D&O insurance – a rising sea of change

Trends and insights, February 2022

Institute of DIRECTORS NEW ZEALAND

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1. Introduction

New Zealand continues to be in the midst of an uncertain and challenging Directors & Officers Liability (D&O) insurance market. This is driven by a number of existing issues and some new and emerging risks, including climate-related risks, all contributing to a rising sea of change.

This is our third report on D&O trends and insights, in which we provide an overview of market developments and regulatory updates, including the impact of covid-19 and a changing class actions regime. Overviews of D&O policy structure and key coverage issues from our previous reports are included in the appendices. In this report we also include an international perspective, *ESG trends in the European market*, (see chapter 5) contributed by Zelda Pitman, Vice President, Marsh U.K.

The New Zealand insurance market is dominated by US and Australian owned insurers, as well as a number of UK based insurers and agencies. This connectedness is an important factor in the flow of global trends into New Zealand.

Changes in the D&O market are not only impacting listed companies, but are also flowing through to private companies and those industries considered high-risk. The outlook for 2022 and beyond is for little change requiring all directors and officers to be vigilant about D&O insurance coverage, and be alert to any potential new covid-19 exclusions.

The global ascent of environmental, social and governance (ESG) matters and their relationship to long term performance, risk and value creation is also apparent in New Zealand. Underpinning this is understanding and responding to evolving expectations of investors, consumers, staff and other stakeholders.

New Zealand is introducing mandatory climate-related reporting. While initially only applying to select larger entities in the financial sector, reporting standards being developed by the External Reporting Board (XRB) will extend to issuing guidance on ESG matters. The advancement of climate-related disclosures will also drive broader ESG disclosures from organisations.

The requirements for additional disclosures can increase the potential for directors to be held liable for wrongful acts when those obligations are not met, and potentially claims that may be covered under D&O insurance. Insurers are therefore increasingly focusing on ESG metrics and disclosures when assessing risks.

How many directors have D&O insurance?

The IoD's 2021/22 Directors' Fees Report found that

85.1 percent of organisations provided directors with liability insurance (up from 78.5%).

85.1%

6.6%

increase on previous year

New and emerging risks

"Following the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021, introducing mandatory climate-related reporting, many boards are in the process of developing reporting protocols for 2023 and beyond. Directors need to assess whether their disclosures to the marketplace assist investors understanding that climate risks are appropriately priced into the valuation of their companies."

Craig Stobo,
Chairman, AIG New Zealand

2. Developments in a covid-19 market

Whilst the covid-19 pandemic has further upset an already disrupted D&O market it has not been to the extent initially envisaged. However, insurers are asking detailed questions about how companies are managing the ongoing impact of the pandemic, and specifically financial impact, business continuity, impact to employees and customers and how they are managing their disclosures.

Insolvency exclusion

With the covid-19 pandemic creating additional financial pressures for companies, insurers are scrutinizing the financial position of entities especially around solvency, compliance with debt obligations and banking covenants. Insurers are asking specific questions about how covid-19 may affect a company's solvency. If the insurer is concerned about financial performance, an insolvency exclusion may be applied.

This exclusion removes cover for claims brought against directors and officers which arise, directly or indirectly, from the insolvency of the company or the inability to pay its debts when they are due. This removes cover for a key exposure faced by directors and officers of a company.

Communicable Disease Exclusion

Whilst there have been reports of some insurers applying a Communicable Disease Exclusion (i.e. covid-19) to D&O programmes, this is probably rare. It would be of concern if applied more widely including such terms as "directly or indirectly", "arising out of", "attributable to", or "occurring concurrently" with a communicable disease, as this could remove cover indirectly connected to the loss.

To that end, there is a constant need for attention on the detail contained within the policy wording.

> "Generally speaking we haven't seen much litigation directly related to covid-19. However there are signs this may change. As the various financial support packages expire, we expect to see company failures increase. We are already seeing a clear increase in employment litigation directly related to vaccination mandates. These claims include unfair dismissal actions, but also some novel actions alleging bullying under health and safety legislation. Directors should also be aware of the risks arising out of covid-19 related supply chain."

Cameron McLisky,
Country Manager, Berkshire Hathaway Specialty Insurance.

3. Key market updates

Whilst the securities class action litigation environment has been the largest contributor to D&O insurance losses in recent years, there have numerous other factors which continue to drive this uncertainty, such as:

- The NZ Law Commission review into class actions and litigation funding (see update in chapter 4).
- NZ's own significant and recent claims activity, which includes several notable class actions.
- Environmental, social and governance concerns.
- TCFD[1] climate impact financial reporting.
- Increased health & safety litigation.
- Impact of cyber/technology events.
- High risk industries.

Environmental, Social and Governance (ESG)

- ESG issues are a growing area of risk. D&O insurers are increasingly looking at potential exposures to climate change risks and sustainability, and also broader ESG issues as well as diversity and inclusion. Concerns around ESG are also gaining traction with governments and regulators worldwide, as discussed in chapter 5. Increased shareholder activism and litigation based on ESG issues is likely to continue.
- Climate change, in particular, is a topic that continues to be focused on. Shareholders and other stakeholders are seeking greater climate-related disclosures and assurance that companies enact environmentally friendly policies, including taking steps to reduce their carbon footprints.

1 Task Force on Climate-related Financial Disclosure (TCFD) climate impact financial reporting.

Cyber and Technology

- The importance of cyber and technology from a business governance perspective should be a key topic in all boardrooms in light of the increasing threat of high-profile data breaches, distributed denial of services (DDoS) attacks, and the rising number of ransomware and cyber extortion attacks. Board members could potentially breach their fiduciary duties to the company and its shareholders if they fail to implement appropriate reporting, cyber security, and data protection controls, or if having implemented such systems and controls, they fail to monitor or oversee them. Whilst it is not apparent any mainstream D&O insurer is currently trying to preclude coverage under their D&O policies, underwriters are requiring more information about companies' cyber and technology governance and maturity.

Many businesses have experienced significant increases in their D&O premiums over the past two to three years. For 2022 and beyond it is anticipated that this trend will continue (albeit at more modest levels) as insurers seek to rebalance their portfolios through premium adjustments to compensate for claims and related costs. It is anticipated that these tough market conditions will result in continuing coverage limitations and scrutiny over the companies/directors insurability.

This challenging environment is a signal to companies and directors alike, that scrutinising their D&O insurance programme continues to be crucial.

Different types of companies are experiencing varying degrees of impact in the current D&O market conditions. For New Zealand privately owned companies, government entities and not-for-profits, there is still a fairly competitive market. For NZX listed companies, although there is reasonably strong capacity available, insurers continue to increase premiums to reflect the changing legal and regulatory New Zealand environment, with average increases between 30-50% in 2021.

The substantial increase in D&O liability claims emanating from the Australian D&O market over the past 10 years is one of the factors having a significant effect on D&O insurance for large and listed companies in New Zealand.

Dual listed companies with ASX investor exposure, and in complex or challenging industries have faced a particularly challenging market. This is largely due to remedial actions being undertaken by the insurance market in Australia and globally in an effort to adjust and rebalance a previously poor performing D&O portfolio. In New Zealand, there have been some premium increases in this sector of over 250% throughout 2020 and 2021, with even larger increases where the risk is perceived to have been underrated in previous renewal periods.

All insurers are requiring a significant amount of information for the D&O policies they are being asked to consider. They are also looking to engage more closely with companies and directors alike regarding a company's risk governance protocols and strategies. If the level of detailed information sought is not provided, the insurer may quote such onerous restrictions or premiums that the cover is effectively unaffordable.

Compounding ongoing uncertainty and the difficult market conditions, are insurers growing concerns over a number of 'higher risk' industries such as Financial Services, Technology, Start-Up, Power & Energy, Healthcare and Engineering/Construction.

Some companies and organisations may therefore face the possibility of a D&O renewal outcome where there will be a reduced overall policy limit with increased retentions, reduced coverage (especially if companies securities cover is purchased), and a year-on-year premium uplift. The challenge for companies in this environment is to find the right balance between the rising cost of insurance and having the right level and mix of protection for directors and the organisation. As D&O relates to exposures of both individuals and the corporation, there is no off-the-shelf "right" approach and it is possible that key stakeholders may have differing opinions on risk appetite, purpose of D&O and preferred coverage.

> "In New Zealand, the average rate per million for listed clients continued to increase by as much as 50% in 2021."
>
> **Steve Walsh,**
> Chief Client Officer, Marsh Ltd.

4. A changing class actions regime

Class action litigation is now well established in Australia.

After years of intense activity in the area of class actions, or aggregate litigation, within the United States, real momentum in that sector is now developing in the UK and the EU as a result of recent changes in the law and market conditions. In the UK, this is presenting opportunities for investors in a wide range of companies, as well as would-be claimants, and risks for potential defendants. Key issues for stakeholders in light of those changes and case law include:

- Government policies which are increasingly promoting the rights of consumers to seek compensation for the wrongs of big business.
- Judicial consideration of "opt-out" collective actions in the UK, including in the antitrust space.
- In the context of data privacy, the recent UK Supreme Court judgment in the *Lloyd v. Google* class action case.
- Increased focus on areas which naturally lend themselves to collective redress, such as data privacy, antitrust, securities misselling, product liability, employee / pensions claims and environmental, social and governance issues (ESG).
- The growth of the third-party litigation funding market.

In New Zealand—despite some setbacks for claimants and funders—the interest in class action litigation is continuing and the environment will likely become more favourable for them. With global capital available to fund claims, directors could be targeted.

What is litigation funding?

Litigation funding is the financing of litigation by an independent party. Their business is to finance litigation they believe will succeed or settle favourably. It is a high risk / high reward approach to investing. A normal funding arrangement will usually see the funder meet all of the costs of the plaintiff's case, and put up security for costs in exchange for a priority share of any judgment or settlement proceeds. If the case fails the funder will also need to meet the defendant's costs.

The Law Commission's review of class actions and litigation funding in New Zealand which commenced in 2020 has continued throughout 2021. In a second consultation paper released 30 September 2021 (refer Supplementary Issues Paper - Law Commission Issues Paper 48 30-09-21) the Commission set out eight principles to guide the development of a class actions regime:

- Consider the interests of both plaintiffs and defendants.
- Safeguard the interests of class members.
- Consider the principles of proportionality, meaning that the time and cost of litigation should proportionate to what is at stake.
- Strike an appropriate balance between flexibility and certainty.
- Be appropriate for contemporary Aotearoa New Zealand.
- Recognise and reflect tikanga Māori.
- Not adversely impact on other methods of group litigation.
- Provide clarity on issues arising in funded litigation.

The Commission also included a proposal to include a certification process at the beginning of proceedings to strike out unmeritorious claims.

The Commission's aim is to create a class action regime that will be more efficient, improve access to justice, and reduce costs. This is welcome. At the moment, there is no regime—just a representative action provision in the High Court Rules that is no longer fit for purpose. A regime that provides funders with confidence will encourage capital inflows. This is especially so with global returns on other investments remaining low.

Litigation lawyers report that funders remain active—looking for claims with merit and which will deliver a return to claimants and investors. Moreover, larger law firms that have historically focused on defence work are now looking for classes and matching them with funders. In part this is because most two-party litigation settles and much of it is not economic.

A representative action involving the Feltex IPO did not make it to a stage two trial despite the claimants having some success in the Supreme Court. With the litigation taking place over 13 years, the directors will hardly feel like 'winners'. Building products claims have also concluded since our last publication. A claim by homeowners against Carter Holt concerning Shadowclad® was discontinued, and James Hardie has disposed of two (out of three) 'class action' claims of involving HardieTex™. Again all the claims have been very long running.

The interest shown by larger firms is a signal to directors and insurers. They can expect their adversary's advisors to be well resourced, resilient, and capable of running large litigation over the long term.

New Zealand insurers are wary of these developments and are looking at the trends in Australia for guidance on the possible claim settlements that could be sought. With claims payments continuing to outweigh the D&O premium pool across all sectors in Australia, the cautious approach of local insurers to offer D&O insurance is likely to continue for some time to come.

> "Despite some setbacks for claimants and funders, directors and their insurers can expect more class actions. The introduction of a class action regime will improve funder confidence and in theory allow claims to be made more efficiently. So long as there is capital looking for a home, funders will be active in New Zealand."
>
> **David Campbell,**
> Partner, Dentons Kensington Swan

5. ESG trends in the European market

Environment Social & Governance (ESG) covers a range of issues, including good governance, corporate responsibility, diversity and inclusion, racism, human rights and modern slavery, ethical behaviour, climate change and other environmental issues and ultimately social licence to operate. While these will be familiar to directors and officers, they are also of interest to D&O insurers.

In light of the recent COP26 summit in Glasgow in 2021, this chapter focusses on the environmental element of ESG and considers trends in the UK and Europe that are relevant to directors and officers; in particular the sustainability transition, ESG disclosures, and corporate resilience in the face of climate change. These trends increase the obligations on boards of directors and their responsibility for environmental matters, and therefore the possibility of directors being found liable for wrongful acts when those obligations are not met. This in turn translates into potential claims that may be covered under D&O insurance. Insurers are therefore increasingly focusing at ESG metrics and disclosures when assessing risks.

The London Insurance Market and ESG

After two years of very hard market conditions, the London D&O market is beginning to soften. The steep rate increases seen in 2019 and 2020 have been gradually falling in 2021 as new carriers have entered the market offering welcome competition. Most insureds are still seeing premium increases on renewal but these are much lower than in the previous two years and some are even renewing flat or on reduced rates. A good submission at renewal can help to differentiate insureds, and this increasingly includes a good ESG submission.

The London insurance market is heavily focused on the transition to a greener economy, aligning itself with the Paris Climate goals and the drive to carbon net zero. Insurers are under pressure to divest themselves of less environmentally friendly risks and investments. For example, some will no longer invest in or insure companies that are heavily involved in coal mining or new oil exploration projects, unless it would help the transition to renewal energy.

Many D&O underwriters now routinely ask for ESG metrics when assessing a risk. They understand that a company with a robust plan to address climate risk and adapt to a more sustainable economy, represents a better risk than those that are ignoring the transition. Failure by directors to prepare for environmental risks brought about by climate change, means these risks will not be properly priced or mitigated. This leaves the board of directors potentially exposed to liability for breaching their duty of care to the company by failing to prepare, as well as facing regulatory action, which can trigger claims under the D&O.

In addition, insurers need to justify their underwriting portfolio in the context of a more environmentally conscious insurance and reinsurance market. There is now a Lloyds syndicate focused exclusively on offering additional capacity to businesses that perform well against ESG metrics, and businesses with a good story to tell on ESG can expect a more receptive market. A good ESG presentation would, for example, provide underwriters with an overview of the company's roadmap to net zero - what it entails and what changes to the business are being made to achieve it, climate change mitigation and adaption, sustainability and energy efficiency, compliance with environmental regulations (where applicable), and a discussion of how the board and senior management team is taking ownership of these issues.

Environmental risks relevant to D&O insurers

The UK and France have legally binding plans to achieve net zero by 2050 and other EU states have also set out net zero emissions targets. Failure to meet national climate pledges may seem like an issue for governments, but businesses are under increasing pressure from governments, investors, consumers and stakeholders to set out their own path to net zero and vague promises are unlikely to be sufficient.

A recent case in the Netherlands potentially set a precedent for companies to be held to account if they fail to meet national or international carbon targets. In May 2021, a Netherlands court ordered a large energy company to cut their CO2 emissions by 45% by 2030. The case was brought by climate activists concerned that the company's environmental policies were not aggressive enough and was premised on the "right to life". It is the first time the Dutch courts have ordered a private company to comply with the Paris Climate Accords, previously considered to only bind nation states. Though the decision only applies in the Netherlands, it has sent a message to embolden climate activists who are likely to try to bring similar cases in other jurisdictions.

Failure to meet publically stated ESG goals exposes directors to allegations of greenwashing and misrepresentation, so companies must consider and set out detailed but achievable plans. Early indications are that greenwashing will be one of the most likely sources of ESG claims. For example, in January 2020 a state-backed energy company was fined €5m by the Italian Competition and Market Authority for claiming its palm oil-based diesel was "green" when the production of palm oil is driving deforestation.

The pressure to report on environmental goals comes from consumers, investors and insurers, but also from governments. For example, on 28 October 2021 the UK confirmed that TCFD-aligned disclosures[2] will be mandatory for public companies and large private companies or LLPs from April 2022. The aim is to help investors and businesses price their climate risks by requiring businesses to set out their direct and indirect exposure to the effects of climate change and their resilience in the face of it. Once the laws come into effect, failure to comply will risk investigation and enforcement action which will in turn impact D&O claims. New carbon and energy reporting regulations also place obligations on certain companies to disclosure emissions, energy consumption and energy efficiency, to encourage businesses to set out their emission reduction plans and sustainability credentials.

Directors and officers are under increasing pressure to evidence their business's commitment to and transition towards a more sustainable economy. This pressure comes from investors, activists, consumers and government bodies and failure to rise to this challenge exposes them to risk. D&O underwriters increasingly expect to see evidence of a company's mitigation of these ESG risks as part of the D&O submission.

2 The Financial Stability Board established the Task Force on Climate-related Financial Disclosures (TCFD) to develop recommendations for more effective climate-related disclosures that could promote more informed investment, credit, and insurance underwriting decisions and, in turn, enable stakeholders to understand better the concentrations of carbon-related assets in the financial sector and the financial system's exposures to climate-related risks. They have been approved by the G7 finance ministers.

6. Focus areas for insurers

As the D&O insurance market continues to experience difficult and uncertain times, insurers are increasingly focusing on understanding the board and director risk.

When insurers do not fully understand the risks they are being asked to underwrite, they may:

- Not offer any capacity or terms.
- Limit the amount of capacity they are prepared to offer.
- Restrict coverage or narrow the scope of the policy wording, 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.[3]
- Introduce exclusionary language.

Placement of D&O insurance programmes are taking longer to conclude. This stems from all the factors including the time required by insurers to provide quotations due to increased underwriting scrutiny and in some cases, referral processes to their respective overseas offices.

The following table sets out a range of areas of financial, governance and business performance and risk.

Financial metrics and performance	Governance, Risk & Culture	Business Strategy & Stakeholders
• Net tangible assets of the organisation. • Debt levels and changes in debt levels. • Refinancing horizon. • Interest cover ratio and changes in the ratio. • Debt and financing covenants. • Profit history. • Profit downgrades. • Dividend history & forecast. • Covid-19 impact.	• Composition and experience of the board. • Relationship between board, Chairman and Executive Leadership team. • Approach to management of people risk in the business. • Risk Management framework and application. • Company structure. • Shareholder structure. • Organisational culture. • Social license to operate. • Covid-19 safety and governance.	• Major shareholders. • Shareholder mix. • Acquisitions, divestments and growth strategy. • Risk Financing strategy – Cyber, Business interruption. • Strategic objectives. • Community stakeholders. • Budget. • Social Media feeds (analysed by insurers as reputational indicator). • Covid-19 impact.

3 Refer Appendix 1, page 16, "D&O policy structure – Side A, B and C cover explained".

Steve Walsh of Marsh Ltd, NZ sees five 'C's as the key areas of focus for insurers:

- Culture (company and boardroom).
- Conduct.
- Cyber.
- Climate Change.
- Covid management.

Assessing risk – is it good or bad?

Of course it is usually never as simple as 'good or bad' risks. But there are some obvious things that make a risk more challenging. Poor financial results can be one of these – for example if a company is at risk of becoming insolvent or may already be insolvent.

Insurers will look to understand why the financial results are poor – whether it was an event that was largely out of the company's control, or an industry wide event, versus a clear case of financial mismanagement. Most importantly insurers will look at whether the company and directors have been transparent, honest and regular with their disclosures to the market as their financial position worsened, and whether they were being reasonable with their discussions about the future recovery of the business.

Insurers are particularly interested in disclosure, and will look at the systems and processes in place, which people internally and externally are involved in deciding what a material disclosure is that the market needs to hear about, and whether they err on the side of conservatism.

The stage that a company is at is also very important. Are they a mature company with a long history of stable earnings growth? Conversely if a company is early stage, highly acquisitive and yet to establish profitability then insurers would look closely at factors such as cash flow generation, how acquisitions are handled and accounted for, and they would want to see a clear consistent and well communicated vision and plan.

The most important factor, and the hardest to get certainty on, is culture. Having the right culture goes to the heart of the key risks – disclosure, solvency, getting M&A right, having an engaged and happy workforce, ESG, engagement with all stakeholders. Some questions insurers will be keen to understand responses to include:

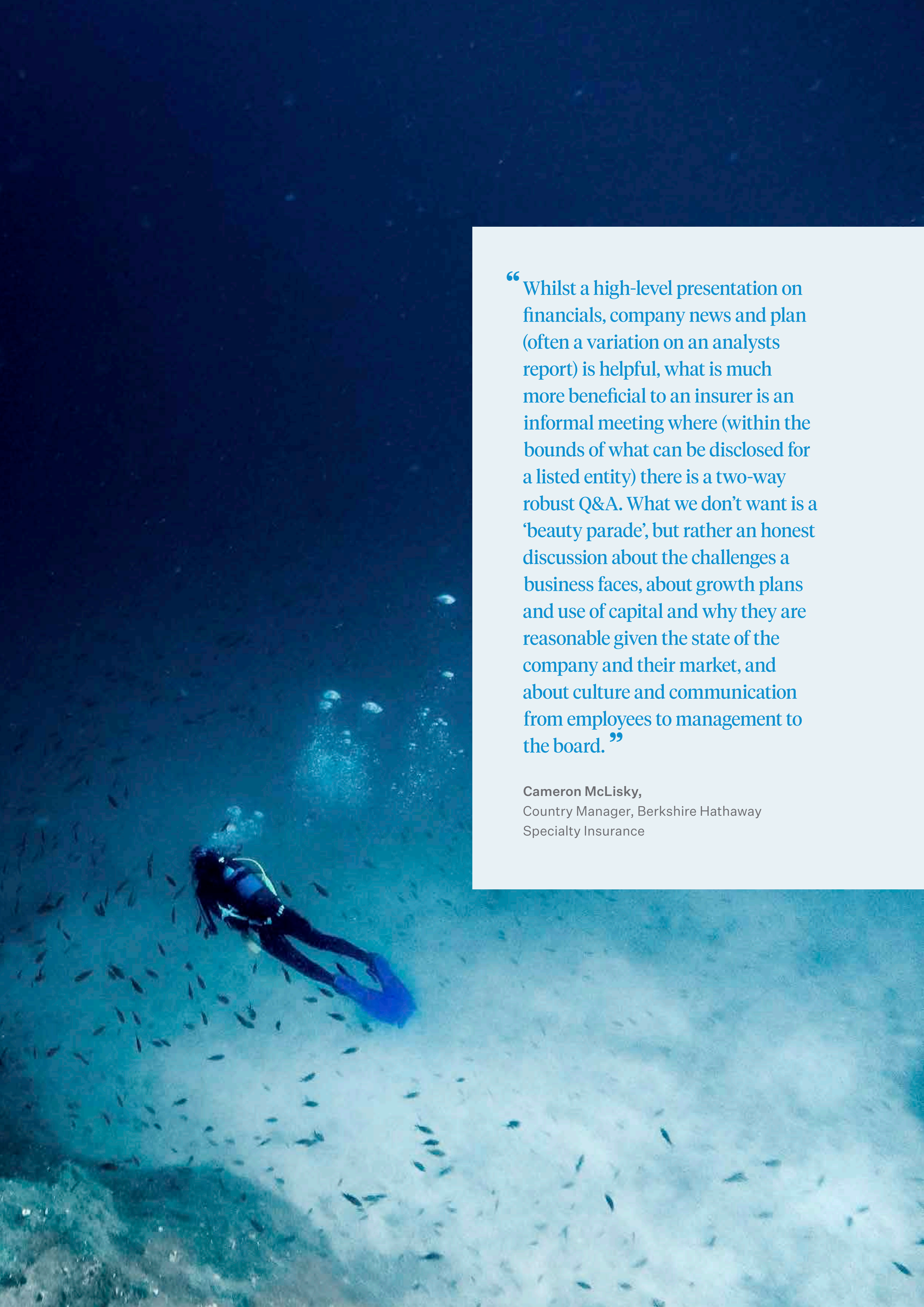
- Is there a clear effort to establish a great culture at the heart of the business?
- Is there a history of dealing with poor behaviour in a fast and transparent manner?
- Is remuneration structured in such a way that it doesn't encourage short term thinking and inappropriate sales practices?
- Are dealings with regulators done in an open constructive manner?
- Is there evidence that there is a strong and open relationship between management and the board?
- Is there evidence that matters such as ESG and other culture highlights are actually being implemented?

Opportunities to differentiate

Given the insurers focus on understanding risk, there are some critical actions directors and officers can take to help insurers understand the business and associated risks.

There is a well-known adage, that 'insurers will fill their gaps in knowledge with premium', so it is in directors' and officers' best interest to prioritise this. Areas to focus on include:

- The experience and expertise of individual directors, and that the board as a whole has the appropriate skill sets.
- The board's awareness and understanding of disclosure requirements with examples of the company's policies, protocols and procedures.
- Culture of the company.
- Boardroom culture and the directors' working relationships with management.
- The directors' oversight of new and emerging risks.
- The directors' appreciation of and response to covid-19 related risks, including working from home (WFH) disciplines and vaccination policies and practices.
- Comment on shareholder/investor relations.
- Cyber security.



“Whilst a high-level presentation on financials, company news and plan (often a variation on an analysts report) is helpful, what is much more beneficial to an insurer is an informal meeting where (within the bounds of what can be disclosed for a listed entity) there is a two-way robust Q&A. What we don’t want is a ‘beauty parade’, but rather an honest discussion about the challenges a business faces, about growth plans and use of capital and why they are reasonable given the state of the company and their market, and about culture and communication from employees to management to the board.”

Cameron McLisky,
Country Manager, Berkshire Hathaway Specialty Insurance

7. D&O Outlook 2022 and beyond

The Climate Imperative

Boards are increasingly recognising the climate imperative and need to take decisive action on climate-related issues and reducing the environmental impact of their organisations. The 2021 *Director Sentiment Survey* saw a rise to 48% of boards saying they were engaged and proactive on climate change risks (up from 35% in 2020). Although engagement is increasing, there's still some way to go for many boards as we reach a critical juncture on the road to creating a sustainable future.

Climate and broader sustainability reporting is here and on the road to becoming standard business practice. The *Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021* ushers in mandatory climate-related reporting. The XRB is already well underway with developing a new reporting standard, based on the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), with initial consultation focusing on governance and risk management. Climate-related disclosures will be mandatory for large listed companies with a market capitalisation of more than $60m; large licensed insurers, registered banks, credit unions, building societies and managers of investment schemes with more than $1b in assets; and some Crown financial institutions (via letters of expectation). Once approved by parliament, these entities could be required to make disclosures alongside wider year-end reporting from 2023 at the earliest.

Risk and Culture

In 2022, effective boardroom engagement, risk differentiation and assertive market positioning are all key factors toward the achievement of optimal outcomes. Directors and officers would be wise to engage early and provide a high level of transparency to insurers when looking to renew D&O policies. This includes providing details of the board and director experience and capabilities, awareness of the company's disclosure and regulatory obligations, and the strength of the company's established risk governance protocols, strategies and procedures.

Insurers should be thoroughly informed about the business and associated risks, the company history or growth stage (i.e. mature or developing), social licence to operate, management of people risk in the business, company financial performance and forecasts (including reasons for any market variations) and clear business growth forecasts in accordance with well-established and communicated vision and plans. Insurers will look for assurance that directors and officers are aware of and have well established plans for responding to known or potential risks - including covid-19 related risks (both solvency and people management related issues), cyber security, shareholder/investor relations, relevant market sector comparisons and developing issues, and any known or potential solvency issues.

Insurers should also be provided with evidence of work undertaken to develop a strong culture within the boardroom and the company, including development of an engaged and happy workforce, and a strong working relationship between the board and management.

> “When assessing D&O risks/placements, AIG focusses on areas such as the track record of directors and senior officers, increasing regulatory imposition, frequent of shareholder litigation/adversarial actions, rising defence and settlement costs, rising bankruptcy exposure, adherence to disclosure obligations and cyber security awareness/resilience.”

Craig Stobo,
Chairman, AIG New Zealand

Appendix 1: D&O policy structure

Side A, B and C cover explained

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)

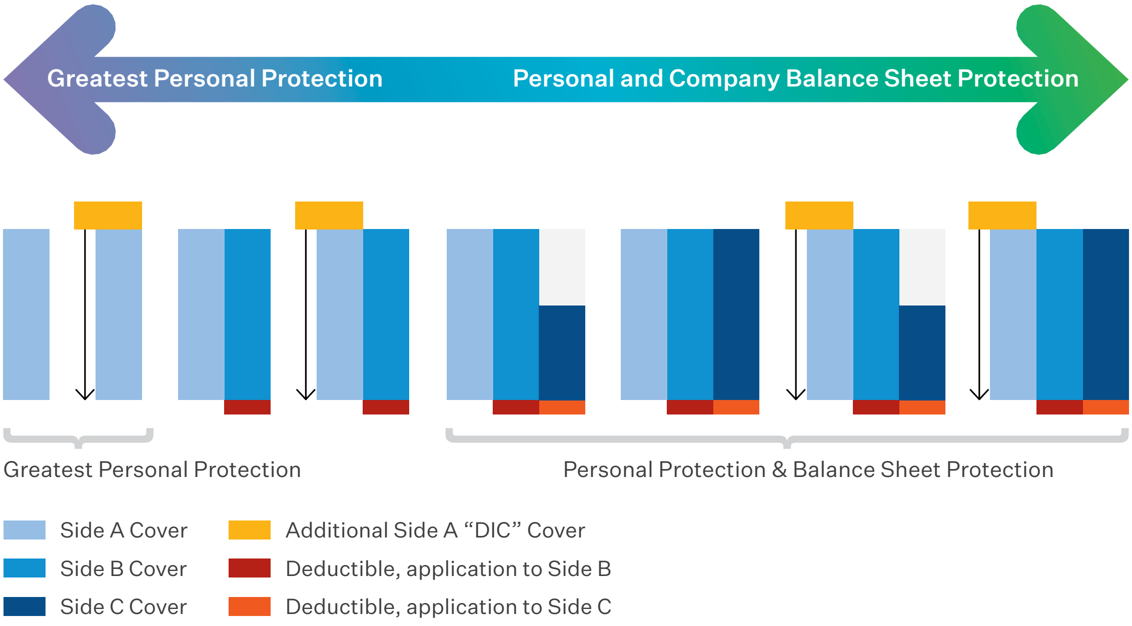
Policy Section	Insuring Clause Side A	Insuring Clause Side B	Insuring Clause Side C
COVERS	Side A covers claims against the directors and officers which their corporation may not indemnify them for	Side B covers claims against the directors and officers which their corporation may indemnify them for	Side C covers the corporation for securities claims against the corporation
DOES NOT COVER	Neither side A nor side B covers claims made against the corporation		Side C does not cover claims made against the directors and officers

The Side C debate for listed companies

For many listed companies, Companies Securities ('Side C') cover has been a staple coverage component of their D&O Programme, however, due to the insurance market difficulties and the affordability of the cover, many are now questioning its value.

Side C does challenge the original purpose of D&O, which was to provide cover for directors and officers only and not the company.

If and when you consider this cover, you need to have a deep and clear understanding of your investor relationships and demographics, the company's historical financial performance (against forecasts), share price fluctuations (and the reasons behind them) and your company's ability to absorb and fund, what could amount to an unbudgeted loss/costs (claim).



Limits are shared across Sides A, B and C

Some will argue that Side C cover within a company's D&O programme may encourage more shareholder class actions to be brought against a company, in the knowledge that the company may have an insurance policy to contribute to a settlement.

This view could well be enhanced, given the predicted changes with the NZ Class Action environment, following the NZ Law Commissions recent public consultation. Their findings are due to be released in May 2022.

With this change, directors and officers need to debate the relevance of this cover, in much more detail, than perhaps has been done in the past.

Some key questions directors and companies should consider include:

- Will removing Side C cover increase the exposure to the company and its balance sheet.
- What is the risk bearing capacity and appetite of the company, should you have a securities class action, without the possibility of access to insurance proceeds?
- What, if any current litigation funding activity is occurring?
- Does removing this cover simply shift the target of class actions from the company to individual directors?
- Will shareholders and litigation funders start pursuing individual directors or officers more rigorously?
- What impact would removing Side C cover have on the premium for the company's D&O policy?
- If a company withdraws its Side C coverage in the hope of managing costs, will it be even more expensive to reinstate in the future? Also, will Side C cover still be available?
- What if any are our obligations for reporting the impact of climate (re TCFD framework) – could our share price fluctuate on the back of this or missed reporting?
- Do you know about greenwashing? Could making false, untrue or exaggerated claims on your ESG attestation impact share price and the company's overall financial performance?

Appendix 2: Key coverage issues for D&O policies

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

When considering D&O policy coverage, recent loss scenarios demonstrate the importance of setting limits in a structured way.

The following are key considerations:

- If a claim is made today, it will be the current D&O policy which will respond. If the claim is not settled until 5 or 10 years' time, would today's policy limit be sufficient? How might the quantum of the risk rise in that period? For example, the Feltex action took over 13 years to be resolved.
- How might legal defence costs (discussed further below) rise in the same period, and might they be increased by a greater number of directors and officers and the possible 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? WorkSafe prosecutions against directors are a good example with the first successful WorkSafe prosecution and subsequent conviction and sentencing of a director under the Health and Safety at Work Act 2015 delivered in October 2021. (Refer IOD article 22 October 2021 - Company director fined under HSWA 2015).
- What are your personal circumstances and your ability to defend and/or fund a loss (if there is limited or no insurance, or the indemnities given by the company are worthless due to its insolvency)?
- Is the industry sector / company you govern susceptible to class actions or other group litigation, or new types of regulatory action and penalties?

Claims Made Policies

- D&O Insurance policies are written on a 'claims made' basis. This means it is the policy in place at the time the first reported circumstance or claim is made and notified to the insurer(s) which will be triggered – not the policy in place at the time the actual or alleged wrongful act was committed so long as it was after the retroactive date stated in the policy schedule.

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 insured ‘individual’, and decline to pay legal costs under the D&O policy until an allegation against a director or officer is made.

It is critical that investigation cover is drafted widely. This 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 *Bridgecorp* case, recognising a claimant’s right to a statutory charge over the directors’ insurance proceeds via Section 9 of the Law Reform Act 1936. A Section 9 charge allows a third party to place a charge over insurance money (compensation) which would otherwise be payable by an insurer to an insured. This means that where there is a liability policy that covers both damages and defence costs under an aggregated limit i.e. a D&O policy, a charge can be placed over the entire policy limit preventing an insured from accessing the policy for defence costs as the entire policy limit has been charged for the benefit of the claimant and their alleged losses. Separating out the defence costs protects an insured from having a charge placed over the entire policy limit, so that these funds remain available for use by the insured party in defence of the claim.

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 and / or officers 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. It is crucial that the most appropriate form of cover is obtained for a particular transaction.

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.

Pollution

In respect of pollution events, 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.

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.

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.

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.

It is important to take 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, it is essential 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, which must also be certified as fair to the company. 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 to do so. 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 director's face.

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The IoD is New Zealand's leading organisation for directors and at the heart of the governance community. We believe in the power of good governance to create a strong, fair and sustainable future powered by best practice governance. Our role is to drive excellence and high standards in governance. We support and equip our 10,000+ members and the broader governance community who lead a range of organisations from listed companies, large private organisations, state and ublic sector entities, small and medium enterprises, not-for-profit organisations and charities.

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