airmic

GUIDE 2023

DIRECTORS' & OFFICERS' LIABILITY INSURANCE

Perfecting Governance

Liability challenges and questions

IN ASSOCIATION WITH:

McGILL AND PARTNERS

Acknowledgements

About McGill and Partners
Francis Kean joined McGill and Partners in 2020, after working 10 years at Willis Towers Watson. Prior to that, he was a partner at the law firm Barlow Lyde and Gilbert. Francis has handled a wide variety of claims for both insurers and clients, and has considerable experience of drafting policies and advising all parties in connection with coverage issues. Francis is considered one of the market's foremost experts on D&O insurance.

Noona Barlow joined McGill and Partners in February 2020, after spending 10 years at AIG, most recently as the head of International Financial Lines Claims. Noona has been involved in many of the largest D&O claims in the market in recent years. She is also a frequent speaker at market events on topics including D&O and claims' best practices.

Francis and Noona are part of McGill and Partners' team of leading industry practitioners focused on providing innovative insurance solutions to clients from all industry sectors and jurisdictions.

McGill and Partners is a boutique specialist (re)insurance broker focused on large clients and/or those with complex and/or challenging needs. Launched in 2019, the firm has significant backing from funds affiliated with Warburg Pincus, a leading global private equity firm. McGill and Partners is a British based firm, headquartered in London with international presence in New York, Miami, Chicago, Bermuda, Switzerland, Germany, Sydney and Dublin.

www.mcgillpartners.com

McGILL
AND PARTNERS

About Airmic
The leading UK association for everyone who has a responsibility for risk management and insurance in their organisation, Airmic has over 450 corporate members and more than 1,800 individual members. Individual members are from all sectors and include company secretaries, finance directors, and internal auditors, as well as risk and insurance professionals. Airmic supports members through learning and research; a diverse programme of events; developing and encouraging good practice; and lobbying on subjects that directly affect our members and their professions. Above all, we provide a platform for professionals to stay in touch, to communicate with each other, and to share ideas and information.

www.airmic.com

airmic

CONTENTS

01 Introduction

Over the past three years, the UK directors' and officers' (D&O) liability insurance market has undergone a period of significant upheaval. During this time, the capacity and appetite for this class of insurance reduced radically, and premium levels shot up. To a large extent, this was a result of payments and settlements being made by insurers in respect of legacy claims, and a rise in US based securities litigation, which had a negative impact on insurers' loss ratios.

The effect of this market correction has eased and continues to do so. Nevertheless, a valuable consequence of it has been to provide companies and boards with an opportunity to reassess the benefits and fitness for purpose of D&O insurance, and to focus on core coverage priorities, some of which may vary from organisation to organisation. The aim of this boardroom guide is to promote and encourage this process by helping to connect D&O insurance to its end users, that is, the board members themselves. It does so by posing twelve questions that are answered. The questions focus on practical coverage issues which commonly arise. The questions are posed from the point of view of board members themselves. Although designed to be answered by reference to specific policy wordings.

The answers supplied below (based on an amalgamation of the position under various commonly used market wordings) are intended to provide general guidance as to the likely position, subject to the significant caveat that no two D&O policies are the same.

There tends to be a mystique surrounding directors' and officers' liability insurance, which often results in a disconnect between the product and its end users, creating the risk of a significant expectation gap in the event of a claim. The reasons for this mystique include:

- D&O polices tend to be relatively complex. Some of this is historical and has to do with the way in which this class of insurance developed. Originally, it took the form of two separate policies – the first was designed to cover individual directors (to the extent that they were not indemnified by the company) and the second was to reimburse the company to the extent it had indemnified its directors. These were then amalgamated into a single class of insurance with two insuring agreements, which became known as Side A and Side B (please see the final page of this document for a brief glossary of terms). This distinction still exists and creates the potential for uncertainty of outcome.

- No two D&O policies are the same or even directly comparable. The directors' and officers' liability insurance market comprises dozens of different carriers. Whilst the majority offer only excess insurance capacity, and therefore tend not to produce their own wordings, there are nevertheless at least ten different base forms to choose from in the London market. Insurance brokers and other advisers often negotiate enhanced versions of these wordings for the exclusive use of their clients. Many of these forms are further modified and tailored to individual risks. All of this adds to the complexity.

- The general approach of D&O insurers is to provide cover on an affirmative basis, i.e. to identify specific categories of risk and set out the basis on which the relevant cover is provided. So, for example, separate extensions commonly exist for matters such as extradition, corporate manslaughter and pollution. Whether this tendency towards complexity always enures to the benefit of the policyholders is open to question.

"In an increasingly high-profile, personal and complex line of insurance, it is ever more important that Risk and Insurance managers are able to confidently articulate the key issues/concerns that all directors and officers should be aware of. This guide does this expertly in a very succinct format. Taking into context the current market conditions, by mapping these 'twelve questions' to their existing D&O policies, this should enable Risk and Insurance managers to stimulate much more effective discussions both internally and externally, and determine what is it that is really required from their D&O insurance policies?"

(Airmic member)

01 Introduction

> "Don't wait until you have a claim, read this guide and get comfortable now"
>
> *(Airmic member)*

The Twelve Questions

1 What limit am I covered for and how do I know it is the right one for my industry sector?

Whilst questions 11 and 12 address the important issue as to what proportion of the overall insurance you can access, there is a prior question about the appropriate limit of directors' and officers' liability insurance (D&O) the company should be purchasing in the first place. Competent insurance brokers are well placed to answer this question by reference to benchmarking and data analytics. The former involves a comparison of buying trends with an anonymised peer group. This can provide a level of comfort for the chosen limit but as peer groups are sometimes elusive, the information can be incomplete and there remains the possibility that the relevant peer group has either underestimated or overestimated the appropriate level of cover. The latter relies on a variety of statistics drawn from multiple sources such as Environmental, Social, Governance (ESG) ratings ratings, historical claims records and litigation trend reports. Whilst the quality of the output can be variable and is only ever as good as the underlying data itself, such reports can provide useful guidance as to the likely severity and frequency of D&O claims. The results of benchmarking and/or data analytics are routinely provided by insurance brokers to risk managers several months prior to the renewal date for the D&O programme. If you as a director wish to be consulted in the decision-making process as to limits, you will need to call for the relevant reports at a sufficiently early stage in the buying process. In addition, during the renewal process, brokers will often prepare a summary document that outlines what, if anything, has changed in your cover from one year to the next, so it may be worthwhile to ask for that information.

> "If you wish to be consulted in the decision-making process as to the limits, you will need to call for the relevant reports at an early stage in the buying process."

2 Am I covered for the right types of exposures especially with regard to emerging risks?

As a director, you will usually be able to access appropriate training and briefing from the company's legal advisers as to both the general liability exposures you face by virtue of your role and any specific or enhanced exposures which may exist by virtue of the particular industry sector or geographical areas in which the company operates. Less commonly, you may receive guidance about (a) which of these liability exposures are (or may not be) covered under your directors' and officers' liability insurance (D&O) policy and (b) how well the standard D&O cover tracks and responds to emerging executive risks. You may wish to ask for a copy of the wording itself or at least a summary of the main provisions, but even then the answers to these questions may not be obvious and policy terms and conditions can vary considerably. Although counter-intuitive, it is useful to remember that a policy with a long and seemingly impressive list of extensions in respect of specific "*defined perils*" such as cyber risk, insolvency hearing costs, corporate manslaughter and extradition etc. may in fact contain more restrictive cover than one in which the main insuring clause and the key gateway definitions such as those for "*Claim*", "*Loss*" and "*Wrongful Act*" are generously and clearly drafted adopting an "*all risks*" approach. (See also the answer to question 5 and, in case of doubt, seek appropriate expert advice.)

> "It is useful to remember that a policy with a long list of extensions may in fact contain more restrictive cover than one in which the key gateway definitions are clearly and generously drafted."

3 What happens to my insurance protection when I leave the company?

There are typically two separate levels of protection here:

i) Under the first, the insurance should continue to protect you in future years as a *"former director or officer"*. In other words, if you commit a wrongful act in the year before you leave the company (Year 1), but the claim is only made against you three years later (Year 3), the policy which will protect you is the policy in force at the time the claim is made (the Year 3 policy). This is the practical application of the so-called *claims made* principle of English law and highlights the importance of seeking appropriate assurances from the company before you leave as to its intentions to buy this form of protection on your behalf in the future.

ii) The second form of protection (which is common but not universal) works as a fail-safe in the event that, for whatever reason, the company does not continue to buy directors' and officers' liability insurance (D&O) on your behalf in future years. Under this extension to cover, the policy in force in the year in which you leave provides cover for future claims in respect of wrongful acts alleged to have occurred while you were in office. These extensions are usually worded to only apply in the event that you have retired or resigned as opposed to having been dismissed or disqualified. Again, no two wordings are identical, so it pays to check.

> "No two wordings are identical, so it pays to check."

4 What happens to my insurance protection in the event that the company is acquired by or merges with another company?

Virtually all directors' and officers' liability insurance (D&O) policies contain *change in control provisions*, which broadly provide that in the event of a merger or acquisition (again the precise language varies) taking place during the relevant policy period, the policy converts into *"run off"* at the effective date of the transaction. This means that cover from that point is limited to wrongful acts that occurred *prior* to the merger or acquisition date. The rationale for this is that, from the insurers' perspective, there has been a fundamental change in risk. Most policies contain a provision in this event under which the insurers agree to extend the reporting period for such future claims, typically for up to six years.
It is important to understand the nature of this conditional agreement. The insurers should ideally grant a contractual entitlement on a pre-priced basis for this added protection to be purchased on your behalf, but that is not always the case, especially in difficult market conditions. Sometimes, the relevant clauses provide no more than a commitment by the insurers to quote such terms as they see fit. If you are staying in office post acquisition, it will be the responsibility of the new owners to secure cover for you going forward in respect of new wrongful acts.

"Most policies contain provision under which insurers agree to extend the reporting period for such future claims, typically for up to six years"

5 What am I covered (and not covered) for and how do I make a claim under the policy?

In general terms, the directors' and officers' liability insurance (D&O) will cover you for:

i) Legal liability incurred by you in your capacity as a director or officer.
ii) Defence costs for claims made against you for wrongful acts committed in your capacity as a director or officer.
iii) Additionally, there will be some measure of protection for you in the form of legal expenses cover in the context of regulatory investigations in which you become involved by virtue of your office. It should be noted, however, that the triggers for cover in respect of regulatory and other forms of investigations (including post insolvency) vary widely from policy to policy and are generally more restrictive than you might think.
iv) Whilst a D&O policy will not cover you in respect of your own dishonest acts, it should assume in your favour that you are innocent, and the insurers will advance defence costs until such time as there has been a final adjudication against you or a formal written admission by you.
v) Other typical exclusions include those in respect of bodily injury and property damage, where the expectation is that there should be cover under other policies (i.e. general liability) for this type of claim.

In the event that you need to claim under the policy, in most cases, the appropriate course will be to contact the company risk manager, general counsel or company secretary, who will ensure (either through the brokers or directly) that the appropriate notices are given to the insurers. It is always sensible to err on the side of caution and discuss any circumstances you feel might give rise to a claim against you with the in-house legal team at the earliest opportunity. In the unlikely event that you need to notify a claim directly to the insurers (for example, if the company itself is pursuing a claim against you), many but not all D&O policies make express provision for this. Remember that you may need to make a claim under a D&O policy long after you have left the company.

> "Remember that you may need to make a claim under a D&O policy long after you have left the company."

6 What impact (if any) does the company's ability and willingness to indemnify me have on my insurance cover?

From your perspective as an individual director, the impact should be limited but this may depend (a) on the company's attitude to your claim and (b) on the nature of your entitlement to an indemnity from the company. The starting point is the nature and extent of your right to seek indemnity from the company. Under English law, whilst a company may indemnify you in respect of a wide variety of (but not all) claims, it is not obliged to do so unless you benefit from a contractual commitment from the company. So the first question is: do you understand the nature and extent of your entitlement to indemnity? The reason this may matter is that your entitlement to receive funds from directors' and officers' liability insurance (D&O) insurers by way of payment of your legal costs (and without prior deduction of any applicable excess or deductible) is usually dependent on the production of evidence of the company's failure or refusal to indemnify you. In other words, most D&O policies are designed to cover you to the extent the company indemnity does not. But since the way insurers deliver on this commitment to advance defence costs varies from policy to policy, it merits close attention.

"The starting point is the nature and extent of your right to seek indemnity from the company."

7 How (if at all) might the conduct or knowledge of others with whom I share my limit affect my position?

There are three ways in which the knowledge or conduct of your co-insureds could potentially affect your position adversely. (This is in addition to the points made in questions 1 and 2 above that your co-insureds can erode the limit you share by virtue of the *first-come, first-served* rule). Each of these ways can and should be mitigated by language in the directors' and officers' liability insurance (D&O) wording, but it pays to check.

i) Firstly, both you and the company are under an obligation under the Insurance Act to make *a fair presentation* of the risk to the insurers at each renewal. The consequence of a failure to do so is to run the risk that the insurers will exercise one or more of the remedies provided for by the Insurance Act against you to restrict or deny cover. Insurers' ability to do so can and should be constrained contractually by a provision to the effect that any such remedies may only be visited on those (including the company) who were responsible for the non-disclosure or misrepresentation of the risk.

ii) Secondly, the exclusionary language that applies — for example, to acts of dishonesty or the gaining of profit or advantage which you were not entitled — should again be restricted so that it is only the individual(s) guilty of such conduct who suffer the consequence.

iii) Thirdly, policies often contain an obligation to co-operate with the insurers and provide information to them in relation to a claim. Again, the consequences of any failure to comply with these provisions can and should be limited contractually only to those responsible.

> "There are three ways in which the knowledge or conduct of your co-insureds could affect your position adversely."

8 When (and subject to what conditions, if any) does the policy allow me to appoint a lawyer of my choice to protect my interests in the event of a claim?

This question assumes that the D&O policy has been triggered so that you are entitled to recover costs from the insurers in the first place. As stated in the answer to question 5, especially when it comes to regulatory investigations in which you are or may become implicated, you should not assume without first checking that the policy has been triggered so far as you personally are concerned. It may be the case that insurers are paying out legal representation expenses to your co-insureds who are ahead of you in the queue (as it were) to answer formal questions so that even though you consider it likely you may be summoned by the regulator, the policy has yet to be triggered for you. When it is triggered, generally, the position with respect to the appointment of counsel is that this needs to be done in consultation with and having obtained the insurers' consent. Some directors' and officers' liability insurance (D&O) policies provide that the insurers will accept as necessary the retention of separate legal representation for individual directors in the event of an actual or potential conflict of interest as sometimes arises. Others are silent on this point or require the existence of *"a material conflict of interest"*. In some circumstances, it may be possible to pre-agree with the insurers both the identity of and the terms on which lawyers may be appointed in the event of a claim.

"The position with respect to the appointment of counsel is that this needs to be done in consultation with and having obtained the insurers' prior consent."

9 If the company becomes insolvent, does the cover remain in place and am I covered for the legal representation costs of interview by the liquidators?

An insolvency event occurring during the policy period does not usually constitute a *change in risk* such as that discussed in the answer to question 4, so in most cases, such an event will not have a direct impact on the cover under a directors' and officers' liability insurance (D&O) policy. The problem is that unless you are able to identify circumstances that make it reasonably likely that a future claim will be made against you in your capacity as a director, you will not be able to lodge a valid *notification of circumstances* before the expiry of the policy period to protect and preserve the existing limit of cover for any future claims. The insolvency event itself is unlikely to be accepted by D&O insurers as such a circumstance. Once the policy has expired, you are also unlikely to be able to find (or pay for) a fresh limit to cover either future claims in respect of pre-insolvency event wrongful acts or (assuming you remain in office in the case of an administration or restructuring) for wrongful acts that occur post insolvency event (although in the latter case, it may be possible to secure some insurance protection.)

There are also other risks associated both with limit erosion and coverage which are specific to company insolvency, and which can to a large extent be mitigated in advance with appropriate input from advisers.

"The insolvency event itself is unlikely to be accepted by D&O insurers as a notifiable circumstance."

10 What else should I be worrying about by way of restrictions or limitations on cover?

As discussed in the answer to question 5, there are a variety of standard exclusions to be found in directors' and officers' liability insurance (D&O) policies. Less obviously (and therefore of potentially greater concern) are limitations commonly found within the definitions and other terms and conditions of many policies. One typical example applies in the scenario addressed in the answer to question 9. Following an insolvency event, the liquidator or other insolvency practitioner (using statutory powers) will invariably invite you for interview to explain what went wrong. Legal representation at this type of interview is essential and yet many D&O insurers seek to impose a sub-limit on the amount of cover available for this exposure. Generally, it is a good idea to understand the nature and extent of any such sub-limits (which sometimes are expressed as additional limits). The definition of "*Loss*" under many policies is also a common repository of exclusionary language. The formula *"Loss does not include…"* frequently precedes a range of excluded perils such as pollution, fines and penalties, and other matters not specifically referenced in the exclusions.

"The definition of "*Loss*" under many policies is also a common repository of exclusionary language."

11 With which and how many employees below board level do I share my insurance limit?

The answer is, it depends. In most directors' and officers' liability insurance (D&O) policies, the definition of *"Insured Persons"* includes directors and officers (including non-executive directors and outside directors) as well as several subcategories of other individuals. Whilst it is difficult to generalise, perhaps the most significant of these sub-definitions is *"any employee acting in a managerial or supervisory capacity…"*. From your perspective as a director, the important point to note here in assessing the adequacy of the limit is that in a large company with significant numbers of employees, you are, in effect, sharing the same limit with all such individuals. It is also relevant to note that under English law (and in the absence of special provision), insurance limits are used up on a *first-come, first-served* basis, regardless of the seniority of the individuals seeking protection.

"Insurance limits are used up on a *first-come, first-served* basis, regardless of the seniority of the individuals seeking protection."

12 Is any part of the limit of indemnity ring-fenced for me and/or for my fellow board members?

As a general rule, the answer is no. The insurance is usually structured as a single aggregate limit shared among all insured persons and with the company itself to the extent the company claims reimbursement from the insurers for any indemnification granted to such persons. Moreover, many listed companies buy additional protection against shareholder claims in which the company itself is an insured entity (known as Side C cover). The same *first-come, first-served* rules apply. It is, however, possible to create ring-fenced protection for board members either on a shared basis or even (more rarely) on an individual basis, but these types of arrangements (and especially individual ring-fenced protection) can be expensive and cumbersome. It is also possible to configure a directors' and officers' liability insurance (D&O) programme that combines traditional shared limits and limits that are preserved for the directors only.

> "It is possible to configure a D&O programme which combines traditional shared limits and limits which are preserved for the directors only."

Glossary

Side A – insurance protection for the benefit of the individual director or officer, where the company cannot or will not indemnify the director. The insurer pays from the first pound incurred.

Side B – the insurer reimburses the company for expenses incurred while defending their directors and officers pursuant to indemnification obligations. This section of the policy is subject to a retention/deductible (there can be wide variety in the size of the retention).

Side C – also known as "*entity cover*" provides coverage for the company itself where the company is sued for a securities claim (including a derivative claim). The scope of Side C coverage can vary depending on whether the organisation is a public or a private company.

Capacity – in order to attract cover under a directors' and officers' liability insurance (D&O) policy, the director (or insured person) must be acting in their capacity as a director or officer. If the claim made against a director is made against them for wrongful acts done, for instance, as an investment advisor or for legal advice provided, these claims may not be covered

Company indemnity – provided to the directors by the company/group company, through a service contract or standalone indemnity deed to protect the individual from civil liability (including defence costs) to third parties. A company indemnity will not respond in the event of civil liability to the company/group company itself or to criminal fines and penalties

airmic

Marlow House
1a Lloyd's Avenue
London
EC3N 3AA
+44 207 680 3088
enquiries@airmic.com
www.airmic.com

GUI-0068-0921