

**DIRECTORS
AND
OFFICERS
INSURANCE**

**TRENDS
AND ISSUES
IN TURBULENT
TIMES**

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MinterEllison RuddWatts

“We strongly recommend that all directors and officers take time to understand the impact of all policy conditions, endorsements and exclusions in light of the risks their business faces, and think carefully about whether their policy limits are aligned with the worst-case scenarios.”

Andrew Horne, Partner, MinterEllisonRuddWatts



“All board members, including those in not-for-profits and small and medium organisations, should consider D&O insurance to cover them in their roles”.

Steve Walsh, Chief Client Officer, Marsh



“In times of dynamic change and complex risk it’s critical that boards and directors prioritise investing time and energy into ensuring that they have appropriate insurance cover.”

Felicity Caird, GM Governance Leadership Centre, Institute of Directors

DIRECTORS AND OFFICERS INSURANCE

TRENDS AND ISSUES IN TURBULENT TIMES

Directors serve in an increasingly challenging operating and regulatory environment. Their roles and responsibilities have expanded over recent years and policy-makers continue to target directors for personal liability in reforming regimes. In addition, regulators are showing more teeth, and litigation funders and activist law firms are changing the nature of the legal landscape.

Substantial awards of damages in Mainzeal and other high profile cases have focused attention on directors' duties and accountability. All of this has led to an unsettled Directors and Officers (D&O) insurance market. Against this background, directors are increasingly conscious of the need to ensure that their D&O insurance provides them with appropriate protection. Lawyers and insurance brokers who represent directors know that some policies are better than others and that important risks are not always adequately covered. It is therefore critical that directors have a policy tailored to cover risks specific to their organisation. The Institute of Directors has partnered with Marsh and MinterEllisonRuddWatts to discuss key trends and issues including:

- Market developments
- The changing regulatory environment
- Insurers' areas of interest
- Key coverage issues for D&O policies, and
- What's next for D&O insurance?

How many directors have D&O insurance?

The IoD's 2018 *Directors' Fees Report* found that 76 percent of organisations provided directors with liability insurance.

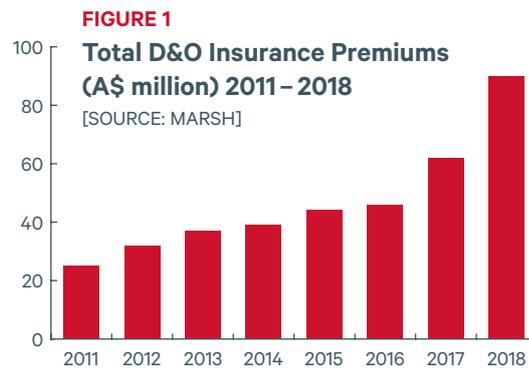
76%

Market developments

The New Zealand liability insurance market continues to harden, with insurers maintaining a conservative and selective approach to their underwriting and deployment of capital. This is evident in increased premiums being applied across most classes of insurance and risks (including D&O insurance), together with targeted uplifts in retentions, restrictions in coverage terms and withdrawal of capacity resulting in lower limits being offered. This is occurring not only where there have been material changes to an individual insured's business or frequency of claims, but where insurers have incurred sustained claims across their wider books for a particular class of risk.

Rise in D&O premiums

The cost of D&O insurance premiums has increased significantly in Australia. The trend is similar in New Zealand, and in 2019 premiums for some organisations have more than doubled.

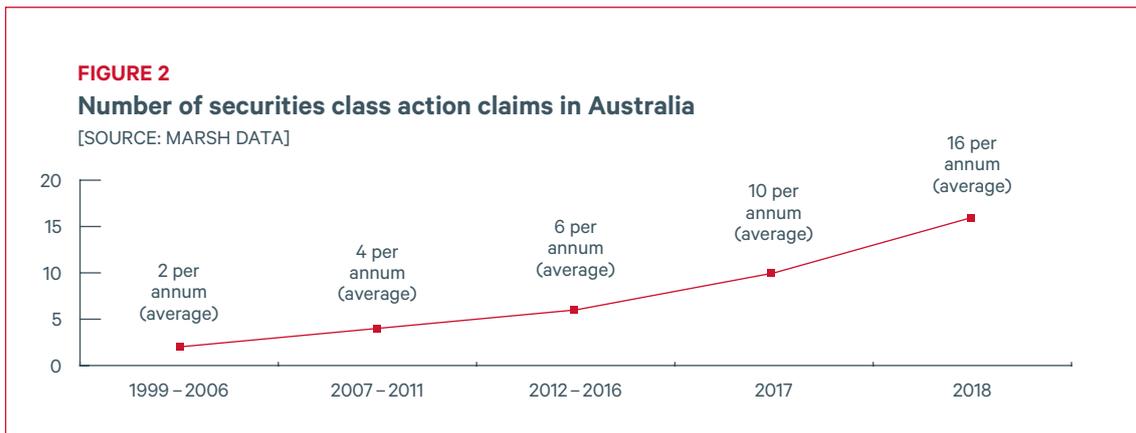


At the same time, the New Zealand regulatory environment continues to tighten, with increasingly active regulators including the Financial Markets Authority, WorkSafe NZ and the Commerce Commission. A number of reviews of existing legislation are currently underway (e.g. the FMA and Reserve Bank's joint review of conduct and culture in the financial sector and the Privacy Act 1993) which may result in new or enhanced obligations and new or increased penalties for companies and their directors. This is resulting in insurers maintaining a close watch on developments in the regulatory space for the potential effects on their books. Litigation funding is growing and some funders are acquiring debts from failed companies' creditors and seeking to install activist liquidators to bring claims against their former directors. There are also activist law firms appearing and organising claims on their own initiative. These are significant developments that are having an impact on the D&O insurance market and legal environment.

What is litigation funding?

Third party litigation funding is the financing of litigation by an independent party, so-called litigation funders. Their primary business is to finance litigation and it is generally a high risk / reward model. A funder will usually contribute all of the costs associated with a plaintiff's case in exchange for a share of any judgment or settlement proceeds. If the case is not successful in court, the funder will be liable for the costs of the case including those of the defendant. For more, see the IoD's 2017 DirectorsBrief: *Litigation funding: friend or foe?*

The D&O insurance market for publicly listed companies (especially where Company Securities ‘Side C’ cover or Statutory Liability is included) has incurred the greatest scrutiny over the last two to three years. This change has been driven predominately by the impact of Australian securities class actions claims on insurers’ financial performance, where the losses incurred greatly outweigh the premium pool available and have done so for a number of years.



While class or group actions in New Zealand have been relatively rare, they are on the rise (e.g. actions against Southern Response, James Hardie and the Ministry of Primary Industries). In 2018, the plaintiffs in a group action against the former directors of Feltex obtained a ruling in the Supreme Court that a forecast in a prospectus was untrue, opening the door to substantial claims against the directors.

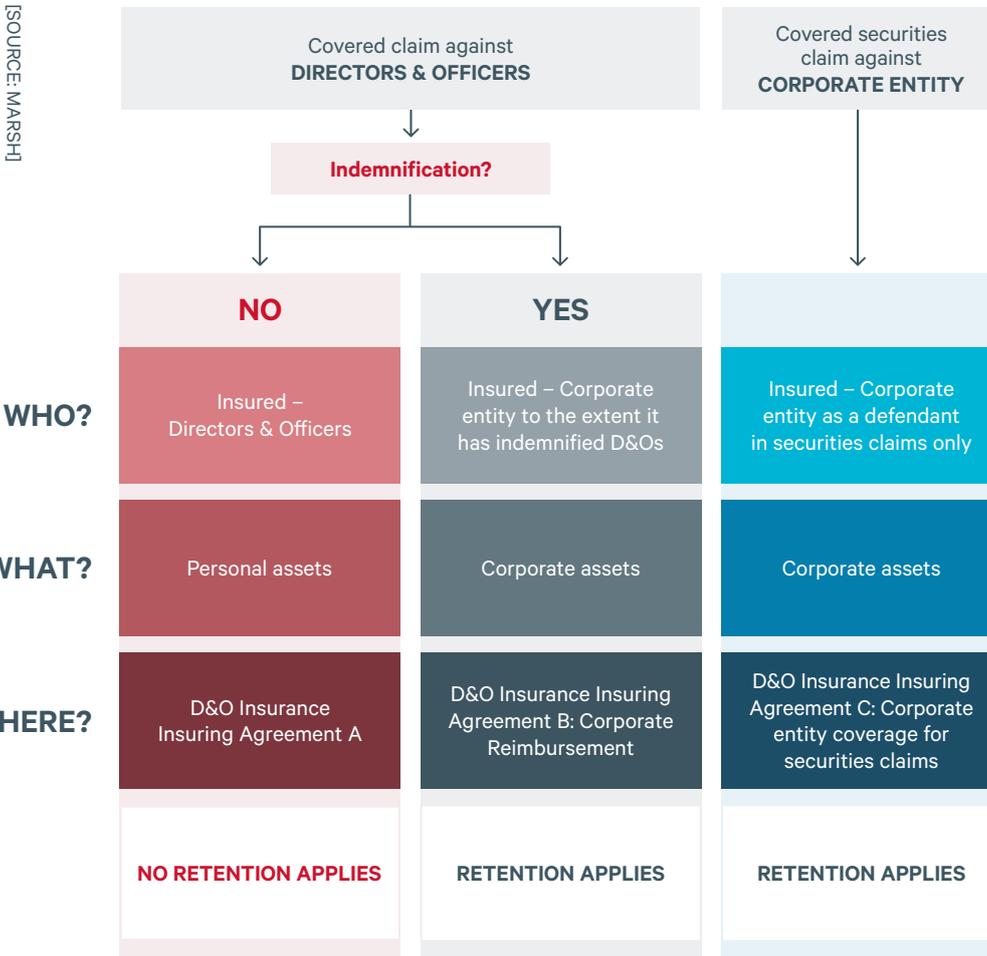
New Zealand dual-listed companies, and to a slightly lesser extent NZX-only listed companies, are not immune from the impact of the securities class action environment in Australia as insurers attempt to remediate their wider portfolios. Insurers are also keeping up to date on developments here. This has resulted in New Zealand publicly listed companies facing a combination of increasingly substantial premium uplifts from insurers, higher excesses (most commonly for Side C exposure) as well as a reduction in the Side C capacity available across the Australasian insurance market. The flow on effects of the Royal Commissions in Australia into aged care and the financial sectors and the regulators’ reports into the financial sector in New Zealand are expected to be felt for some time.

What’s Side A, B and C cover?

D&O POLICY

Side A cover	Insures directors and officers for losses not indemnifiable by the company
Side B cover	Reimburses the company for amounts paid to its directors and officers as indemnification (e.g. legal defence costs, settlements or judgments)
Side C cover	Insures losses incurred by the company resulting from securities claims (made against the company for its own liability in relation to its securities)

FIGURE 3
D&O policy structure – it's as easy as A, B...C



Changing regulatory environment

Most directors and officers will be abundantly aware of the changing regulatory environment, as it pertains to their particular governance roles. The financial services industry as a whole, for example, is under the spotlight following the FMA / RBNZ culture and conduct reviews of banks and life insurers in New Zealand and the release of the Australian Royal Commission's *Final Report into Misconduct in the Banking, Superannuation and Financial Services Industry*. There is also an increasing focus on the following areas:

- Continuous disclosure
- Fiduciary duties
- Health and safety
- Anti-competitive behaviour
- Cybersecurity and privacy
- Climate related matters
- Market / Codes of conduct.

The continually evolving regulatory environment has the potential to alter both the business and personal risk to directors and officers, who must monitor their risks and seek advice, particularly when there are regulatory changes.

Insurers' areas of interest

When the D&O insurance market is going through a difficult time, insurers pay even more attention to detail, including when requesting information and learning about the business being insured.

If D&O insurers do not fully understand the risks they are being asked to underwrite, they will commonly:

- Limit the amount of capacity they are prepared to offer
- Restrict coverage, so as to not expose themselves to risks and/or claims they do not fully understand
- Increase pricing
- Remove offers for Side C cover and, potentially, individual D&O protection
- Narrow the scope of the policy wording
- Introduce exclusionary language.

To respond to insurers' requirements and concerns (aside from the completion of insurance proposals, personal declarations, provision of company financials, company indemnities if applicable) directors need to commit further time, effort and resource to strategies such as the following:

- Face to face meetings with insurers and the C-suite
- Explain in detail the compliance and risk culture of the insured company, including examples of compliance and risk management standards being adhered to
- Meet the claims team of the insurers and identify or develop a claims handling protocol (where applicable).

Key coverage issues – not all D&O policies are equal

It is essential that those arranging cover for directors and officers take great care when negotiating terms and placing cover.

When considering the D&O policy coverage, recent loss scenarios demonstrate that it is most important to think about setting limits in a structured way. The following are key considerations:

- When you set the limit, it could be as many as 10+ years before it is called upon when a claim is made. How might the quantum of the risk rise in that period?
- How might legal defence costs rise in the same period, and might they be increased by a greater number of directors and officers over time and the need for separate representation?
- What, if any, changes are you likely to face in the future, in terms of developments in the standards required or the duty of care?
- What are your personal circumstances and your ability to defend and/or fund a loss (if there is limited or no insurance)?
- Is the industry sector / company you govern susceptible to class actions or other group litigation, or new types of regulatory action and penalties?

Balancing performance and compliance

The 2018 *Director Sentiment Survey* found that 71% of directors were spending more time on compliance related activities in the last 12 months. Balancing time on strategic and performance issues with compliance requirements is becoming increasingly challenging for many boards.



Key coverage issues that directors and officers need to consider:

Investigation costs

Most D&O policies include cover for directors' and officers' 'investigation costs' incurred in responding to a regulator's investigation. Proper legal representation and advice at the investigation stage is crucial. A poorly handled investigation may result in damaging evidence or admissions that enable a regulator to pursue a claim.

Not all D&O policies are equal and coverage can differ greatly, especially in relation to investigation costs. Many policies limit such costs in ways directors may find surprising. It is not unusual for investigation costs cover to be triggered only when an allegation of a breach of a legal duty is made against a director. The problem is that, in most investigations, allegations are not made until the investigation is concluded. Indeed, the purpose of the investigation is normally to identify whether allegations should be made and against whom.

It is surprisingly common for D&O insurers to resist paying for legal representation to respond to initial document requests and representation at interviews. Insurers may assert that what is being investigated is an 'event' or an 'entity', not an 'individual', and decline to pay legal costs until an allegation against a director is made.

Care should be taken to ensure that investigation cover is drafted widely. It should include cover for the costs of responding to a notice requiring the provision of documents and information or attendance at interviews, without the need for an allegation of breach.

Separate defence costs cover

Most directors and insurers are now aware of the importance of separate defence costs-only cover in addition to D&O liability cover. Separate defence costs cover is necessary because of the 2013 decision of the Supreme Court in the *Bridgcorp* case, recognising a claimant's right to a statutory charge over the directors' insurance proceeds. This meant

that the directors could not call upon their D&O insurance for their legal costs incurred in defending the claim. The rule in the *Bridgcorp* case applies to all liability policies, not just D&O policies. Directors who rely upon statutory liability, professional indemnity, employment liability and other liability policies should take note.

Adequacy of cover

Care should be taken in deciding the amount of D&O liability and defence costs cover that is taken out. A variety of factors should be taken into account when determining what limit is appropriate. For example, consideration should be given to the likelihood that directors will have differing interests in defending the claim (depending, for instance, upon their differing roles and the extent of their personal knowledge) but will generally not have a limit of liability reserved only for them within the insurance but rather will share an aggregate limit with other directors and officers.

It is commonplace for groups of directors to require separate legal representation when a claim is made, which increases overall defence costs substantially. The costs of defending claims have risen significantly. D&O insurance programmes can be structured in a number of ways to achieve different coverage objectives. These require careful consideration of the overall limits of liability for defence costs.

Capital raising / IPO

Most policies do not provide automatic cover for any capital raising or IPO transactions. Liability arising from this type of activity can be complex. Care needs to be exercised to ensure that the most appropriate form of cover is obtained for a particular transaction.

Pollution

Other liability policies will provide some protection for directors, officers and in certain instances, the company, but only from pollution events caused by a sudden and accidental occurrence. Usually, liability arising from pollution events is complicated and often arises from historical or continual exposure types of events that have occurred over time.

Climate-related risks

The increasing occurrence of extreme weather events, severe temperatures, floods and wildfires across the world are reminders of the impact of climate change, one of the IoD's top 5 issues for 2019. Overseas, legal action has been taken against organisations and directors for failing to address climate-related risks. *The climate risk reporting journey* by MinterEllison is intended to assist boards in understanding, evaluating and overseeing climate-related risks and opportunities. As part of this, directors should consider whether climate change-related matters also impact on their D&O insurance (from coverage exclusions and 'occurrences', to disclosure and notification considerations).

See also the World Economic Forum's resource *How to Set Up Effective Climate Governance on Corporate Boards: Guiding principles and questions*.

Costs, awards and penalties (typically under the Resource Management Act) can be severe so it is very important to understand and study any risk related information a company has on these exposures. Only then will it be possible to consider properly specific pollution / environmental insurance coverage.

Majority shareholders

This key policy exclusion can be a particularly difficult matter to resolve for directors and officers. Some insurers will provide a 'carve-out' or a limited form of cover for claims arising from majority shareholders. From an insurance perspective, a majority shareholder is typically classified as one holding shares of 15% or greater of the insured entity.

To obtain an extension of cover, insurers will typically look at the shareholder and board composition and company indemnities, as well as any historical activity in relation to those particular shareholders.

Failure to insure

This exclusion has the potential to be significant, yet it often seems to be overlooked. Directors and officers may incur personal liability if they fail to ensure the appropriate insurance coverage is in place for their entity, if it suffers a loss that ought to have been covered.

Cyber risk

There is a lot of material available for directors and officers on cybersecurity, including the IoD's *Cyber Risk Practice Guide* and guide on *Reporting Cybersecurity to Boards*. It is essential that directors understand their entity's approach to managing cyber risk. Our experience indicates that, whilst many entities have significant resource to attend to this risk, others are still taking the approach that 'it won't happen to us'. In the 2018 *Director Sentiment Survey* only 58% of directors said that their boards discussed cyber-risk at least annually.

Liability from this risk comes in the form of both first and third party losses. Whilst D&O policies (and some others) may offer limited cyber related cover, a specific Cyber Insurance Policy is strongly recommended.



The disclosure trap

When a claim is made, insurers are increasingly scrutinising whether the directors fairly disclosed any relevant information before the policy was initiated or renewed. Insurers are particularly diligent in investigating claims where a claim is made shortly after a policy renewal.

Directors should take their disclosure requirements seriously and ensure that a proper process has been followed to ensure that any claims or potential claims are identified and reported to insurers.

Company indemnities

It is good practice for companies to indemnify their directors for claims made against them, where the law allows. However, many companies do not indemnify their directors, or do not have proper regard to the Companies Act limitations and procedural requirements when arranging cover. It is important to note that an indemnity given in breach of the Companies Act is void.

Accordingly, care should be taken to ensure that indemnities given to directors are in a proper form and are authorised in the company's constitution and by resolution. The same applies where the company arranges insurance for directors. Irrespective of the policy language used, D&O insurers have a general expectation that the company will indemnify its directors where it is legal and it has the financial ability. D&O insurers commonly cover both the company for any payments it makes to its directors under an indemnity (known as 'Side B' cover) and the directors where the company does not meet their costs (known as 'Side A' cover). It is nevertheless important to ensure that valid indemnities are provided so that no insurance issues arise.

Dual-listed companies

Directors of New Zealand companies that are dual-listed on both the New Zealand and Australian stock exchanges should consider whether their D&O policies are adequate to protect them from claims arising in both jurisdictions.

Most dual-listed companies have attained 'foreign exempt' status in Australia, which means that they are not obliged to comply with ASX rules provided they comply with corresponding NZX rules. Established Australian 'class action' law firms and litigation funders face a disincentive in pursuing directors of New Zealand companies with foreign exempt status because they will need to deal with claims in the New Zealand courts, which they may not be familiar with.

There remains a risk, however, of an Australian claim being brought against the directors of a New Zealand dual-listed company, particularly if it does not enjoy foreign exempt status. Where that is the case, directors will need to ensure that their D&O insurance extends to claims in Australia under Australian law. All listed company directors should take a strong interest in their D&O insurance and seek reassurance that it is appropriately tailored for the heightened risks that listed companies and their directors face.

Top 5 insurance issues

Marsh's 2018 *Directors' Risk Survey Report* asked whether directors were confident that they had the right amount of cover and that they actually understood what is in the policy. The top five issues ranked in order were:

1. The policy not responding in the event of needing to make a claim
2. Lack of clarity about policy terms
3. Not knowing what is in the policy (i.e. it is organised by another party)
4. Not having sufficient cover in the D&O liability policy
5. The cost of the insurance premiums.

What's next for D&O insurance?

We expect that there will be a continuation of the difficult D&O insurance market trends for some time, perhaps worsening for some industries. We also expect that increasing activity by third party litigation funders, possible claimant-friendly changes to the class or group action rules in New Zealand and the increasing regulatory burden on directors and officers will have the following effects:

- The D&O insurance market will continue to be difficult with increasing premiums and increasingly limited cover
- Insurer consolidation is likely to continue
- Cover may become subject to additional exclusions as insurers respond to evolving risks (e.g. cyber / failure to insure, anti-money laundering, industry-wide commissions, and climate change).

At present, good risks can still expect to continue to buy broad insurance, but it will increasingly cost more and may be harder to come by. In a world of changing and increasing risks for directors, D&O insurance is also changing. Care must be taken to ensure that policies continue to be relevant and effective.

Learn more about D&O insurance

Marsh's Directors' Pack outlines the fundamentals of D&O insurance including how it works in practice, and questions most often put to brokers. It also sets out statutory duties of directors and sources of claims. Contact Marsh for a copy (details provided on p 12).

Authorship

This brief has been authored by MinterEllisonRuddWatts, Marsh (with support from AIG) and the Institute of Directors.

MinterEllison RuddWatts

MinterEllisonRuddWatts is a top tier New Zealand law firm known for providing clients with technically excellent legal solutions and innovative commercial advice. We are trusted advisors and work alongside our clients to ensure success. Our offices in Auckland and Wellington are able to access an international network through the MinterEllison Legal Group, a leading firm in the Asia-Pacific region.

ANDREW HORNE PARTNER

Andrew specialises in commercial litigation and dispute resolution and leads the MinterEllisonRuddWatts insurance practice. He has particular expertise in commercial and contract disputes, corporate and regulatory issues, financial services, insurance, technology and telecoms.

+64 9 353 9903 | +64 21 2451 545
andrew.horne@minterellison.co.nz | Auckland

MARSH

Marsh is a global leader in insurance broking and innovative risk management solutions. We help clients quantify and manage risk – and help them unlock new opportunities for growth. Marsh has been working with New Zealand businesses since 1958 and has 10 offices around New Zealand with over 250 experienced professionals.

STEPHEN WALSH CHIEF CLIENT OFFICER

Steve has been a corporate broker since 1993, managing a large cross section of NZX, corporate and government business. His focus is on understanding the challenges companies face, the attendant risks and aligning their insurance programs based on the risk profile and tolerance.

+64 9 928 3126 | +64 21 858 855
stephen.walsh@marsh.com | Auckland

Institute of Directors

The Institute of Directors in New Zealand (Inc) connects, equips and inspires its more than 9000 members, to add value across New Zealand business and society, through thought leadership, our extensive network, professional governance courses, events and resources.

FELICITY CAIRD GM GOVERNANCE LEADERSHIP CENTRE

Felicity leads the IoD's Governance Leadership Centre, which keeps members up-to-date on key governance developments, current best practice and issues affecting directors and their roles.

+64 4 470 2663
felicity.caird@iod.org.nz | Wellington
