D&O insurance – hitting the reset button

Trends and insights, February 2023

Institute of DIRECTORS NEW ZEALAND

Marsh

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1. Introduction

Over the past few years the pandemic and economic instability have fuelled significant increases in premiums and constricting of terms, but recent trends indicate insurers are becoming more flexible and pricing has started to stabilise.

This is our fourth report on Director and Officer insurance (D&O) trends and insights in which the Institute of Directors (IoD) have partnered with Marsh to provide an overview of market developments and regulatory updates, including looking at new and emerging risks and perspectives from overseas.

All directors are expected to govern to the best of their abilities. However, even the most careful board can find itself involved in legal claims. Best practice governance is your best defence against a claim, as well as being an important aspect of indicating to your insurers how risk is being considered, managed and mitigated within your company. D&O insurance is a critical protection mechanism for any board with the IoDs 2022/23 Directors' Fees Report finding 89.5% of organisations provided directors with liability insurance (up from 85.1% in the previous year and 78.5% prior to that).

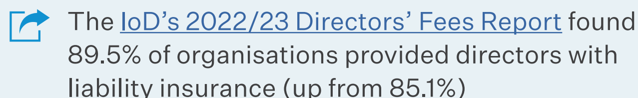
D&O insurance is cover for directors, so the conversation needs to be led by the board so they are aware of what the policy entails including company structure, coverage of directors, limits, trends in litigation and settlements in your industry, and confidentiality and non-disclosure requirements.

When presenting your company risk to your insurer, you need to find opportunities to differentiate your company from any other business, such as through financial metrics and performance, governance structure, risk framework/processes and culture, business strategy and stakeholders, and company's risk financing strategy. Engage early, separating out your D&O renewal discussions with those of your other insurance policies. It is important to ensure your D&O policy is relevant for your company, and your directors and officers.

The other publications in this series are available online at:

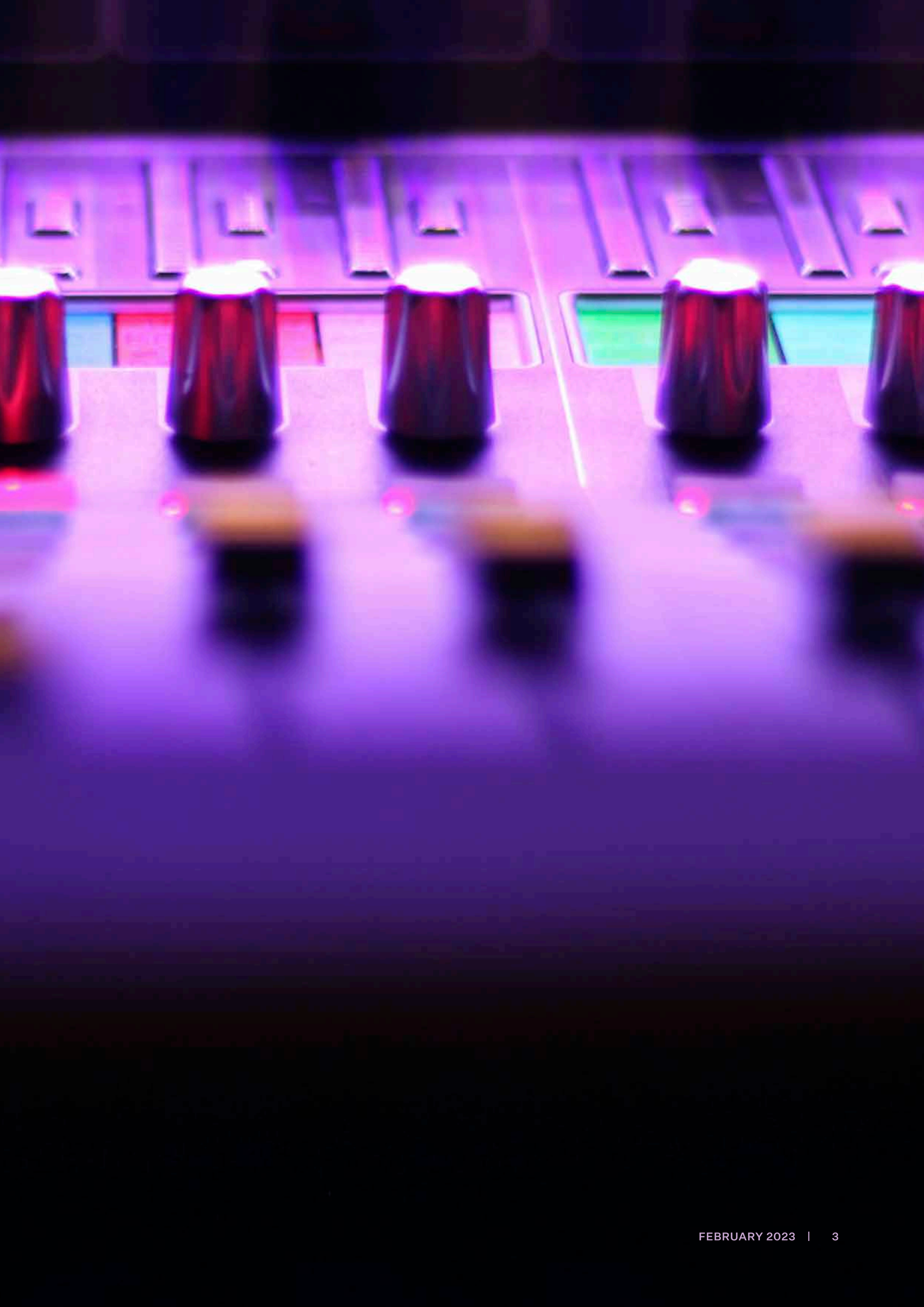
- D&O insurance: a rising sea of change (2022)
- D&O insurance in a hard market (2020)
- D&O insurance – trends and issues in turbulent times (2019)

How many directors have D&O insurance?



The IoD's 2022/23 Directors' Fees Report found 89.5% of organisations provided directors with liability insurance (up from 85.1%)

89.5%



2. Key market updates

With an ever-changing legislative environment, more active regulators, ESG, an increased focus on your social licence to operate and increasing demands from your customers, it's time to reset how you think about D&O insurance.

After five years of significant disruption and premium uplift in the D&O insurance market, there are signs from offshore that the market is being 'reset' with new market forces and changes coming our way.

Insurers have always focussed their attention on the quality of the risks they underwrite and no more so than for D&O over recent years. Typically, their attention was focussed on the financial performance of the entity to which the directors and officers sought cover.

But now the focus of their inquiry is much broader with a focus on the risk profile of the directors, officers and overall governance of the respective entities.

Changing risk profile

With this in mind, and in their pursuit of continuing a 'flight to quality' – where insurers will look to give preferential focus, terms and conditions on those risks that they see as 'high quality risks' – it is important that insurers, directors and officers understand that the risk landscape is changing, at pace.

In the tables below, we summarise the traditional areas of risk for directors, as well as some of the new areas of risk that have emerged over the past three years.

Traditional areas of risk

Source of claims	Comments
Reckless trading	A high likelihood that the D&O insurance may not respond.
Insolvency	Claims from creditors and/or shareholders. If not a securities class action, likely to bring action against officers as well (mismanagement).
Employee-related issues	Based on common law.
Continuous disclosure	ASIC regulations easing (Feb 2021). No other significant changes.
Fraud	Typically low risk exposure to directors, more risk for officers.
Regulatory	Exposures vary greatly, although the Health and Safety at Work Act is a particular concern. Increasing focus from regulators such as Financial Markets Authority and Work Safe.
Anti-competitive behaviour	Often claims emanate following a potential trade transaction or a privacy/security breach.
Credit breach	On the lower end of the directors' risk profile, higher for officers.
Securities class actions	The average class action claim in Australia is AU$55m. While law reform and litigation funder regulation is yet to be enacted in New Zealand, this remains an area of some uncertainty.

New and emerging risk areas	
Source of claims	**Comments**
Social disruption e.g. – Diversity & Inclusion – Racial equity – Ethical trade – Gender equality	Impact of social uprising and/or political instability can affect the trading patterns and directors need to be attuned to these activities in the global territories in which you operate. Unlikely to be large scale in New Zealand at the moment, but this could change at any time.
Climate & ESG	New External Reporting Board (XRB) climate-related disclosures reporting requirements for larger companies and financial institutions and environmental consciousness will make this a significant emerging risk for directors.
Cyber/technology disruption	This is of major concern and should be a high priority for any director, particularly for entities holding personal information. Some event-driven class actions occurring globally based on cyber security breaches.
Pandemic/Covid	New sources of global event-based class actions.
Privacy breach	New sources of global event-based class actions.

How does this impact each director?

We believe the potential impacts of these emerging risks and the likely severity of their consequences should drive a new level of inquiry by each director and officer, to ensure they understand:

- A deeper level of likely claim scenarios from both a frequency and severity perspective
- The likely legal impacts, including defence and summary costs
- How their D&O insurance will respond, including Limit of Liability, defence and allocation

Allegations of wrongful acts by directors or officers are the key drivers of claims, so having a deeper understanding of their proximate cause and likely consequences is essential. Unfortunately, the overall claims landscape in New Zealand continues to evolve with a number of high-profile cases, as well as hundreds of less notable claims, often driven by regulators and other professional and/or licensing bodies or agencies.

> “One of the best things you can do is to disengage the D&O renewal conversation from any other insurance conversations. This is a cover for the directors. And the directors need to feel comfortable with what they’re taking on.”

> “If you’ve got a robust D&O policy in place that is bespoke for your company you can attract talented directors that then feel comforted by the fact that there’s proper cover in place apart from the company indemnity.”

Carien Adhar,
Marsh New Zealand

Time for a rethink

To help directors and officers reset their thinking on D&O, we have developed a simple checklist of factors for both individual directors and boards to review when selecting:

- D&O insurer(s)
- D&O insurance limits
- Retentions
- Extent of coverage

The factors to consider when arranging, negotiating and selecting D&O limits of liability and retentions include:

- ✓ Board composition and experience e.g. do you have a broad base of business disciplines such as finance, legal, industry expertise, marketing, technology, health & safety?
- ✓ The numbers of directors and officers relying on the cover
- ✓ The individual risk appetite of each director and officer
- ✓ The company/ies risk tolerance/appetite for company retentions
- ✓ What peer companies are doing
- ✓ The industry sector the entity operates in
- ✓ Any specific legislation relevant to your sector/entity
- ✓ The extent of company indemnities
- ✓ Board v executive relationship
- ✓ Historic company performance eg share-price performance, meeting prior forecasts
- ✓ Exposure to overseas activity
- ✓ Shareholder composition ie corner-stone shareholder, institutional, retail, off-shore
- ✓ Investor relationships
- ✓ Relevant claims or loss experiences
- ✓ The cost of cover
- ✓ The availability of insurance capacity

A surge of D&O claims is considered likely as we move into a period of economic downturn. A 2016 study by Marsh of its UK clients between 2005 and 2015 found D&O claims increased by 75% during the Global Financial Crisis, peaking in 2012. The average number of annual claims rose from 200 to 300 between 2005 and 2007, to 1,685 in 2012. Similarly, in the US, filings and enforcement actions doubled between 2006 and 2011 rising from 1,000 to 2,000 annually.

3. A legal lens

As Boards' understanding of their legal and practical exposures continues to evolve and mature, so too should their focus on and interrogation of their D&O cover. Not all D&O policies are created equal, and prudent boards will ensure their D&O covers are appropriately tailored to their particular risks.

Directors in New Zealand face a continually evolving liability landscape. Topics that have dominated recent discussion in this space include:

- **Cyber and data loss risk**
  High-profile cyberattacks over the past several years on organisations such as the Waikato District Health Board, the Ministry of Justice and Mercury IT (to name just a few) have continued to reinforce the importance of ensuring organisations invest in appropriate cyber protections and training and that boards actively engage with the assessment of their companies' cyber risks and response strategies.
- **Environmental, social and governance issues**
  Climate change has been a particular focus due to increasing societal awareness of the impacts of climate change, New Zealand's world-first enactment of legislation mandating climate-related reporting for financial market participants[1] and endeavours by claimants to enforce climate-related agendas through litigation.[2] The Companies (Directors Duties) Amendment Bill proposes to amend the Companies Act expressly to permit a director to take into account "recognised environmental, societal and governance factors" when determining the best interests of the company.
- **Health and safety**
  There is a continued focus on directors' and officers' due diligence duties under health and safety legislation. Prosecutions are currently underway against directors in connection with the Whakaari/White Island eruption, and there are now examples of directors being convicted and fined (as well as being required to pay reparations) for failing to exercise due diligence to ensure compliance with the company's health and safety obligations.
- **Class actions**
  Particularly for companies with ASX exposures, the risk of shareholder class actions and the impact of that risk on D&O pricing have been at the forefront of every D&O renewal discussion. In New Zealand, the prevalence of litigation funders and the class actions they support continues to grow. Te Aka Mautua o te Ture Law Commission has recommended the enactment of new class actions legislation to make the class action regime clearer and more accessible, with proposed features including the preservation of both opt-in and opt-out class actions, court supervision and approval of settlements and discontinuances, and mechanisms to deal with concurrent or competing classes. It is currently expected that policy work to advance these reforms will commence in 2023.

As the liability landscape for directors in New Zealand continues to evolve and increase in complexity, boards are increasingly focused on ensuring their D&O insurance programmes are appropriately tailored to cover their particular risks. Whereas some boards may in the past have succumbed to the temptation to leave the placement of D&O insurance to management, directors now – more and more – want to understand the interplay between the indemnification

1 Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021.

2 Smith v Fonterra Co-operative Group Ltd [2021] NZCA 552.

they have from the company and their protections under the D&O policy (as well as the company's other liability covers), the detail in the endorsements and exclusions to the D&O programme, and the practical realities of managing the defence of claims in conjunction with their insurer.

In these discussions, a number of common themes and key legal considerations emerge. While the extent to which these matters can be addressed will necessarily be dependent on market conditions and the attitudes and underwriting appetites of insurers, boards would be well advised to turn their minds to these matters (among others) and discuss them with their insurance brokers where appropriate.

Claims by the company and/or major shareholders

D&O policies can often exclude cover for claims brought against directors by the company itself or its subsidiaries. The breadth of these exclusions can be varied: some are broad and simply exclude any claim brought by the company; others are more nuanced, for example incorporating write-backs of cover for shareholder derivative claims or liquidator claims. Because, for obvious reasons, directors cannot be indemnified by the company for liability they have to the company, the presence of such exclusions can have potentially serious consequences for directors and leave them out of pocket if they are sued by the company.

D&O policies also often exclude cover for claims brought against directors by 'major shareholders'. The thresholds can differ across policies, but can be as low as 10%. While the company may be permitted to indemnify the director (if the 'major shareholder' is not a related company), that may provide directors with scant comfort where the company is in financial difficulty – perhaps triggering the claim against the director in the first place – and/or the board dynamics are such that there are practical hurdles to extracting indemnification from the company.

Insolvency risks

The personal liability risks for directors in an insolvency context have been highlighted by the recent proceedings against the former directors of Mainzeal. The litigation has also highlighted the real prospect that, whatever D&O cover might be in place for the benefit of the board, the available limits may be insufficient to cover the directors' (and any officers') collective liabilities.

A number of important considerations for the D&O cover arise in connection with such scenarios, including:

- Whether the D&O policy contains an insolvency exclusion (for example, providing that the insurer is not liable to make payment under the policy "for loss directly caused by, arising out of, attributable to or in any way connected with any insolvency event"). Both the Australian and New Zealand courts have tended to interpret such exclusions relatively narrowly; however ultimately whether cover is excluded will depend on the specific drafting and the nature of the particular claim. Phrases such as "arising from" have been held, generally, to require a less proximate relationship between the insolvency and the particular claim than phrases such as "caused by".
- Whether the D&O limits are sufficient. In this regard, it may be prudent to consider the nature of the company's business, what types of claims it might face, and how many directors (and officers) may need to share the cover.
- How any insurance moneys are to be allocated between directors if the limit of liability is insufficient to cover the directors' total collective liability (and costs). Often, D&O policies will permit the insurer to discharge its obligations by paying the funds to the company, leaving the company to distribute the funds among insureds. That may be problematic, however, where there is discord among the board (or between the board and the directors sued) and/or there are no clear principles guiding the appropriate distribution of those funds.

Health and safety cover

New Zealand's health and safety legislation prohibits insurance for health and safety fines. Liability to pay reparations following a health safety event are, however, insurable. Typically, cover for such liabilities would sit under the company's statutory liability policy rather than be a focus of the D&O cover (a number of D&O policies also contain broad exclusions of cover for claims arising out of bodily injury, which could operate to exclude cover for proceedings arising from a health and safety incident). It is important for directors to understand the interplay between these policies and to ensure there is appropriate cover for both the company and directors personally.

Defence costs and defence control rights

A critical component of any D&O policy is the defence costs cover, which funds directors' legal fees and other costs of defending claims brought against them. Because of the statutory charge over insurance moneys that arises under the Insurance Law Reform Act 1936, there remains a need for separate or 'ring-fenced' defence costs cover to ensure directors can continue to access defence costs cover pending resolution of a claim (although the insurance contracts law reform is set to repeal and replace this legislation, the timing of this reform remains unclear). Setting an appropriate limit for such separate cover, however, is far from a science. Relevant considerations are likely to include the nature of the company's business, what types of claims it might face, and how many directors (and officers) may need to share the defence costs cover.

Relatedly, directors may also wish to scrutinise the extent of the insurer's defence control rights under the D&O policy. While some D&O policies allow directors to appoint their own legal counsel (with insurer approval) and simply require the insurer to be permitted to 'associate' in the defence of the claim, other policies allow the insurer to step in and control the defence of the claim, including the right to appoint legal counsel. Given claims against directors could have significant personal reputational (as well as financial) repercussions, directors need to be comfortable with the practical realities of defending claims covered by their D&O policies.

4. A view from the US

As the global events continue to reverberate, their impact is being felt among communities and businesses alike in the US, as they are elsewhere in the world writes Matthew T. McLennan, Marsh Financial and Professional Services USA.

On the one hand, supply chain, demand-led shorfall and labour shortages issues are causing no end of challenges for all, yet on the other hand our high inflationary environment is masking what we describe as a two-speed D&O environment – an increase in focus by regulators driving a potential for an increase in litigation, yet there is an increase in insurer competition providing a downward pressure on rate and coverage.

Market activity

In 2021 the initial public offering (IPO) market was one for the history books. A stunning 397 IPOs raised $142.4 billion in the busiest year by deal count since 2000 and the biggest year for proceeds ever. Traditional IPOs plus special purpose acquisition companies (SPACs) IPOs produced over 1,000 new public companies in 2021 (613 + 397 = 1,010 as at 1 January 2022).

In 2022, transactional public IPO activity vs 2021 is down significantly year over year. Inflation is skyrocketing, prompting the Federal Reserve to raise interest rates and investors to pull their money out of the transactional space. Additionally, regulatory scrutiny of the SPAC market is increasing, which has made these deals less enticing.

There are clear trading conditions that need to be met before activity resumes, but with recession fears looming over investors, signs may point to a relatively quiet period ahead. However, the transactional public IPO market has time and again demonstrated its ability to recover from downturns, and there are plenty of issuers ready to jump when the window reopens, including those that may have D&O programs fully quoted prior to pausing their plans to go public.

Regulators and litigation

There is a heightened focus from the Securities and Exchange Commission (SEC) on issues such as ESG, cybersecurity disclosures, executive compensation, insider trading and SPACs. These measures are all part of SEC Chairman Gary Gensler's stated goal of heightened investor protection.

The SEC's formation of a Climate and ESG Task Force has already resulted in some companies facing regulatory scrutiny over alleged inadequate ESG disclosures. Furthermore, the SEC's proposed new rules on cybersecurity disclosures require a more robust reporting of the board's focus and credentials on cyber matters and on reporting material incidents to shareholders.

Despite this, ESG investing isn't universally accepted, with House of Representative Republicans establishing a working group to push back against what they described as a "threat to our capital markets". In particular, the group intends to challenge the SEC climate emissions disclosure proposal.

Enhanced ESG disclosures

Climate-related disclosures

In March 2022, the SEC proposed rules regarding climate-related disclosures for public companies. The rules would require disclosure of company oversight of climate matters as well as climate-related impacts and specific metrics for items such as greenhouse gas emissions. In addition to the proposed rules above, the SEC is expected to act on the additional ESG-related topics below:

- Corporate Board Diversity – board members and nominees
- Human Capital Management – workforce diversity, turn-over, benefits, and other items
- Payments related to Resource Extraction

Special Purpose Acquisition Company (SPAC) proposed rules

In March 2022, the SEC proposed new rules to enhance disclosures and investor protections in connection with SPAC IPOs and business combination transactions involving SPACs and private operating companies. The new rules are designed to effectively treat SPAC transactions more like traditional IPOs, which are regarded by the SEC as providing greater investor protection, particularly due to the strict liability regime of the Securities Act of 1933. The rules are currently subject to public comment.

Insider trading and share repurchases

- **"Freshen-up" Rule 10b5-1** – Proposed rules would amend Exchange Act Rule 10b5-1, which provides an affirmative defense against insider trading liability for trades by individuals and share repurchases by issuers if they are made pursuant to a written plan entered into when the individual or issuer did not possess material nonpublic information about the company or securities traded. Potential changes may include a new mandatory cooling off period, limitations on cancellation and other new disclosure requirements.
- **Issuer Share Repurchase Disclosures** – SEC may consider amendments to modernize the share repurchase disclosure requirements.

Executive compensation

Following adoption of formal rules in November, companies will now be required to adopt claw-back policies relating to executive compensation in further implementation of the Dodd-Frank Act, as well as disclosure information involving executive pay versus company performance, among other requirements. These rules apply to a broad range of executive officers and do not require a finding of fault. Under the rules, companies must seek compensation recovery from individuals who receive incentive pay based on financial metrics that were later the subject of a restatement.

Cybersecurity disclosures

On March 9, 2022, the SEC proposed rules regarding cybersecurity disclosures for public companies. The rules would require disclosure of material cyber incidents within four business days, along with updated disclosures regarding previously reported cybersecurity matters, risk mitigation procedures, and management/board experience. This topic was addressed in the SEC's 2018 interpretive guidance but was not codified in SEC rules. The rules are subject to a comment period with final actions on rules expected to be announced April 2023.

Corporate crime

The Department of Justice (DOJ) has described a re-energised focus on combating corporate crime and individual wrongdoing. This has been called by some commenters, a return to the "Yates Memorandum and Obama-era enforcement priorities".

With a more active regulatory regime, individual directors and executives, along with their companies, could face increased claim activity and shareholder scrutiny.

What does this mean for 2023?

With the changing trading environment, it is imperative that directors and officers focus on profiling their risk(s) via their brokers to all existing and potential insurers. A 'flight to quality' will gain insurer support being evidenced by broader terms, increased capacity and downward pressure on rates being offered during Q2 and Q3 2022. We anticipate seeing this trend continue into 2023.

Directors should temper any over-inflated expectation that rate and coverage will return to the pre-2016 period, because there are still some serious issues for both insureds and insurers to consider.

TOP TOPICS TO WATCH

- *Environmental, Social and Governance – practices and disclosures*
- *Securities and Exchange Commission and Department of Justice enforcement regime*
- *Continued frequency of claim filings on any bad news*

5. Governance insights

Risk management is a key focus for boards with new risks emerging all the time. Directors Mary-Jane 'MJ' Daly, Craig Stobo and Sarah-Jane 'SJ' Weir discuss what this means for directors and boards and how they assess personal risk.

Risk management is a key focus for effective boards, and includes identifying, prioritising and assuming business risks. Risk management is critical to governing and operating a business effectively. Mitigating risks can include risk transfer solutions such as D&O insurance, which specifically transfers personal risks facing directors to the insurer.

For some directors, the greatest personal risk can be not having D&O insurance. Without D&O insurance or if your cover is insufficient, you can find yourself exposed to significant risk. If D&O insurance isn't available, perhaps due to an adverse loss history (company or individual) or a very volatile outlook for the company, MJ says directors need to carefully consider their personal exposure and their own risk appetite before taking on a role.

> "D&O insurance is not just the domain of big corporates, it is for anybody – not-for-profits, trusts, small businesses – it's there to protect you in the role where you're making decisions on behalf of businesses and entities."
>
> **Stephen Walsh,**
> Marsh New Zealand

Each year the percentage of organisations surveyed by the IoD with D&O insurance is increasing, with a corresponding decrease in the percentage of directors who are wary about taking on governance roles due to increased personal liability. However, D&O insurance is not a proxy for governance and part of the due diligence that insurers undertake includes understanding organisations' governance structures and processes.

"One of the key things I have learnt about risk management is that risks can evolve and impact businesses in much broader ways than we first anticipate," says MJ. "The key to mitigating risk is enabling board and management discussion to explore future potential risks and consider how they might evolve and impact the business. I also like to focus on the financial strength of the business to ensure it has the capacity to weather adverse developments."

Importantly, boards need a paper trail demonstrating what has been considered, what questions have been raised, what the answers were, and what the decisions were as a consequence. A lack of a paper trail can expose directors to liability. Systems need to be established for determining risk and testing the advice, and if in doubt, getting independent advice. SJ says that actively seeking information and actively listening are critical to managing risk. You also need to "be alert to what's not said or presented. Directors need to understand organisational processes that manage the risk, understand the industry and what best practice looks like, and proactive monitoring. There are no dumb questions."

It is well acknowledged that business is inherently risky, so it is important for directors to understand their industry, their business, and their risks. "Business is risky. There are always going to be risks, so directors need to know what they are," says Craig. "Directors need to be risk-aware and curious. More time needs to be spent quizzing management and checking the checkers", he says. "There will always be things that you can't foresee, but you need to be asking about 'black swans' –

extremely negative events that are impossibly difficult to predict but clearly do happen."

In addition to having systems in place, MJ says "critical to being effective in a governance role, is having an alignment of values and risk appetite with the rest of the board and the organisation". And if the alignment isn't there, then neither should you be. "Take the time to explore and understand your risk appetite and how it changes in various contexts. Some directors are more comfortable operating in different risk environments to others, and it's important you understand your own risk appetite to ensure the right organisation and board fit."

For emerging directors, SJ says it's important not to take the reputation of an organisation (or the people around the table) as a given. "Be thorough in your due diligence. Ideally, as a new director you want an organisation that has a culture of transparency, a great chair, and knowledgeable and experienced people around the table."

Getting on a board can be overwhelming, but you are part of a team, so it's important to ask questions at the table, and outside of the meetings. In addition to your board colleagues, Craig considered that getting a mentor is of real benefit to emerging directors, and if he had his time over, says that he would have joined the IoD and undertaken training a lot earlier.

While cyber risk is top of mind for directors, the 2022 Director Sentiment Survey found that just 37% of directors felt their board had the right digital capability to lead their organisation into a digital future. In the 2021 Directors' Risk Survey Report by Marsh and the Institute of Directors, cyber risk was a key emerging risk, with cyber breaches considered a matter of "when, not if". The report noted that "the dynamic growth of technology and the adaptation of digital transformation, artificial intelligence and robotics have increased both the threat landscape for businesses and a bigger playground for cyber criminals". The report highlighted that cyber security is one of the most common and fastest growing risks irrespective of the industry. It also reported an increase in cyber attacks due to employees working remotely.

Craig says that while cyber risk can be hard to get your head around, the risk associated with loss of data, privacy breaches, reputational damage, and work disruptions, means it's critical to spend the time to determine where an attack may come from. "You need to determine what your soft entry points are, for example, communications with and among directors."

But it's not all downsides according to Craig. With risk comes opportunity. "Are we asymmetric when it comes to risk? Do we fear risk rather than see the upsides?" he asks. "It's about understanding your risks, not necessarily avoiding them. Embracing risk can be a key element of innovation."

As they say, the biggest risk is doing nothing.

MJ Daly is a Chartered Fellow of the Institute of Directors who sits on a number of boards including Chair of AIG Insurance and Fonterra Shareholders Fund, and a Director of Kiwibank and Kiwi Property. She has a breadth of governance experience across a wide range of industries including insurance and financial services.

Craig Stobo is a Chartered Fellow of the Institute of Directors with extensive governance experience including Chair of listed companies Precinct Properties and NZ Windfarms, and is Chair of the Local Government Funding Agency. He is also a Chair and shareholder of private market businesses and a board advisor. He has previously worked as a diplomat, economist, Chief Investment Officer and CEO.

SJ Weir is a Chartered Fellow, Chair of the Nelson Marlborough branch, and a member of the national Council of the Institute of Directors. She is a director on a number of boards and trusts including independent Chair of Nelson Bays Primary Health and a member of two tribunals. She was previously a law firm partner.

6. Market predictions 2023 and beyond

In 2021, over 1000 D&O and Statutory Liability claims notifications were lodged with insurers in New Zealand. With legal costs escalating, claims costing in the tens of millions of dollars and cases often lasting for years, the risks facing directors are very real. A good quality D&O insurance policy should form part of a comprehensive risk management programme, protecting against the exposures directors and officers face.

Predicting the D&O and cyber insurance market conditions for 2023 and beyond can be compared with trying to pick the outcome of a sporting world cup or a major horse race. With both, there are similar characteristics:

- The form book isn't always right
- Be prepared for a few wild card or unexpected results
- Sometimes common sense does prevail
- Outcomes are always earned and are not easy to achieve

These characteristics will underpin the D&O, cyber and liability markets for the foreseeable future.

TOP TIPS FOR 2023

1. *Focus on risk profiling and good risk management*
2. *Get ahead of the curve on ESG*
3. *Establish metrics to measure value (not just price)*
4. *Check the detail of each policy*
5. *Consider your options*

Directors' & officers' liability

Key areas of focus for all insurers will be Culture and Conduct, Environmental, Social, and Governance (ESG) and Business Continuity.

Profiling the **culture and conduct** of the business provides an insight as to how a company operates in areas such as people, gender equality, diversity and inclusion practices, and health and safety record.

It is difficult for insurers to get a sense of the mood of the business (and the boardroom), so it will remain important for you to continue to provide these insights to them.

ESG will continue to develop as a key consideration for all global insurers. It is a constant challenge for underwriters to understand known and emerging ESG risks, with their focus often on the environment, sustainability and social outcomes. We predict that businesses will increasingly have to clearly articulate their ESG journey to reach goals such as net-zero and adequacy of financial reporting on the impacts of climate.

Business Continuity and the ability of your businesses to recover from major events or interruptions will have an increasing focus in 2023. With continuing economic uncertainty, your ability to demonstrate the resiliency of the businesses you govern will be important.

Coverage, capacity and cost

While directors will need to hit the reset button for their D&O needs, the good news is that for most, quality coverage and capacity will be available, from local, regional and global markets. Internationally, you can expect to see some downwards pressure on pricing, which is being driven by new entrants and levels of competition in the market not seen since pre-2016.

For those risks which demonstrate the characteristics of a 'flight to quality', you can expect to see similar trends occurring in the New Zealand and regional insurance markets.

Cyber

As cyber attacks continue to dominate news headlines, you will be faced with an increasingly challenging cyber-security landscape. This means that insurers will continue to focus on the correlation between the strength of the cyber risk management procedures an organisation has in place and the corresponding exposure to potential cyber incidents.

Over the past few years, insurers have been remediating their pricing models, reaching a level of adequacy to cover the sorts of day-to-day attritional and ransomware-type losses that are currently occurring. The recent improvement of insurer loss ratios may also be driven by improved cyber hygiene, increased deductibles/waiting period and the managing of limit capacity.

As to the future, we are cautiously optimistic that insurer appetite to deploy capacity will continue into 2023 and beyond. With a new year comes the renegotiation of insurers' own reinsurance capacity and we do expect that new insurer technical rating guidelines will apply some additional upward pressure on pricing.

General

We know that for most businesses, the entire insurance arrangements fall under senior management control and board governance at least on an annual basis. For 2023 and beyond, you will continue to see high levels of uncertainty and in some cases continued volatility with coverage and pricing, as insurers grapple with many of the current economic issues. Top of mind are matters such as escalating costs of claims, general inflationary pressures, labour shortages, the increasing frequency (and severity) of major natural weather events and the ever-present existence of global impacts.

Appendix 1:

Why is D&O insurance necessary?

The risk is real

Directors and officers of companies of all sizes face more variety of exposures to liability under statute, contract and common law and operate in an environment of increasing scrutiny of their performance and conduct. Regulators, enforcement agencies, creditors, liquidators/receivers, shareholders and other stakeholders like litigation funders, are not only able but increasingly willing to hold boards accountable for alleged breaches of their duties. Even where an action is successfully defended, the legal costs incurred can be significant.

> *Recent court action also imposed a de-facto duty on directors not to engage in "reckless behaviour" – which remains open to future interpretation.*

Robust indemnity and trust arrangements may not be sufficient

The Companies Act 1993 does not allow companies to indemnify its directors, officers or employees in all circumstances and constitutional indemnities are generally discretionary rather than compulsory. This means that the indemnity may not be available to the director or officer when needed because the company is in financial difficulties or has ceased to exist. Alternatively the constitutional indemnity may be altered or removed by subsequent boards, or the company may be the party bringing the action against the director and therefore unlikely to authorise indemnification.

Deeds of Indemnity effected by the company in favour of its directors or employees may be legally enforceable but the company must still have the financial ability to meet its obligations for them to be effective.

Trust arrangements, while offering asset protection, may not meet the cost of defending legal action. Attendance at some regulatory proceedings is legally compellable and leaving legal action undefended can have undesirable consequences, e.g. being banned from serving as a director or having a successful creditor subsequently petition for the director(s) to be declared bankrupt.

Statutory sources of directors' duties

The Companies Act 1993 imposes a number of core duties on directors. For example, directors must:

- Exercise the skill, care and diligence of a reasonable director.
- Not disclose or make use of confidential company information.
- Not permit the company to carry on business in a manner likely to create a substantial risk of serious loss to the company's creditors.

Personal liability is also imposed on directors under many other statutes both in New Zealand and overseas. Examples of New Zealand legislation under which directors may find themselves personally liable include:

- Financial Markets Authority Act 2011
- Commerce Act 1986
- Fair Trading Act 1986
- Health & Safety at Work Act 2015
- Resource Management Act 1991
- Building Act 2004
- Privacy Act 2020

Limited cover for defence costs arising from prosecution for an alleged breach of statute may be provided under a D&O Insurance policy, however, in New Zealand it is also common to purchase a separate Statutory Liability Insurance policy covering the company and its employees for legally insurable fines and defence costs arising from inadvertent breach of insured New Zealand statutes for which the punishment is a fine on conviction of an offence.

Potential sources of claims against directors and officers

Claimant	Example of Allegation
Creditors	Reckless trading (seeking to recover debt following insolvency of the company), alleged breach of contract.
Competitors	Unfair trade practices, defamation breach of intellectual property rights.
Customers	Misrepresentation in connection with a product or service.
Employees and job candidates	Breach of employment law (eg discrimination, wrongful dismissal).
Liquidators/Receivers	Reckless trading (trading while insolvent); negligence resulting in loss to the company.
Regulatory bodies	Financial Markets Authority/Reserve Bank of New Zealand, Department of Labour, Commerce Commission alleging breach of Securities Act, Health & Safety at Work Act, Commerce Act and Fair Trading Acts respectively.
Shareholders and other investors	Misrepresentation, inadequate or inaccurate disclosure in financial reporting in public or private placement materials, failure to exercise reasonable standard of care.

Appendix 2:

What does D&O insurance cover?

Subject to the particular policy's terms, conditions and exclusions, cover is commonly provided for:

- Legal costs incurred by or on behalf of the insured director, or person in investigating, defending or settling claims, or investigations/prosecutions brought against them.
- Awards/settlements of insured damages (most commonly limited to compensatory damages).

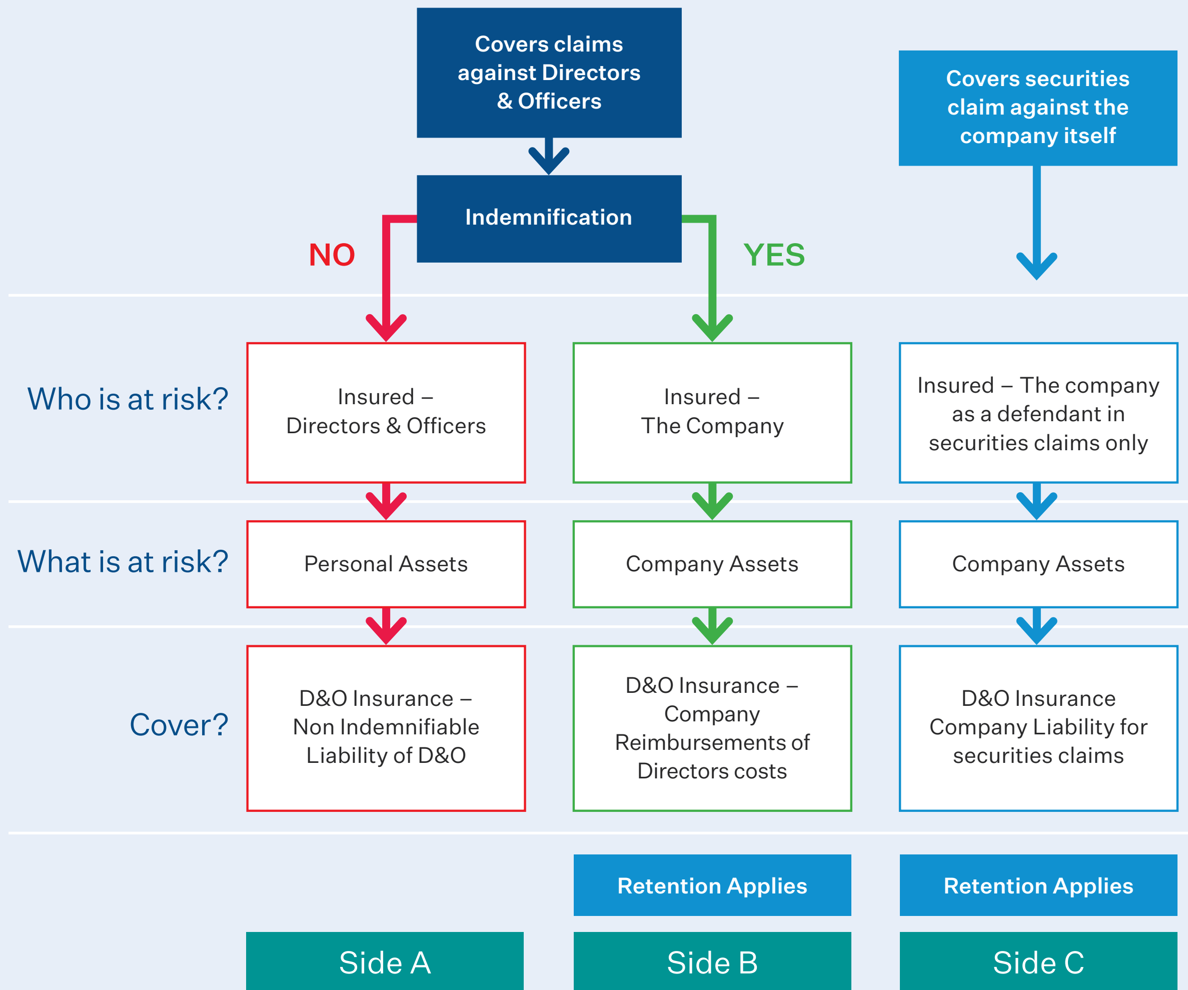
In the absence of D&O Insurance, individuals must rely on receiving indemnity from the company to pay their defence costs and any eventual settlement or judgment. Where such indemnity is not forthcoming for whatever reason, the individual will have to fund the cost of the defence themselves (which can be protracted and expensive) and if their defence is unsuccessful, they face the loss of their personal assets to pay settlements or judgments, or bankruptcy, or prison for criminal activities.

Often D&O Insurance is arranged by a company on behalf of its directors and officers and those of its subsidiaries. In such cases it is usual for the insurance to cover:

- The relevant individuals for loss for which they do not receive indemnity from the company ("Individual" or "Side A" cover).
- The company/ies for the cost of legally indemnifying their individuals for such legal action brought against them ("Company Reimbursement" or "Side B" cover).
- If arranged, the company/ies for certain claims made against it in its own right, e.g. from holders of securities ("Company Securities" "entities cover" or "Side C" cover).

Other policies, such as those which are intended to cover a single person in respect of multiple directorships (Personal Directors and Officers Liability Insurance or "Side A" policies") reserve cover solely for the insured individual(s) and provide no cover to the company whatsoever. These policies operate in excess of any indemnity the individual is entitled to from the company they serve and/or any insurance effected by the company for its individual(s).

The D&O Policy Structure



About us

Marsh is a trusted advisor and global leader in insurance broking and innovative risk management solutions. We protect and promote possibility, helping our clients dream bigger, reach further, and plan for the opportunities ahead. We help clients quantify and manage risk – and help them unlock new opportunities for growth. Founded over 150 years ago, Marsh operates in 130 countries and has been working with New Zealand businesses since 1958. There are 10 offices around New Zealand with over 250 experienced professionals tapping into a global network of 45,000 experts.

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 10,500+ members and the broader governance community who lead a range of organisations from listed companies, large private organisations, state and public sector entities, small and medium enterprises, not-for-profit organisations and charities.

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