Texas-based software company SolarWinds and its chief information security officer (CISO) with fraud and internal control failures relating to the company's handling of allegedly known cybersecurity risks and vulnerabilities. The SEC's complaint, filed in the Southern District of New York, alleges that SolarWinds and its CISO violated the antifraud provisions of the Securities Act of

1933 and of the Securities Exchange Act of 1934; SolarWinds violated reporting and internal controls provisions of the Securities Exchange Act; and its CISO aided and abetted the company's violations. The SEC seeks permanent injunctive relief for these violations, disgorgement with prejudgment interest, the imposition of civil penalties, and an officer and director bar against the company's CISO.

Specifically, the SEC alleges that, from at least its October 2018 initial public offering through at least its December 2020 announcement that it was the target of a broad-reaching cyberattack spanning nearly two years, SolarWinds and its CISO defrauded investors by overstating SolarWinds' cybersecurity practices while purposefully understating or failing to disclose ongoing risks to investors in its filings with the SEC during this period by disclosing only "generic and hypothetical" risks, when in fact the company was aware of its cybersecurity exposure, but ignored repeated red flags about its cyber risks due to internal control failures and/or actively concealed an ongoing, live cyberbreach.

The SEC's complaint further alleges that the CISO was fully aware of SolarWinds' cybersecurity risks and vulnerabilities but failed to address or sufficiently escalate these issues. The company partially informed the SEC of the ongoing attack, dubbed "SUNBURST," in an incomplete disclosure (Form 8-K filing) filed on December 14, 2020. By its failures to disclose the company's cyber control deficiencies, SolarWinds and its CISO withheld accurate material information from its investors, according to the SEC.

The action reinforces the SEC's focus on individual liability, adequate investor disclosure, timely regulatory notice, and the provision of full and complete information in regulatory filings.

2. Binance

On November 21, 2023, in the Western District of Washington, Binance Holdings Ltd. (Binance), the world's largest cryptocurrency exchange, and its founder and CEO, Changpeng Zhao, pleaded guilty to violations of the Bank Secrecy Act (BSA) and several other felony criminal violations. As part of the settlement, one of the largest corporate resolutions ever, Binance agreed to forfeit $2.5 billion and to pay a criminal fine of $1.8 billion, for a total monetary penalty of over $4.3 billion payable to the U.S. Department of Justice (DOJ). Zhao waived indictment and pled guilty to failing to maintain an effective anti-money laundering (AML) program in violation of the BSA, agreed to pay a $50 million fine, and stepped down from his role as Binance's CEO. Zhao faces a prison sentence of up to 18 months. As part of its plea agreement, Binance has agreed to retain an independent compliance monitor for three years and to enhance its AML and sanctions compliance programs.

Binance and Zhao have also separately reached agreements with the U.S. Commodity Futures Trading Commission, the Financial Crimes Enforcement Network, and the Office of Foreign Asset Control. The DOJ will credit approximately $1.8 billion toward those resolutions. Notably absent from the settlement with Binance and Zhao was the SEC, which filed a 13-claim suit in June 2023 alleging that Zhao and Binance operated an illegal securities exchange.

The SEC's charges against Zhao and Binance bolstered the claims in a newly filed proposed class action suit against soccer player Cristiano Ronaldo. The lawsuit, filed on November 28, 2023, in the Southern District of Florida, alleges that Ronaldo's promotion of Binance on social media and through traditional advertising violated anti-fraud provisions of federal securities laws and that Ronaldo participated in an unregistered offer and sale of securities.

3. Former FTX CEO Samuel Bankman-Fried

In December 2022, the DOJ charged former FTX CEO Samuel Bankman-Fried with conspiracy to commit wire fraud, actual wire fraud, conspiracy to commit commodities fraud, conspiracy to commit securities fraud, and conspiracy to commit money laundering. The DOJ claimed that Bankman-Fried funneled billions of dollars of customer funds deposited with FTX, Bankman-Fried's crypto exchange, to Alameda Research – Bankman-Fried's privately held crypto hedge fund. The DOJ alleged that Bankman-Fried used the money for investments, political donations, and lavish personal purchases. FTX collapsed in November 2022, leaving more than 1 million customers unable to access their deposits.

Bankman-Fried's trial commenced in October 2023. During the trial, three former FTX and Alameda executives took the stand and testified that Bankman-Fried directed them to move funds from FTX to Alameda. Bankman-Fried testified that he believed in good faith that FTX could loan funds to Alameda. He further tried to convince the jury that his lack of experience caused FTX's collapse, not any fraudulent activity.

On November 2, 2023, after a nearly three-week trial and deliberating for just four hours, a jury in the Southern District of New York found Bankman-Fried guilty on all seven counts he faced. Bankman-Fried is set to be sentenced on March 28, 2024 and faces the possibility of decades in prison.

The FTX/Bankman-Fried saga highlights the need for digital asset investors to take a hard look at the entities through which they choose to invest in, transact in, or store digital assets. Important questions to ask are how customer funds are held, what steps the entity has taken to combat and prevent fraud and other financial misconduct, and what the entity's approach is to regulatory compliance.

4. Pending challenge to the SEC's civil enforcement authority

On November 29, 2023, the Supreme Court heard arguments in *SEC v. Jarkesy*, a case challenging the SEC's enforcement powers. Although the case presents three administrative law questions, the Court focused almost exclusively on the Fifth Circuit's conclusion – defended by Jarkesy – that the SEC's in-house administrative enforcement proceedings seeking civil penalties violate the Seventh Amendment. The Court's decision later this term could significantly impact the SEC's enforcement program.

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Super-cycle election year and political risk insurance

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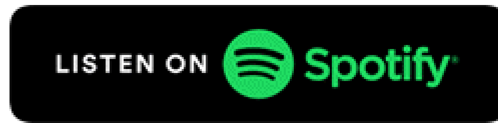
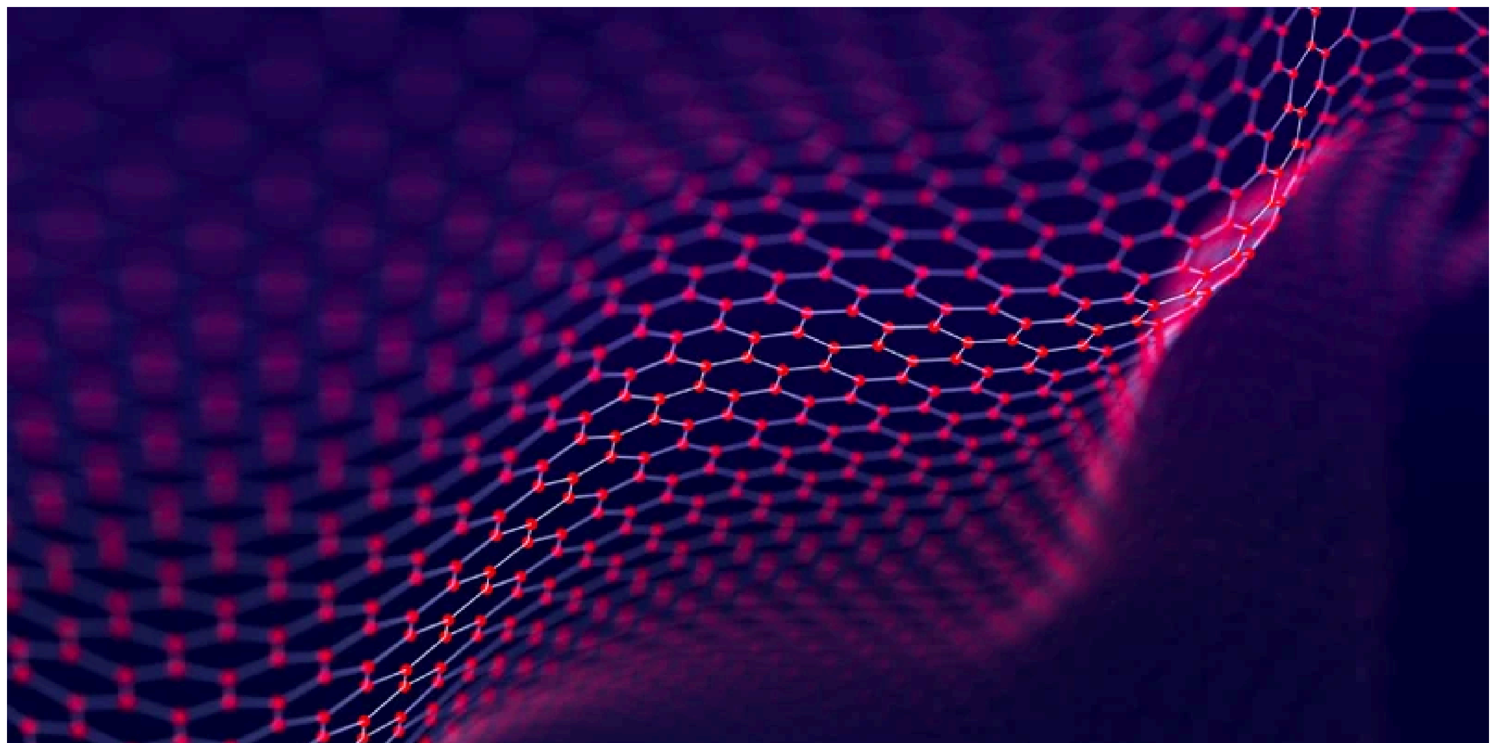


Authors: **Laura-May Scott, Emily McMahan, Katherine J. Ellena**



In 2024, the citizens of more than 60 countries have gone or will be going to the polls to exercise their electoral rights, leading some to dub this year the "super-cycle" election year. The political change that some of these elections will bring could also bring political risk, but political risk insurance can mitigate some of those risks. In this podcast, Laura-May Scott, Emily McMahan and Katherine Ellena discuss what this insurance is designed to cover, how it could be triggered during this year's elections and some practical considerations for evaluating a company's risk profile and insurance suites in respect of political risk.

Transcript:

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Emily: Hello, listeners, and welcome to the Insurance Success Podcast. My name is Emily McMahan, and I am an associate in the Global Commercial Disputes Group at Reed Smith in London.

Laura-May: And I'm Laura-May Scott, a partner in the Disputes Group at Reed Smith in London.

Katherine: And lastly, I'm Kat Ellena, an associate in the Insurance Recovery Group in Los Angeles. Today, we're going to talk about a key insurance in a business's armory, political risk insurance. We will also be considering this type of insurance in the context of elections. Emily: So this year, over 60 country citizens have gone to or are going to the polls to exercise their electoral rights, dubbing 2024 the super cycle election year. As we know, political change brings about uncertainty and therefore increased risk for organizations operating from or doing business in those affected countries. This is where political risk insurance can step in to mitigate some of these risks experienced by organizations that are associated with political change.

Laura-May: Exactly that. And for those experienced in insurance and risk management, political risk insurance isn't just a peripheral concern. It's a critical tool in strategic planning and operational continuity. This insurance serves as a crucial tool for mitigating uncertainties that arise from political shifts, which we often see are magnified during elections or political unrest.

Katherine: So with that backdrop in mind, in the next 10 minutes or so, we will explore three things. First, what political risk insurance is designed to cover. Second, how this coverage could be triggered in light of this year's super cycle of elections throughout the world. And lastly, some practical considerations for risk managers and company executives alike when evaluating their company's risk profiles and insurance programs in respect of political risk coverage.

Emily: Great. So let's start with setting out what exactly political risk insurance is. Political risk insurance is designed to cover a policyholder's financial losses and operational disruptions arising from political events,

such as government changes, policy shifts, civil unrest, and geopolitical tensions.

Katherine: That's right, Emily. and political risk insurance specifically provides coverage for risks like expropriation, political violence, currency and convertibility, and government contract breaches. During election periods in particular, these risks can become pronounced, which requires a proactive approach to risk management.

Laura-May: Yes, and in an election context, the risk faced by companies is twofold. So we have immediate market reactions, where there's riots and civil unrest, which results in business interruption. And you also have long-term policy implications as a result of government policy changes, which can cause more permanent implications for businesses. So let's look at how coverage can be triggered by elections. So elections inherently introduce a level of volatility that can disrupt business operations and financial stability. For instance, the anticipation of regulatory changes or shifts in foreign policy can lead to market volatility, which can ultimately then impact investment decisions and corporate strategies.

Katherine: Right. And as you can see, there are many types of political risks that can be addressed through political risk insurance. For many businesses, the most relevant types of coverage that could be called upon as a result of losses experienced due to election fallout would be business interruption, expropriation, or political violence coverage. However, organizations based in or with assets in traditionally less stable regions may also require political risk coverage for losses experienced due to, for example, forced abandonment of assets or forced divestiture from an affected location.

Emily: So, turning to ex-appropriation, this type of cover caters to losses experienced due to government acts which interfere with fundamental ownership rights of the insurance investment in the relevant region, which include but are not limited to confiscation and nationalization. This can occur when the new government enacts policies or takes actions to confiscate assets of the insured or chooses to nationalize an industry previously run by privately owned businesses which the insured participates in. This cover can also address the ex-appropriation of an insured's funds by a new government which are held in a deposit account in the affected country. This type of cover can also be triggered if the new government imposes laws or restrictions that selectively and discriminately apply to a company or category of companies, which includes the insured. And political violence insurance provides cover for the insured's losses due to physical damage to investments and assets, usually located in a particular area, and where those losses have been caused by political violence, such as war, revolution, terrorism, insurrection, riots, strikes, sabotage. Such causes can emanate from an election or be in direct response to an election result.

Katherine: So while ex-appropriation and political violence coverage may be triggered as a result of events following the election of a new government, the most likely type of political risk coverage that would become relevant in relation to an election cycle is business interruption insurance. Business interruption insurance provides coverage for financial losses experienced by the insured, which are caused by the insured's business operations having been interrupted by the covered political risk. So, for example, political tension surrounding

an election could lead to rioting, looting, arson, and other violent acts that could force an insured's business to close or potentially lose revenue or suffer property damage.

Emily: So, we will now discuss some examples to highlight why political risk insurance is an important consideration in light of this super-cycle election year.

Katherine: That's right, Emily. So even in stable democracies, the election of new governments can produce losses for uninsured. Consider the 2016 United States presidential election and the election of Donald Trump. His tenure in office brought significant policy change, particularly in trade and foreign relations. Both U.S. and international businesses involved in global trade practices face new tariffs and regulatory hurdles. And these changes force companies to re-evaluate their risk management frameworks and in many cases increase their reliance on political risk insurance. In fact, there are legitimate concerns that should President Trump be re-elected this November, the U.S. could withdraw from international organizations like NATO, which would have widespread geopolitical consequences. There are also concerns regarding rioting and other public disturbances related to the U.S. Election this November. According to the U.S. Attorney's Office, the riots after the 2020 U.S. elections alone caused approximately $3 billion worth of damage. And the unpredictability of the upcoming U.S. Election this November emphasizes the necessity of robust risk management strategies.

Laura-May: And political upheaval due to elections is not limited to the U.S. For example, according to the French government, the anti-government yellow vest movement in France in 2018 caused over 200 million US dollars worth of damages. Kenya also experienced significant rioting and violence following its general elections, most notably after the 2017 presidential election. That election, which took place in August 2017, resulted in widespread unrest due to allegations of vote rigging and irregularities. The results were in fact later annulled, which led to further tensions and violence. And the exact quantification of the total loss varies, but the financial impact of the 2017 post-election violence in Kenya was extensive, and it affected multiple sectors, and it slowed down the country's economic growth.

Emily: So, as we have discussed, not only can elections result in short-term reactions, such as political violence or rioting, but can in turn result in longer-term shifts in government policy and regulation. Political risk insurance can help provide a buffer against the unpredictability of a new government's priorities following an election, which is why it is integral for companies to assess their exposure in this super cycle year and assess whether their current insurance suite is sufficient.

Katherine: So now that we understand both what political risk insurance can cover and the potential impact elections can have on a business that could trigger losses which may need to be met by this type of insurance, let's discuss what companies can practically do to ensure they're catering to the risk posed by a super-cycle year.

Laura-May: Companies should adopt a practical approach to managing political risk insurance during election cycles by undertaking comprehensive risk assessments. And this can be done internally at the business

or through the engagement of external political analysts and risk consultancy firms who develop scenario-based evaluations, providing a spectrum of potential outcomes and their implications for the insured.

Emily: And once a comprehensive view is established of your company's risk exposure to political risks, companies will also need to ensure that those risks are met, either through strategic business changes or mitigation measures such as insurance. Laura-May Scott: Yes, and tailoring a company's insurance policies to align with the specific risk exposure identified and the geopolitical landscape of a business is crucial. It's something that we always come back to when we're talking about insurance. Cover needs to be tailored to a business's risks. Insureds must adopt a multifaceted approach to risk management. And this involves not only securing appropriate political risk insurance, but also doing other things like diversifying investments, staying abreast of political developments, and continuously refining risk assessments based on emerging data and trends.

Katherine: And given that one of the most common types of losses a business may face due to an election is business interruption, companies should specifically review their business interruption policies to ensure that it would respond to the risks identified by each individual business.

Emily: So on that topic of business interruption, when you review your company's current business interruption insurance, we recommend that you consider the following questions. First, does access to the business's premises have to be entirely prevented, or is it sufficient that access is merely hindered to trigger cover? Second, are there any geographical limitations to cover that could limit the cover available? On that note, we recommend reviewing definitions such as vicinity or similar types of geographical terms. Third, are there any monetary thresholds, monetary deductibles, or time deductibles for accessing this cover? In other words, is there a period of time or an amount of loss that is for the insurer to account for before insurance kicks in? Fourth, what is the definition of damage and is it wide enough to cover possible losses? And lastly, consider definitions like the definition of civil unrest or other relevant terms that operate within the specific political risk cover. The political landscape is constantly changing, and with the increasing prevalence of disinformation and social media, there is a risk that losses experienced by a business due to an election may not fit neatly into some of the legacy language in a political risk policy. We recommend that businesses think creatively about what types of events emanating out of an election could give rise to losses to ensure they are appropriately covered. With that said, elections also present opportunities. A sophisticated risk management strategy encompassing diversification and comprehensive insurance coverage presents an opportunity for businesses to grow and prosper.

Laura-May: Exactly that, Emily. Use the political landscape change to ensure that your business is appropriately covered from an insurance perspective. So in summary, political risk insurance is an integral component of strategic planning for businesses and investors, particularly during election periods. The volatility and uncertainty elections bring can significantly impact various sectors, and being equipped with robust risk management strategies is critical.

Katherine: So what are some key takeaways for companies in this super cycle election year that can help ensure potential risks are identified and also mitigated? First, it's crucial to continue to stay informed on political developments, polling data, and potential policy changes in the regions affecting your business. Second, businesses should regularly evaluate the relevant political landscape and its potential impact on business operations. Thirdly, businesses should also ensure that they're diversified, and they can do that by spreading their investments and operations across different regions to mitigate localized potential risks. Finally, it's imperative that companies review their insurance programs, specifically their political risk coverages, to protect against significant uncertainties. We also recommend that companies speak to their insurance brokers who are well placed to ensure that any identified political risks are properly mitigated through the right insurance policies. But in addition to speaking to insurance brokers, businesses can also consider engaging other external experts, such as political analysts and risk assessment firms that can help develop an even more robust risk management strategy.

Emily: Great. Thank you, Kat. And thank you, Laura-May. And thank you, listeners, for turning into this podcast. If you enjoyed this episode, please subscribe, rate, and review us on your favorite podcast platform and share your thoughts and feedback with us on our social media channels.

Laura-May: Yes, indeed. That's all for now. Bye, everyone.

Katherine: Thanks, everyone.

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26 September 2024 | Disputes in Perspective

The evolving landscape of global ESG litigation and regulation

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Disputes in Perspective

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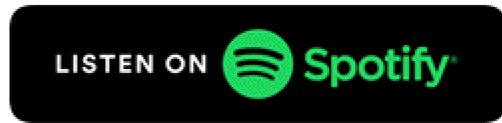

Authors: **Tom Webley, Mark S. Goldstein, Mark Pring**

In the U.S. and UK, issues relating to ESG risks are expanding and evolving rapidly and continually for commercial entities. Organizations have a part to play in promoting good ESG conduct, but this comes with the responsibility of managing potential liability and litigation. In this podcast, Tom Webley, partner in our Global Commercial Disputes Group in London, Mark Goldstein, partner in our Labor and Employment Group in New York, and Mark Pring, partner in our Insurance Recovery Group in London, discuss topical issues relating to ESG risks and steps directors can take to mitigate these risks in both the UK and U.S.

Transcript:

Intro: Welcome to Disputes and Perspective, a Reed Smith podcast. This podcast series will discuss disputes related trends, hot topics and developments occurring in the global legal landscape, and hopefully provide you with some helpful insights and practical tips. If you have any questions about any of the episodes, please feel free to contact our speakers.

Mark P: Welcome back, everyone, to Disputes in Perspective. My name is Mark Pring and I'm a partner in our global commercial disputes and insurance recovery teams. I'm delighted to be joined by my partners and colleagues, Mark Goldstein, a labor and employment lawyer in our New York office, and Tom Webley, a commercial disputes and regulatory lawyer in our London office with extensive experience, particularly in the financial services sector. In this short podcast, we'll be addressing some topical issues relating to disputes arising out of ESG risks. We think it's fair to say that people have long been aware of the risk of litigation in the ESG context, but we're starting to sense that the litigation landscape and indeed the regulatory landscape is changing in a number of jurisdictions, including the UK and the US in relation to litigation. The focus of attention previously was on class action claims against the likes of polluters and governments directly responsible for environmental damage or impacts on communities, but now there are myriad other risk exposures. Tom, if we can start with you. Do you get the sense that the UK risk landscape is changing?

Tom: I do. Mark, I mean, I think it's not just changing, but it's fair to say that in relation to ESG risks and litigation risks, it's probably expanding and expanding quite rapidly and continually. You mentioned that a lot of the previous claims were against what we probably could look at as primary infringes. So for example, anyone who's directly responsible for any pollution or emissions or environmental harm. But that certainly isn't what we are seeing claims limited to now and probably increasingly so, ESG and particularly the E. So if we think about climate change, this is seen as something for which all commercial entities have some sort of responsibility to drive change for the good, to improve their own conduct in their own performance in that sphere. And I think the net result of that is likely to be an increased amount of claims against a much wider range of potential defendants, almost to the point where actually any single commercial entity could be in the firing line. And if we take an example of how this has manifested in practice, you could look at the action that's been taken by organizations like ClientEarth. You may well be aware a lot of people will. That client brought a claim against directors of Shell. Again, that's much more focused on the more primary infringer type claims, but they've also been writing to wider organizations like trustees of pension funds, reminding those

trustees that people investing money also have an obligation to the wider community to ensure that the investments drive change in a positive way. So that's an example of the expansion away from the original target for those claims into something completely different. And it's likely not just to be pension funds and the asset managers and people with large amounts of money to invest banks and lenders have really been put on a pedestal as an industry, which is at the forefront of change, forefront of promoting good practice and ensuring that all organizations are moving in the right direction. And with that responsibility comes potential liability as well. So I mean, I think the scope really has expanded dramatically from only those directly involved in certain industries, certain sort of higher risk industries being the potential targets to actually it being much broader. And I think it's almost fair to say, Mark, that it's difficult to imagine any sort of commercial entity or organization these days that doesn't have a part to play in promoting good ESG conduct and therefore takes on some responsibility and potentially some sort of liability for doing so.

Mark P: Yeah, yeah, no, I agree. Can we explore a little bit further what might actually be driving a lot of those claims? Maybe not all of them, but from a sort of social context, what do you see in terms of underlying currents that might be driving a lot of those claims?

Tom: I think in its most basic market, a lot of them are driven by genuine passion and desire and a really strong sense of feeling. I mean, if you look at compared to Mark Goldstein compared to the US where class actions are very well established practice, we have only had a few class actions group litigations strike claims being brought over here by comparison, but a lot of them are financially driven, whereas the sense that I think we're getting particularly again going back to the environmental side of the ESG claims is that people feel very, very strongly about this. I mean, all you have to do is look at some of the other activities that people do, the activist activities such as people who are going out of their way to take physical steps to stop certain types of what they see as harmful activities and risking prison sentences increasingly in the UK as well, that people do feel strongly about this and they feel that litigation is a very powerful tool which can be used to change how people behave to hold wrongdoers to account and promote good conduct. And so therefore, I think part of this is being driven by that real genuine desire for change and seeing that litigation be a part of that. Social media as with so many other things, plays an important part as it means people can combine together, they can unify, there's a real sense of power in numbers as people can coordinate activities, which makes these sort of claims much easier to bring rather than individuals trying to do it themselves. And I think also there's a wider opportunity for there to be causes of action. And I think there are a number of reasons for this. One is an increase in legislation. There's much more pro ESG legislation that's being brought out. That means that companies and organizations are under more legal pressure and legal obligations, which the more obligations you have, the easier it is to breach them. So that can trigger causes of action. And there's also the greater ability for claimants to actually bring the claim. If you go back, Mark, to the sort of the primary infringer point that you raised earlier, often any action or any negative action would really affect relatively small communities. They could have catastrophic effects, but they would still be quite localized. For example, in oil spill emissions, something that came out of a particular factory or mine, whatever it is. But because the focus on climate change is such a global one and everyone sees it as now an issue that's affecting absolutely

everybody. On the one hand you have this being looked at as almost a human rights issue, which gives everyone the ability to bring a claim because they've been affected by it or more narrowly. If you take a look at, for example, anyone who's choosing which companies to use, who to invest in whatever it is, consumer behavior is being much more driven by ESG related criteria. And that means people are being induced or people are being convinced to take certain action to buy certain goods, to invest in certain companies on the back of their ESG credentials. And that means that there's much more opportunity to argue that there was, for example, a misrepresentation which caused you to take certain steps, which meant you suffered loss. So that I think is increasing the opportunity for claims to be brought as well. As I mentioned above, there's a much wider pool of potential defendants out there against whom to bring the claims, but none of that would be possible without the funding to bring them. I mean, I think it's fair to say that litigation, particularly in the UK, is incredibly expensive. It's very, very challenging to get enough money to get these claims off the ground, let alone run them to completion. And that's where litigation funders come in and they've been very vocal as an industry, I think in promoting ESG claims as a potential source of their funding or potential home for their funding. And they do see this as a big growth market for that sort of investment. And that will very much help drive these claims as well, I would've thought. So what it really is is a combination of a groundswell of genuine feeling added to more opportunities to bring the claims and then the available funding in order to be able to bring them and take them through. And that I think has created a potential perfect storm in relation to the growth and development of ever increasing ESG related litigation.

Mark P: Yeah, lots of food for thought there, Tom, and we'll pick up on one or two of those strands. I think later on. I'm very conscious we want to bring Mark in on the US side as well. But just briefly alongside and perhaps interlinked with the litigation risk, there's a perception of greater, if I can put it, regulatory risk as well. And how are the regulators from the UK context at least behaving and responding to this new litigious environment or landscape? And two, those systemic ESG related pressures that you talked about as well. What's the regulatory response?

Tom: Well, I think it's very much, again, seen as part of the process for change. I think certainly in the UK there's a huge governmental pressure towards things like net zero towards improving behaviors, and the regulator has to be a key part of that as the custodian of good conduct, if you like. So they're very much part of that process. I think there's a greatly increased amount of regulation, a growing amount of regulation in this area to try to encourage good conduct. But again, particularly on the environmental side, but certainly not uniquely and they're likely with everything as with the legislation, the more regulation there is and the more regulatory activity and keenness for the regulators to do something about it, the more chances there are of companies falling foul, there've been breaches, sanctions, fines, any sort of adverse regulatory finding. And Mark, you talked about the interconnectivity between the regulatory side and the litigation, and that I think is an incredibly important point and a very strong driver potentially for future ESG related claims. Historically, in relation to other areas, what we saw was a huge connection between adverse or negative regulatory findings and litigation, particularly on the almost quasi class actions or group litigation coming through. Because a negative finding by regulator is almost doing part of the work for a claimant already. There's already been a

finding of wrongdoing. So all the claimant then has to shoot is go on to show that they've got standings to bring a claim and that they suffered loss, but they're starting from a very strong position. So if we start to see a lot more negative findings on organizations such as their disclosure obligations or if they do disclose certain ESG related information that shows that they've fallen short of where they should, I think that is a really potentially good source for the real claimant driving firms or the funders or anyone else to bring litigation against those organizations that there always has been a very strong connection there. And I can't see why it would be any different with ESG, but I mean that's certainly very much coming from a UK centric focus. And Mark G. I mean, I know that particularly on the class action side and on the regulatory side, the US is probably a much more advanced market than we are. I don't know if you are seeing the same sort of trends there or you think you're likely to see similar sort of trends in the future.

Mark G: It is interesting when you talk about the US I do think there is somewhat of a contrast between the governmental approach, but even just the more public perception to ESG compared to the US, compared to Europe and the United Kingdom specifically. Historically, ESG matters and efforts have been largely voluntary. And while there may have been some best practices promulgated by regulators, they weren't much more than that. It's only in the last few years where we have seen a substantial increase in public awareness and corporate awareness of ESG related matters and started to see some regulations come into form their admittedly early stages regulations, for example, from the US Securities and Exchange Commission. But a lot of the regulation has been taken on by state lawmakers, California in particular, but several other states as well. And then talking about measures relating to things like board diversity, climate related issues, I think the focus of the E, the S and the G and the US, if you had to pick one, would be the S. As I think over the past decade or so, we've seen a substantial rise in corporate DEI efforts and social responsibility efforts in the US and that's eventually kind of heading towards the litigation realm. And what's happened is in last summer, the US Supreme Court issued a decision that the long and short of it, and it does not have direct applicability in the ESG context, but I'll explain in a moment why I'm raising it basically determined that admissions to Harvard and University of North Carolina could not consider race-based factors, so-called affirmative action, it undid about four decades of Supreme Court precedent. And now in the wake of that, what some partisan groups are doing is filing suits against businesses that have and their DEI efforts claiming that they amount to some sort of quota or similar system that violates the concepts that the US Supreme Court struck down in that Harvard USC about a year ago. So I would say that's been the focus really here in the US is corporate DEI programs, making sure they're structured in such a way that they're permissible and seeing how it plays out in the courts challenges to those programs. For instance, there was a recent business down in Georgia that was sued, that gave grants out only to black owned companies and a recent federal court decision. The challenge is brought again by one of these groups, at least federal court decision did come down and say that that was impermissible and violates the law. So that's I think where we have a very robust dichotomy right now is on the S aspects of ESG. And that's where the litigation, I think is primarily focusing on as more states consider and adopt regulations, California continues to be at the forefront of that, but as that spreads to places like New York and Illinois and other states around the country, especially in the absence of real meaningful federal

regulation in that regard, I do think that the litigation will correspondingly expand. But that's where we are for right now.

Tom: Thanks. That's sort of incredibly interesting point. It shows the difference I think between the two reasonably similar jurisdictions, but with a slightly different focus. But I mean, from my point of view, I think one thing that seems to have sort of cut across both the E and the S of the ESG, I mean obviously this impacts organizations and commercial entities themselves, but a lot of this seems to come down to the people within those who are actually making the decisions. And from that point of view, I mean there seems to be some potential risk and liability at the very least there. Not just for the organizations themselves, but for individuals. I mean, I'm thinking in particular for a lot of organizations in relation to the directors, and I mean on that basis, Mark Pring, can you think of any particular risks that those sort of management individuals, directors, partners, whoever they are, might be facing, and if there are risks that they do have to deal with at the moment, based on what Mark just said on the potentially increased risk of ESG litigation, is there anything they can be doing to mitigate those risks or prepare for them in advance?

Mark P: Broadly, in terms of risks, we're certainly seeing, to your point, increased scrutiny of directors in many sectors, both from applicable regulators and from other stakeholders in particular investors as you were flagging earlier. It's noteworthy for instance that all UK public and larger private companies have reporting requirements that include what's referred to as a section 1.72 statement in their annual director's report. And that statement includes reporting on the impact of the company's operations on the community and environment. So reference to the community there, but again, that focus we have maybe more here on the environment. I'd also note in passing the significance, particularly in the financial services sector of the so-called anti-green washing rule that applies to all firms authorized by the financial conduct authority who make sustainability related claims about financial products and services. And as a result of those requirements and others, there's certainly an increased risk of claims targeting directors and officers in circumstances where companies may have failed to deliver, for instance, on their ESG targets. So in the UK, without bearing into the detail, it's expected that what we refer to as sections 90 and 90A of the Financial Services and Markets Act or FSMA may increasingly become prevalent tools in the context of climate litigation. In particular, shareholders may claim that they've suffered losses arising from untrue or misleading statements made either under Section 90 in a prospectus or under 90A in other published information such as, again, director's reports. Those are just by way of example really. But I think prominent examples, you asked about mitigating risks. How much time have you got? But in any event, certainly directors should assess whether corporate governance could be improved in the ESG arena, whether their company has performed an up-to-date risk profile assessment, whether mitigants in particular insurance are adequate in view of, among other matters, the increased costs associated with the sort of litigation and regulatory investigation we've been touching on. And for the directors, whether they have access to specialist and early legal and accounting advice when considering reporting obligations, I think these lessons as it were, or these thoughts apply across the Atlantic, either side of the Atlantic. And it goes without saying that directors should always ensure that all decision-making is appropriately recorded. So I think those would be the initial thoughts, Tom.

Tom: No thanks, Mark. I mean I completely agree with that, particularly in relation to not just the mitigation steps, but the potential risks of statements being made, which are then used against directors and companies if they're proven not to be true. And it's interesting what you were saying about the decision making process and also the actual strict obligations on directors to consider the community at large and issues outside their organization. But I suppose that raises the question, well, what are the competing liabilities and responsibilities of directors and could that cause any problems? So for example, if a director in an organization was absolutely compliant with ESG related criteria is living up to the standards that it placed on itself and its wider obligations, is that enough or is there any sort of other risk that in doing so it is failing to fulfill another obligation or it's wider purpose or IT sort of focus to shareholder investor or that sort of thing? I mean, Mark G., can you see any risk that even an organization which is very, very good with its ESG compliance might still end up facing some sort of liability?

Mark G: Yeah, I still think that's absolute possibility that the US happens to be an extremely litigious atmosphere and our courts are always overburdened with cases. So I think that's entirely possible. I think you could do everything the right way and still find yourself ending up in court regardless of that.

Tom: No, I mean, so it really sort of emphasizes the difficulty of the type rape, doesn't it Mark mean how to balance those competing factors? I mean, just sort of anecdotally, I know that certain organizations in the financial services sector are pulling out of lending to certain industries because it's seen as too high risk. It's seen as against their ESG criteria and obligations. But at the same time, other funds are going into oil and gas into other what are seen as the less popular areas because they're under an obligation to make the best possible return for their investors. So it is a very difficult balance to hit, isn't it? And tricky to get that right.

Mark G: That's an exactly right point. And because there's a fiduciary obligation, you do have to strike that balance. I do think there's been some interesting polling in the US suggesting that most Americans do not care if ESG factors into investment decisions. So I just think that's an interesting starting point. But certainly we've seen a rise of social impact investing and socially conscious investing, but for businesses that issue opportunities that to so-called vice opportunities or vice stocks, you do have the potential of breaching your fiduciary or at least being alleged to have fiduciary for fiduciary obligations to the shareholders, to the investors by not pursuing the opportunities that could maximize the return. And so if you are trying to be socially or ESG conscious can be caught in a bit of a catch-22.

Tom: And Mark Pring, I mean Mark mentioned that the US is particularly litigious jurisdiction, but I imagine there'd be similar pressures on directors in the UK.

Mark P: Yes, Tom, I was just thinking through this in terms of competing risks. I mean, certainly we may be operating slightly different environment in terms of at least historical pressures caused by class or collective actions, but in theory, I think we'll see actions being possible, even the sort of vice stock type actions depending upon the nature of representations made to investors by directors. So we can see some of those sort of countervailing pressures potentially. It's certainly the case that directors are under potentially competing

pressures thinking about, again, regulatory position, reputational risk duties to shareholders, expectations of insurers and so on. And we know that the investors and their lawyers are increasingly creative, so directors and their advisors have to keep pace with these creative arguments.

Tom: Mark, in circumstances where based on all of that, a director could be at risk no matter what they do. I mean, because there are two competing groups and sets of obligations. You've mentioned a number of things that they can do to mitigate that risk, particularly the mapping through the decision making process. But given your background and area of expertise as being insurance, is there something on the insurance side that they should be thinking about as well?

Mark P: Yeah, I mean, absolutely right. I mean, briefly again, as you say, without repeating some of my earlier comments in the first instance, directors should ensure that their companies implement robust policies and procedures to address any risks identified in proactive risk assessments. And not only should they do that anyway, but they should do that prudently in order to satisfy that they satisfy their various insurers that they are what we would call prudent uninsured as well. They should at the same time, as you've hinted, be identifying affordable insurance options with the help of their specialist professional insurance brokers. And that applies potentially to their companies in terms of their insurance program and the individual directors. So along with D&O liability insurance, for instance, they should look at the availability and scope of employment practices liability cover, depending which arena they operate in environmental liability covers for instance as well. There's a myriad of insurance options they should be considering, depending which sector they're involved in, Tom.

Tom: Yeah, no, very good advice and important for people to be considering that. And Mark G., I mean, the risks are fairly common across both sides of the Atlantic. So typically you guys in the US would see things probably before we did, but it'd be similar trends coming across. But is there anything particularly US specific in relation to risk identification and mitigation in this area, or is it much the same as we'd expect to see over here?

Mark G: It's much the same. And the steps should really focus on any types of social programs, corporate DEI programs, and anything should be focused, the steps should be focused on that. We haven't quite caught up on the E to the UK yet. And so really focusing on what are your goals, what do you do as a company want to stand for, and trying to tailor that in a way that complies with what is an evolving area of the law.

Tom: And I think that last point is a crucial one, isn't it, Mark? I mean, it is constantly evolving. So we talk about risk assessment and analysis and try to work out what the potential risks are, but they are constantly changing and both just legislatively regulatory, but also just more widely socially. This isn't something where you can just put a policy in place, stick it in a drawer and forget about it. I mean, this is something which does need constantly monitoring, updating, and assessing.

Mark G: That's absolutely right. That's absolutely right. At least in the US I think we are at early stages of all these things for the most part. And so what the landscape is going to look like in five and 10 years may both be drastically different. So you need to be staying abreast of the developments consulting with council on a fairly frequent basis to make sure that you're up to date on the latest developments.

Tom: No, completely agreed and conscious that time is running away from us. And this is obviously a huge topic we could talk about for many hours, but Mark P. in conclusion, I mean, is there any concluding thoughts or calls for action that you think would be a good takeaway for the listeners?

Mark P: Well, it would be selfish of us to start with consult a lawyer, but obviously whenever risks are involved, then lawyers are involved from one angle or another. I mean these areas, and it's interesting again to hear of the different perspectives from the US and the UK. These areas are clearly a minefield and a careful balancing act for companies and for their directors is required. They're going to need to consider all competing ESG pressures when setting strategies. Directors in particular will need to address carefully the tension between their traditional duties as directors, if you like, with increasing obligations to advance an ESG agenda with elements of the ESG that they need to advance maybe varying between jurisdictions like the US and the UK. So they've got to look at it from every angle.

Tom: They're absolutely right. And again, it goes back to that global point, doesn't it? Where these things affect so many different people nowadays. You can't just look at it, it's very much in one jurisdiction, it has to be across the globe. Mark G, anything in particular from you as a final takeaway?

Mark G: I think the jurisdiction specific point is a good one because in the US for many years until recently, we just had corporations really focusing on having robust DEI programs, social responsibility programs, and that was great. And then all of a sudden, a few years ago in particular, we started seeing certain states like Florida and take on, try to counterbalance that with certain types of regulations that corporations can't have certain types of information in their training and their workplace trainings and things like that. So being cognizant of the rules in the jurisdiction that you're operating in, which may differ from two states that border each other, may take two very different approaches. But as with many things in the US, this is very much a state specific thing. US law, while everybody looks to the federal government, obviously much of US law, probably the most important aspects of US law really comes down to state law. And we've got 50 different states, which means potentially 50 different approaches. And while there really aren't 50 different approaches, there are different approaches taken based on a whole set of factors. So if you're operating in California versus Florida, you have to have a whole different strategy and approach. And if for an operating in both California, Florida, you have to think about precisely those things. So I completely agree. And second, the suggestion to consult with counsel.

Tom: Thanks. It is just sort of hugely challenging, isn't it? Dealing with so many competing jurisdictions even within one country, let alone within various different continents. From my point of view, I think it's the final point I'd emphasize is again, going back to that issue that the legal landscape is changing so fast, you just got

to keep monitoring it, particularly going, you just said Mark G. about the various different jurisdictions, but even within one jurisdiction, things change so quickly that everyone's just got to keep on top of it. And one thing in particular, going back to something that Mark Pring said earlier on is it's important as part of that to monitor what statements any organization is making and ensure that they are accurate and you're still living up to them because it's such an easy source of litigation for claimants to pick up on things which have been said, but the action doesn't quite match up to that, that it's just so important to just keep an eye on that and make sure everything is up to date and everything is accurate. And that as much as anything else is a good way to mitigate any potential risks. And as we've seen, there are increasing and ever-growing risks out there. So I do think that's important, but unfortunately I think we are very much out of time as a result of that. But as I say, this is a huge topic and one that we could carry on talking about for a very, very long time. Unfortunately, we don't have the opportunity to do so now. So all it leaves me to do is to thank both Marks, Mark Goldstein and Mark Pring for their time, and also to thank the listeners for listening. We hope you enjoyed it. If you have any questions or if there are any issues coming out of this that you'd like to discuss further with us, obviously please do not hesitate to get in touch.

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What you need to know about the Economic Crime and Corporate Transparency Act 2023

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Key takeaways

- UK government passed Economic Crime and Corporate Transparency Act 2023 on 26 October 2023 as part of its efforts to tackle economic crime
- The Act alters established "identification principle" to introduce a new "senior manager" test, which came into force in December 2023
- The introduction of a "failure to prevent fraud" offence increases the scope of corporate criminal liability. This offence will come into force after the UK government has issued guidance
- Organisations should take proactive steps to ensure they avoid liability

Authors: **Patrick Rappo, Rosanne Kay, Christian Lally, Ali Ishaq**

A. Background

In May 2023, the UK government published its "Fraud Strategy" paper in which it set out its plan to reduce fraud on 2019 levels by 10% by December 2024.[1] The UK government has now made it easier to prosecute companies for economic crime offences.

The Economic Crime and Corporate Transparency Act 2023[2] (the **Act**) follows the Economic Crime (Transparency and Enforcement) Act 2022 in handing new tools to prosecutors and authorities to tackle economic crime.

The most significant changes that feature in the Act are the introduction of a new **"failure to prevent fraud" offence** and the replacement of the common law "directing mind and will" test for corporate criminal liability for economic crimes with a new statutory **"senior manager"** test.

Under the former framework, organisations could only be held criminally liable for fraud offences where it could be shown that there was a "directing mind and will" of the company involved.

The High Court in 2018 stated that to be considered a "directing mind and will" of the company, the individual directors need to be the ultimate decision maker; that is, they needed to have fully delegated to them the responsibility and authority to do the act in question, with Lord Justice Davis setting out at paragraph [122] of the judgment:

"[T]hat the individuals had some degree of autonomy is not enough. It had to be shown, if criminal culpability was capable of being attributed to [the company], that they had entire autonomy to do the deal in question".

As a result, it has been markedly more difficult for prosecutors to establish corporate liability for a company's principal decision-makers for an offence in large companies where there are often numerous layers of management and decentralised business decisions. Conversely, it has historically been much easier to prosecute smaller companies, which will invariably have fewer directors and less formal delegation to subcommittees.

B. The key changes

The "senior manager" test

How is "senior manager" defined?

Under the new test, an organisation can be held criminally liable under the so-called "identification doctrine" if a senior manager "acting within the actual or apparent scope of their authority" commits a relevant crime. Only specified economic crimes are in scope so the elevated liability will only apply where any of those offences are committed.

A senior manager is defined as "an individual who plays a significant role in:

> i. the making of decisions about how the whole or a substantial part of the activities of the body corporate or (as the case may be) partnership are to be managed or organised; or
>
> ii. the actual managing or organising of the whole or a substantial part of those activities".

The person's actual title will be irrelevant providing they fall within the scope of the definition.

What offences are in scope?

The Act applies the senior manager test to a broad spectrum of relevant, principally economic offences including theft, false accounting, fraud, fraudulent trading, bribery, money laundering, terrorist financing and certain tax evasion offences.

Practical application

The senior manager test applies to senior managers of a body corporate or partnership, with the definition of a body corporate including those incorporated outside of the UK. This is in contrast to the failure to prevent offence (which applies only to "large organisations"), as the senior manager offence applies to all organisations, regardless of size.

It can therefore be assumed that offences will be capable of being committed by senior managers who are UK nationals or are foreign nationals who commit an offence in the UK or are located in the UK at the time of the offence.

This may give rise to a situation whereby a non-UK domiciled company, with UK senior managers, is found liable for an offence committed by those managers.

The scope of the offence is limited, however, in that where a relevant offence is committed wholly outside of the UK, an organisation will not be liable unless it would be guilty of that offence were it to have been committed by the organisation itself and not the senior manager.

The senior manager offence came into force on 26 December 2023, two months following the Act receiving Royal Assent, meaning that organisations need to be alive to the increased risk posed by the extension of corporate criminal liability in this area, which is discussed in more detail below.

The "failure to prevent fraud" offence

The "failure to prevent fraud" offence expands corporate criminal liability by holding a "relevant body" accountable where they or their customers were intended to benefit from fraud committed by an associated party and have failed to have reasonable prevention procedures in place.

The offence is one of strict liability with a statutory defence of having reasonable policies and procedures in place to prevent fraud.

Unlike the senior manager offence, the failure to prevent fraud offence has not yet come into force and will do so following the release of guidance by the UK government. This guidance is expected imminently, initially being planned for Q1 2024, with the offence to come into force following a brief preparatory period, which could be as little as six months meaning that the offence should come into force by late 2024.

Who is in scope?

The scope of the offence has been subject to continued scrutiny and amendments by the House of Commons and the House of Lords with the latter favouring a broad approach to capture all organisations. The offence is, as initially proposed, limited to "large organisations", to avoid disproportionate regulatory burdens on small and medium-sized enterprises (**SMEs**).

The definition of a "large organisation" covers companies and partnerships where **two or more** of the following conditions in the financial year that precedes the year of the fraud offence are met:

(a) A turnover of more than £36 million

(b) A balance sheet total of more than £18 million

(c) A total number of employees of more than 250

In contrast to the senior manager test, the failure to prevent fraud offence applies to "relevant bodies", which means a "body corporate or a partnership (wherever incorporated or formed)" that meets the test for a large organisation. Non-UK entities are therefore in scope.

A "relevant body" will commit an offence where there is a failure to prevent fraud by an "associate" with this definition, including:

(a) An employee or an employee of a subsidiary, agent or subsidiary undertaking; or

(b) A person who otherwise performs services for or on behalf of the relevant body.

What offences are in scope?

An organisation will be liable where a specific fraud is:

(a) Committed by an "associate";

(b) For the benefit of the organisation or any person to whom services are provided on behalf of the organisation; and

(c) The organisation did not have reasonable fraud prevention procedures in place (unless it was not reasonable to expect them to have such procedures).

The following offences will be in scope:

- Fraud by false representation (section 2 Fraud Act 2006)
- Fraud by failing to disclose information (section 3 Fraud Act 2006)
- Fraud by abuse of position (section 4 Fraud Act 2006)
- Obtaining services dishonestly (section 11 Fraud Act 2006)
- Participation in a fraudulent business (section 9 Fraud Act 2006)
- False statements by company directors (section 19 Theft Act 1968)
- False accounting (section 17 Theft Act 1968)
- Fraudulent trading (section 993 Companies Act 2006)
- Cheating the public revenue (common law)

An interesting omission in the above list is money laundering offences, the explicit exclusion of which was subject to a House of Commons vote, meaning that those offences will continue to be covered by the pre-existing Money Laundering Regulations. It should also be noted that the Act specifically envisages offences being added to the list, including relevant money laundering offences under the Proceeds of Crime Act 2002.

The types of conduct that can be caught by the new offence are broad and could include the misconduct of an employee or agent in reference to warranties, and representations in transaction documents, prospectuses, annual reports and insurance claims might also lead to an organisation being liable.

Which organisations are in scope?

The UK government released a factsheet during the legislative process which stated in relation to jurisdiction that "If an employee commits fraud under UK law, or targeting UK victims, their employer could be prosecuted, even if the organisation (and employee) are based overseas".[3]

There are no territorial qualifications on who is caught by the definition of an "associate" within the Act, and it remains to be seen whether this will be clarified further in later (presumably non-binding) guidance.

Accordingly, in addition to the possibility of foreign companies being liable where they maintain a UK presence or subsidiary, there is also the possibility of liability where an offence is committed within the UK regardless of the domicile of the body corporate or partnership.

It would also appear that jurisdiction will be predicated on the underlying fraud offence committed. This may mean that a relevant body can be liable under a failure to prevent offence, even where it has no UK presence, if an associate commits an in-scope offence.

Practically, this allows for a foreign organisation to be prosecuted under the failure to prevent offence where, for example, it fails to prevent an associate, whether they are a UK-based associate or not, from committing an offence outside of the UK where there is an intended loss or gain in the UK.

C. How will the new offences impact organisations?

These changes should make it significantly easier for UK authorities to hold organisations accountable. The “failure to prevent” offence and the “senior manager” test supplement each other to make it more likely that organisations can be successfully prosecuted and fined for economic crime offences.

Organisations prosecuted under the new offences are expected to face unlimited fines, and sentencing will likely be akin to the Sentencing Council Guidance for fraud, bribery and money laundering.

When looking at what will constitute “reasonable procedures” by way of a defence to liability under the failure to prevent fraud offence, the guidance will likely follow that set out in the Ministry of Justice Guidance on the UK Bribery Act and the “reasonable procedures” laid out in the HMRC guidance to the Criminal Finances Act 2017.

What is the extra-territorial effect of the new offences?

The definition of a “body corporate or partnership” within the senior managers offence includes those incorporated outside of the UK meaning a non-UK company could be liable where an offence is committed by a UK national senior manager or a foreign national, where the offence is committed in the UK.

On the failure to prevent fraud offence it is likely that foreign organisations can be caught where an employee or agent commits fraud under UK law, or targeting UK victims provided the organisation meets the “large organisation” definition.

When do the offences come into force?

The senior manager offence came into force on 26 December 2023, two months following the Act receiving Royal Assent.

The failure to prevent fraud offence has not yet come into force and is awaiting the publication of guidance by the UK Home Office, following which there will likely be a six-month adjustment period before the offence comes into force. On this basis it is expected that the failure to prevent provisions will be in force towards the end of 2024.

Practical steps

Organisations should look to take the following steps:

- Conduct risk assessments specifically focused on fraud risk and the risk of other economic crime and/or review any such assessments previously carried out to see if they remain fit for purpose.
- Review and amend policies and procedures to account for these risks in a proportionate way.
- Train employees, agents and senior management to identify risks and to mitigate them if they are spotted.
- Ensure appropriate methods are in place for reporting and reviewing any suspicions.
- Identify individuals and relevant roles that may fall into the definition of "senior manager" and consider whether additional training is required.
- Establish procedures for the ongoing monitoring of the above to ensure continued compliance.

Failing to take adequate steps could lead to a potential world of pain for organisations where it is clearly the purpose of the Act to make it easier to target organisations for economic criminal offences.

While it is too early to say whether the new offences will see a marked uptick in prosecutions, it is clear that the compliance landscape for organisations has now changed and become more onerous.

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1. gov.uk
2. legislation.gov.uk
3. gov.uk

In-depth 2024-068

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