Lowenstein Sandler's Insurance Recovery Podcast: Don't Take No For An Answer

Episode 43
ESG is All The Rage, but How Does It Intersect with the D&O and RWI Insurance Markets?

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Lynda Bennett: Welcome to Don't Take No For an Answer. I'm your host, Lynda Bennett, Chair of the Insurance Recovery practice, and I'm very pleased to have two special guests today to talk with me about a very hot topic in the insurance space right now, which is how ESG initiatives intersect with the insurance space. I've got with me today Emily Maier, who's a partner with Woodruff Sawyer and is very knee deep in the M&A space. Welcome, Emily. Thanks for joining us.

Emily Maier: Thank you so much.

Lynda Bennett: And I've also got Wayne Imrie, who is the focus group leader of the London market D&O for Beasley Insurance. Wayne, thank you so much for joining us as well.

Wayne Imrie: Thank you.

Lynda Bennett: All right. Why don't we dive right in and give our listeners a quick overview of what ESG is and why it has become such a hot topic in the last year or so?

Emily Maier: I mean, put simply ESG is environmental, social and governance, which is a very wide range of topics all put into some neat letters.

Lynda Bennett: Rightly so. Are there any meaningful or standardized metrics to measure ESG compliance and performance?

Emily Maier: Hear what Wayne has to say, because it might be different in London and Europe, but MSCI is sort of the market leader over here. And it's interesting because it doesn't so much measure compliance or performance as it does risk, but Wayne, you may have a broader answer.

Wayne Imrie: There's definitely different rating agencies out there and there's different ways of looking at it. There are more global standards becoming more prevalent, but it's still an evolving space depending on which service we look at, which rating agency we use and depending on the methodology around how they capture that data. We are seeing some varying levels of responses and varying levels of rankings and ratings. It is an interesting area, and I think because it is evolving and as an industry, we're getting our heads around it and seeing different levels of criteria and things being captured. It continues to change. Some of the main approaches that we are seeing, though, are sort of global indexes, industry indexes, peer to peer comparables, set own corporate history. Whilst there are good measurement tools out there, it does continue to evolve and continue to change as we move through.

Lynda Bennett: Yeah, I'm really struck. Both of you used the word evolve because I think at its core, when I first started to learn about ESG, it was corporate responsibility. We want to be perceived as a good corporate citizen and it seemed like the E, the environmental, was the initial driver. We're going to show that we're a green company and that we are worried about climate change and we're reducing carbon emissions. And then over the last couple of years, it really has, in your words, evolved. And we're looking a lot more about diversity, equity, inclusion, employee welfare, cyber security. It really has morphed into this gigantic, important, corporate identity, but in touching many different areas. And so for that reason, it's hard not to notice that governmental regulators have become quite interested in this, as has the plaintiff's bar as companies are out there trying to really enhance their brand around ESG. Why do you think that those stakeholders have really taken an interest in this space?

Wayne Imrie: Well, I think from a regulator's point of view, it's really around improving the focus on all of those areas, the environmental, the social, the governance side of things, providing transparency, looking at disclosures that are being made to the street and what information is being given to investors to make their investment decisions. The overall goal of improving all risks from an ESG point of view and improving just the worldwide exposure. And I think when you look at the plaintiff bar, you have the other side of the area. They're looking for the under-performance or the failure or incorrect disclosures, or the investment impact on failing to execute or not doing enough in this area. You've got two sides of the coin, but very much the same focus.

Lynda Bennett: And so is good faith compliance enough in terms of the disclosures, as well as the public statements? As you said, Wayne, the plaintiff's bar is certainly going to be paying very careful attention as to what you're putting up on your website and whether you're living up to the standard and goals that you're identifying there. Is good faith compliance going to be enough to box out liability claims here, do you think?

Wayne Imrie: Probably not, in all honesty. I think where we are at the moment, and we talked about how the area continues to evolve, and it is all part of that process, good faith compliance is probably the best that's available at the moment. And looking at what the regulators are coming out with, they're not necessarily looking or geared up to second guess what's being disclosed. And, in fact, disclosures coming from well-meaning companies is probably a good thing, but obviously it's going to give the plaintiff bar the ability to challenge and scrutinize what's being disclosed, whether those good faith compliance disclosures are enough. And I'm sure we'll see litigation surrounding those.

Lynda Bennett: Yeah. I think one of the challenges there with the litigation is this is all going to be very fact-intensive, which of course becomes a very expensive undertaking to defend. Wayne, let me pose this question to you, too. What impact is that going to have on how the D&O market's going to respond to this risk exposure?

Wayne Imrie: D&O market is obviously looking at this with a keen eye. It's another area of potential litigation. It's another area of potential heavy regulation, and just another area for our insureds and our client base to potentially fall afoul of issues, either make trips on disclosures or not disclose enough or not actually do enough in the whole entire area. And I think we'll see litigation around that, and the D&O market is aware of that and are starting to scrutinize that ESG and ESG focuses and policies, procedures, governance on all of their risks that come across their desks.

Lynda Bennett: Are you seeing companies that have particularly high risk profiles in terms of industry? Or is it really a case by case and looking at what representations are being made and what process is in place to measure the success of those initiatives?

Wayne Imrie: It's a bit of a mix. There's two ways of looking at this, I guess. There's one, the companies that are ESG focused and are doing lots of things around strategy and initiatives and improving their ESG profile. That's a good thing. For starters, we believe that those risks will probably outperform others over time. But it does raise the threshold for potential things to go wrong and things to be missed and disclosures to be challenged, especially anything that's being made to the street and that could be scrutinized. But also the other side of the coin is those risks that aren't focused on ESG. It's not part of the high up on their agenda, not being pushed from the board down. We believe that those will likely be under performers over a longer period and will probably be those risks that run into other issues around under performance and probably create more exposure to D&O insurers.

Lynda Bennett: And those companies, I assume it's going to be harder for them to place their coverage and maybe a little more expensive than those that are doing ESG well and are able to present themselves well in the underwriting meetings on that point?

Wayne Imrie: Yes, like I say, over time, I think we will see that. We believe there'll probably be a quite clear divergence between those that have been focused and have been doing good work in and around ESG as a focus area. They'll begin to outperform their peers. They will not run into as many troubles as the companies that haven't taken it as seriously and who are starting to underperform. Those that are performers should, in turn, benefit from improved terms conditions for their policies, premiums, SILs. But at the moment, it's a little bit early to tell. But I think over time, that's what we'll see.

Lynda Bennett: That's great. One last question on D&O before we transition over to the M&A world here. Are D&O carriers and underwriters looking more carefully with respect to the board composition? In other words, is it really important for boards to have diversity on that board not just in terms of race, gender, ethnicity, but also skill sets? Because, as we said at the top here, ESG touches on lots of different areas and different disciplines. Are the underwriters looking carefully at exactly who's serving on that board and what talents they bring to it?

Wayne Imrie: Absolutely, yes. And I think as an industry, we've been focused on this for a number of years now. We spent a lot of time scrutinizing the composition of boards, also looking at the next level, the management and the executive levels of corporations. And we want to see that. We want to see the right composition. We want to see the right skill sets. We want to see the right diversity. We want to see the right blend of gender, race, and experience and everything else. And I think, as I said before, those companies that really focus on that and have the right composition of their board will outperform the others. And I think the skill set thing is really coming to the forefront at the moment, especially with the amount of macroeconomic issues going on in the world and having the kind of broad spectrum of skill sets on the board and having access to those skills is helping those companies navigate some of these issues.

Lynda Bennett: Let's hope that at least one board member knows a little something about cybersecurity, right?

Wayne Imrie: Absolutely. Absolutely.

Lynda Bennett: All right, Emily, how has the focus on ESG issues made its way into the M&A space and all the work that you're doing right now in placing reps and warranties insurance?

Emily Maier: I think looking at it from a wider than rep and warranty insurance perspective, we've seen it coming in a few ways. We've seen ESG activism, where companies are being forced to divest or acquire because of their ESG profile by activist shareholders. And we think we'll probably see more of that, especially in the spec market where so many investments have not gone well. The other thing I think is potentially really impacting on a wider basis is credit rating, right? Now that ESG is sort of influencing credit rating and the availability of money has changed, with the interest rates rising, I think it's actually going to impact. And my understanding is, and this is anecdotal to a degree, but it is easier to raise money for us to acquire a strong ESG candidate. And there are some places where you'll find it incredibly difficult to raise money, for instance, for a carbon-based industry.

I think it will have an impact there and then more sort of micro, around sort of rep and warranty issues if you like, and diligence. What's interesting was Bane and Company did a survey recently that I think this sort of sums the evolving nature, that about 11% of respondents said that they actively diligence ESG issues, but about 65% of respondents expected that they would start doing that in the next year or two. We're very much, I think, on the cusp of how it's going to impact M&A, from a very specific, rather than the wider world area.

Lynda Bennett: Can you give me a couple of instances of that increased diligence? What are they doing? What are these companies doing to get comfortable with the

ESG representations and policies that are being made in the early stages of the transaction?

Emily Maier: For a rep and warranty position, it's interesting. We are seeing it in reps, but we're also seeing it a lot in covenants and behavioral governance and we're seeing it sort of potentially trying to creep in to MAE clause. How successful that will be, because it's such an amorphous topic, I don't know. It's hard to bring an MAE at the best of times, but it's interesting that we're seeing it there. And from a rep and warranty perspective, obviously covenants and MAEs aren't really impacted. We are seeing it come up more in reps. We saw it come up more in reps after the "Me Too" movement, right?

Lynda Bennett: Yeah.

Emily Maier: Where we suddenly started to have meaningful reps about behavior and we started to have meaningful diligence about behavior, and I suspect it will evolve in the same way that has.

Lynda Bennett: Yep. Probably, again, with cyber in particular and privacy policies, right?

Emily Maier: Right.

Lynda Bennett: In any M&A transaction, obviously company valuation is a significant driver of the transaction. And so what are we seeing on that issue intersecting with ESG on company valuation? And is there a difference between a company that is advertising itself as a ESG driven versus ESG informed?

Emily Maier: Sure. I think this is a sort of endless and fascinating topic because one man's treasure is another man's trash. And I think when we talk about ESG driven versus ESG informed, I think we're talking about is the acquisition ESG driven or is it ESG informed? And I think, in my head, that means if it's ESG driven, we are literally buying this target to improve our ESG position. And if it's ESG informed, we're buying this target and we're hoping it won't make it worse. Right? They still play a part. And I think what's interesting, because this is such an amorphous topic, is for one person, the same company is an ESG driven acquisition. And for another, it's an ESG informed acquisition.

It's going to be more valuable to one than the other, and I think while the matrix that we have, and I think Wayne elaborated on how many there are, but the ones that we see most are more about risk evaluation than actual good citizenship, right? You can be a big polluter, but as long as the rating company thinks that you are managing that risk well, right? Or it's not going to have a big impact on your valuation, then you get a good score. Now, that doesn't mean you're necessarily a good acquisition from an ESG perspective, right? Or that value's going to hold when you are sort of integrated into a wider thing. I think what I'm hoping is that we'll see a much clearer set of matrices beyond risk as to what is a good ESG score.

Lynda Bennett: For all those entrepreneur listeners that we have, you've just identified a couple of businesses that can be developed and formed and become very profitable very quickly. We're just about out of time. I want to give each of you a parting shot here. What are one or two tips that you have for our listeners about how to be perceived as a stronger or more favorable risk when it comes to ESG issues? And what benefits will our listeners have by following your advice? Wayne, why don't you kick it off?

Wayne Imrie: I think the main tip really is sort of embed it. Embed ESG government, the governance side of things, in all of your key decisions, all of your key decisions that you're making from the very top down, from the board to the exec, right through to the operations and the financial decisions that you make and the customers and the suppliers that you deal with. Really, it's kind of embedding it just into the normal thought process around all key business decisions. And over time, you'll start to see that you'll outperform peers, the benefit from less litigation, and in turn, probably more favorable terms on your insurance. And we're already seeing the market, the D&O market, respond early on with some additional coverage grants that are coming in for those ESG focused and favorable profiled companies. There's additional capacity out there from different types of investors seeking to support good ESG risk profile risks. There's additional capacity available. I think the market will continue to respond to the evolution of this exposure. And I think those that outperform and are doing the right thing will benefit from that.

Lynda Bennett: Terrific. Emily, what about you? For those who are out in the market, buyers, sellers, what do they need to do to be more favorable on the ESG front?

Emily Maier: Sure. I think similar to what Wayne said, that it is very strong and that there is very strong board oversight specifically, right? That they are very connected to what is happening in the rest of the company. It's nice to have initiative, but the sense that the board is actually seeing and driving that, I think is very important. And then also management attitude. We can have all kinds of lovely things, but if management at a senior level are rolling their eyes, it just doesn't happen, and that's going to show up in diligence. That's going to show up in the conversations that you start to have once you start probing a little deeper into companies. I think especially from an M&A perspective, green washing isn't going to cut it.

Lynda Bennett: All right. That's a great tip to end on. Don't green wash, because then you're going to be submitting a claim to Wayne and life's not going to be good for you, right? Well, thank you Wayne and Emily so much for joining us today. This is certainly one of the newer and emerging topics. We'll be very happy to have you back in a year or so and see where things are headed there, and thanks for joining us today. Really appreciate your time.

Emily Maier: My pleasure.

Wayne Imrie: Thank you.

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