D&O Insurers as Climate Governance Monitors

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Society's demands on corporations to address the climate crisis are falling on the shoulders of directors and officers. Directors and officers who either shrug off these challenges, or make missteps, are facing shareholder lawsuits and regulatory investigations. D&O insurers are stepping in, like they always have, to pay for claims. But inside the familiar paradigm, something different is afoot: D&O insurers are beginning to monitor their insureds' climate governance.

This Article argues that climate risk, unlike traditional corporate governance risk, threatens the financial viability of the insurance industry—increasing the incentives for D&O insurers to serve as climate governance monitors. By closely examining the intersection of D&O insurance and climate risk, this Article makes three novel contributions. First, it relies on qualitative interviews with insurance industry experts to provide a descriptive account of the climate risk facing the insurance industry, and how D&O insurers are starting to monitor their insureds' climate governance in response. Second, it theorizes that this trend is likely to continue, not only for the obvious reason that D&O claims relating to climate risk are increasing, but also because both insurers and insureds benefit from improving their climate governance. Third, it makes a normative argument that invites scholars and policymakers to recognize, and fortify, D&O insurers as climate governance monitors.

Global regulators and institutional investors are searching for ways to bolster boards' climate governance. D&O insurers should have a greater role to play in monitoring the monitors.

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INTRODUCTION

Society demands accountability for the climate crisis, and its demands have entered the boardroom. The global investment community recognizes that "climate risk is investment risk."[1] But there is more to the story than financial risk. All manner of stakeholders, including NGOs, employees, and consumers, are increasingly asking companies to reduce their environmental harms.[2] These appeals are prompting global regulators and lawmakers to focus on board oversight of climate risk. Today, climate governance is a crucial pillar of corporate governance.

In this shifting landscape, directors and officers are exposed to more legal scrutiny than ever before, including shareholder litigation and regulatory investigations.[3] These claims allege that the board's oversight duties extend to climate governance, from reducing carbon emissions to protecting biodiversity.[4] But the directors and officers under scrutiny do not bear the financial burden of defending, settling, or paying for these claims. Instead, the legal costs fall almost entirely on the insurers who issue directors' and officers' liability insurance ("D&O insurance").[5] In fact, almost all public companies buy D&O insurance for precisely this reason: to protect their directors and officers, and the corporation itself, from the financial costs arising out of claims.

D&O insurers bear the brunt of the cost of poor corporate governance.[6] In the climate context, both "good" and "bad" climate governance can have compounding effects on both sides of insurers' balance sheets.[7] "Bad" climate governance enables climate disasters, which simultaneously draw on numerous lines of insurance coverage and

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[1] BlackRock, *Larry Fink's 2022 Letter To CEOs: The Power of Capitalism* (last visited Feb. 8, 2023) https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter [https://perma.cc/C4TY-99TX]. *See* MANAGING CLIMATE RISK IN THE US FINANCIAL SYSTEM 1 (Leonardo Martinez-Diaz, Jesse M. Keenan & Stephen Mocs eds., 2020) (arguing "[c]limate change poses a major risk to the stability of the U.S. financial system and to its ability to sustain the American economy.").

[2] *See* Mark Hillsdon, *Society Watch: How Employees Are Taking Their Companies to Task Over Climate Change*, REUTERS (Apr. 18, 2022), https://www.reuters.com/business/sustainable-business/society-watch-how-employees-are-taking-their-companies-task-over-climate-change-2022-04-18/ [https://perma.cc/8C83-BPR5] (describing employee climate activism at Amazon); Tove Malmquist, *More Consumers Are Serious About Climate Change. Are Business and Government Listening?*, GREENBIZ (Jan. 24, 2022), https://www.greenbiz.com/article/more-consumers-are-serious-about-climate-change-are-business-and-government-listening [https://perma.cc/P93H-RS87] ("Seventy-three percent of consumers globally agree that we need to reduce consumption to preserve the environment for future generations[.]").

[3] Sam Meredith, *Shell's Board of Directors Sued Over Climate Strategy in a First-of-Its-Kind Lawsuit*, CNBC (Feb. 9. 2023, 4:07 AM E.T.), https://www.cnbc.com/2023/02/09/oil-shell-board-of-directors-sued-by-investors-over-climate-strategy.html [PERMA].

[4] *See infra* Part II.C.

[5] *Id.*

[6] *See infra* Part I.B.

[7] *See infra* Part III.A.

threaten insurers' diversified investments.[8] Meanwhile, "good" climate governance reduces claims and creates portfolio-spanning value for insurers.[9] Thus, scholars have theorized that insurers may be uniquely incentivized to monitor the board, and perhaps even improve climate governance.[10]

This view is consistent with a renewed hope in the ability of insurance to reduce harm as opposed to transfer risk—referred to as "insurance as regulation."[11] An emerging number of scholars argue that insurance can increase diversity, improve cybersecurity, and decrease police brutality.[12] With respect to climate change in particular, numerous scholars have argued that insurance can provide incentives for private parties to mitigate environmental harms.[13] However, critics argue this approach runs afoul of the traditional "moral hazard" problem of insurance, in which the presence of insurance coverage arguably encourages insureds to take *less* care. Insurers attempt to mitigate the effects of moral hazard by using a variety of "carrots and sticks" to monitor their insureds.[14] Examples are familiar and wide-ranging—property liability insurers require fire safety measures and conduct site inspections, auto liability insurers provide credits for safe driving, and so on.

These active monitoring measures may be useful for reducing loss in other insurance contexts, but Tom Baker and Sean Griffith's comprehensive empirical study concluded that D&O insurers "do almost nothing to monitor the public corporations they insure."[15] Consequently, without active monitoring, D&O insurance is merely a backstop preventing directors and officers from feeling the pressure of shareholder litigation and regulatory investigations. As Andrew Verstein recently

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[8] *Id.*

[9] *Id.*

[10] *See, e.g.*, Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' and Officers' Liability Insurer*, 95 GEO. L.J. 1795 (2007) [hereinafter Baker et al., *Missing Monitor*].

[11] *See* Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 MICH. L. REV. 197, 217–28 (2012) (describing the ability of insurance to regulate risk in ways that are superior to government regulation).

[12] *See* Kenneth S. Abraham & Daniel Schwarcz, *The Limits of Regulation by Insurance*, 98 IND L. J. 215, 274 (2022); *see also infra* Part I.B.

[13] This scholarship is focused almost exclusively on property insurance. *See, e.g.*, Christina Ross, Evan Mills & Sean B. Hecht, *Limiting Liability in the Greenhouse: Insurance Risk Management Strategies in the Context of Global Climate Change*, 26 STAN. ENVTL. L.J. 251, 252 (2007) ("The most widely discussed insurance-related consequences of climate change are the impacts of property damage from extreme weather events."); Christopher D. Stone, *Beyond Rio: "Insuring" Against Global Warming*, 86 AM. J. INT'L L. 445, 474 (1992). But see Howard C. Kunreuther & Erwann O. Michel-Kerjan *Climate Change, Insurability of Large-Scale Disasters, and the Emerging Liability Challenge*, 155 U. PA. L. REV. 1795 (2007) (discussing D&O liability insurance).

[14] *See* TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION 11 (Univ. Of Chicago Press 2010) [hereinafter Baker et al., ENSURING CORPORATE MISCONDUCT] (defining moral hazard as "the tendency of insurance to increase loss by reducing an insured's incentive to take care to avoid loss"); *see also* discussion *infra* Part I.B.

[15] Baker et al., ENSURING CORPORATE MISCONDUCT, *supra* note 14, at 6.

summed up, "nearly everyone agrees [D&O insurance] is part of the problem" for poor corporate governance.[16]

Why have scholars and policy makers concluded that D&O insurers are unfit to monitor corporate boards? First, D&O insurers have traditionally lacked the incentives to monitor their insureds. Although they ultimately pay for claims, they can also set their premiums to cover the cost of claims. Insurance is also a competitive business, and insureds do not want their carriers prying into the inner workings of the board. Second, even if they had the *incentives*, D&O insurers lack the *ability* to monitor their insureds. Active monitoring is expensive and requires idiosyncratic knowledge about each insured. How can D&O insurers possibly compete with the governance expertise of law firms, whose analysis is highly tailored and cloaked with the attorney-client privilege? Moreover, given that corporations generate value from risk-taking, D&O insurance may be working as designed—to give directors the freedom to take business risks. For D&O insurance, then, scholars have assumed that moral hazard may be a hard-wired feature, and not a bug.[17]

Board oversight of corporate governance remains one of the most salient issues in corporate law. Scholars are actively debating the virtues and vices of various external monitors.[18] Yet there is no remaining faith in the ability of D&O insurers to influence corporate boards. This Article argues that the novel nature of climate risk is resurrecting the promise of D&O insurers as corporate governance monitors. By closely examining the intersection of D&O insurance and climate risk, the first in the literature, this Article makes three primary contributions.

This Article's first contribution is an original, empirical study of how climate risk affects the insurance industry, and how those changes impact D&O underwriting.[19] Relying on qualitative interviews and roundtable

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[16] Andrew Verstein, *Changing Guards: Improving Corporate Governance with D&O Insurer Rotations*, 108 VA. L. REV. 983, 985 (2022).

[17] *See infra* Part I.B.

[18] A rich literature in corporate law has addressed the promise and limitations of internal and external gatekeepers for improving corporate governance. *See generally* Reiner H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 54 (1986) (explaining the concept of gatekeepers); JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 2–3 (2006) (discussing the history of auditors, attorneys, securities analysts, and credit-rating in monitoring corporate governance); For a discussion of how gatekeepers protect the public interest, *see* Merritt B. Fox, *Gatekeeper Failures: Why Important, What to Do*, 106 MICH. L. REV. 1089, 1089 (2008) ("Each of these professions can serve as a watchdog for the public"); Sung Hui Kim, *The Banality of Fraud: Re-Situating the Inside Counsel as Gatekeeper*, 74 FORDHAM L. REV. 983, 988 (2005) (arguing that inside counsel can serve as a gatekeeper); Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1592–93 (2010) (reviewing the literature on gatekeepers); Stavros Gadinis & Amelia Miazad, *The Hidden Power of Compliance*, 103 MINN L. REV. 2135, 2154-55 (2019) (describing in-house compliance officers as outside gatekeepers similar to accountants, bankers, and attorneys); John C. Coffee, *Why Do Auditors Fail? What Might Work? What Won't?,* 49 ACC. BUS. RSCH 540 (2019); Yaron G. Nili, *Board Gatekeepers*, 72 EMORY L.J. 91 (2022)(discussing the limitations of the independent director as a gatekeeper).

[19] *See infra* Part III & Part IV.

discussions, the Article illuminates how D&O insurers are becoming active monitors of their insureds' climate governance.[20] These practices, though nascent, still mark a notable departure from D&O insurers' traditionally passive approach to corporate governance; for instance, the Marsh Initiative enlists the governance expertise of law firms to help top insurers underwrite ESG risks, including climate risk.[21] The Article's qualitative approach uncovers the insurance industry's approach to climate governance at a very early stage in its development. Though many questions remain unanswered, these emerging developments invite scholarly and policy interventions at a crucial juncture—before internal practices become too "hard-wired."

The Article's second contribution is a rich theoretical justification for why D&O insurers are starting to incorporate climate governance into their underwriting, as well as an argument that this trend will continue.[22] As opposed to observing D&O insurers in a vacuum, this account situates them within the political economy of the insurance industry in which they operate.[23] Notoriously resistant to change, the insurance industry has

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[20] *See* Appendix A for Methodology and Participants. Consistent with best practices for anonymized qualitative interviews, the specific dates of the interviews have not been provided.

[21] *Id.* This Article focuses on climate risk oversight, or "climate governance." While ESG encompasses many topics, climate governance is a core pillar of ESG. *See, e.g.*, Tyson Dyck & Henry Ren, *Torys LLP, ESG and Climate Change*, *in* TORYS QUARTERLY: ESG'S TURNING POINT (Q2 2021), https://www.torys.com/Our%20Latest%20Thinking/Publications//2021/03/esg-and-climate-change/[https://perma.cc/J685-ZHZM] ("Given the potential for climate change to drive transformation across entire economic sectors, the fact that it often dominates the environmental, social and governance (ESG) conversation is hardly surprising."); *see also* Marsh, Press Release, Marsh to Recognize Clients with Robust ESG Frameworks (Oct. 25, 2021), https://www.marsh.com/us/about/media/marsh-to-recognize-clients-with-robust-esg-frameworks.html [https://perma.cc/CXK9-X9WL] (quoting Marsh Head of Climate & Sustainability: "Marsh is proud to introduce D&O coverage enhancements that recognize organizations taking a proactive approach to managing the risks associated with ESG, including the transition to a low-carbon economy. We ... are pleased to be driving climate positive innovation in our industry."). However, D&O insurers are also monitoring their insureds' governance of social risk, especially DEI. *See, e.g.*, ADRIAN JENNER & ANOUSHKA PRAMANIK, ZURICH, WHITEPAPER ON THE ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) CONSIDERATIONS FOR DIRECTORS AND OFFICERS (Aug. 25, 2022), https://www.zurich.com/products-and-services/protect-your-business/commercial-insurance-risk-insights/environmental-social-and-governance-considerations-for-directors-and-officers [https://perma.cc/MZ4N-NLYH]. For an in-depth exploration of the "ESG" term and its evolution, *see* Elizabeth Pollman, *The Making and Meaning of ESG* *3 (Eur. Corp. Gov. Inst. Working Paper No. 659, 2022) ("ESG as an acronym for "environmental, social, governance" is a common denominator of the discourse using the term, but a deeper examination reveals that little beyond that understanding is fixed.").

[22] *See infra* Parts II & IV.

[23] The term "D&O insurer" can obscure that D&O insurance is one type of insurance that major insurance companies—such as Chubb and AIG, among others—offer. How these insurance companies monitor their own climate risk is impacting various types of insurance, including D&O. *See infra* Part IV.C.

lagged behind the financial industry in incorporating climate governance into business strategy. Consequently, insurers are now facing unprecedented business, legal, and regulatory pressure to minimize their own impact on the climate crisis.[24] For the first time, shareholder and stakeholder pressure on both insureds *and* insurers to address the climate crisis are converging, increasing the incentives and ability of D&O insurers to monitor their insureds' climate governance.

The business model of insurance helps contextualize why climate risk is uniquely problematic for the insurance industry.[25] The financial risks arising from climate change threaten *both* sides of the insurers' balance sheet. On one hand, insurers collect premiums and promise to pay for losses arising out of covered claims. This is the "liabilities" side of insurers' balance sheets, and where the corporate law literature has focused. It is not hard to see why the insurance industry is bracing for an increase on the liabilities side of the balance sheet; climate disasters are multiplying in force and frequency around the globe.[26] However, the other side of insurers' balance sheets gone largely unnoticed in the literature, though it is equally vulnerable to climate risk—if not more so.

On the "assets" side of the balance sheet, insurers generate profit by investing the premiums they collect; indeed, some are among the largest and most diversified investors in the world. According to modern portfolio theory, such diversification is a powerful protection against risk. But this logic is upended in the presence of "systematic risk" that affects the economy broadly, such as climate change. By definition, such risk cannot be diversified away. Indeed, the largest and most diversified investors are especially exposed to such systematic risks.[27]

This Article is the first to illuminate how climate risk pressures both sides of insurers' balance sheets. These pressures are prompting insurers to develop new climate governance practices. For instance, some are instituting board-level oversight of climate risk (and ESG more broadly). Others are creating executive positions tasked with developing companywide strategy to address climate risk.[28] Moreover, though insurance is a competitive business, insurers are starting to collaborate on climate governance. The recently-formed Net Zero Insurance Alliance is one notable example.[29] However, D&O insurance does not play

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[24] *See infra* Part IV.A.

[25] *Id.*

[26] *See infra* Part III.A.

[27] For example, regulators, shareholders, NGOs, and other stakeholders are pressuring insurers not to underwrite fossil fuel companies, because fossil fuel companies' activities harm insurers' underwriting and investment portfolios. *See infra* Part III.B.

[28] *Id.*

[29] The Net-Zero Insurance Alliance is an association of 30 insurers representing 15% of global premiums that have committed to net-zero greenhouse gas emissions in their underwriting and investment portfolios by 2050, and in operations by 2030. *See Net-Zero Insurance Alliance*, UN ENVIRONMENT PROGRAMME (last visited Feb. 11, 2023), https://www.unepfi.org/net-zero-insurance/ [https://perma.cc/2N25-KGYF];

prominently in these efforts. This Article argues that D&O insurers offer a uniquely proactive solution to mitigating climate risk. Because D&O insurers underwrite the behavior of directors and officers, they can theoretically *prevent* environmental harms. Indeed, this is precisely why investors and regulators are focused on boards' climate governance. This Article's third contribution is thus a normative recommendation: policymakers and academics ought to cultivate the potential of D&O insurers as climate governance monitors.[30]

Beyond its novel contributions, the Article responds to several debates in corporate law. First, it contributes to the theory of "insurance as regulation" by arguing that D&O insurers can augment efforts by regulators to enhance boards' oversight of climate risk.[31] Second, given the salience of climate risk to shareholders, there is a renewed scholarly focus on how to encourage boards to monitor environmental externalities, though scholars have overlooked D&O insurers' potential.[32] The Article fills in that gap, arguing D&O insurers can augment other external gatekeepers on encouraging boards to monitor climate risk. Third, it contributes to the emerging literature on how large, diversified investors like pension funds and asset managers are disproportionately exposed to systemic risks, such as climate change.[33] Insurers, too, are highly-diversified investors, but unlike other investors, they are *doubly* exposed to climate risk, because they also must pay claims on covered losses.[34] Finally, by demonstrating how underwriting decisions by D&O insurers function as effective private environmental governance, this Article adds to a small but growing literature at the intersection of corporate law and environmental law.[35]

Part I traces the theoretical roots of insurance as regulation. Part II introduces the pressure on directors and officers to monitor climate risk, and how those pressures are materializing into claims. Part III shows that there are parallel pressures on the insurance industry to monitor climate

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see also, Net Zero by 2050: a Roadmap for the Global Energy Sector, INT'L ENERGY AGENCY (May 2021), https://www.iea.org/reports/net-zero-by-2050 [https://perma.cc/9YXX-ERT5].

30 *See infra* Part V.A.

31 *See infra* Part I.B.

32 *See infra* note 149.

33 *See infra* Part III.B. *See also, e.g.,* Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1 (2020) (arguing "diversified investors should rationally be motivated to internalize intra-portfolio negative externalities); John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 54–70 (arguing for a different fiduciary duty for directors to maximize portfolio values, as opposed to firm-specific shareholder value).

34 *See infra* Part IV.

35 Michael P. Vandenbergh, *Private Environmental Governance*, 99 CORNELL L. REV. 129, 133 (2013) (defining private environmental governance as "play[ing] the standard-setting, implementation, monitoring, enforcement, and adjudication roles traditionally played by public regulatory regimes"); *See also* Sarah Light & Christina Parajon Skinner, *Banks and Climate Governance* 121 COLUM. L. REV. 1895, 1898 (Oct. 18, 2021) (arguing that banks that "push debtors to be more environmentally responsible represent significant new forms of private environmental governance").

risk. Part IV offers an original, descriptive account of efforts by the insurance industry to monitor their insureds' climate governance. Part V argues that D&O insurers are uniquely positioned to serve as climate governance monitors, and offers next steps for both private and public actors toward realizing that promise.

I. THE PROMISE AND LIMITS OF INSURANCE AS REGULATION

What is the purpose of insurance? The traditional contractual conception of insurance describes it as a voluntary and bilateral agreement between the insurer and policyholder for the purpose of transferring risk and compensating victims for loss.[36] Thus, insurance law is grounded in contract theory. But there is a loftier view of insurance as a form of private regulation.[37] This view is not new, but it has recently gained momentum. The promise of insurance to *reduce* risk, as opposed to merely shift or spread risk, is wide-ranging. Proponents claim that it can improve health and safety, enhance cybersecurity, and even increase diversity.[38] Others caution against this exuberance and point out that because insurance is a tool for encouraging *risk-taking*, it will, by design, increase losses.[39] These critics argue that the essential feature of insurance also invites its greatest bug—moral hazard, the idea that an insured party will be inclined to take less care because it is not bearing the cost, or at least full cost, of harm.[40] The job of insurers, then, is not to reduce the damage to zero, but to calibrate the balance between risk-taking and moral hazard to a socially optimal level.[41] They argue no amount of fine-tuning can reduce the amount of loss to a level below what would exist without insurance.[42]

This Part offers an introduction to the theory of insurance as regulation. Section A describes the arguments in support of insurance as regulation. Section B examines the theory's many limitations, setting the stage for the Article's key argument—the traditional limitations of

[36] There are other, less common conceptions of insurance, including "the public utility conception," which views insurance as the sale of an essential good requiring regulation, or "the product conception," which views insurance as the sale of a tangible good regulating the quality of certain products. *See generally* Kenneth S. Abraham, *Four Conceptions of Insuran*ce, 161 U. PA. L. REV. 653 (2013).

[37] Ben-Shahar & Logue, *supra* note 11, at 217–28 (2012) (describing the ability of insurance to regulate risk in ways that are superior to government regulation).

[38] *See, e.g.*, John Rappaport, *How Private Insurers Regulate Public Police*, 130 HARV. L. REV. 1539 (2017); Troy Herr, *Cyber Insurance And Private Governance: The Enforcement Power Of Markets*, 15 REGULATION AND GOVERNANCE 98 (2021); Anat Lior, *Insuring AI: The Role of Insurance in Artificial Intelligence Regulation*, 35 HARV. J. LAW & TECH 467 (2022).

[39] Abraham et al., *supra* note 36, at 274 (2022) (arguing that because insurance is designed to promote productive risk-taking, it cannot "produce a net-positive effect on loss prevention").

[40] Rappaport, *supra* note 39, at 5 (defining moral hazard as the quandary in which insurance "dampen[s] the incentives of insured parties to take care").

[41] *See generally* Tom Baker, *On the Genealogy of Moral Hazard,* 75 TEX. L. REV. 237 (1996).

[42] Abraham & Schwartz, *supra* note 12, at 67-68.

insurance as regulation either do not apply, or apply less forcefully, to climate risk.

A. The Promise of Insurance as Regulation

Political gridlock and polarization, among other factors, have sparked renewed interest in private regulatory efforts, reviving a longstanding debate.[43] Critics warn that relying on the private sector to advance the public interest is normatively misguided and practically infeasible.[44] Proponents disagree and point to the many ways that private regulators routinely reinforce the public interest by informing, shaping, testing, refining, and legitimizing regulation.[45] For example, Michael Vandenbergh finds that private regulatory initiatives have "important effects on environmental behavior and environmental quality."[46] Relatedly, Kishanthi Parella argues that private governance can address regulatory gaps, particularly when the harm spans jurisdictions, or when government regulators are too entrenched to act in the public interest.[47]

Sociologist Richard Ericson was the first to conceptualize insurance as a form of private regulation that is separate from, and collaborates with, the state.[48] Rather than adhering to the contractual theory of insurance,

[43] The focus on private versus public regulation is a core debate in corporate governance today. *See generally* Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 173 (2020) (arguing that private regulatory efforts "would impede or delay legal, regulatory, and policy reforms that could provide real, meaningful protection to stakeholders"); Dorothy S. Lund, *Asset Managers as Regulators,* 171 U. PA. L. REV (forthcoming 2023) (highlighting concerns with asset managers acting as "private regulators" in response to government dysfunction); *But see* Aneil Kovvali, *Stark Choices for Corporate Reform*, COLUM. L. REV. (forthcoming 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4067505 [https://perma.cc/VUV9-QLU7] (discussing the false dichotomy between internal and external regulation).

[44] *See, e.g.*, Ralf Michaels, *The Mirage of Non-State Governance*, 2010 UTAH L. REV. 31, 33 (2010) (criticizing the notion of "non-state governance" as "conceptually," "empirically," and "normatively unattractive").

[45] *See, e.g.*, Michael P. Vandenbergh, *The Private Life of Public Law*, 105 COLUM. L. REV. 2029, 2033 (2005) (describing how private regulation reinforces public environmental law through incorporation into insurance policies); *see also* Cary Coglianese & David Lazer, *Management-Based Regulation: Prescribing Private Management to Achieve Public Goals*, 37 LAW & SOC'Y REV. 691 (2003) (discussing analyzing management-based regulation in the context of social goals including pollution reduction).

[46] Michael P. Vandenbergh, *Private Environmental Governance*, 99 CORNELL L. REV. 129 (2013). *See also* Pamela S. Quinn, *Regulation in the Shadows of Private Law*, 28 DUKE J. COMPAR. & INT'L L. 327 (2018).

[47] *See* Kishanthi Parella, *Outsourcing Corporate Accountability*, 89 WASH. L. REV. 747, 767-69 (2014) (examining the limitations of regulation in reducing human rights-related and other violations across global supply chains); see also

[48] RICHARD V. ERICSON, AARON DOYLE, & DEAN BARRY, INSURANCE AS GOVERNANCE (Univ. of Toronto Press 2003) ("Thus insurers have long been among the private entities involved in regulation."). Ericson identifies nine ways that insurance governs: it objectifies risks into "degrees of chance and harm," converts

advocates of this view describe insurance as "a crucial form of delegated state power."[49] Insurance companies, they argue, are not merely private companies, but operate as "social institutions … that serve important, particularized functions in modern society—often acting as adjunct arms of governance and reflecting social and commercial norms."[50] For example, various legal mandates require insurance for risky activities, and the government essentially outsources compliance monitoring to insurers.[51] Insurance scholars also point to tort law as an example of this symbiotic relationship between government and insurers. While rare, this prosocial articulation of insurance occasionally shows itself in judicial opinions that distinguish insurance contracts from other purely commercial contracts.[52]

In sum, insurance as regulation adherents believe that their view is normatively grounded.[53] But they also support their claims with empirical accounts, both qualitative and quantitative, of how insurance reduces socially harmful behavior.[54] Insurers utilize the following tools at various phases of the insurance relationship to reduce their insureds' losses including underwriting, monitoring, claims management, and external advocacy.[55]

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risks into costs and probabilities, creates a pool of people interested in minimizing loss, protects against loss of capital against which the insurer offers indemnification, manages risk "through surveillance and audit," makes risk "subject to contract and adjudication," offers a cultural framework for conceptions such as responsibility, offers "a social technology of justice," and "combine[s] aspects of collective well-being and individual liberty." *Id.* at 47-49.

[49] Tom Baker & Jonathan Simon, *Embracing Risk*, *in* EMBRACING RISK: THE CHANGING CULTURE OF INSURANCE AND RESPONSIBILITY 13 (Tom Baker & Jonathan Simon, eds., Univ. of Chicago Press 2002).

[50] Jeffrey W. Stempel, *The Insurance Policy as Social Instrument and Social Institution*, 51 WM. & MARY L. REV. 1489, 1495 (2010).

[51] *See* KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 57 (1986) (describing insurance for toxic torts and environmental risks as "surrogate regulation").

[52] *See, e.g.,* Aecon Bldgs., Inc. v. Zurich N. Am., 572 F. Supp. 2d 1227, 1238 (W.D. Wash. 2008) ("The business of insurance is one affected by the public interest."); Schwarz v. Liberty Mut. Ins. Co., 539 F.3d 135, 150 (2d Cir. 2008) ("Unlike most other contracts for goods or services, an insurance policy is characterized by elements of ... public interest.") (citing Cates Constr., Inc. v. Talbot Partners, 980 P.2d 407 (1999).

[53] *See, e.g.*, Deborah Stone, *Beyond Moral Hazard: Insurance as Moral Opportunity*, *in* EMBRACING RISK: THE CHANGING CULTURE OF INSURANCE AND RESPONSIBILITY (Tom Baker & Jonathan Simon, eds. 2010); Stempel, *supra* note 50, at 1495 ("The concept I am advancing could accurately be termed the insurance policy as social instrument, ... public policy instrument, or even political instrument.").

[54] Ben-Shahar & Logue, *supra* note 37, at 217–28 (2012) (describing the ability of insurance to regulate risk in ways that are superior to government regulation).

[55] For an overview of the ways that insurers engage in risk reduction, *see* Ben-Shahar & Logue, *supra* note 37, at 36; Tom Baker, *Liability Insurance as Tort Regulation: Six Ways That Liability Insurance Shapes Tort Law in Action*, 12 CONN. INS. L.J. 1, 10–12 (2005).

1. Underwriting

At the outset of an insurance relationship, insurers influence behavior through the way they underwrite risks. At one extreme, insurers may simply refuse to provide coverage to certain industries, locations, entities, or individuals.[56] Their sweeping authority to refuse to underwrite risks enables insurers to effectively dictate who engages in certain activities, and often whether the activity occurs at all.[57] If insurers choose to underwrite risk, the terms and conditions of the insurance policy can incentivize risk-reduction or encourage risk-taking. Moreover, insurers have robust tools for "information acquisition, aggregation, and prediction."[58] Motivated by a business interest to accurately price risks, insurance companies invest resources in gathering data both from and about their insureds. Arguably, this access to information makes insurers superior to government actors in reducing moral hazard, as insurers use data to create an optimal level of risk and price accordingly. This risk-based pricing can of course be inaccurate or imbued with bias,[59] but those defects apply to government regulation, too. Other tools available to insurers include "experience-rating," in which they offer benefits for risk-minimizing insureds, such as discounts for a good driving record.[60] A similar strategy is "feature rating" where insurers provide a discount to insureds that adopt a specific safety measure, such as a house alarm.[61]

Through underwriting, insurers also bolster the effectiveness of legal or regulatory efforts by conditioning insurance on strict compliance. For example, when the Federal Trade Commission created the NIST Framework for cybersecurity, insurance companies essentially enforced the framework by conditioning cyber insurance policies on compliance.[62] Insurers also encourage compliance with voluntary codes and standards that go beyond legal mandates by incorporating them into the insurance agreement. In this regard, insurers are often create much-needed "teeth"

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[56] Noor Zainab Hussain & Carolyn Cohn, *Insurer AIG Steps Back From Coal, Arctic Energy Underwriting,* REUTERS (Mar. 1, 2022, 10:15 A.M.), https://www.reuters.com/business/sustainable-business/insurer-aig-steps-back-coal-arctic-energy-underwriting-2022-03-01/ [https://perma.cc/U2M7-TAZ6].

[57] *See* Stempel, *supra* note 50, at 1498-1501 (describing the types of insurance that are required as a condition of engaging in activities including driving, operating a business, and even taking out a mortgage). Notably, some argue that we should expand the scope of mandatory insurance to other areas of harm such as cybersecurity. *See generally* Minhquang N. Trang, *Compulsory Corporate Cyber-Liability Insurance: Outsourcing Data Privacy Regulation to Prevent and Mitigate Data Breaches*, 18 MINN. J.L. SCI. & TECH. 389, 409-16 (2017).

[58] Ben-Shahar & Logue, *supra* note 37, at 217–28 (2012).

[59] Jeff Larson, Julia Angwin, Lauren Kirchner & Surya Mattu, *How We Examined Racial Discrimination in Auto Insurance Prices,* PROPUBLICA (Apr. 5, 2017), https://www.propublica.org/article/minority-neighborhoods-higher-car-insurance-premiums-methodology [https://perma.cc/RF7V-CY5U].

[60] Abraham & Schwarcz, *supra* note 12, at *12.

[61] *Id.*

[62] Justin Hurwitz, *Cyberensuring Security*, 49 CONN. L. REV. 1495, 1504-05 (2017) (explaining how insurers acted as the "regulator" for the NIST Framework).

or enforcement mechanisms for otherwise voluntary codes of conduct, including climate risk oversight standards.[63] Therefore, insurers often augment standard-setting and safety monitoring functions that the government traditionally performs. Through their underwriting, insurers also legitimize voluntary standards. Given the politicization of climate change, particularly in the US, insurers can play a crucial role in legitimizing the fact that climate risk is financial risk as opposed to a social value.[64]

2. Monitoring

After they issue a policy, insurers sometimes monitor their insureds' practices. Given that insurance contracts are renewed annually, insureds arguably have an incentive to heed their insurers' demands. Even in a more competitive market, there are transaction costs to switching insurers, and insureds rarely do.[65] Moreover, given their informational advantage and ability to track and compare their insureds' practices, insurers are uniquely equipped to offer their insureds valuable information about how to minimize loss. An obvious example is property insurers, who routinely conduct site visits and provide guidance on safety measures.[66] More recently, ransomware claims have skyrocketed, prompting cyber-insurers to begin advising their insureds on best practices to protect against ransomware.[67]

3. Claims management

Active claims management practices by insurers can help companies reduce loss *after* an adverse event has occurred. Across industries, most insurance policies require a covered party to follow certain post-injury steps to reduce loss, or coverage may be waived.[68] A clear example is automobile insurance, in which insurance companies are heavily involved in the repair process. Ben-Shahar et al. have found that this form of post-accident monitoring helps "reduce the magnitude" of loss.[69] The insurers' experience in dealing with similar claims may help them manage costs as well. Cyber insurance is another example. After a breach, some insurers help stem the tide by creating teams of cybersecurity, forensics, legal, and

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[63] William McGeveran, *The Duty of Data Security*, 103 MINN. L. REV. 1135 (2019). (describing insurance underwriting as a complimentary tool to industry standards as a form of private regulation).

[64] Roundtable Discussion # 1 with Insurance Industry Participants, January 12, 2023 (discussing the unique role that insurers, as experts and trusted advisors in risk, can play in advancing the public discourse on climate change as a financial risk.)

[65] Andrew Verstein, *supra* note 16, at *39.

[66] Baker et al., *Missing Monitor*, *supra* note 10, at fn.163 (2007).

[67] NCC GROUP, 2021 ANNUAL THREAT MONITOR (2021).

[68] Ben-Shahar & Logue, *supra* note 37, at 214.

[69] *Id.*

public relations experts.[70] These teams can help a breached party recover hacked information, respond to regulators, and deal with ransom demands.

4. External efforts to mitigate loss

Outside of the insurance agreement, insurers attempt to reduce loss in other ways, including public policy advocacy and lobbying. Of course, these efforts are designed to advance the insurance industry's business interests, but they can also be prosocial when it reduces aggregate harm. For example, insurance companies were among the first to advocate for the use of airbags,[71] seat belts, and fire sprinklers.[72] In these contexts and many others, insurers use data to pinpoint which safety measures are most effective, providing "legislative blueprints" to policymakers.[73] Insurers have also formed various public-private partnerships to develop industry codes of conduct to fill regulatory gaps, particularly with respect to health and safety. The Underwriters Laboratories, created in 1894 for the purpose of developing safety standards, is one longstanding example.[74]

B. The Limits of Insurance as Regulation

As hope in insurance as regulation proliferates, some warn that this rosy view is bound to disappoint. Most recently, Kenneth Abraham and Daniel Schwarcz have argued that, while insurance can spread risk and compensate for loss, it is woefully ill-equipped to *monitor* risk and *reduce* loss.[75] The failures are not absolute—they concede that insurance as a regulatory tool can reduce harm in certain niche cases, including police liability and legal malpractice insurance.[76] But, they argue, D&O insurance is not one of the exceptions to the rule. Before turning to why that is so, it is important to contextualize how D&O insurance functions.

1. D&O coverage, explained

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70 Shauhin A. Talesh, *Data Breach, Privacy, and Cyber Insurance: How Insurance Companies Act as "Compliance Managers" for Business*, 43 LAW SOC. INQUIRY 417, 422-25 (2018*); but see* James Sullivan & Jason R. C. Nurse, *Cyber Security Incentives and the Role of Cyber Insurance,* ROYAL UNITED SERVS. INST. (Dec. 7, 2020), https://rusi.org/explore-our-research/publications/emerging-insights/cyber-security-incentives-and-role-cyber-insurance [https://perma.cc/X2T7-XDF4] (offering mixed results).

71 MARTIN ALBAUM & INS. INST. FOR HIGHWAY SAFETY, SAFETY SELLS: MARKET FORCES AND REGULATION IN THE DEVELOPMENT OF AIRBAGS 54 (2005).

72 Verstein, *supra* note 16, at 25.

73 Ben-Shahar & Logue, *supra* note 37 at 213.

74 *Home Page*, UNDERWRITERS LABORATORIES (last visited June 21, 2022), https://www.ul.com [https://perma.cc/WK4V-7WQQ].

75 Abraham & Schwarcz, *supra* note 12.

76 *See* Tom Baker & Rick Swedloff, *Mutually Assured Protection Among Large U.S. Law Firms*, 24 CONN. INS. L.J. 1, 39-40 (2017).

D&O insurance provides three basic types of coverage to corporate directors and officers and the companies they serve. "Side A" provides coverage for claims that would otherwise hold directors personally liable. Demand for Side A insurance increased after the Enron and Worldcom financial crisis scandals, in which outside directors were held personally responsible for some of the damages.[77] Side A insurance may be problematic because its presence likely increases risk to shareholders.[78] Indeed, Baker and Griffith have argued that D&O insurers do not engage in effective monitoring, resulting in a "moral hazard"[79] in which directors and officers are not deterred by the threat of shareholder litigation, because Side A insurance will cover any personal liabilities.[80]

"Side B" reimburses the company for the indemnification payments it makes to its directors and officers. "Side C," or entity coverage, covers the company for claims against it. For publicly-traded companies Side C coverage is typically limited to securities law claims.[81] It is useful to note that with Side A coverage, individual directors and officers are the insureds, whereas with Side B and C coverage, the entity is the insured. Side B and C coverage is also subject to large deductibles, whereas side A coverage rarely is. This lack of "skin in the game" is one reason why some argue that Side A coverage is designed to incentivize directors and officers to *take*, as opposed to avoid, risks.[82]

Whether a claim is covered depends on the terms of the D&O policy, but policies typically cover "wrongful act," defined broadly as "an actual or alleged act, error, omission, misstatement, misleading, neglect, or breach of duty by an Insured Person in her or his capacity as such."[83] Fraud is specifically excluded, but only when a court adjudicates it as such. Therefore, as a practical matter, insurers pay defense and settlement costs even for fraud claims.[84]

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[77] *Side A Coverage: How It Can Help During and After the COVID-19 Pandemic?*, GALLAGHER (last visited Jul. 13, 2022), https://www.ajg.com/us/news-and-insights/2020/jun/side-a-coverage-covid-19-newsletter/ [https://perma.cc/4TZS-HZEK].

[78] *Id.* at 1842.

[79] Baker et al., *Missing Monitor*, *supra* note 10.

[80] *Id.* at 1841.

[81] Priya Cherian Huskins, *The ABCs of Your Private Company D&O (Policy Terms),* WOODRUFF SAWYER (May 7, 2014), https://woodruffsawyer.com/do-notebook/do-abc/ [https://perma.cc/XQC7-C97W].

[82] *See, e.g.,* Tzu-Ching Weng, Guang-Zheng Chen & Hsin-Yi Chi, *Effects of Directors and Officers Liability Insurance on Accounting Restatements,* 49 INT'L REV. ECON. & FIN. 437 (2017) (finding "when managers are covered by relatively higher levels of D&O insurance, they are more likely to restate their financial reports"); Zhihong Chen, Oliver Zhen Li & Hong Zou, *Directors' and Officers' Liability Insurance and The Cost of Equity*, 61 J. ACCT. & ECON. 100 (2016) (concluding "D&O insurance weakens the disciplining effect of shareholder litigation, leading to an increase in the cost of equity").

[83] *Directors and Officers (D&O) Liability Insurance*, AON (last visited Aug. 17, 2022) https://www.aon.com/solutions/commercial-risk/directors-officers-insurance/ [https://perma.cc/53K9-FUX6].

[84] *Id.*

For most large entities, an individual insurer is not able to underwrite the entire D&O policy. As a result, D&O brokers construct "insurance towers," or several layers of primary and excess insurance coverage from different insurers.[85] Moreover, multi-national companies with global subsidiaries often require an international insurance solution to protect directors and officers.[86]

2. Insurers often lack ability, incentives to monitor

The purported limitations of insurers as effective loss monitors fall under two categories. First, insurers lack the incentive to reduce loss. Second, even if insurers had the incentive, they are ill-equipped to reduce loss. As Abraham and Schwarcz have argued, the entire purpose of D&O insurance is "to encourage productive and valuable risk-taking."[87] Consequently, they infer that it is unsurprising that D&O insurance cannot reduce total aggregate loss.[88] Further, corporations purchase D&O insurance so that the board can take business risks without worrying about the threat of litigation.[89]

While a shield from liability for shareholder litigation often creates business upside, it can also encourage corporate misconduct. Since insurers pay the bill for this misconduct, there is little incentive for corporate actors to avoid the risk of shareholder litigation. Therefore, by design, D&O insurance *increases* the risk of corporate misconduct by merely "pocket-shifting" the risk of shareholder litigation from directors and officers to D&O insurers.[90] The unfortunate result is that D&O insurance strips shareholder litigation of its sting and encourages risky behavior that runs counter to shareholder interests. The resultant paradigm benefits both insurers and insureds at the expense of shareholders and society at large. For this reason, scholars have concluded that D&O insurance produces "greater moral hazard than more traditional property and liability insurance."[91]

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[85] *Directors & Officers (D&O) Insurance Explained*, ALLIANZ (Jun. 2022), https://www.agcs.allianz.com/news-and-insights/expert-risk-articles/d-o-insurance-explained.html [https://perma.cc/H7P7-9J8A].

[86] *Considering D&O Policies Outside the US?*, MARSH (May 6, 2022), https://www.marsh.com/us/services/financial-professional-liability/insights/considering-directors-and-officers-policies-outside-us.html [https://perma.cc/964Q-522A].

[87] Abraham & Schwarcz, *supra* note 12, at 5.

[88] *See id.* at 6-7.

[89] Jason Metz, *How To Get Directors and Officers Insurance,* FORBES (May 16, 2022), https://www.forbes.com/advisor/business-insurance/directors-and-officers-insurance/ [https://perma.cc/QPV8-VCZ9] (asserting that to "attract and retain qualified executives and board members, a company needs to have a D&O insurance policy in place").

[90] *See* TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION 6 (Univ. Of Chicago Press 2010) [hereinafter Baker et al., ENSURING CORPORATE MISCONDUCT].

[91] *Id.* at 18.

Moreover, while D&O insurers may nudge corporate directors to adopt one governance practice or another, they do not typically condition insurance terms on specific governance reforms or practices.[92] The reasons are market-driven. Insurance is a highly competitive business. In a competitive market, insureds might not agree to restrictive terms in a policy when another insurer is offering a similar policy without the restrictions.[93] As Andrew Verstein has recently argued, even in a "hard" insurance market where insurers have the upper hand, insureds rarely switch their carriers.[94]

Even if insurers have the incentives, scholars argue that they lack the ability. After all, loss prevention and risk mitigation in the context of D&O requires governance expertise, which is amply supplied by law firms and other consultants. Unlike property damage, or even cybersecurity, where insurers' risk mitigation services may be in demand, insurers and brokers can hardly compete with sophisticated outside counsel on corporate governance.[95] This reality is exacerbated by the fact that any corporate governance gaps identified by counsel are cloaked in attorney-client privilege.[96] In comparison, loss prevention efforts by D&O insurers are weak or symbolic.

All these findings are consistent with Tom Baker and Sean Griffith's comprehensive empirical analysis of the D&O insurance industry, in which they concluded that, far from reducing loss, D&O insurance worsens corporate governance.[97] Andrew Verstein recently agreed with this sobering account, summing up that "nearly everyone agrees that D&O insurance is the problem" for the rather uninspiring approach that many directors take towards risk oversight. [98]

What, then, must change to encourage insurers to use the tools at their disposal to improve corporate governance and reduce D&O losses? One obvious motivating factor is loss.[99] If the expected loss to the D&O insurer exceeds the value of the premiums, it will tip the scale in favor of

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[92] *See id.* at 109 (stating "D&O insurers do not condition the sale of insurance on compliance with loss-prevention requirements in any systematic way").

[93] In-person interview with Law Firm Partner # 1 (December 2021).

[94] *See* Verstein, *supra* note 16, at 34.

[95] Online interview with Law Firm Partner # 3 (May 2022), Law Firm Partner # 5 (August 2022).

[96] *See id.* Although information provided to underwriters can remain confidential, it does not have the same level of protection as the attorney client privilege provides.

[97] Baker et al., ENSURING CORPORATE MISCONDUCT, *supra* note 90, at 3 (finding that "D&O insurance significantly erodes the deterrent effect of shareholder litigation, thereby undermining its effectiveness as a form of regulation"); Baker et al., *Missing Monitor*, *supra* note 10; Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' and Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487 (2007) [hereinafter Baker et al., *Predicting Corporate Governance Risk*]; Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755 (2009) [hereinafter Baker et al., *How the Merits Matter*].

[98] Verstein, *supra* note 16, at 3.

[99] Interview with Insurance Broker # 4 (November 2021), Interview with D&O Underwriter # 3 (July 2022).

loss-monitoring. Cyber insurance is a recent example of this phenomenon at play. According to coverage counsel specializing in cybersecurity risk, the loss prevention efforts imposed by cyber insurers amounted to little more than window dressing just two to three years ago.[100] Today, however, cyber insurance underwriters routinely condition coverage on the insureds' cybersecurity protocols and processes. Insurers also engage in active monitoring of their insureds' cybersecurity efforts. This shift occurred after the spike in claims paid by insurers to resolve ransomware attacks.[101] Analogously, as Part II details, climate-related legal and regulatory risks facing directors and officers have increased, and those risks are materializing in an increase in covered claims.[102]

II. THE MOUNTING PRESSURE ON BOARDS TO MONITOR CLIMATE RISK

This Part describes the forces that are pressuring boards into prioritizing climate governance as a crucial pillar of corporate governance. Section A details investor pressure on boards to step up their oversight of climate risk. Section B discusses regulatory pressures on boards to disclose and mitigate climate risk. Section C explains how such regulatory pressure prompts climate governance-related D&O claims. In sum, these pressures are increasing insurers' incentives to invest in monitoring their insureds' climate governance.

A. Investor Pressure

As BlackRock CEO Larry Fink has repeatedly stressed, "climate risk is investment risk."[103] This recognition from BlackRock, the largest asset manager in the world, is not anomalous among today's institutional investors. Climate governance was the top ESG priority for US institutional investors in 2022.[104] Such investor focus on climate risk is a product of how large investors experience systemic risk.[105] Due to the rise of index investing, a small number of "universal owners" manage

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[100] Interview with Law Firm Partner # 4 (April 2022).

[101] *Id. See also, e.g.*, BAKER ET AL., ENSURING CORPORATE MISCONDUCT, *supra* note 90, at 44; Talesh, *supra* note 70, at 423 (comparing cybersecurity with D&O insurance monitoring); Abraham, *supra* note 12, at 14; Ben-Shahar & Logue, *supra* note 37, at 204.

[102] It is not just the *quantity*, but the *quality* of ESG-related claims that is causing insurers to behave differently. As Part IV examines, unlike most discreet risks, ESG risks are systemic, and threatening the viability of the insurance industry. *See infra* Part IV.

[103] *See* BlackRock, Larry Fink's Letter to CEOs, *supra* note 1.

[104] Chris Hall, *Climate Tops ESG Priorities for US Institutional* Investors, ESG INVESTOR (Dec. 13, 2022), https://www.esginvestor.net/climate-tops-esg-priorities-for-us-institutional-investors/ [https://perma.cc/6UZA-T5JZ].

[105] *See* Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1, 5 (2020); John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEG. ANALYSIS 35, 54–70 (2014) (arguing for a different fiduciary duty for directors to maximize portfolio values, as opposed to firm-specific shareholder value).

portfolios that are highly diversified. Modern portfolio theory teaches that diversification allows universal owners the ability to avoid idiosyncratic risks arising from a particular company or industry, but diverse portfolios are, by design, exposed to systemic or "unhedgeable" risks[106] that affect the entire economy.[107] Climate change is one such systematic risk.[108] While estimates vary, experts project that climate risk threatens 18% of the global GDP, with a 10% GDP forecasted loss for the United States.[109] Moreover, in 2021 alone, climate disasters amounted to a combined $170 billion in damages globally.[110]

To address these portfolio-wide and economy-wide impacts, investors have recognized that they need to work together, prompting the rise of Investor Climate Alliances.[111] Consider Climate Action 100+ (hereinafter "Climate Action") which represents 700 global investors and over $68 trillion of assets under management.[112] Of the three goals central to Climate Action's engagement agenda, improving climate governance—such as board oversight of climate risk—is ranked first.[113] The coalition is demanding ambitious transition plans from companies for the short-term, medium-term, and long-term.[114] Similarly, the Glasgow Financial Alliance for Net Zero (GFANZ) is a UN-backed coalition of seven net zero alliances that span the financial services industry. Its more than 500

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106 *Id.*

107 *Id. See* John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEG. ANALYSIS 35, 54–70 (2014) (arguing for a different fiduciary duty for directors to maximize portfolio values, as opposed to firm-specific shareholder value). *But see* Roberto Tallarita, *The Limits of Portfolio Primacy*, 76 VAND. L. REV. (forthcoming 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3912977/ [https://perma.cc/WX2L-78CS]; *see also* Marcel Kahan & Edward B. Rock, *Systematic Stewardship with Tradeoffs* (N.Y.U. Law & Econ. Rsch. Paper No. 22-01, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3974697 [https://perma.cc/BY33-LCDM].

108 *See id.*

109 Natalie Marchant, *This is How Climate Change Could Impact the Global Economy*, WORLD ECON. F. (June 28, 2021), https://www.weforum.org/agenda/2021/06/impact-climate-change-global-gdp/ [https://perma.cc/N2G7-VD5M].

110 Damian Shepherd, *The World Paid a Huge Financial Price for Climate-Driven Extreme Weather in 2021*, TIME (Dec. 26, 2021, 9:34 PM), https://time.com/6131659/climate-disaster-extreme-weather-cost/ [https://perma.cc/PWM5-NDV3].

111 This is a recent phenomenon. Climate Action is one of at least eight investor alliances that have formed over the past three years. *Climate Programmes and Investor Initiatives*, PRI (Oct. 31, 2022), https://www.unpri.org/climate-change/climate-programmes-and-investor-initiatives/10745.article [https://perma.cc/L7YL-ATA3].

112 *Home Page,* CLIMATE ACTION 100+ (last visited June 23, 2022), https://www.climateaction100.org/ [https://perma.cc/XC6D-TKXW].

113 *The Three Asks*, CLIMATE ACTION 100+ (last visited June 23, 2022), https://www.climateaction100.org/approach/the-three-asks/ [https://perma.cc/VW29-EG72]

114 Bailey McCann*, Investors Put New Weight Behind ESG Mandates*, PENSIONS & INVS. (June 6, 2022, 12:00 AM), https://www.pionline.com/largest-money-managers/investors-put-new-weight-behind-esg-mandates/ [https://perma.cc/MS6Y-8EWR].

members represent 40% of global financial institutions. GFANZ members commit to five requirements:

1. Using science-based guidelines to reach net zero emissions across all emissions scopes by 2050;
2. Setting 2030 interim targets that represent a fair share of the 50% decarbonization required by the end of the decade;
3. Setting and executing on a net zero transition plan;
4. Transparent reporting and accounting on progress against those targets; and
5. Adhering to strict restrictions on the use of offsets.[115]

Alliances like GFANZ and Climate Action are reinforcing public regulatory efforts to address climate risk, which the next section examines.

B. Legal and Regulatory Changes

1. US regulators are hesitant and inconsistent

The SEC is finally turning up the heat on climate governance. In March 2022, the Commission proposed enhanced climate disclosure rules, which were described by many as "the most sweeping overhaul of corporate disclosure rules in more than a decade."[116] Notably, the proposed rules focus on climate governance. They would require disclosure of boards' committees tasked with climate governance, expertise on climate, information-gathering on climate risks, and incorporation of climate risk into oversight duties.[117] Beyond that, the proposed rules do not prescribe a specific governance framework, leaving the details to the board's discretion. Legal and insurance advisors warn that directors will now owe "a heightened level of diligence."[118] The SEC has also made it easier to file shareholder proposals on ESG issues more broadly.[119]

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[115] *Membership*, GFANZ (last visited Jan. 27, 2023), https://www.gfanzero.com/membership/ [https://perma.cc/J3JD-MM33].

[116] SEC, Press Release, SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors (Mar. 21, 2022), https://www.sec.gov/news/press-release/2022-46 [https://perma.cc/2FYE-YFY6].

[117] *Proposal for the Enhancement and Standardization of Climate-Related Disclosures for Investors*, SEC 33-11042, 34-94478, File No. S7-10-22, at 94 (2022), https://www.sec.gov/rules/proposed/2022/33-11042.pdf [https://perma.cc/3VQC-WR7M].

[118] Lenin Lopez, *Governance Disclosure and the SEC's Proposed Climate Rules*, WOODRUFF SAWYER (May 3, 2022), https://woodruffsawyer.com/do-notebook/governance-disclosure-and-the-sec-proposed-climate-rules/ [https://perma.cc/5VEP-PRSK].

[119] The SEC did so by issuing a bulletin acknowledging that it would "no longer focus on determining the nexus between a policy issue and the company, but will instead focus on the social policy significance of the issue that is the subject of the shareholder proposal." Shareholder Proposals, Staff Legal Bulletin No. 14L (CF), SECS.

At the state level, New York and California, among a few others, are passing disclosure laws of their own.[120] In direct opposition to these efforts, conservative politicians are attempting to cast doubt on ESG's efficacy and climate change more broadly. Conservative think tanks, such as the Heartland Institute, have already succeeded in passing anti-ESG legislation in 24 states. Likewise, the Heritage Foundation, another conservative think tank, has proposed model legislation to help states "fight back against progressive ESG initiatives and the attempt to redefine the purpose of businesses."[121] This "ESG backlash" is taking place on all levels of the U.S. government, though national Republicans, at least, have gained very little legislative ground to that effect. All in all, these conflicting legal regimes muddy boards' playbooks, and increase the pressure on the board to reinforce its climate governance.[122]

2. International law on climate risk monitoring

Unlike the US, the European Union is on the forefront of a growing global movement to transform voluntary ESG norms and standards into "hard law." [123] Since 2014, European companies have been required to report on various social and environmental matters.[124] In January 2022, the EU increased the reporting burden to include more rigorous and quantifiable data. However, EU efforts go beyond corporate disclosure. Regulations adopted in February 2022 require large companies to ensure that their own activities—and those of their supply chains—comply with

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EXCH. COMM'N. (Nov. 3, 2021), https://www.sec.gov/corpfin/staff-legal-bulletin-14l-shareholder-proposals [https://perma.cc/4DMJ-F8G9] (citing example of a proposal "raising human capital management issues with a broad societal impact would not be subject to exclusion solely because the proponent did not demonstrate that the human capital management issue was significant to the company," which previously would have been viewed as excludable under Rule 14a-8(i)(7).).

[120] For instance, California has passed legislation requiring large companies to disclose all their greenhouse gas emissions, which would be a first in the U.S. *See* Cydney Posner, Cooley LLP, *California's Proposed Climate Corporate Accountability Act Goes Belly Up*, HARV. L. SCH. F. CORP. GOV. (Sep. 25, 2022), https://corpgov.law.harvard.edu/2022/09/25/californias-proposed-climate-corporate-accountability-act-goes-belly-up/ [https://perma.cc/A4WH-36YL]. In New York, the State Assembly is considering requiring global fashion and apparel companies to map their supply chains, disclose critical climate risks, and publish mitigation plans. *See* Fashion Sustainability & Social Accountability Act, S. A8352, Assemb. (NY. 2021),

[121] *State Pension Fiduciary Duty Act*, HERITAGE FOUNDATION (last visited Feb. 10, 2023), https://www.heritage.org/article/state-pension-fiduciary-duty-act [https://perma.cc/J3UF-RUCR].

[122] Due in part to the backlash against ESG, boards must ensure that their climate commitments can be supported by data that verifies that the climate risks are financially material, rather than mere values-based statements.

[123] HOGAN LOVELLS, NEW AND EMERGING ESG LAWS (May 5. 2021), https://www.hoganlovells.com/~/media/hogan-lovells/pdf/2021%20PDFs/2021_05_05_New_and_Emerging_ESG_laws.pdf [https://perma.cc/E9C9-DM5V] (noting that the EU is the "forerunner on legislative developments").

[124] *Id.*

human rights and environmental sustainability criteria.[125] This directive created an affirmative "corporate duty to identify, prevent, mitigate and account for external harm resulting from adverse human rights and environmental impacts" in supply chains.[126]

Looking beyond traditional regulatory action, the Paris Agreement was the first climate treaty to grant public and non-state actors a role, marking a new era in "polycentric" governance. As coined by Nobel Prize-winning economist Elinor Ostrom, "polycentric" governance requires public and private entities to collaborate on standard setting, certification, monitoring, and reporting.[127] Indeed, states as well as individual companies are signatories to the Agreement. Commentators have argued that climate change demands such an all-hands approach.[128] However, making empty climate commitments—or potentially even failing to fulfill earnest climate commitments—can expose companies to additional D&O liability.

C. Increased Climate Risks Result in D&O Coverage Obligations

Climate risk is starting to materialize into cognizable claims against D&O insurers. Climate-related D&O claims include: 1) shareholder lawsuits, 2) shareholder activist campaigns, and 3) regulatory investigations. This Section will examine each of these types of claims in turn.

1. Shareholder litigation

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[125] Press Release, European Commission, Just and Sustainable Economy: Commission Lays Down Rules for Companies to Respect Human Rights and Environment in Global Value Chains (Feb. 23, 2022), https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1145 [https://perma.cc/V7VP-8MQN]. *See also* Proposal For a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and Amending Directive (EU) 2019/1937, COM (2022) 71 final (Feb. 23, 2022), https://ec.europa.eu/info/sites/default/files/1_1_183885_prop_dir_susta_en.pdf [https://perma.cc/CZ4Z-NH2P].

[126] Council Directive 2014/95, Amending Directive 2013/34/EU as Regards Disclosure of Non-Financial and Diversity Information by Certain Large Undertakings and Groups, 2014 O.J. (L 330) 1, 4 (EU).

[127] *See* Elinor Ostrom, *A Polycentric Approach for Coping with Climate Change*, Policy Research Working Paper 5095 (2009), https://documents1.worldbank.org/curated/en/480171468315567893/pdf/WPS5095.pdf [https://perma.cc/XNP4-BR5V].

[128] Caroline Streck, *Strengthening the Paris Agreement by Holding Non-State Actors Accountable: Establishing Normative Links between Transnational Partnerships and Treaty Implementation*, 10 TRANSNATIONAL ENV'T L. 493 (2021); *see also* Elinor Ostrom, *A Multi-Scale Approach to Coping with Climate Change and Other Collective Action Problems*, 1 SOLUTIONS 27 (2010); Ostrom, *supra* note 127.

Event-driven securities litigation: Directors and officers of publicly-traded companies can be liable under federal securities laws[129] for failing to disclose material information.[130] In the past, securities litigation largely arose out of financial misstatements.[131] If the stock price fell in response to restated financial results, shareholders would sue; often alleging that the restatement itself was as an admission that directors misstated financials. Today, shareholders have found a new avenue for securities litigation.[132] This new breed of shareholder suit is often filed after the press exposes a corporate crisis, such as an environmental disaster or a sexual harassment claim.[133] The ensuing negative press tarnishes the company's reputation, precipitating a drop in the share price. Shareholders can then argue that the directors and officers concealed financially material risks, as exposed by the disaster at hand.[134]

Corporate disasters arising from climate issues are triggering an increase in so-called "event-driven" securities litigation.[135] For example, California's well-publicized wildfires led to lawsuits against PG&E alleging poor climate governance.[136] A unique feature of these lawsuits is that the underlying victims are not shareholders.[137] For instance, in accounting fraud cases, shareholders suffer only financial harm, and "money certainly compensates for money."[138] On the other hand, in the

[129] 17 C.F.R. § 240.10b-5 (2022). There is also D&O exposure for violating state securities law or "blue sky" laws. *See generally* Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229, 234 (2003).

[130] Such an omission is material if "the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder." TSC Indus. v. Northway, Inc., 426 U.S. 438 at 449 (1976).

[131] For a comparison of traditional "fraud on the market" securities litigation to event-driven litigation, *see generally* Matt Levine, *Everything Everywhere is Securities Fraud*, BLOOMBERG (June 26, 2019, 9:01 AM), https://www.bloomberg.com/opinion/articles/2019-06-26/everything-everywhere-is-securities-fraud [https://perma.cc/5XA8-BWX3] (distinguishing traditional securities fraud cases from "event-driven" litigation). *See also* Merritt B. Fox & Joshua Mitts, *Event-Driven Suits and the Rethinking of Securities Litigation* (Colum. L. Sch. Law & Econ. Working Paper No. 660, 2022), https://ssrn.com/abstract=4140444 or http://dx.doi.org/10.2139/ssrn.4140444 [https://perma.cc/X5LE-UP6Q].

[132] These suits may be filed as either a securities class action suit (alleging harm to investors) or a shareholder derivative lawsuit (alleging harm to the company).

[133] *See* Donald C. Langevoort, *Disasters & Disclosures: Securities Fraud Liability in the Shadow of a Corporate Catastrophe*, 107 GEO. L.J. 967, 974 (2019).

[134] *See id.* at 133 at 969. *See also* Michael Klausner et al., *Guest Post: "Stock Drop" Lawsuits,* THE D&O DIARY, (June 28, 2020), https://www.dandodiary.com/2020/06/articles/securitieslitigation/guest-post-stock-drop-lawsuits/ [https://perma.cc/7TH7-QVBL].

[135] Brian Mastellone, *Environmental Event-Driven Litigation: An Evolving Risk for Directors and Officers,* ZURICH INS. GRP. (Sept. 15, 2021), https://insights.zurichna.com/Environmental-event-driven-litigation-An-evolving-risk-for-directors-and-officers [https://perma.cc/SY2F-TGT8].

[136] *Id.*

[137] Emily Strauss, *Is Everything Securities Fraud?* 12 U.C. IRVINE L. REV. 1331, 1334 (2022).

[138] Baker et al., *The Missing Monitor*, *supra* note 10 at 1819.

PG&E litigation, the true victims were non-shareholders who lost their lives or their homes. Critically, as Emily Strauss points out, shareholder lawsuits involving non-shareholder victims succeed more often and garner higher settlement values.[139]

These results suggest that Delaware courts have, at least implicitly, endorsed a prosocial articulation of corporate law. In the climate context, environmental harms enabled by poor climate governance victimize non-shareholders. Thus, as Part V will argue, the "pocket-shifting" nature of D&O insurance is normatively untenable. If boards' insufficient climate governance harms society at large, the moral hazard at play is more harmful than the traditional moral hazard of reducing shareholder value.

That problem notwithstanding, scholars have found a positive correlation between good governance and avoidance of shareholder litigation.[140] Regardless, the increase in event-driven litigation is causing D&O insurance brokers to caution that policy terms "will be tested."[141] Insurance experts further predict that the SEC's proposed rules on climate-related disclosure is likely to "provide fruitful hunting grounds" for shareholder litigation.[142] In these cases, plaintiffs allege that the

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[139] Strauss, *supra* note 137, at 1346 (finding that when shareholders are the primary victims, cases are nearly 20 percentage points more likely to be dismissed than event-driven securities cases).

[140] Tom Baker and Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755 (2009). Of course, some argue that these lawsuits are designed to line the pockets of plaintiff's attorneys, not to benefit shareholders or society. CHUBB, FROM NUISANCE TO MENACE: THE RISING TIDE OF SECURITIES CLASS ACTION LITIGATION (2019), https://www.chubb.com/content/dam/chubb-sites/chubb-com/ca-en/microsites/rims/documents/pdf/from-nuisance-to-menace--the-rising-tide-of-scas--chubb.pdf [https://perma.cc/LFQ9-YGAQ]. ("[T]he class benefitting most from such litigation is not shareholders … [but] a growing cohort of lawyers who are filing meritless lawsuits … every time . . . a corporate misfortune impacts a company's share price[.]").

[141] AON, CLIENT ALERT: THE NEW WAVE OF SECURITIES CLASS ACTION LITIGATION—MISMANAGEMENT OF CORPORATE EVENTS CAN CREATE VULNERABILITY, (Apr. 2019), https://www.aon.com/getmedia/c071e33d-8469-492f-976c-b9d4378c453c/Aon-April-2019-Event-Litigation-April-Client-Alert.aspx [https://perma.cc/K9LX-LQER]. *See also D&O Coverage for Climate Change-ESG-Related Liabilities*, ANDERSON KILL (Apr. 7, 2022), https://www.andersonkill.com/Publications/D&O-Coverage-for-Climate-Change-ESG-Related-Liabilities [https://perma.cc/5VJ8-AA9B] (noting that some insurers are considering a climate change exclusion in D&O policies).

[142] Kevin LaCroix, *Thinking About the SEC's Proposed Climate Change Disclosure Requirements*, THE D&O DIARY (Mar. 22, 2022), https://www.dandodiary.com/2022/03/articles/climate-change/thinking-about-the-secs-proposed-climate-change-and-greenhouse-gas-disclosure-requirements/ [https://perma.cc/4WEJ-8VTZ]. In particular, an increase in greenwashing claims is prompting warnings that insurers may introduce broader coverage exclusions. David Halbreich et al., *Will SEC's Climate Disclosure Proposal Trigger D&O Coverage?* PROPERTY CASUALTY 360 (5:00 AM, May 24, 2022), https://www.propertycasualty360.com/2022/05/24/how-the-secs-climate-disclosure-proposal-may-trigger-insurance-coverage/?slreturn=20220424154716 [https://perma.cc/8DP3-GQRN].

board's failure to disclose climate change risks caused the company's stock to trade at artificially inflated prices.[143] For example, Chemours Company stockholders sued the company in 2019 for "knowingly and systematically understat[ing] its known environmental liabilities exposure," relying on a lawsuit filed by Chemours accusing its parent company, DuPont, of secretly offloading its significant environmental liabilities onto Chemours.[144] Thus, as climate-related litigation proliferates, it builds a foundation for later lawsuits that can use the preceding cases as evidence of "red flags." With over 1800 climate-related cases pending worldwide, and an increase in climate change legislation, we expect this trend to continue.

Caremark: In Delaware, the landmark *Caremark* decision of 1996 instilled directors with a proactive duty to monitor corporate wrongdoing, but required an exceedingly high pleading burden.[145] Accordingly, legal scholars have overwhelmingly dismissed *Caremark*'s ability to magnify board risk oversight.[146] But recent developments resurrect the promise of *Caremark* to strengthen board accountability for climate risks.

D&O insurers could previously take some comfort from the fact that shareholders ultimately failed to meet their pleading burden in each *Caremark* case, but recent Delaware decisions are disrupting this sense of assurance. For example, in *Marchand v. Barnhill*, an ice cream manufacturer's listeria outbreak led to three deaths, a product recall, and a stock price plummet.[147] The Delaware Supreme Court held that the plaintiffs adequately pleaded the claim that the board failed to oversee food safety.[148] *Marchand* introduced the concept of "mission-critical" business functions that require enhanced board oversight because they are, or should be, so central to the company's business operation that compliance with them is an absolute necessity; here, food safety was the "mission-critical" sector of business.[149] As Cynthia Williams has argued,

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143 *Climate Change Litigation Threats to Directors and Officers*, WILLIS TOWER WATSON (Nov. 27, 2019), https://www.willistowerswatson.com/en-US/Insights/2019/11/climate-change-litigation-threats-to-directors-and-officers [https://perma.cc/7M4A-939M].

144 Kevin LaCroix, *Environmental Liability-Related Securities Suit Filed against DuPont Spin-Off Chemours*, THE D&O DIARY (Oct. 13, 2019), https://www.dandodiary.com/2019/10/articles/environmental-liability/environmental-liability-related-securities-suit-filed-against-dupont-spin-off-chemours/ [https://perma.cc/4WVK-CJJH].

145 *See In re* Caremark Int'l Inc. Derivative Litig*.*, 698 A.2d 959 (Del. Ch. 1996).

146 *See generally* Jennifer Arlen, *The Story of Allis-Chalmers, Caremark, and Stone: Directors' Evolving Duty to Monitor*, *in* CORP. L. STORIES 323 (J. Mark Ramseyer ed., 2009) (arguing that the importance of Caremark may have been exaggerated). *But see* Claire A. Hill, *Caremark as Soft Law*, 90 TEMPLE L. REV. 681, 687–88 (2018) (arguing that *Caremark* has a meaningful impact on how boards oversee risk).

147 Marchand v. Barnhill, 212 A.3d 805, 809 (Del. 2019) (reversing the denial of a motion to dismiss in the food safety context).

148 *Id.*

149 *See id.* at 822 (stating that food safety "has to be one of the most central issues

oversight of climate risk is arguably becoming "mission-critical" for boards.[150]

Subsequent cases including *Boeing*, *Hughes*, and *Armstrong* warn that *Marchand* is not an anomaly.[151] As Roy Shapira has argued, we are amid "A New Caremark Era."[152] Shapira argues this era was propelled by the Delaware court's increasingly deferential posture towards Section 220 demands in *Caremark* cases. These demands allow stockholders to examine corporate documents such as board minutes and directors' personal emails, placing boards' risk oversight processes in the spotlight.[153] Though a series of financial crisis-era cases limited *Caremark*'s scope to legal violations, the new line of cases holding that *Caremark* applies to "mission critical" risks is causing scholars and legal experts to wonder if the distinction is obsolete.[154] As the court in *Boeing* explained,

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at the company" and "a compliance issue intrinsically critical to the company's … business operation"). *See also* SARAH BARKER, CYNTHIA WILLIAMS, & ALEX COOPER, CANADA CLIMATE LAW INITIATIVE, FIDUCIARY DUTIES AND CLIMATE CHANGE IN THE UNITED STATES 4 (Oct. 20, 2021), https://ccli.ubc.ca/resource/fiduciary-duties-and-climate-change-in-the-united-states/ [https://perma.cc/7RRQ-QU98] ("Climate change significantly increases the risks a corporation faces, and therefore may catalyze a breach of directors' and officers' duty of oversight.").

[150] Jonathan Drimmer & Yousuf Aftab, *ESG and Mission-Critical Issues for Director & Officer Liability*, CORPGOV (2019), https://corpgov.com/esg-and-mission-critical-issues-for-director-officer-liability/ [https://perma.cc/JP9E-YAUU] ("For global companies across sectors, a growing array of ESG issues increasingly play a similar [mission-critical] role and are increasingly being regulated as such."); *see also* Cole Gray, *Climate Enterprise Risk as Socially Critical* (Jan. 20, 2023) (unpublished student note) (on file with author) (arguing that climate change risk should be considered "mission critical" for most companies).

[151] Roy Shapira, *A New Caremark Era: Causes and Consequences*, 98 WASH. U.L. REV. 1857 (2021). *See also In re* Clovis Oncology, Inc. Derivative Litig., No. 2017-0222, 2019 WL 4850188, at *10 (Del. Ch. Oct. 1, 2019) (denying motion to dismiss in the pharmaceutical regulatory approval context); Hughes v. Xiaoming Hu, No. 2019-0112, 2020 WL 1987029, at *1 (Del. Ch. Apr. 27, 2020) (denying a motion to dismiss in the financial reporting and oversight context); Inter-Mktg. Grp. U.S. v. Armstrong, No. 2017-0030, 2020 WL 756965, at *1 (Del. Ch. Jan. 31, 2020) (denying a motion to dismiss in part in the environmental compliance context).

[152] Shapira, *supra* note 151, at 1895-96 ("Delaware courts have been carving a constantly growing exception to the deferential standard, in the form of 'mission critical compliance:' in situations where meeting certain regulatory demands is critical to the firm's success, directors should be especially alert to yellow and red flags, and proactively monitor compliance.").

[153] *Id.*

[154] *See* Roy Shapira, *Mission Critical ESG*, at *36 (forthcoming 2023) ("[T]his is less of an argument against applying *Caremark* to ESG, and more of an argument about *how* to apply *Caremark* to ESG. The argument basically calls on judges to focus on the process, and to leave the merits of specific managerial choices alone. Coincidentally, this is exactly what Delaware courts are already doing ... the courts refrain from interfering with the merits of the board's choices on how to set up compliance systems and how to prioritize among different risks. ... What judges do instead is focus on the process, and interfere only in cases where directors failed to even consider a critical factor."); Gray, *supra* note 150, at 20-24 (arguing that *Citigroup's* distinction between legal and business risk under *Caremark* is irrelevant because, among other reasons,

"the fact that the company's product facially satisfies regulatory requirements does not mean that the board has fulfilled its oversight obligations to prevent corporate trauma."[155] The *Boeing* holding, which led to the largest *Caremark* settlement in Delaware history, emphasized the absence of a board committee tasked with overseeing airplane safety and the lack of information the board received on airplane safety,[156] placing increased scrutiny on how boards oversee "mission critical risks."[157]

In sum, *Caremark* liability for boards "remains exceedingly rare," but legal advisors warn it is "the obvious cause of action for plaintiffs seeking to complain about board inaction in the face of climate-related exposure, or in response to high-profile corporate trauma."[158] This blurring of the lines between legal and enterprise risk is prompting commentators[159] and practitioners[160] to warn that directors have a duty to oversee climate change risks and ESG risks more broadly. Further, under the *Caremark* standard, underlying lawsuits are themselves red flags to which boards must respond.[161] Given the increase in lawsuits on environmental damage, the "red flags" will increase, signaling to investors that the time is ripe for shareholder lawsuits. For all of these reasons, D&O insurers and brokers are bracing for an increase in *Caremark* lawsuits alleging the board's failure to oversee "mission critical" climate change risks.[162]

International D&O litigation: Louise Fournier, legal counsel for Greenpeace International, predicts that "[c]ommunities impacted by the climate emergency and shareholders will increasingly sue directors, officers, and board members of large polluting companies." Indeed, on February 9, 2023, ClientEarth—a UK-based environmental law charity—filed a derivative suit against Shell's directors for failing to adopt a strategy that "truly aligns" with the 2015 Paris climate agreement, as well as the

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Citigroup is founded on the business judgment rule, while *Caremark* does not or should not implicate the business judgment rule).

155 *In re* The Boeing Co. Derivative Litig., C.A. No. 2019-0907-MTZ, 2021 WL4059934 (Del. Ch. 2021).

156 *Id.*

157 Jeff Montgomery, *Chancery OKs Record $237.5M Boeing 737 Max Damage Deal*, LAW360 (Feb. 23, 2022, 8:53 PM), https://www.law360.com/articles/1467870/chancery-oks-record-237-5m-boeing-737-max-damage-deal [https://perma.cc/6YTB-4MYA].

158 Priya Cherian Huskins, *Duty of Oversight Claims: Hard to Prove but Boards Need to Be Proactive,* WOODRUFF SAWYER (Mar. 3, 2021), https://woodruffsawyer.com/do-notebook/duty-oversight-claims-proactive/ [PERMA].

159 *See* Gray, *supra* note 150 (arguing that climate risk should be considered mission critical for most companies because the distinction in *Citigroup* between legal and enterprise risk is obsolete).

160 DEBEVOISE & PLIMPTON LLP, THE DUTY OF US COMPANY DIRECTORS TO CONSIDER RELEVANT ESG FACTORS, PRI (2020), https://www.unpri.org/download?ac=11696 [https://perma.cc/3SJ6-3ERJ].

161 *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 364 (Del. 2006); *In re* Lear Corp. S'holder Litig., 967 A.2d 640, 654–55 (Del. Ch. 2008).

162 Huskins, *supra* note 158.

company's legal obligation to reduce its greenhouse gases by 45% by 2030.[163] Similar cases in France, the Netherlands, Germany, and Australia allege that governments and private companies are not living up to the commitments they made to meet the Paris agreement's goals.[164] These suits are revealing a new line of exposure for boards that make empty promises on climate. Indeed, the Bank of England recently warned that the biggest exposure for D&O policies today is climate litigation, including greenwashing.[165]

2. Shareholder proposals & director 'no' votes

Shareholders filed a record 471 proposals relating to environmental and social issues in 2022, a 15% increase over 2021.[166] Of those "E&S" proposals, 101 of them focus on climate change, including demands for disclosure of climate governance information. One of four resolutions relating to climate change that made it to a vote received majority support, "an unprecedented performance for this proposal type."[167] Indeed, institutional investors are increasingly willing to use the power of their vote. For example, in the 2022 proxy season, BlackRock voted against 176 directors and 234 companies on climate-related issues.[168] Similarly, in a

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163 Sam Meredith, *Shell's Board of Directors Sued Over Climate Strategy in a First-of-Its-Kind Lawsuit*, CNBC (Feb. 9. 2023, 4:07 AM E.T.), https://www.cnbc.com/2023/02/09/oil-shell-board-of-directors-sued-by-investors-over-climate-strategy.html [https://perma.cc/UU6E-Q6ZR]; *see also* Press Release, ClientEarth, We're Taking Legal Action Against Shell's Board for Mismanaging Climate Risk (Mar. 15, 2022), https://www.clientearth.org/latest/latest-updates/news/we-re-taking-legal-action-against-shell-s-board-for-mismanaging-climate-risk/ [https://perma.cc/MG83-PFY5]; James Denison, *ClientEarth v. Shell: Alleged Breaches of Board Duties*, WEIGHTMANS (Mar. 24, 2022), https://www.weightmans.com/insights/clientearth-v-shell-alleged-breaches-of-board-duties/ [https://perma.cc/S22S-3TZ7].

164 Denison, *supra* note 163 (observing that "while this action may appear novel, it is the latest in a developing line of global jurisprudence").

165 Stefan Claus, Speech at the Association of British Insurers' Climate Summit 2022 (June 8, 2022), https://www.bankofengland.co.uk/speech/2022/june/anna-sweeney-speech-at-the-association-of-british-insurers-climate-change-summit-2022 [https://perma.cc/8KXC-3QQY].

166 Daniel Litowitz & Lara Aryani, Shearman & Sterling LLP, *Trends in E&S Proposals in the 2022 Proxy Season*, HARV. L. SCH. F. CORP. GOV. (Nov. 28, 2022), https://corpgov.law.harvard.edu/2022/11/28/trends-in-es-proposals-in-the-2022-proxy-season/ [https://perma.cc/ZE42-CW8M].

167 MATTEO TONELLO, CONFERENCE BOARD, SHAREHOLDER VOTING TRENDS (2018-2022): EXECUTIVE SUMMARY (Sep. 27, 2022), https://www.conference-board.org/topics/shareholder-voting/proxy-trends-2022-executive-summary [https://perma.cc/7LDL-88HS].

168 BLACKROCK, 2022 VOTING SPOTLIGHT 20 (2022), https://www.blackrock.com/corporate/literature/publication/2022-investment-stewardship-voting-spotlight.pdf [https://perma.cc/YAR8-SWQM]. BlackRock may be pulling back. In 2021, the firm voted against 255 directors and 319 companies. Similarly, after supporting 47% of environmental and social shareholder proposals in

2022 letter, State Street emphasized that it would use its proxy vote to press companies that are falling behind on ESG.[169] When traditional institutional investors like these get involved, boards are forced to pay attention. For instance, BlackRock supported Engine No. 1's bid to replace three Exxon directors. The activist fund accused the world's largest oil company of failing to oversee climate risk and shocked the world by succeeding in its campaign.[170] Given the increase in shareholder activism on ESG issues, D&O brokers are negotiating with insurers for expanded coverage terms,[171] or bespoke stand-alone policies to cover this emerging risk.[172]

3. Government investigations

Federal and state regulatory agencies are beginning to step up enforcement of ESG issues, with a specific focus on climate risk. The SEC formed an ESG Task Force to "proactively identify ESG-related misconduct" and has sprung into action on a number of fronts.[173] In 2022, the task force charged the directors and officers of BNY Mellon Investment Advisor for misstatements and omissions by "greenwashing" its investment products.[174] According to insurance expert Kevin LaCroix,

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2021, BlackRock voted in favor of just 21% E&S proposals in 2022. BlackRock said many 2022 proposals were "more prescriptive or constraining on companies and may not promote long-term shareholder value. *Id.*; BLACKROCK, *BlackRock on Climate-Related Shareholder Proposals* (May 12, 2022), https://corpgov.law.harvard.edu/2022/05/12/blackrock-on-climate-related-shareholder-proposals/ [https://perma.cc/46QN-A5B4].

[169] Cyrus Taraporevala, *CEO's Letter on Our 2022 Proxy Voting Agenda*, STATE STREET GLOBAL ADVISORS (Jan. 12, 2022), https://www.ssga.com/us/en/institutional/ic/insights/ceo-letter-2022-proxy-voting-agenda [https://perma.cc/6S2Q-7R52].

[170] Svea Herbst-Bayliss, *BlackRock Backs 3 Dissidents to Shake Up Exxon Board*, REUTERS (May 25, 2021), https://www.reuters.com/business/energy/exclusive-blackrock-backs-three-director-nominees-challenging-exxons-board-2021-05-25/ [https://perma.cc/8BVM-W9DA]; *see also* John C. Coffee., *The Coming Shift in Shareholder Activism: From "Firm-Specific" to "Systematic Risk" Proxy Campaigns (and How to Enable Them)*, 16 BROOK. J. CORP. FIN. & COM. L 45 (2021).

[171] Anthony Rapa, *Shareholder Activism and D&O Insurance: A Valuable But Overlooked Resource,* WILLIS TOWERS WATSON (Nov. 12, 2018), https://www.wtwco.com/en-US/Insights/2018/11/finex-observer-shareholder-activism-d-o-insurance [https://perma.cc/5FHF-2Z2L].

[172] *Shareholder Activist Protection Insurance,* MARSH (last visited Jun. 30, 2022), https://www.marsh.com/uk/services/financial-professional-liability/products/shareholder-activist-protection-insurance.html [https://perma.cc/CY2G-74VM] (presenting the world's first shareholder activism insurance solution).

[173] Press Release, SEC, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42 [https://perma.cc/KW7M-Q9YU].

[174] Press Release, SEC, SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations (May 23, 2022), https://www.sec.gov/news/press-release/2022-86 [https://perma.cc/6R5X-5UPT].

the "SEC's actions – so far and in the future – will have a lot to say about the ultimate meaning of ESG issues in the D&O world."[175] The DOJ has gotten involved as well, responding to President's Biden's call for "a comprehensive, [g]overnment-wide strategy" on climate-related financial risk[176] by creating the first Office of Environmental Justice.[177] At the state level, attorneys general are preparing to launch their own investigations on climate risk disclosures.[178] This marshaling of government regulatory power is spawning warnings from insurance experts and board advisors of an increased risk of enforcement actions against misrepresentations in ESG disclosures.[179] The next Part will discuss how these pressures come to bear upon the insurance industry.

III. THE MOUNTING PRESSURE ON INSURERS TO MONITOR CLIMATE RISK

If climate-related D&O claims continue to rise, it is logical to predict that D&O insurers will step up their monitoring of insureds' climate governance.[180] Such analysis has commonsense appeal and is accurate in many contexts, such as cybersecurity. As Part IV explains, climate-related liability exposure for directors and officers is causing D&O underwriters to gather climate governance information from insureds in engagement meetings. However, scholars are less convinced that increased D&O claims activity will provide a strong enough incentive for insurers to monitor corporate governance. The reason is simple: insurers can charge higher premiums to cover losses.[181] This Part responds to that argument, positing that unlike the traditional D&O claims (i.e., securities fraud), climate risk is a "systematic risk" threatening the financial viability of the

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[175] Kevin LaCroix, *Attention: The ESG Cops Are On The Beat,* THE D&O DIARY (May 24, 2022), https://www.dandodiary.com/2022/05/articles/regulatory-enforcement-2/attention-the-esg-cops-are-on-the-beat [https://perma.cc/TB7V-BG2C].

[176] Exec. Order No. 14,030, 86 Fed. Reg. 27,968 (May 5, 2021); Jonathan D. Brightbill & Jennifer Roualet, *New DOJ Policies Impact Environmental and ESG Enforcement*, WINSTON & STRAWN LLP (Nov. 9, 2021), https://www.winston.com/en/winston-and-the-legal-environment/new-doj-policies-impact-environmental-and-esg-enforcement.html [https://perma.cc/4ZFH-H6HK].

[177] Merrick B. Garland, U.S. Attorney General, Remarks Launching Comprehensive Environmental Justice Strategy, U.S. DEP'T OF JUSTICE (May 5, 2022), https://www.justice.gov/opa/speech/attorney-general-merrick-b-garland-delivers-remarks-launching-comprehensive-environmental [https://perma.cc/DUH7-WAER].

[178] Jonathan Brightbill & Jennie Porter, *An Early Look At What State AGs Want From ESG Disclosures,* LAW360 (July 8, 2021, 2:55 PM), https://www.law360.com/articles/1401457/an-early-look-at-what-state-ags-want-from-esg-disclosures [https://perma.cc/XQJ5-G3WK].

[179] Jay A. Dubow et al., *Recent SEC Complaint Signals Increased Enforcement Risk for Companies on ESG Disclosures*, TROUTMAN PEPPER (May 10, 2022), https://www.troutman.com/insights/recent-sec-complaint-signals-increased-enforcement-risk-for-companies-on-esg-disclosures.html.

[180] *See* Talesh*, supra* note 70, at 479-84. In-person Interview with Law Firm Partner #1 (December 2022).

[181] *See* Baker et al., *Predicting Corporate Governance Risk*, *supra* note 97.

insurance industry.[182] Merely increasing premiums is not a sufficient response to these risks, as they threaten both sides of the insurer's balance sheet. Indeed, climate governance—good or bad—has cascading effects for insurers, far beyond the bargained-for contractual risk.[183] For instance, climate disasters enabled by poor climate governance trigger claims across lines of coverage, from property insurance to life insurance. Meanwhile, good climate governance creates cost savings that span insurers' entire portfolios. As such, climate risk provides potent incentives for insurers to monitor climate governance.

This Part argues that the potentially multiplicative financial consequences of climate risk should rationally motivate the insurance industry to *reduce*, rather than merely spread, climate risk. Section A examines how the insurance business model renders insurers uniquely exposed to climate risk. Section B explains how climate risk exposure is prompting insurance industry stakeholders to demand that insurers improve their climate governance by embedding climate risk across their underwriting, investment, and operational decisions.

A. The Two Sides of the Insurer's Balance Sheet & Systematic Risk

Insurers create revenue through both underwriting and investing.[184] On the underwriting side of the balance sheet, insurers assume risk on behalf of their policyholders in exchange for a premium. When an insured suffers a covered loss, the insurer is contractually obligated to pay. Thus, to remain profitable, payouts cannot exceed premiums. Obviously, then, insurers bear risk if they either charge insufficient premiums or underwrite losses that, in the aggregate, exceed premiums. On the other side of the balance sheet, insurers invest the premiums they collect to generate profits and capitalize long-term liabilities.[185]

Though prior scholarship has focused exclusively on underwriting and claims management, poor climate governance also poses risks to insurers' *assets*, particularly in the long term.[186] In part, this is because

182 CAPGEMINI EFMA, WORLD PROPERTY AND CASUALTY INSURANCE REPORT 2022 (May 19, 2022), https://www.capgemini.com/us-en/news/insurers-need-to-fundamentally-change-business-models-to-achieve-climate-resiliency/ (reporting that "[c]limate change is hurting the insurance industry and only 8% of insurers are preparing adequately for its impact").

183 For instance, climate disasters enabled by poor climate governance can trigger claims across lines of coverage, from property insurance to life insurance.

184 *See* AM BEST, BEST'S GUIDE TO UNDERSTANDING THE INSURANCE INDUSTRY (2019) (explaining the general operations of the insurance industry).

185 *See* Helmut Gründel et al., *The Evolution of Insurer Portfolio Investment Strategies for Long-Term Investing,* 2016 OECD J. FIN. MARK. TRENDS 1, 5 (2016) (noting life insurance contracts are relatively longer-term compared to non-life insurance policies); *Insurers as Investors*, ASSOC. BRITISH INSURERS (last visited Jun. 8, 2022), https://www.abi.org.uk/data-and-resources/tools-and-resources/regulation/insurers-as-investors/ [https://perma.cc/6VZ7-LAS4].

186 Hailey Ross, *Climate Risks for Insurers: Why the Industry Needs to Act Now to Address Climate Risk on Both Sides of the Balance Sheet,* S&P GLOBAL (Aug. 27, 2021),

insurers are investing in "stranded assets," or companies and industries that are failing to account for financially material climate risks.[187] For instance, as of 2021, the U.S. insurance industry had roughly $536 billion invested in fossil fuel-related activities.[188] These investments expose insurers' portfolios to massive financial risk, and impact both sides of the insurance industry's balance sheet.[189]

As highly diversified investors, insurers are the paradigmatic example of a "universal owner."[190] As Madison Condon has argued, given their systematic risk exposure and long-term horizons, universal owners are less tolerant of companies that externalize costs.[191] Unlike traditional investors, universal owners do not benefit from an *individual* company's gains if it comes at the expense of other companies in their portfolio.[192] John Armour and Jeffrey Gordon have also argued that, while diversified investors typically want an individual firm to take on more risk compared to a concentrated shareholder, this logic falls apart if that firm is taking on

https://www.spglobal.com/esg/insights/climate-risks-for-insurers-why-the-industry-needs-to-act-now-to-address-climate-risk-on-both-sides-of-the-balance-sheet [https://perma.cc/LLT2-KVMY] (arguing that the "insurance industry is exposed to climate-related liabilities … [i]n both its investments, and on the liability side through … underwriting").

187 Eli Flesch, *How Climate Change Threatens To Strand Insurer Assets*, LAW360 (Jun. 3, 2022, 6:35 PM), https://www.law360.com/insurance-authority/articles/1498803/how-climate-change-threatens-to-strand-insurer-assets [https://perma.cc/6VA6-NBLB]; *The Investment Challenges Facing Insurers*, AVIVA INVESTORS (May 5, 2021), https://www.avivainvestors.com/en-us/views/aiq-investment-thinking/2021/05/insurers-investment-challenges/ [https://perma.cc/CP42-4WXN] ("One of the primary drivers of increased interest and allocations to ESG-positive real assets is the recognition these will sit on the balance sheet for a long time, sometimes decades.").

188 S&P GLOBAL, ESSENTIAL ESG INTELLIGENCE: CLIMATE RISK & RESILIENCE ANALYSIS 8 (Apr. 2022), https://interactive.web.insurance.ca.gov/apex_extprd/cdi_apps/r/260/files/static/v58/Analysis%20of%20Insurance%20Company%20Investments%20-CDI-Final-Reportv2.pdf [https://perma.cc/R7QP-S9NT].

189 Flesch, *supra* note 187.

190 For an overview of universal ownership, *see generally* Condon, *supra* note 33; Ellen Quigley, Universal Ownership in the Age of COVID-19: Social Norms, Feedback Loops, and the Double Hermeneutic (unpublished manuscript) (May 21, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3612928 [https://perma.cc/F7QM-TYEB]. For a historical account, *see Universal Ownership: Why Environmental Externalities Matter to Institutional Investors*, PRI (Oct. 1, 2010), https://www.unpri.org/environmental-issues/universal-ownership-why-environmental-externalities-matter-to-institutional-investors/4068.article/ [https://perma.cc/G4EL-S3AH].

191 *See, e.g.,* Condon, *supra* note 33, at 5 (arguing "diversified investors should rationally be motivated to internalize intra-portfolio negative externalities"); Armour & Gordon, *supra* note 33, at 54–70 (arguing for a different fiduciary duty for directors to maximize portfolio values, as opposed to firm-specific shareholder value). *See also* John C. Coffee, *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk*, 2021 COLUM. BUS. L. REV. 602, 614 (claiming "institutional investors are more concerned with 'systematic risk' than are individual investors").

192 *See* Condon, *supra* note 33, at 7.

systematic risks.[193] This growing body of scholarship argues that for universal owners, the cost-benefit analysis of externalities must be made not at the individual company level, but at the portfolio level.[194] A systematic risk, by definition, cannot be eliminated through diversification.[195] While the concept can be amorphous, "the clearest example of a major systematic risk is the risk of adverse climate change."[196] Since 2020, climate disasters have caused $760 billion in damages globally, according to Munich Re.[197]

Investor focus on climate change reflects how these diversified investors experience systematic risks.[198] John Coffee has predicted an era in which "universal owners … align[] their strategy with minimizing portfolio-wide risks."[199] The SEC's recent proposed climate change disclosure requirements reveal that this era has already arrived:

> [I]nvestors often employ diversified strategies, and therefore do not necessarily consider risk and return of a particular security in isolation but also in terms of the security's effect on the portfolio as a whole, which requires comparable data across registrants.[200]

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193 Armour & Gordon, *supra* note 33, at 57.

194 *See id. But see* Tallarita, *supra* note 107, at *16.

195 *See id.* (explaining that "diversification reduces 'idiosyncratic' (or 'firm-specific') risk, but not "systematic risk"). *See* RICHARD A. BREALEY, STEWART C. MYERS, & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 178-81 (13th ed. 2020); *see generally* JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC 21 (2000) (explaining that systemic risk affects a wide range of economic, political, and social institutions whereas systematic risk impacts financial markets and portfolios).

196 *See id.*

197 Damian Shepherd, *The World Paid a Huge Financial Price for Climate-Driven Extreme Weather in 2021*, TIME (Dec. 26, 2021, 9:34 PM), https://time.com/6131659/climate-disaster-extreme-weather-cost/ [https://perma.cc/MZH6-QPY3]; Press Release, Munich Re, Record Hurricane Season and Major Wildfires – The Natural Disaster Figures for 2020 (Jan. 7, 2021), https://www.munichre.com/en/company/media-relations/media-information-and-corporate-news/media-information/2021/2020-natural-disasters-balance.html [perma.cc/5QPJ-K6D5]; Press Release, Munich Re, Climate Change and La Niña Driving Losses: The Natural Disaster Figures for 2022 (Jan. 10, 2023), https://www.munichre.com/en/company/media-relations/media-information-and-corporate-news/media-information/2023/natural-disaster-figures-2022.html [perma.cc/X95H-DQQE]; Press Release, Munich Re, Hurricanes, Cold Waves, Tornadoes: Weather Disasters in USA Dominate Natural Disaster Losses in 2021 (Jan. 10, 2022), https://www.munichre.com/en/company/media-relations/media-information-and-corporate-news/media-information/2022/natural-disaster-losses-2021.html [perma.cc/D5ZG-Y476].

198 *See* Condon, *supra* note 33.

199 *See, e.g.*, Coffee, *supra* note 191, at 46-47 ("This recognition that change at one firm can affect the value of other firms in the portfolio implies a new goal for activism: namely, to engineer a net gain for the portfolio, possibly by reducing "negative externalities" that one firm is imposing on other firms in the investor's portfolio.").

200 SEC Proposed Rule 17 CFR §§ 210, 229, 232, 239 (proposing rule that broadly

The universal owner phenomenon is even more acute for insurers because they are feeling the impacts of climate change on both their liabilities and their assets. Climate risk, such as biodiversity loss, impacts multiple types of insurance and assets.[201] However, unlike most universal owners who cannot "exit," insurers also have the unique ability to *prevent* the activities that threaten the value of their assets by refusing to underwrite firms or industries that externalize their costs onto the broader economy.[202] Moreover, they have the incentive to do so: if they fail to exercise this power, they threaten their own financial sustainability. This is not a theoretical argument—it is consistent with a growing sentiment among insurance industry regulators and experts. For example, economists at the Swiss Re Institute, the research arm of the world's largest reinsurer, has warned that insurers must act swiftly to prevent climate change from creating economy-wide harms that insurers will disproportionately bear.[203] And the European Central Bank's latest Financial Stability Report has stressed that extreme weather events will only exacerbate these financial harms to insurers:

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diversified investors evaluating any individual asset for addition to a portfolio need to consider its risk and return characteristics not in isolation, but in terms of the asset's effect on the portfolio as a whole, and providing CalPERS as an example of an asset owner holding a diversified growth-oriented portfolio that has integrated climate risk assessment into its investment process); *see also* Carine Smith Ihenacho & Severine Neervoort, *The Proposed SEC Climate Disclosure Rule: A Comment from Norges Bank Investment Management*, HARV. L. SCH. F. CORP. GOV (Jul. 24, 2022), https://corpgov.law.harvard.edu/2022/07/24/the-proposed-sec-climate-disclosure-rule-a-comment-from-norges-bank-investment-management/ [https://perma.cc/LAS3-M3JG] ("We welcome the Commission's proposed rules, which we believe will lead to more consistent, comparable, and reliable climate-related reporting from companies, and thereby help investors get a better picture of companies' value. Better sustainability reporting can also contribute to well-functioning and efficient markets."); Press Release, Amalgamated Bank, Amalgamated Bank Statement on Proposed SEC Climate Disclosures (Mar. 21, 2022), https://amalgamatedbank.com/news/amalgamated-bank-statement-proposed-sec-climate-disclosures [https://perma.cc/M3PK-JMPQ] ("Evaluation and disclosure of climate risk to investors is central to the work of companies and investors the world over.").

[201] *See infra* Part IV. For example, commentators are predicting that failure to oversee biodiversity loss risk has the potential to "impact multiple classes of insurance." Wynne Lawrence, *Biodiversity Risk Will Become Material by 2024*, INSURANCE DAY (Mar. 21, 2022), https://insuranceday.maritimeintelligence.informa.com/ID1140218/Biodiversity-risk-will-become-material-by-2024 [https://perma.cc/JGU4-YNX2].

[202] *See generally* VINCENT HUCK, INSURERS' SUSTAINABLE INVESTING JOURNEY, J.P. MORGAN & INSURANCE ASSET RISK (2021), https://www.insuranceassetrisk.com/content/partnered-content/market-insight/insurers-sustainable-investment-journey.html [https://perma.cc/W8QN-QRQM].

[203] SWISS RE INSTITUTE, THE ECONOMICS OF CLIMATE CHANGE: NO ACTION NOT AN OPTION 28-30 (Apr. 2021) https://www.swissre.com/dam/jcr:e73ee7c3-7f83-4c17-a2b8-8ef23a8d3312/swiss-re-institute-expertise-publication-economics-of-climate-change.pdf/ [https://perma.cc/7ZPS-TQ92].

> The floods and wildfires in Europe earlier this year illustrate financial impacts of climate-related hazards. This includes not only impacts on bank lending, but also on insurers directly exposed to losses from natural catastrophes. From a systemic perspective, insufficient and potentially diminishing insurability of climate-related risks and associated risk pooling could also significantly amplify future economic losses.[204]

Insurers are also exposed on the liability side of the balance sheet because they are obligated to pay for losses arising out of climate change-related disasters. These losses necessarily manifest across insurance lines. For example, a failure to oversee climate change risk can trigger both a D&O claim and a property damage claim.

B. The Insurance Industry Faces Pressure to Monitor Climate Risk

Given the industry's unique exposure to climate risk, regulators, investors, and other stakeholders are imploring insurers to incorporate climate risk analysis into their underwriting and investment decisions.[205]

1. Regulatory pressure

State and federal insurance regulation: The 1945 McCarran-Ferguson Act granted states the authority to regulate insurance.[206] Thus, state regulators are taking the lead on climate change risks in the insurance industry.[207]

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[204] EUROPEAN CENTRAL BANK, FINANCIAL STABILITY REVIEW (Nov. 2021) https://www.ecb.europa.eu/pub/financial-stability/fsr/html/ecb.fsr202111~8b0aebc817.en.html [https://perma.cc/4GM3-4ZSH].

[205] Alex D'Amico et al., *A Better Investor Story for Insurers,* MCKINSEY & CO. (Sept. 20, 2021), https://www.mckinsey.com/industries/financial-services/our-insights/insurance-blog/a-better-investor-story-for-insurers [https://perma.cc/V2LT-REBN].

[206] McCarran-Ferguson Act, Pub. L. No. 79-15, 59 Stat. 33 (1945) (codified at 15 U.S.C. §§ 1011-1015 (2006)).

[207] The Federal Insurance Office (FIO) has traditionally played a limited role in the industry. But commentators predict that the Biden administration's executive order on climate-related financial risks has "the potential to reinvigorate the role of the FIO." DELOITTE, *Climate Risk Regulatory Developments in Financial Services*, *in* 6 CREATING A CLIMATE OF CHANGE DIG. 2 (July 2021). *See also* Exec. Order No. 14,030, 87 Fed. Reg. 8289 (May 20, 2021) (directing the FIO to analyze the climate matters pertaining to the insurance sector, including threats of disrupting private insurance coverage in vulnerable regions). The FIO's current priorities include: (1) assessing climate-related gaps in insurance regulation; (2) assessing and planning for potential disruptions of insurance coverage in climate change-vulnerable U.S. markets; and (3) leveraging the insurance sector's ability to help achieve climate-related goals. *Id.* This newfound focus on climate change portends a more expansive role for the FIO, and is sparking a

For instance, the New York Department of Financial Services (NYDFS) analyzed over $550 billion of insurer-owned assets and concluded that the investment portfolios of New York insurers are over-exposed to carbon-intensive sectors, with looming financial risks on the horizon.[208] To address this, the report issued guidance requiring New York's domestic insurers to adopt and disclose a climate risk policy with details on board oversight, as well as risk mitigation at the management level.[209]

Similarly, in California, the fourth-largest insurance market in the world,[210] insurers have invested $536 billion of assets into fossil fuel companies.[211] In 2016, the state's insurance department asked insurers to divest from coal and carbon-based investments.[212] More recently, in April 2022, the department launched an effort to reduce fossil fuel investments.[213] Going even further, lawmakers are proposing legislation to require insurance companies to disclose fossil fuel investments and underwriting.[214]

The National Association of Insurance Commissioners: States regulate the insurance industry, and the FIO has a budding role, but the National Association of Insurance Commissioners (NAIC) coordinates national insurance standards.[215] The NAIC recently established a Climate and

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backlash against climate and ESG regulation more broadly. *See* Scott M. Seaman, *Comments Due to the Federal Insurance Office on its Wide-Ranging Work Relating to the Insurance Sector and Climate-Related Financial Risks,* HINSHAW & CULBERTSON LLP (Oct. 12, 2021), https://www.hinshawlaw.com/newsroom-updates-insights-for-insurers-federal-insurance-office-climate-change-rfi-comments.html/ [https://perma.cc/6NY7-S9EN] (arguing the FIO "could greatly diminish or virtually supplant many aspects of state regulation of insurance").

208 Press Release, N.Y. Dep't of Fin. Services, Superintendent Lacewell Announces New DFS Report on New York Domestic Insurers' Exposure to Financial Risks Arising from the Low-Carbon Transition, (June 10, 2021) (on file with author).

209 *See, e.g.*, Andrew Otis & Brittany Batts*, Insurers Can Use an ESG Program To Implement New York's New Climate Change Financial Risk Guidance,* N.Y. L.J. (Jan. 5, 2022), https://www.law.com/newyorklawjournal/2022/01/05/insurers-can-use-an-esg-program-to-implement-new-yorks-new-climate-change-financial-risk-guidance/ [https://perma.cc/6T4G-3LSR].

210 *Id.* California is not only the largest insurance market in the US, but the fourth largest market in the world. *$332B in Premiums Makes California World's 4th Largest Insurance Market*, INS. J. (Apr. 5, 2018), https://www.insurancejournal.com/news/west/2018/04/05/485527.htm [https://perma.cc/4NDA-HJC7].

211 Carmen Balber, *California Climate Insurance Disclosure Bill Stalls*, CONSUMER WATCHDOG (Apr. 18, 2022, 4:46 PM), https://consumerwatchdog.org/insurance/california-climate-insurance-disclosure-bill-stalls [https://perma.cc/C97C-N9XJ].

212 Press Release, Cal. Dep't of Ins., California Insurance Commissioner Dave Jones Calls for Insurance Industry Divestment From Coal (Jan. 25, 2016), https://www.insurance.ca.gov/0400-news/0100-press-releases/archives/statement010-16.cfm [https://perma.cc/P6VF-UTHH].

213 *California Climate Insurance*, CAL. DEP'T OF INS. (last visited June 8, 2022) http://www.insurance.ca.gov/cci/ [https://perma.cc/4UA9-V7GN].

214 Balber, *supra* note 211.

215 The NAIC is a US standard-setting and regulatory support organization created

Resiliency Task Force,[216] and announced a new standard aligning with the Task Force for Climate Related Financial Disclosures (TCFD) for reporting insurance company climate risks.[217] Insurance commissioners in fifteen states have committed to use the new standard, which requires specific disclosures concerning climate governance. Only 28 insurance companies published TCFD-aligned reports in 2021, but nearly 400 insurance companies—or 80% of the US insurance market—committed to publishing such reports in 2022.[218]

International insurance regulation: Insurers are regionally regulated, but insurance is a global business. Accordingly, global regulation places pressure on insurers, regardless of where they are domiciled. Notwithstanding the recent developments discussed above, US state and federal regulators have generally lagged behind their international counterparts on climate risk regulation.[219] For example, while California is considering requiring TCFD-aligned reports from insurers, insurance regulators from France, Switzerland, and the UK, among others, already

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and governed by the chief insurance regulators from all 50 US states, the District of Columbia and five US territories. *See Home Page*, NAIC (last visited June 8, 2022), https://content.naic.org/ [https://perma.cc/FJ9M-RQ6T]. A similar organization exists at the international level. The International Association of Insurance Supervisors (IAIC) published a recent paper providing recommendations for insurance supervisors to strengthen efforts to address climate-related risks. *Application Paper on the Supervision of Climate-related Risks in the Insurance Sector*, INT'L ASSOC. INS. SUPERVISORS (May 2021), https://www.iaisweb.org/uploads/2022/01/210525-Application-Paper-on-the-Supervision-of-Climate-related-Risks-in-the-Insurance-Sector.pdf [https://perma.cc/AVS6-C33U] ("Climate-related risks are material for the insurance sector as they impact the insurability of policyholder property and assets as well as insurers' operations and investments.").

216 CLIMATE AND RESILIENCY (EX) TASKFORCE, NAT'L. ASSOC. OF INS. COMM'RS (last visited June 8, 2022), https://content.naic.org/cmte_ex_climate_resiliency_tf.htm [https://perma.cc/5QPZ-VT8W].

217 J. Paul Forrester & Lawrence R. Hamilton, *US NAIC Prioritizes Climate Risk and Resilience with a Focus on Related Disclosure,* MAYER BROWN (Feb. 16, 2021), https://www.mayerbrown.com/en/perspectives-events/publications/2021/02/us-naic-prioritizes-climate-risk-and-resilience-with-a-focus-on-related-disclosure [https://perma.cc/59B8-WWBB].

218 Press Release, California Dep't of Ins., U.S. Insurance Commissioners Endorse Internationally-Recognized Climate Risk Disclosure Standard for Insurance Companies (Apr. 8, 2022), https://www.insurance.ca.gov/0400-news/0100-press-releases/2022/release025-2022.cfm/ [https://perma.cc/AQ62-4WGQ].

219 Thomas M. Dawson, *The Future of Climate Change Risk Regulation for Insurers in America?*, MCDERMOTT WILL & EMERY (Mar. 12, 2021), https://www.mwe.com/insights/the-future-of-climate-change-risk-regulation-for-insurers-in-america/ [https://perma.cc/AQ62-4WGQ] (discussing how political polarization in the U.S. limits efforts to incorporate climate change into insurance regulation). *See also* Bill Marcoux, *The ESG Agenda and Insurance: Regulatory Developments, Goals and Limitations*, INT'L INS. SOC'Y (Apr. 2021), https://www.internationalinsurance.org/sites/default/files/2021-04/ESG%20Agenda%20and%20Insurance%204.12.2021_0.pdf [https://perma.cc/Y7M4-DZBC] (discussing global regulatory efforts).

require such reports.[220] Insurance authorities in the Netherlands and the UK were among the first to request a formal assessment of climate change risks in 2018 and 2019, respectively.[221] In 2021, the European Insurance and Occupational Pensions Authority issued an opinion setting forth the expectation for companies to integrate climate risk scenarios into short-term and long-term planning.[222] Finally, in 2021 the EU issued directives requiring integration of sustainability factors into the product oversight and governance requirements of insurance products.[223]

2. Investor pressure

The insurance industry is facing its own shareholder pressure to incorporate climate risk into its underwriting, investments, and operations. As an industry executive explained via interview, investors are focused on insurers' climate governance, especially oversight of climate risk. Climate risk governance is dominating the agenda in engagement meetings with insurance industry board members and executives.[224] When engagement fails, investors turn to more public channels such as shareholder proposals. In the 2022 proxy season, a record 11 climate-related shareholder proposals gained majority support from shareholders at companies like Boeing, Chevron, Costco, and Exxon.[225] Similarly, 2021

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220 Press Release, Nat'l Assoc. Ins. Comm'rs, U.S. Insurance Commissioners Endorse Internationally Recognized Climate Risk Disclosure Standard for Insurance Companies (Apr. 8, 2022), https://content.naic.org/article/us-insurance-commissioners-endorse-internationally-recognized-climate-risk-disclosure-standard [https://perma.cc/66J7-9FGE].

221 Valerie Stephan & Keven Roy, *Building Climate-Aware Stress Tests,* JPMORGAN CHASE & CO. (Oct. 2021), https://am.jpmorgan.com/content/dam/jpm-am-aem/global/en/institutional/investment-strategies-/insurance/climate-stress-test-web.pdf [https://perma.cc/BY29-ZTE4].

222 Press Release, European Ins. & Occupational Pens. Auth., EIOPA Issues Opinion on the Supervision of the Use of Climate Change Risk Scenarios in ORSA (Apr. 19, 2021), https://www.eiopa.europa.eu/media/news/eiopa-issues-opinion-supervision-of-use-of-climate-change-risk-scenarios-orsa_en [https://perma.cc/7AU6-7D2M].

223 Commission Delegated Regulation 2021/1257 of April 21, 2021, 2021 O.J. (L 227) 18-24 (EU).

224 Online Interview with Insurance Executive #1 (July 2022).

225 Press Release, The Conference Board, Proposals on Climate Disclosures Gained Momentum in 2022 (Sept. 28, 2022), https://www.conference-board.org/press/climate-disclosures-2022-proxy-season [https://perma.cc/7XZE-NKZG]. Because bank lending is contingent on insurance, insurers are in a unique position to impact the viability of new fossil fuel projects. Shareholders recognize this; as one aptly summed up, "without insurance, almost none of the [new fossil fuel] projects can go forward." *See* Emile Hallez, *Chubb Faces New Kind of Shareholder Vote Over Fossil Fuels*, INV. NEWS (Mar. 29, 2022), https://www.investmentnews.com/chubb-shareholder-resolution-green-century-219240 [https://perma.cc/96M9-7HVJ]. However, proposals asking insurers to reduce or eliminate fossil fuel underwriting gained much less support. Investors at Chubb (19.4% support), The Hartford (8.8%), and Travelers (13.2%) rejected proposals to end

resolutions at Chubb and Travelers demanding climate change disclosures received 72% and 56% support, respectively.[226] The passage of these proposals reflects shareholders' exasperation with U.S. insurance companies "driving climate risk to investors, insurers, and the global economy."[227] The SEC has ruled against major insurers' attempts to exclude such proposals from their proxy statements, paving the way for more such proposals in the future.[228]

Shareholders and investors are relying on credit rating agencies to assess financial resilience of insurance companies.[229] Crucially, these credit rating agencies can impact the cost of capital for *both* public and private insurers. For example, AM Best, the largest global credit rating agency specializing in the insurance industry, was the first to incorporate climate risk into insurers' credit ratings.[230] Morningstar, another major agency, was not far behind, and now incorporates "17 significant ESG factors"

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fossil fuel underwriting in 2022. Jen Frost, *Travelers Swerves Fossil Fuel Insurance Block*, INS. BUS. AMERICA (May 30, 2022), https://www.insurancebusinessmag.com/us/news/environmental/travelers-swerves-fossil-fuel-insurance-block-407833.aspx [https://perma.cc/NS2D-YBRH]. *See also* Elizabeth Dilts Marshall & Ross Kerber, *Bank Shareholder Proposals to Curb New Fossil Fuel Lending Get Slim Support*, REUTERS (Apr. 26, 2022, 4:55 PM E.T.), https://www.reuters.com/business/sustainable-business/bank-shareholder-proposals-curb-new-fossil-fuel-lending-get-slim-support-2022-04-26/[https://perma.cc/C7RC-58WV] (discussing similar shareholder proposals aimed at banks, which also gained little support in 2022).

[226] Eli Flesch, *Chubb Investors Split On Approving 2 Climate Proposals*, LAW360 (May 19, 2022, 9:51 PM), https://www.law360.com/insurance-authority/articles/1495133/chubb-investors-split-on-approving-2-climate-proposal [https://perma.cc/329D-NANY]; Press Release, As You Sow, Investors Send Greenhouse Gas Reduction Message to National Insurance Companies (Jun. 1, 2022), https://www.asyousow.org/press-releases/2022/6/1/investors-greenhouse-gas-reduction-message-insurance-companies [https://perma.cc/VZV8-6PTS].

[227] Press Release, As You Sow, Investors Send Greenhouse Gas Reduction Message to National Insurance Companies (Jun. 1, 2022), https://www.asyousow.org/press-releases/2022/6/1/investors-greenhouse-gas-reduction-message-insurance-companies [https://perma.cc/VZV8-6PTS].

[228] Letter from Sanford Lewis, Sec's Exch. Comm'n, to Edward S. Best, Mayer Brown LLP, Re: Chubb Limited (Mar. 26, 2022), https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2022/greencenturychubb032522-14a8.pdf [https://perma.cc/BQ9C-JVB5]; Roxanne Libatique, *SEC Rules on Calls for Chubb to Stop Underwriting Fossil Fuels*, INS. BUS. MAG. (Mar. 28, 2022), https://www.insurancebusinessmag.com/us/news/breaking-news/sec-rules-on-calls-for-chubb-to-stop-underwriting-fossil-fuels-400303.aspx [https://perma.cc/R2AR-UQKF].

[229] Of course, these ratings themselves will face SEC scrutiny. *See SEC Flags Risks for Ratings Firms in ESG Boom,* BUS INS. MAG. (Feb. 1, 2022), https://www.businessinsurance.com/article/00010101/NEWS06/912347618/SEC-flags-risks-for-ratings-firms-in-ESG-boom [https://perma.cc/H555-54GA].

[230] Press Release, AM Best, AM Best Issues FAQ on ESG and Insurance Credit Ratings, Announces Inclusion of ESG Section in Best's Credit Reports, (Nov. 22, 2021, 8:04 AM E.T.), https://news.ambest.com/newscontent.aspx?refnum=237927&altsrc=174 [https://perma.cc/SME8-S59W].

into its credit ratings.[231] And in 2021, the S&P 500 Global released its first ever report detailing the ESG factors impacting insurers.[232] Relatedly, the S&P 500 has stressed its higher expectations for insurance companies when it comes to governance. Notably, S&P did not give a single insurance company with a G1 rating (the highest score for governance), calling specifically for board oversight improvements before it could award higher scores.[233] It is widely predicted that "ESG-driven decisions will influence insurers' credit ratings in the medium term as social and regulatory pressures push more insurers to account for ESG considerations."[234]

1. Stakeholder pressure

In addition to regulators and shareholders, insurers are facing scrutiny from NGOs, environmental activists, employees, and communities. For instance, the "Insure Our Future" campaign releases an annual scorecard assessing global insurers' relationships with the fossil fuel industry. The 2021 scorecard gave Chubb and Travelers low marks for both underwriting and investing in fossil fuels.[235] This spawned a letter from more than 70 environmental and public health groups to Chubb, claiming that the company has gone from "a leader to a laggard."[236] In response to widespread criticism, the company in September 2021 dropped its plan to insure the Trans-Mountain Pipeline, a controversial tar sands project considered "destructive and risky" by many.[237] These events show that insurers must compete on climate governance to attract new customers

231 *Id.*

232 Daniel Wood, *S&P Releases First Ever ESG Report on Insurers*, INS. BUS. AUSTL. (Jan. 7, 2022), https://www.insurancebusinessmag.com/au/news/environmental/sandp-releases-first-ever-esg-report-on-insurers-321245.aspx [https://perma.cc/F5QG-3WX2].

233 *Id.*

234 Jahna Jacobson, *ESG Will Increasingly Influence Insurers' Strategies: Fitch Ratings*, INS. J. (Nov. 21, 2022), https://www.insurancejournal.com/magazines/mag-features/2022/11/21/695640.htm [https://perma.cc/YF76-K3J7].

235 *See* INSURE OUR FUTURE, 2021 INSURE OUR FUTURE SCORECARD, https://insureourfuture.co/wp-content/uploads/2021/11/2021-Insure-Our-Future-Scorecard.pdf [https://perma.cc/MY85-2PY3] ("Together, the world's biggest oil and gas insurers AIG, Travelers, Zurich, Allianz, Chubb and Liberty Mutual could end more than half the underwriting of the [fossil fuels] industry.").

236 Ryan Smith, *Chubb CEO Under Fire for Environmental Approach – 70 Groups Join Forces*, INS. BUS. AM. MAG., (May 21, 2021), https://www.insurancebusinessmag.com/us/news/ environmental/chubb-ceo-underfire-for-environmental-approach--70-groups-join-forces-255727.aspx [https://perma.cc/2SA2-7MC4]. The company was once a leader because it was among the first to pledge not to insure new coal projects. *See id.*

237 *Chubb Is the 16th Insurer to Cut Ties With the Trans Mountain Tar Sands Pipeline*, WATERKEEPER ALLIANCE (Sep. 14, 2021) https://waterkeeper.org/news/chubb-is-the-16th-insurer-to-cut-ties-with-the-trans-mountain-tar-sands-pipeline/ [https://perma.cc/2SA2-7MC4].

and avoid negative attention and stockholder action, mirroring an accelerating trend throughout the business world.[238]

With respect to D&O insurers in particular, a campaign led by Greenpeace in 2014 sought to put insurers on notice that climate risk is a D&O issue. The NGO wrote letters to energy companies and their D&O insurers warning that attempts to defeat climate action or spread misleading information "could pose a risk to directors and officers personally."[239] These early warnings foreshadow an increase in climate governance shareholder litigation.

IV. CLIMATE RISK PROMPTS ACTIVE D&O MONITORING

Insurers who seek to minimize their insureds' losses invest in a range of "active" strategies throughout the insurance contract. Conversely, so-called "passive" insurers sit by until a loss occurs, then raise premiums.[240] Though the line between active and passive is blurry in practice, scholars have placed D&O insurers firmly in the "passive" category because they historically "devote essentially zero effort" to monitoring their insureds' corporate governance.[241] Even if that is a fair account of D&O insurers' traditional practice, climate risk is ushering in the era of active D&O insurance.

Active monitoring depends on information. Section A explains that insureds and insurers share climate risk information for reasons that go far beyond the insurance contract itself. Section B details how insurers are building their own climate risk governance procedures, which allow them to gather and analyze climate risk information across their underwriting portfolios. Section C describes how this systematic and portfolio-wide approach to risk is prompting a more active approach to all lines of insurance, including D&O insurance.

A. Insurers and Insureds Value Sharing Climate Risk Information

The business of insurance hinges on information, and information is a two-way street. For insurance to function profitably, insurers must be able to gain information from and about their insureds and share that information with their insureds. Insurers gather information from their insureds through questionnaires, formal engagement meetings, and more informal discussions with insureds. This information can obviously be

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238 Mary Or, *Zurich Insurance Awarded Highest ESG Rating from MSCI,* INS. BUS. AM. (June 1, 2022), https://www.insurancebusinessmag.com/us/news/breaking-news/zurich-insurance-awarded-highest-esg-rating-from-msci-408141.aspx [https://perma.cc/USA2-2HWB].

239 Kevin M. LaCroix, *Is Climate Change a D&O Insurance Issue?*, LEXISNEXIS CORPORATE (Jun. 2, 2014), https://www.lexisnexis.com/legalnewsroom/corporate/b/blog/posts/is-climate-change-a-d-amp-o-insurance-issue [https://perma.cc/L4PK-5NJ9].

240 For a discussion of active and passive insurance, *see* Verstein, *supra* note 16, at 988.

241 *Id.* at 987.

incomplete or biased, so insurers enlist an array of external sources, including data providers and consultants.[242] Then, they use this information in a variety of ways.

Most obviously, they use it to perform an "actuarial analysis" that weighs the likelihood of harm against its potential cost.[243] This analysis helps insurers set premiums or decide whether to refuse or limit coverage. Insurers also use information to nudge, coach, or require their insureds to engage in safer conduct. But gathering and sharing information is time-consuming and expensive. To warrant that investment, a few things must be true.

First, the information that insurers collect must have some correlation to reduced harms. For example, if home alarms do not actually prevent break-ins, then it does not make sense for insurers to survey insureds about home alarms. Second, the value of gathering the information must exceed the cost of gathering it. Third, the insured must be willing to provide information to its insurers. Fourth, the insured must value insurer input, such that they are willing to make reforms. Some of these things may apply to some types of insurance, but historically, none of them have been true for D&O insurance in the past.[244] Therefore, it did not make economic sense for insurers or insureds to gather and share corporate governance information. Today, in contrast, climate risk information is valuable to both insurers and insureds for reasons that are both internal and external to the insurance agreement. This reality is prompting insurers and insureds to adopt a more collaborative approach to sharing addressing climate risk.[245]

1. Good climate governance correlates to reduced securities risk

To an extent, the intuition that good governance leads to less D&O liability—or that "the merits do matter"—has always been reflected in underwriting.[246] Baker and Griffith's work revealed that D&O underwriters equate stronger ethical cultures with fewer risks.[247] But in the past, the tools insurers used to assess this "deep governance" amounted

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242 *See* Anya E.R. Prince & Daniel Schwarcz, *Proxy Discrimination in the Age of Artificial Intelligence and Big Data*, 105 IOWA L. REV. 1257 (2020).

243 *See* Ben Shahar & Logue, *supra* note 37, at 203 (calling information "critical to the business of insurance"). This is called actuarialism – the basic methodology underlying insurance.

244 *See* Baker et al., *Missing Monitor*, *supra* note 10, at 1808.

245 This collaborative information sharing is also prevalent in meetings between companies and their investors. *See* Jill E. Fisch & Simone M. Sepe, *Shareholder Collaboration*, 98 TEX. L. REV. 863, 865 (2020) (positing that "collaboration offers a mechanism for enhancing firm value that unilateral decision-making by either insiders or shareholders cannot provide").

246 Baker et al., *How the Merits Matter*, *supra* note 97. For a historical perspective, *see* Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465 (2004) (summarizing recent empirical work on the question of whether the merits matter).

247 *See* Baker & Griffith, *Missing Monitor*, *supra* note 10, at 1840.

to little more than underwriters' gut reaction.[248] Without the ability to pinpoint the actual components of effective governance, insurers could not guide their insureds on which reforms made a difference or reduced loss. Insurers' tools for loss mitigation thus remained quite blunt. Consequently, the correlation between strong governance and reduced D&O claims failed to convince insurers and insureds alike.[249] Over time, the few D&O insurers that invested in loss prevention services ultimately changed course because they could not "show the discount," or verify that their reforms reduced claims.[250]

Though insurers have not yet pinpointed every component of effective climate governance, there is a growing recognition that better board oversight of ESG issues, including climate risk, correlate with fewer shareholder lawsuits. Zurich Insurance Group recently observed a "solid connection between good governance and fewer, less severe D&O losses."[251] Recent academic studies concur.[252] For instance, Frank Partnoy and Adam Badawi conducted the first empirical account of the correlation between "strong" or "good" ESG behavior and securities litigation.[253] Their study found an empirical link between firms with "bad" ESG ratings and more shareholder litigation.[254] Investors, too, are using strong climate governance as a proxy for financial resilience, as evidenced by

248 *See id.*

249 *See id.*

250 *Id.* at 1811.

251 Adrian Jenner & Anoushka Pramanik, *ESG to Drive a New Wave of D&O Liability*, ZURICH (Aug. 30, 2022), https://www.zurich.com/en/products-and-services/protect-your-business/commercial-insurance-risk-insights/esg-to-drive-a-new-wave-of-d-o-liability [https://perma.cc/46LT-C9RT].

252 *See* Adam B. Badawi & Frank Partnoy, *Social Good and Litigation Risk*, HARV. BUS. L. REV. (forthcoming 2023) (exploring the relationship between ESG metrics and securities litigation) (on file with the author). While scholarship on ESG and litigation risk is scant, there is a rich literature on ESG and financial sustainability. *See also* Mozaffar Khan, George Serafeim, & Aaron Yoon, *Corporate Sustainability: First Evidence on Materiality*, 91 ACCT. REV. 1697, 1703 (2016) (similarly categorizing "good" and "bad" ESG firms to examine stock returns); Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 651 (2016) (examining "non-financial risks" that can influence stock price).

253 While this is the first analysis of ESG and securities litigation, some have suggested that strong ESG performance can act as insurance against risk. *See* Ping-Sheng Koh, Cuili Qian & Heli Wang, *Firm Litigation Risk and the Insurance Value of Corporate Social Performance*, 35 STRAT. MGMT. J. 1464, 1478–80 (2014) (arguing that positive social performance is worthwhile as insurance against litigation risk). *See also* Dylan Minor & John Morgan, *CSR as Reputation Insurance: Primum Non Nocere*, 53 CAL. MGMT. REV. 40 (2011); Steven Freund, Nam H. Nguyen, & Hieu V. Phan, *Shareholder Litigation and Corporate Social Responsibility*, J. FIN. & QUANTITATIVE ANALYSIS (forthcoming 2023).

254 Badawi & Partnoy, *supra* note 252. Though it is difficult to disentangle climate risk from the "S" and "G" of ESG in Badawi et al.'s study, climate risk is a crucial pillar of ESG. *Id.* at *34 ("First, ... investors and practitioners are highly focused on ESG factors, and often their discussions are framed in terms of risk ... Obviously, climate change is widely regarded as a significant ESG risk.").

their demands for increased climate disclosure.[255] In sum, unlike investments in traditional corporate governance, insurers can increasingly "show the discount" for their insureds' good climate governance.[256]

2. The value of climate risk information outweighs the expense

Given that improved climate governance likely reduces D&O claims, D&O insurers can justify investing in monitoring of their insureds' climate governance. As Part II detailed, D&O claims are expected to increase due to the SEC's proposed climate disclosure rules, as well as the intensifying effects of climate change.[257] If D&O claims are expected to increase, but insurers can reduce these claims by monitoring their insureds by gathering information on their climate governance practices, then such information has increasing value over time. Insurers that do not gather such information risk falling behind on both sides of the balance sheet, and failing to meet shareholder and stakeholder demands. Therefore, the value of insureds' climate governance information is far greater to insurers than other corporate governance information was in the past, warranting a greater investment.

3. Insureds and insurers benefit from sharing climate risk information

Information sharing grants benefits to both insurers and insureds. Firms are already gathering and sharing climate risk information with their investors, because doing so is an economic imperative for companies today; failure to disclose such risks shuts them out of the multitrillion-dollar ESG investment movement.[258] As one underwriter explained:

> [T]here's a lot of pressure from investors, … customers, and clients … people [want to] … support

[255] *See Proposal for the Enhancement and Standardization of Climate-Related Disclosures for Investors*, SEC 33-11042, 34-94478, File No. S7-10-22, at 94 (2022), https://www.sec.gov/rules/proposed/2022/33-11042.pdf [https://perma.cc/3VQC-WR7M]. The proposed rules frequently cite to investor letters written in support of the proposal.

[256] Online Interview with Underwriter # 13 (February 2023), Underwriter # 7 (July 2022), Underwriter # 9 (October 2022) (explaining that corporate directors are seeking out climate governance information from their D&O underwriters because it is valuable to their investors);

[257] The SEC has warned that lawsuits will increase against companies that "overpromise and under-deliver on ESG goals." Russ Banham, *SEC Climate Disclosure Rules Increase D&O Risk*, RISK MGMT. (Aug. 1, 2022) https://www.rmmagazine.com/articles/article/2022/08/01/sec-climate-disclosure-rules-increase-d-o-risk [https://perma.cc/QK2J-9HAH].

[258] Paul Polman & Andrew Winston, *Yes, Investing in ESG Pays Off*, HARV. BUS. REV. (Apr. 13, 2022), https://hbr.org/2022/04/yes-investing-in-esg-pays-off/ [PERMA].

> companies that are good corporate citizens. So, yes, … all that has impact on us and how we evaluate the risk.[259]

Thus, insureds are already bearing the cost of this data-gathering because it is to their benefit. Brokers explained that they advise their insureds to use the information they assembled for quarterly investor presentations "and tweak it" for engagement meetings with underwriters.[260] Similarly, an insureds' climate governance information is valuable to insurers *irrespective* of any correlation to liability claims.

Such information-sharing could theoretically help both insurers and insureds. Insureds with "good" climate governance could receive improved rates, while insurers could properly calibrate terms to account for climate risk if they hold all the available information. However, insureds are still not willing to allow their insurers to peer into the inner workings of the board. Therefore, insurers remain at a competitive disadvantage to ascertain this highly idiosyncratic information. To address this limitation and balance informational asymmetries, insurers are turning to external sources.

4. Insureds value insurer input and are willing to make reforms

In the recent past, most insureds did not value the loss prevention services or governance advice provided by their D&O insurers. In fact, exactly the opposite was true: "reducing the intrusiveness of … monitoring" was a competitive advantage for D&O insurers.[261] Making policy renewals contingent on implementation of insurer-suggested loss reduction measures was not economically viable, particularly in buyer's markets.[262] The loss prevention services offered by D&O insurers necessarily constrained the freedom of directors, officers, and managers to take risks. But corporations purchased D&O insurance precisely so that they can take on *more* business risk, since the D&O policy would likely cover any potential loss from shareholder litigation. Insurance companies, then, not the insureds, were the beneficiaries of loss prevention efforts.

Under this paradigm, executives and risk managers procuring D&O coverage had little incentive to implement meaningful internal controls for already covered risks. Indeed, one of Baker and Griffith's key insights was identifying agency costs inherent in this system as a key culprit:

> Buying D&O insurance without monitoring increases the freedom of managers to take financial reporting and other risks that improve accounting measures of performance and, hence, their compensation, but not the long-term

[259] Online Interview with Underwriter #1 (May 2022).

[260] Online Interview with Broker #4 (Jun. 2022) (noting that insureds "talk to investors all the time, and in many cases it's a very similar presentation").

[261] Baker et al., *Missing Monitor*, *supra* note 10, at 1840.

[262] *Id.* at 1809 (referring to buyer's markets for insurance as "soft markets").

> value of the firm. If these risks lead to shareholder litigation, D&O insurers step in to pay the claim.[263]

It is thus unsurprising that monitoring efforts remained nominal or symbolic.

Today, insurers' capability to assess industry-wide climate risk is extremely valuable to corporate managers. As one underwriter noted, "we see claims that the client may not be privy to … so we may also be able to show where some of the vulnerabilities are a 'lesson learned' for them."[264] Consequently, insureds are proactively turning to their brokers and insurers for industry-specific intel on claims activity. Thus, D&O insurers serve a complimentary role to the external advisors, such as law firms, that traditionally provide climate governance advice. For instance, insurers contribute superior expertise in predicting and pricing risk, because they are staffed with large teams of actuarial professionals. Further, they are incentivized to track which investments in climate-risk governance lead to fewer losses—among other "policy entrepreneurs" such as lawyers, consultants, auditors, and brokers, insurers are the only that are "residual claimants on the litigation risk they insure[.]"[265] Moreover, insurers' data is naturally more representative than other providers of climate risk expertise because they serve a broader section of the economy than, for instance, law firms. In sum, D&O insurers bring valuable input to the table, which should be heeded by rational insureds.[266]

B. The Insurance Industry's Novel, Holistic Approach to Climate Risk

1. Corporate governance reforms

Though it lags others in the financial industry, climate risk is prompting insurers of all stripes to focus on their own climate governance. A review of the insurance industry's TCFD reports demonstrates that the insurance industry is investing significantly in its own climate governance, including hiring executive level positions. At AIG, for example, the board amended its charter in 2021 to include explicit oversight of "policies that relate to current and emerging

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263 *Id.* at 1832.

264 Online Interview with D&O Underwriter # 10 (October 2022); Online Interview with D&O Underwriter # 11; Insurance Industry Roundtable # 2 (February 9, 2023).

265 Verstein, *supra* note 16, at 26. *See also* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1528–29 (2005) (describing how corporate governance consultants profit from proposals that make no meaningful difference); Baker & Griffith, *Missing Monitor*, *supra* note 10, at 1835, n.189. (arguing that "[b]ecause the insurer ultimately bears corporate governance risk, it is unlikely to be fooled by merely cosmetic governance features").

266 At a recent engagement meeting with a D&O insurer, the insured said to the underwriter, "[D]on't scold us [on our climate governance], help us." Interview with D&O Underwriter #12 (February 2023).

sustainability, corporate social responsibility and public policy issues of significance to AIG."[267] The company also announced a new C-suite position: Executive Vice-President, Global Head of Strategy & ESG. Similarly, Zurich has recently set up a Governance, Nominations, and Sustainability Committee to review and approve the group's sustainability goals.[268] The major insurer launched a Sustainability Leaders Council, composed of senior executives from all of Zurich's businesses and chaired by a Group Head of Sustainability.[269] Assignment of ESG responsibilities to a dedicated executive position is but a preliminary step, but other insurance companies are likely to follow the major insurers' lead. These governance reforms are not cosmetic—the mandate of these new corporate executives is to set and monitor climate risk reduction targets, including net-zero targets, within their portfolios. [270]

The insurance industry's newly emerging climate governance is also signaling a holistic approach towards underwriting and assets. For example, Chubb's 2021 TCFD report states:

> The impact of climate risk on underlying credits will naturally be an increased factor in our investment decision–making over time given the future impact on certain long–dated asset classes, such as mortgages and municipal bonds.[271]

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[267] AIG, *ESG Governance Structure*, 2021 ESG REPORT, https://www.aig.com/esgreports/governance/esg-governance-structure [PERMA]. AIG's Risk and Capital Committee also assists the board in overseeing and reviewing climate-related risks, through reviewing policies, procedures, and practices employed to manage all of AIG's key risks that may be impacted by sustainability-related issues (e.g., liquidity, credit, market, operational, and insurance risks).

[268] *Our Governance and Policies: Being a Responsible Business*, ZURICH (last visited Feb. 10, 2023), https://www.zurich.com/en/sustainability/governance-and-policies [PERMA].

[269] *Constance Hunter Joins AIG as Global Head of Strategy & ESG*, BUSINESSWIRE (Dec. 14, 2021, 4:16 PM), https://www.businesswire.com/news/home/20211214006239/en/Constance-Hunter-Joins-AIG-as-Global-Head-of-Strategy-ESG [PERMA]; AIG, *A Message From Our Executive Vice President, Global Head of Strategy & ESG*, *in* AIG 2021 ESG REPORT, https://www.aig.com/esgreports/home/a-message-from-our-evp-global-head-of-strategy-and-esg [PERMA].

[270] *See, e.g.*, CHUBB, CHUBB 2021 CLIMATE-RELATED FINANCIAL DISCLOSURE & ENVIRONMENTAL REPORT, https://www.chubb.com/content/dam/chubb-sites/chubb-com/us-en/about-chubb/environment/doc/Chubb_2021_Climate-Related_Financial_Disclosure_and_Environmental_Report.pdf [PERMA] (announcing new board and executive level climate governance including the hiring of a Climate Sustainability Manager tasked with coordinating Chubb's climate strategy across its underwriting and investment decisions).

[271] CHUBB, *supra* note 270, at 15.

3. The beginning of a climate risk-integrated approach to underwriting

Insurers cannot issue TCFD reports or respond to investor demands without sharing information within and outside of the company.[272] For instance, climate commitments invariably force insurers to closely examine their business operations.[273] This compels departments to communicate with one another, breaking down corporate silos.[274] When these departments communicate, there is space for integrated underwriting practices that incorporate climate risk factors. For example, AIG is currently piloting an "ESG Underwriting Framework" for consistently integrating issues "across all product lines."[275] The new framework includes intensely screening clients for ESG risks, including climate-related risks, sharing data across insurance lines to give AIG's underwriters "full visibility into ESG considerations," and implementation of "a robust governance structure" for "monitoring … underwriting."[276] As AIG explained in its most recent ESG report, it uses ESG ratings to "support responding to regulatory requirements, guide stress testing and provide a link between liabilities and investments."[277]

This is consistent with accounts from the insurance industry experts interviewed. As one senior executive charged with leading a major insurers' ESG integration stated, "[the insurer] want[s] to create a system where all parts of our company feel accountable and responsible for our ESG agenda."[278] This integration involves sharing a significant amount of information with both internal and external stakeholders–the company recently hired a Head of ESG Investment Strategy–and has increased its

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[272] Stavros Gadinis & Amelia Miazad, *Corporate Law & Social Risk*, 73 VAND. L. REV. 1401, 1458 (arguing "that ESG helps managers address diverse risks relating to the company's business by obtaining information from stakeholders that are ideally placed to understand such risks"). *See also* Lynn LoPucki, *Repurposing the Corporation Through Stakeholder Markets*, 55 U.C. DAVIS L. REV. 1445, 1512 (2022) (describing the "ESG Information System" as a way to "measure the externalization of a variety of social costs").

[273] *See generally* Gadinis & Miazad, *supra* note 272; Bob Eccles, *Twenty Years of the Global Reporting Initiative: Interview with CEO Tim Mohin*, FORBES (Aug. 15, 2017, 9:35 AM), https://www.forbes.com/sites/bobeccles/ 2017/08/15/twenty-years-of-the-global-reporting-initiative-interview-with-ceo-tim-mohin/ [https://perma.cc/8HJB-D3CV].

[274] Online Interview with D&O Underwriter #4 (July 2022) (explaining that, due to the "pure silos" of traditional insurance companies, "you never talked to anybody who didn't do your line of business").

[275] *Integrating ESG into Underwriting*, AIG (last visited Aug. 18, 2022), https://www.aig.com/esgreports/strategy-and-solutions/general-insurance/integrating-esg-into-underwriting/ [https://perma.cc/2R86-ZFVJ].

[276] AIG, 2021 ESG REPORT, https://www.aig.com/content/dam/aig/america-canada/us/documents/about-us/report/aig-esg-report_2021.pdf.coredownload.pdf [https://perma.cc/G2G9-BNM7].

[277] *See generally* Witold J. Henisz & James McGlinch, *ESG, Material Credit Events, and Credit Risk*, 31 J. APPLIED CORP. FIN. 105 (2019).

[278] Online Interview with Insurance Industry Executive Specializing in ESG # 1 (July 2022).

dialogue with external parties, like "regulators, investors, NGO, clients, brokers, [and] suppliers."[279]

C. D&O Insurers Begin to Monitor Insureds' Climate Governance

It is still early days, but D&O insurers are stepping up to the plate to monitor their clients' climate governance. This Section will discuss how climate governance is entering engagement meetings and changing underwriting practices. The Section concludes by discussing the Marsh Initiative, a novel system of monitoring organized by one of the world's largest brokers.

1. D&O insurers are addressing climate risks in engagement meetings

ESG issues, including climate governance, are increasingly on the agenda at engagement meetings. One underwriter noted that he "has yet to go to an underwriting meeting this year where ESG is not mentioned." In comparison, "three years ago," it got "virtually none."[280] Another underwriter said "the D&O underwriting meeting now has a very solid block of time devoted to ESG oversight and controls."[281] Shareholder and regulatory pressure played a major role in carving out a place for climate governance at engagement meetings. As one underwriter explained:

> We care [about ESG and climate governance] because . . . what we're facing are rules and laws being put in place mandating certain requirements … and what [insureds] disclose and what they do creates risk. … Here's the most important part: … the shareholders do care … and you're seeing that in some of the proxy issues that we're facing[.][282]

The proliferation of net zero climate commitments is another factor increasing climate governance scrutiny by D&O insurers. Such commitments create D&O risk, as the SEC has warned.[283] Thus, D&O underwriters are incentivized to monitor companies' progress toward such commitments. In the words of one underwriter:

> So [a firm says], "We're going to have net zero emissions by 2030." Then, we want to see sort of a plan laid out. Every year, we can evaluate that plan. In those one-on-

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[279] *Id.*

[280] *Id.*

[281] Phone Interview with Underwriter # 6 (July 2022).

[282] Online Interview with Underwriter # 3 (July 2022).

[283] The SEC has warned companies not to "overpromise and under-deliver on ESG goals." Russ Banham, *SEC Climate Disclosure Rules Increase D&O Risk*, RISK MGMT. (Aug. 1, 2022) http://www.rmmagazine.com/articles/article/2022/08/01/sec-climate-disclosure-rules-increase-d-o-risk/; Online Interview with D&O Underwriter # 9 (October 2022).

> one meetings, we can assess: "Where are you in this process? What hurdles did you hit? Do you feel like you're still on target?"[284]

Another underwriter explained that her team seeks to gain "a very particular understanding of that [client's] mission critical exposure,"[285] given the increase in *Caremark* litigation. This means trying to ascertain how a company's "corporate structure" is set up to address mission-critical exposure and keep the board informed:

> What's the connectivity of the board? Is it charged with overseeing that [mission critical] risk? Do they have a privacy expert? Do they have a safety expert? Do they have someone who was formerly a regulator? … Have they appointed a special committee to oversee that risk? … We spend time on understanding the interplay between the board and the C-suite governance, because it's not always immediately obvious how the board is measuring and overseeing internal controls … and there's no one right answer to that.[286]

Though there is "no one right answer,"[287] another insurer explained that they are "ultimately … looking for ESG to deeply penetrate an organization."[288]

2. The prevalence of ESG issues in underwriting

Some insurers are going further and investing in verification of insureds' climate risk information. Before discussing this emerging practice in depth, it is worthwhile to review the inner workings of the underwriting process.[289]

Insurers issue and renew policies once a year. D&O insurance is structured in "towers" of primary and excess coverage. Thus, when a company seeks D&O insurance, the company's broker solicits bids from multiple D&O insurers. Before offering policies, these insurers must gather information from the potential insured. This process begins with

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[284] Online Interview with Underwriter # 5 (July 2022).
[285] Online Interview with Underwriter # 2 (June 2022).
[286] *Id.*
[287] *Id.*
[288] Online Interview with Underwriter # 3 (July 2022).
[289] For a general overview of D&O insurance, *see D&O Insurance Explained*, ALLIANZ (Jun. 2022), https://www.agcs.allianz.com/news-and-insights/expert-risk-articles/d-o-insurance-explained.html [https://perma.cc/WR8Z-H24N]; Stephen D. Allred, McGuire Woods LLP, *Key Issues in Evaluating and Negotiating D&O Insurance Coverage*, MONDAQ (Jun. 18, 2014), https://www.mondaq.com/unitedstates/directors-and-officers/321374/key-issues-in-evaluating-and-negotiating-do-insurance-coverage [https://perma.cc/UJJ2-G6MP].

basic questionnaires from each insurer in the proposed "tower." The broker serves as an intermediary and provides responses to the insurers' questions. Then, through a series of meetings, underwriters further scrutinize the insured before issuing a policy.

At this crucial step in the underwriting process, some insurers are beginning to invest more resources into analyzing insureds' climate risk information.[290] This includes utilizing ESG or climate data providers, raters, rankers, among other strategies.[291] Some D&O insurers are also starting to develop their own predictive climate risk tools.[292] Insurers use this information to determine the scope of coverage, the price of premiums, and whether to offer a policy at all. As one underwriter noted, "better ESG risks obviously translate to better pricing."[293] Many underwriters noted that efforts to price climate-change risks suffer from a lack of reliable, predictive data.[294] Several underwriters reported that their companies are building proprietary risk assessment tools to address this shortage. These investments will allow underwriters to accurately price climate-change risks. Given that certain aspects of climate governance remain qualitative, D&O insurers are seeking external validation, including from law firms.

3. The Marsh Initiative

In 2021, insurance titan Marsh McLennan ("Marsh") announced that clients "with superior environmental, social, and governance frameworks" would be eligible for favorable coverage terms.[295] Coming from the world's largest insurance broker, the "Marsh Initiative" reflected insurers' demand for climate governance information and assurance.[296] The initiative combines law firms' ESG oversight expertise with the actuarial capabilities of some of the largest D&O insurers.[297]

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[290] Roundtable Discussion # 1 with Insurance Industry Participants (January 2023); Roundtable Discussion # 2 with Insurance Industry Participants (February 2023).

[291] *Id.*

[292] *Id.*

[293] Online Interview with Underwriter # 5 (July 2022).

[294] *See* Roundtable Discussion # 1 with Insurance Industry Participants (January 2023); Roundtable Discussion # 2 with Insurance Industry Participants (February 2023).

[295] *Marsh to Recognize Clients with Robust ESG Frameworks,* BLOOMBERG (Oct. 25, 2021, 12:00 AM PDT), https://www.bloomberg.com/press-releases/2021-10-25/marsh-to-recognize-clients-with-robust-esg-frameworks [PERMA].

[296] *Top 20 Global Insurance & Reinsurance Brokers*, REINSURANCE NEWS (last visited Aug. 16, 2022), https://www.reinsurancene.ws/top-global-insurance-reinsurance-brokers/ [PERMA].

[297] The initiative began with four underwriters but now includes six: American International Group Inc., Berkshire Hathaway Specialty Insurance, Sompo International, Starr Insurance Cos., Hartford Financial Services Group Inc. and Zurich Insurance Group. Claire Wilkinson, *More Insurers Participating in D&O ESG initiative: Marsh*, BUS. INS. (Jun. 30, 2022),

To participate, Marsh clients first engage a law firm to perform an independent evaluation of the client's ESG frameworks.[298] If the report is favorable, the client can share a summary of the evaluation with Marsh, and the broker will use it to negotiate better ESG-related terms with D&O underwriters. Importantly, the client's full ESG assessment is never shared with the underwriters. Only the summary is shared, and only at the client's discretion. The participating carriers then apply their own underwriting analysis to determine whether the clients can get "preferred terms"–typically a discount.

Given that they only see a summary of the independent evaluation, it is perhaps unclear what value D&O underwriters derive from an initiative that provides them with limited information. Underwriters will never know, for example, whether their insureds received an ESG assessment that found "red flags," because neither the insured nor the broker would logically share that information. Even when potential insureds receive a positive assessment, underwriters receive very few specific details. Why would underwriters trust a law firm assessment that gives them no ability to scrutinize the findings? Underwriters said, these challenges notwithstanding, the initiative helps them identify clients who are choosing to be proactive about "getting ahead" of legal and regulatory climate-related risks:

> We look for companies that are … going above and beyond, not just following rules and regulations … implemented today. It is in our best interest. It is something we believe in. It's something that we monitor[.][299]

Another underwriter emphasized that the Marsh Initiative gives underwriters "more visibility and assurance than we might have in other instances."

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https://www.businessinsurance.com/article/20220630/NEWS06/912350866/More-insurers-participating-in-D&O-ESG-initiative-Marsh [PERMA].

[298] *Id.* ESG practices are proliferating at law firms. Helping boards perform sufficient climate risk oversight is a core part of that practice. Partners at two law firms that participate in the Marsh Initiative said their firms are developing proprietary methods for assessing clients' climate risk oversight, including helping clients develop their own TCFD reports. *See* Smith, *supra* note 236 (listing major firms that are creating specific ESG practices). Most of these firms view climate risk as a "central pillar" of ESG. Tyson Dyck & Henry Ren, *Torys LLP, ESG and Climate Change*, *in* TORYS QUARTERLY: ESG'S TURNING POINT (Q2 2021), https://www.torys.com/Our%20Latest%20Thinking/Publications//2021/03/esg-and-climate-change/[https://perma.cc/J685-ZHZM]. In fact, some have argued it is an "open question is whether climate action has outgrown the ESG mandate and needs its own." *Id; see also ESG Monthly Newsletter*, SULLIVAN & CROMWELL LLP (Oct. 2022), https://www.sullcrom.com/esg-newsletter-oct-2022 [https://perma.cc/2AL7-EUQR] (listing three recent updates in ESG, all of which directly relate to climate risk.).

[299] Online Interview with D&O Underwriter # 5 (July 2022).

> But … we're also pressing in the one-on-one engagement we have with these clients …. We then evaluate [clients] from an external perspective … and if we feel that … this is a good company and a good industry sector, and they've taken the initiative to go and get this assessment and [are] really trying to better themselves … we'll give them some credit and … enhance the coverage in certain ways.[300]

Although the interviewed underwriters agreed that the Marsh Initiative helped them identify "good" risks, it meant that the D&O insurer remained uninformed about "bad" risks. By design, the insurers lack visibility into the clients who have gaps in their ESG programs. However, underwriters said that a firm's very participation in the program shows initiative that is worth betting on in the underwriting process.

According to these accounts, the Marsh Initiative could be considered a contemporary example of an underwriting strategy known as "feature rating,"[301] which refers to the practice of setting premiums based on "features of the applicant's current operations" at the time the policy is issued.[302] A classic example of feature rating is when a property insurer requires an insured to install a certain type of fire sprinkler. In this way, the property insurer is leveraging the superior information it has–regarding which fire sprinklers reduce losses most effectively in the aggregate–to induce their insureds with discounts. Critics of feature rating point out that it fails because it challenging and expensive for insurers to verify that the efforts are ongoing, and insureds may abandon certain features after the policy is issued. The Marsh Initiative avoids these obstacles; as noted above, the ESG reform that clients are making are valuable to them for reasons outside of the insurance contract, and, unlike a fire sprinkler, reforming the composition of your board is not easily reversed. Moreover, the cost of the monitoring is borne by the insureds who are paying for the law firms. While it remains to be seen how successful the Marsh Initiative will be, it is a rare example of bundling monitoring and risk distribution efforts, which scholars have endorsed:

> [E]conomists have understood that monitoring can be an important benefit that corporate insurance provides to shareholders, and the obvious candidates to perform monitoring in the D&O insurance context are the accountants who are already deep inside the corporation.[303]

Though D&O underwriters are starting to step to the plate, the promising potential of D&O insurance to advance climate governance

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300 Online Interview with D&O Underwriter # 5 (July 2022).
301 Abraham & Schwarcz, *supra* note 12, at 22.
302 *Id.* at 23.
303 Baker & Griffith, *Missing Monitor*, *supra* note 10.

remains unrealized/untapped by regulators and industry alike. In response, the next Part offers a normative argument for public and private actors to utilize D&O insurance as a way to enhance climate governance.

V. NORMATIVE IMPLICATIONS & NEXT STEPS

This Article has argued D&O insurers have the incentives, and are gaining the ability, to monitor their insureds' climate governance. Neither policymakers nor private market actors have fully appreciated this still-emerging phenomenon. Though it is too early to prescribe policy interventions, Section A identifies a few next steps for policymakers and private actors to take. Section B concludes by summarizing key implications for corporate law. In doing so, it hopes to inspire further scholarly attention to the intersection of D&O insurance and climate risk.

A. Next Steps

1. Private ordering

The UN-convened Principles of Responsible Insurance (PSI) and Net Zero Insurers Alliance (NZIA) have committed to "insuring the net-zero transition."[304] The NZIA has established a range of work streams including metrics, target setting, engagement, antitrust and competition laws, life and health insurance, and communications.[305] The net-zero transition depends on the actions of officers and directors; executives often risk shareholder litigation if they fail, so D&O insurance is in demand. Such demand creates a rare opportunity for D&O insurers to communicate with boards directly about climate governance. However, D&O insurance is currently not included in PSI and NZIA's initiatives. Thus, given the importance of climate governance to the climate transition, NZIA and the PSI should start a specific initiative or workstream for D&O insurance. As a first step, PSI could convene industry participants, policy makers, and scholars with expertise in D&O insurance, climate governance, and corporate law to address the following topics:

Information gathering and sharing: How can D&O underwriters share information with corporate boards in a way that facilitates the board's climate governance and transition to net-zero?

External advisors: Are there ways for insurers to collaborate with external advisors, in particular climate risk disclosure auditors and

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304 *Principles for Sustainable Insurance*, UN ENVIRONMENT PROGRAMME FINANCE INITIATIVE (last visited Feb. 11, 2023), https://www.unepfi.org/insurance/insurance/ [https://perma.cc/EB74-UGWG]. While US insurers remain unwilling to join these alliances, in part due to fears of antitrust scrutiny, the PSI includes one-third of global insurers. *Id.*

305 *Id.*

accountants or law firms, to enhance their capacity to monitor climate governance? Can this be achieved through new products, such as Climate Disclosure Insurance, to formalize the external monitoring within a new insurance product?[306]

Public policy advocacy: What are areas of public policy advocacy specifically for D&O insurers? Given that the inconsistent and voluntary nature of climate disclosure pose risk for directors and officers, should D&O insurers advocate for mandatory climate reporting and disclosure?

Along with these collaborative efforts, insurers should sharpen their focus on D&O insurance and incorporate D&O underwriting into their overall climate governance strategy. Insurance industry asset managers have a key role to play, too.[307] But industry professionals report that investors and insurers are still not focused on D&O insurers potential role as climate governance monitors.[308]

2. The Federal Insurance Office

Climate governance requires data to evolve. Insurers need it to pinpoint which governance reforms reduce harm. As discussed above, D&O insurers are investing in data gathering and analytics processes. But this data remains largely proprietary. As discussions with insurance industry participants illuminated, insurance is a competitive business, and companies often lack the financial incentives to share data with their competitors.[309] Even if insurers would opt to share information, the fear of antitrust scrutiny is preventing them from doing so.[310]

The FIO has a unique role to play in overcoming obstacles to climate governance data sharing. Though the agency lacks supervisory authority over state insurance regulators, the Dodd-Frank Act grants it broad authority to collect data from insurance companies.[311] The agency has recently taken one important step towards centralizing climate data—on October 18, 2022, it requested public comment on a proposal to collect

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306 This is similar to proposals for Financial Disclosure Insurance, in which the insurance company bundles risk transfer with risk monitoring and outsources the monitoring to accountants. *See, e.g.*, Angela K. Gore, Kevin Sachs, & Charles Trzcinka, *Financial Disclosure and Bond Insurance*, 47 J. LAW & ECON. 275 (2004).

307 *See supra* Part IV.B.

308 Roundtable Discussion # 2 with Insurance Industry Participants (February 2023); Interviews with Investors # 2 (February 2023).

309 Roundtable Discussion # 1 with Insurance Industry Participants (January 2023).

310 *See* Amelia Miazad, *Prosocial Antitrust*, 73 Hastings L.J. 1555 (2022) (discussing how antitrust prevents companies from sharing best practices on sustainability).

311 For a discussion of how the FIO can use its authority to gather data from individual insurers, *see* Alex Fredman, *Regulators Should Identify and Mitigate Climate Risks in the Insurance Industry*, Ctr. Am. Progress (Jun. 13, 2022), https://www.americanprogress.org/article/regulators-should-identify-and-mitigate-climate-risks-in-the-insurance-industry/ [PERMA].

underwriting data on homeowners' insurance from property and casualty insurers.[312] Along similar lines, the FIO should use its power to gather climate governance data from D&O insurers, and store it in a centralized clearinghouse. There are normative arguments in favor of such public access to climate risk data given that "the private sector cannot be relied upon to provide climate services equitably or at a fast enough pace."[313]

3. Insurance regulators

Although insurance regulators are incorporating climate risk into underwriting decisions, their focus is overwhelmingly on property and health insurance. Given that climate catastrophes are increasing in frequency and force, this is unsurprising. Consequently, however, regulators have thus far overlooked D&O insurance's unique power to advance environmental and social goals. Even California's Insurance Commission—widely considered a leader in addressing ESG risks—has not weighed in on the one-of-a-kind role D&O insurers can play.[314] This Article argues that prioritizing property insurance over D&O is a *reactive* approach to addressing climate risks. As a first step, then, the NAIC should convene a task force or working group to assess the potential of D&O insurers as climate governance monitors.

4. The SEC

Unlike some international regulatory regimes, the SEC does not require U.S. registrants to disclose the details of their D&O insurance policies.[315] Rather, Item 702 of Regulation S-K merely requires that registrants:

> [S]tate the general effect of any statute, charter provisions, by-laws, contract or other arrangements under which any

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312 Comment Request on Insurance Office Climate-Related Financial Risk Data Collection, 87 Fed. Reg. 64134 (released Oct. 21, 2022. This move has prompted an outcry from state insurance regulators, who issued a strongly-worded rebuke. Comment Letter from Nat'l Ass'n Ins. Comm'rs to Fed. Ins. Office, Re: FIO Insurance Sector and Climate Related Financial Risks (Nov. 11, 2021), https://content.naic.org/article/naic-responds-fio-request-information-climate-related-financial-risks [PERMA] ("As the primary regulators of this sector, state insurance regulators are on the frontlines of climate-related natural catastrophe preparedness and response, protecting policyholders and maintaining well-functioning insurance markets. We have long been committed to monitoring and addressing how climate risks impact policyholders and the industry.").

313 Madison Condon, *Who Owns the (Climate) Future?*, (2022) (unpublished manuscript) (on file with author).

314 *See California Climate Insurance*, CAL. DEP'T OF INS. (last visited Aug. 18, 2022), https://www.insurance.ca.gov/cci [[https://perma.cc/4UA9-V7GN].

315 Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies*, 154 U. PA. L. REV. 1147, 1198 (2005).

> controlling person, director or officer of the registrant is insured or indemnified in any manner against liability which he may incur in his capacity as such.[316]

This Article is not the first to bemoan the SEC's unwillingness to disclose D&O details. As Sean Griffith has argued, the agency should require companies to disclose more information about their D&O insurance policies because D&O contract terms reveal useful information to investors about the quality of the insureds' corporate governance.[317] Recent scholarship agrees that Griffith's "argument that D&O insurance premiums can be indicative of a company's corporate governance quality is theoretically correct."[318]

The agency's recent focus on enhancing ESG disclosure and preventing greenwashing provides an opportunity to reexamine its reluctance to require D&O policy disclosure. A comprehensive proposal for specific disclosures is beyond the scope of this Article, but the SEC could, for example, require insureds to disclose specific policy terms (such as credits or increases in retentions) that are a result of the insureds' ESG efforts. Of course, this raises many questions, but it would be a step in the right direction. Alternately, the SEC could require publicly listed insurers to disclose how they are using ESG ratings and rankings in their underwriting decisions, which would be consistent with several state laws that require such disclosure.[319]

B. Implications for Corporate and Securities Law

The intersection of D&O insurance and climate governance has important implications for corporate law. Most notably, by monitoring their insureds and encouraging climate governance reforms, D&O insurers could prevent or reduce corporate misconduct. This intervention comes at a vital time. In the traditional accounting fraud case, shareholders filed litigation and sought financial compensation—and "money surely compensates for money."[320] As Part II explained, shareholders today also file litigation to reduce environmental and social harms. Similarly, though the *Caremark* cases do not explicitly reference climate risk, they are unique in that "they are based on serious ESG-related concerns about externality risks to humans."[321] Shareholder litigation that alleges harms to non-shareholder constituents is not only

[316] 17 C.F.R. § 229.702 (2022).

[317] Griffith, *supra* note 315, at 1203.

[318] Rene Otto & Wim Weterings, *D&O Insurance and Corporate Governance: Is D&O Insurance Indicative of the Quality of Corporate Governance in a Company*, 24 STAN. J.L. BUS. & FIN. 105, 107 (2019).

[319] *See* Darcy Steeg Morris, Daniel Schwarcz, & Joshua Teitelbaum, *Do Credit Based Insurance Scores Proxy for Income in Predicting Policyholder Risk?*, 14 J. EMPIRICAL LEGAL STUD. 397, 404 (2017).

[320] Baker et al., *The Missing Monitor*, *supra* note 10, at 1819.

[321] Partnoy & Badawi, *supra* note 252, at *43.

more prevalent, but also more successful, which means that Delaware courts are at least implicitly endorsing this prosocial purpose for corporate law. In this new era of prosocial shareholder litigation, money cannot fully compensate for social and environmental harms, rendering D&O's traditional "pocket-shifting" normatively untenable.

Moreover, information-sharing between insurers and corporate boards signals a new era of collaborative corporate governance, which deserves more scholarly attention.[322] Under this cooperative mode of insurer/insured engagement, each party can access information they would not otherwise possess.[323] Such information sharing between D&O underwriters and corporate boards helps boards oversee climate risk more effectively, and allows insurers to underwrite risk more efficiently.[324] But there remain obstacles to collaborative governance, including antitrust concerns, the "ESG backlash," and investors' myopic focus on single firms, rather than portfolio-wide returns. This Article argues that the promise of D&O insurers as climate risk monitors offers another reason for corporate law to accommodate a more collaborative approach to climate governance.

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[322] As Jill Fisch and Simone Sepe have argued, corporate law scholarship remains beguiled by agency theory, but "the corporate world has moved on" to a far more collaborative approach. Fisch et al., *supra* note 245, at 864.

[323] Faith Stevelman and Sarah C. Haan, *Boards in Information Governance*, 23 J. Bus. L. 179, 181 (2020).

[324] *See* Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 880 (1993); Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REVS. 96 (1998).

CONCLUSION

Corporate law scholars have overlooked the D&O insurer in their quest for an ideal board monitor. In response, this Article describes how a recent convergence of factors is increasing the incentives and ability of D&O insurers to help their insureds reduce environmental harms. Further, it theorizes that the trend of "D&O insurers as climate governance monitors" is likely to continue because the long-term financial sustainability of the insurance industry (and insureds) depends on reducing environmental externalities. This insight comes at a crucial time; lawmakers, regulators, and investors are searching for ways to motivate boards to step up their climate governance. Indeed, D&O insurers' potential impact on board oversight of climate risk is no longer utterly unexplored.

This Article took the first step by identifying and examining D&O insurers' potential to serve as climate governance monitors. Their changing role has wide-ranging implications, providing rich areas for future scholarship. By identifying these emerging forces within the insurance industry, this Article hopes to spark further dialogue at the intersection of D&O insurance and climate risk.

APPENDIX A

I. METHODOLOGY

In addition to an extensive review of publicly available sources, the findings in this Article are informed by original and semi-structured qualitative interviews and roundtables with insurance industry members.

Participants include executives at major insurers specializing in climate risk strategy; D&O insurance brokers; D&O insurance underwriters; law firm counsel specializing in board governance of ESG; law firm counsel specializing in shareholder litigation on ESG issues; corporate counsel; corporate risk managers; D&O coverage counsel representing policyholders; insurance industry investors; insurance industry asset managers; and NGOs focused on the intersection of climate change and insurance.

These participants are unique because they have first-hand experience with, and in some cases are designing or leading, the insurance industry's most high-profile efforts to incorporate climate risk into its business strategy. Moreover, each of the participants is a seasoned senior level executive in the insurance industry.

A snowball sampling technique was used to identify interview subjects, which relies on interview subjects to assist in identifying more participants. The major shortcoming of this technique is that it introduces bias into the sample. In this case, however, that is less of a concern because this Article is not relying on these interviews to argue that the participant's experiences are representative of the insurance industry. Rather this Article has used the interviews to shed light on insurance industry climate governance initiatives that are in the public domain.

To encourage candid and detailed responses, the interview participants were also promised anonymity. For that reason, the table below does not include specific dates, but only the month that the interviews took place. The author has retained copies of each interview transcripts and/or detailed notes, with personal information removed. This research method has received IRB approval from the University of California at Davis School of Law.

II. INTERVIEW PARTICIPANTS

Type	General description/experience level	Date(s)
D&O Insurance Broker # 1	Managing Director at large D&O insurance broker with nearly 40 years of experience in the D&O insurance industry.	March 2022
D&O Insurance Broker # 2	Managing Director at large D&O insurance broker with over 35 years of experience in the D&O insurance industry.	March 2022
D&O Insurance Broker # 3	D&O coverage specialist at large insurance broker with over 21 years of experience in the D&O insurance industry.	November 2021
D&O Insurance Broker # 4	D&O insurance broker specializing in insurance for asset managers with nearly 20 years of experience in insurance and asset management industry.	June 2022
D&O Insurance Broker # 5	D&O insurance broker with over 30 years of experience in the D&O insurance industry.	June 2022 November 2021

D&O Insurance Broker # 6	D&O liability product leader at major broker with over 28 years of experience in the D&O industry.	November 2021 June 2022 June 2022 May 2022
D&O Underwriter # 1	D&O liability underwriter with over 20 years of experience in the insurance industry.	May 2022
D&O Underwriter # 2	Former D&O liability underwriter (recently transitioned) with over 30 years of experience in the D&O insurance industry.	June 2022
D&O Underwriter # 3	Chief Underwriting Officer at major insurer with over 15 years of experience in the D&O insurance industry.	July 2022
D&O Underwriter # 4	D&O underwriter at major insurer with nearly 30 years of experience in the D&O insurance industry.	July 2022
D&O Underwriter # 5	Head of Financial Underwriting at major insurer with over 20 years of experience in the D&O insurance industry.	July 2022
D&O Underwriter # 6	Senior Vice President at major insurance company with over 25 years of experience in the D&O insurance industry.	July 2022

D&O Underwriter # 7	Senior D&O underwriter at major international insurer with over 10 years of experience in insurance industry.	July 2022
D&O Underwriter # 8	Senior underwriter at major insurer with over 15 years of experience in insurance industry.	October 2022
D&O Underwriter # 9	Senior underwriter at major insurer with over 8 years of experience in insurance industry.	October 2022
D&O Underwriter # 10	Senior underwriter at major insurer with over 10 years of experience in the D&O industry	October 2022
D&O Underwriter # 11	Underwriter at major D&O insurer specializing in ESG with over three years of experience.	October 2022
D&O Underwriter # 12	Senior underwriter at major D&O insurer with over 15 years of experience in D&O insurance	February 2023
Insurance Industry Executive specializing in ESG # 1	Head of ESG at major insurer with over 15 years of experience in insurance industry.	July 2022
Insurance Industry Executive specializing in ESG # 2	Public relations specialist focused on ESG at major insurance company with over 25 years of experience.	July 2022

Law Firm Partner # 1	Partner and head of law firm's insurance coverage practice group, with over 25 years of experience representing corporate policy holders in D&O coverage disputes.	December 2021 June 2022
Law Firm Partner # 2	Partner at major law firm filing litigation on behalf of shareholders, including "event-driven" litigation on diversity, equity, and inclusion. Over 25 years of experience.	April 2022
Law Firm Partner # 3	Partner and head of major law firm's ESG practice group, with over 35 years of experience.	May 2022
Law Firm Partner # 4	Antitrust partner and a part of major law firm's ESG practice group. Has specific experience advising insurers on Net Zero commitments, with over 25 years of antitrust experience.	April 2022
Law Firm Partner # 5	Partner and head of major law firm's ESG practice group, with 20 years of experience.	August 2022
Corporate Risk Manager # 1 at Fortune 100 company	Head of Risk at major airline who interfaces with all insurance brokers and underwriters with over ten years of experience.	June 2022
Corporate Risk Manager # 2 at Fortune 100 company	Head of corporate governance at major technology company who interfaces with D&O brokers and underwriters, with over ten years of experience.	July 2021

Roundtable Discussions	Roundtable discussions on climate risk and the insurance industry conducted in-person under Chatham House Rules with: 1) insurance industry underwriters and executives; 2) insurance industry asset managers; 3) insurance industry investors; 4) scholars specializing in insurance, ESG, and private environmental governance; and 5) representatives from civil society including NGOs. The discussions took place from 8:30am to 2:30pm.	January 2023 February 2023