HERBERT SMITH FREEHILLS

M&A STANDPOINT: A VERY DIFFERENT D&O LANDSCAPE

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Legal Briefings – By **Alex Kay** and **Charles Steward**

The market for directors' insurance cover has dramatically tightened after years of easy terms. How should boards respond?

A VERY DIFFERENT D&O LANDSCAPE

Over the last 12 months or so there has been a significant change in the directors’ and officers’ liability insurance (D&O) market. After many years of declining premiums and increasing coverage (premiums reached a low in 2017), we have seen very significant premium increases particularly in the last 12 months (with premiums at least doubling, and in certain situations increasing by up to 20 times), alongside reductions in coverage limits, increases in retentions, and less favourable terms. This has turned the D&O renewal process from an uncontroversial BAU process usually handled by risk or insurance teams into an important boardroom topic as directors consider their personal liabilities and the proper use of the company’s resources.

Two factors have combined to drive this trend. The first is the increasing cost and frequency of class action shareholder lawsuits and regulatory actions against companies and their directors. The US has a long history of shareholder actions in connection with corporate actions, particularly M&A and capital raisings, but recent years have seen significant increases in shareholder litigation in other jurisdictions, in particular in Australia, and increased regulatory action in relation to non-financial issues such as environmental and data compliance. Although the difficulty in bringing a successful shareholder class action in the UK was reinforced last year by the decision in the Lloyds/HBOS litigation, insurers have responded to the claims environment by reducing coverage limits and tightening policy terms worldwide.

The second is a correction in pricing coupled with a reduction in capacity due to a number of insurers having chosen to exit the D&O insurance market completely, having seen their profitability in this market squeezed by many years of competition driving year on year reductions in premiums as well as increased payouts. D&O cover has long been a loss making line of business for insurers, particularly in the soft market that prevailed for many years. Premiums were low and, while companies understandably focus on ultimate director liabilities, investigation and defence costs represent the lion's share of the losses paid by insurers. The market had been due a correction.

Combined, these trends have led to a significant reduction in capacity and increase in premiums in the D&O market. Whilst clients in all sectors are affected, the impact has been particularly severe in sectors which are susceptible to regulatory enforcement (e.g. banking) or, more recently, which have been heavily impacted by COVID-19. It is also appears marked in some sectors which are perceived as higher risk, such as pharmaceuticals or mining. This has driven huge increases in premiums for some companies, despite the coverage limits offered to them by insurers often being a fraction of what they purchased last year.

THE DECISIONS FOR BOARDS

In this context, directors of listed companies are understandably anxious to ensure that they and their companies have appropriate levels of protection whilst ensuring that the costs are reasonable and they are acting reasonably and in the best interests of the company, as required by their duties. These decisions were easier when tens of millions of pounds of coverage could be purchased for a couple of hundred thousand pounds (or hundreds of millions of cover for a few million premium) but warrant deeper consideration now that lower levels of coverage may cost many hundred thousand, or even several million, pounds, particularly when the same companies are facing significant revenue declines as a result of the economic impact of COVID-19.

In many cases, provided that it is available at a reasonable cost, the purchase of D&O insurance by the company for the benefit of the directors is required by the terms of appointment of the directors and/or the deed of indemnity which is commonly entered into by companies for the directors' benefit. In any case, robust D&O cover is expected by most, if not all, current and potential directors and so it is generally in the best interests of the company and its shareholders for the company to purchase D&O insurance to enable the company to attract and retain high quality executive and non-executive directors. Nonetheless, companies and their directors must consider how much of the company's funds it is reasonable to spend on D&O insurance. The appropriate level of cover will depend on various factors, including whether the company is listed, and if so whether only in the UK or also in higher risk jurisdictions such as the US and Australia; the size of the company; whether it is regulated; the company's financial position; and the sector and jurisdictions in which the company operates.

ARE THERE ALTERNATIVES?

Given the need to balance the interests of the company and the directors, we are working with clients and brokers on alternative structures. These structures aim to replicate some of the benefits of D&O insurance and include self-insurance where possible, setting up and funding a captive insurer (or similar) to provide coverage and ring-fencing funds to allow the satisfaction of claims under the directors' indemnity in the event of an insolvency event affecting the company. The implementation of such alternative structures presents challenges to ensure that the company remains in compliance with the restrictions on indemnification of directors under English law and to ensure that they remain viable in the event of future changes in law or company circumstances. In other words, the challenge is in replicating external market "Side A" D&O coverage which protects individuals against claims the company can't or won't pay (e.g. claims by the company itself or where it is insolvent). The added cost and complexity that these structures bring needs to be compared to the increased cost of D&O insurance premiums: do the alternatives bring sufficient benefit to the company to justify the expense, and in the case of more complex structures, the management time involved in their implementation?

WHAT DOES THE FUTURE HOLD?

It remains to be seen whether the recent changes we have seen to the D&O insurance market are temporary, with the market returning to something closer to its pre-2019/20 state in the short term, which we doubt, or a longer-term change that will drive a permanent change in market practice in respect of the level of D&O insurance coverage purchased and the adoption of alternative structures for the protection of directors. There may also be scope for policyholders, brokers and insurers to take a more bespoke approach to structuring the D&O programme rather than the 'all sides' coverage which is the current default. Likewise, hybrid approaches involving self insurance of certain layers / "sides" of cover are likely, and no doubt the ever-inventive insurance market will come up with products suited to this changed dynamic. Whatever happens, we expect D&O insurance to continue to be a prominent topic in board rooms for the foreseeable future and an area where advisers can contribute value with their technical understanding and broader market overview.

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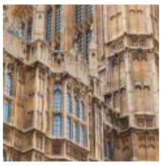

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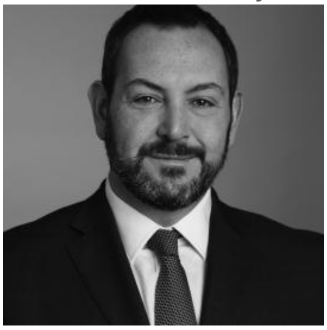

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