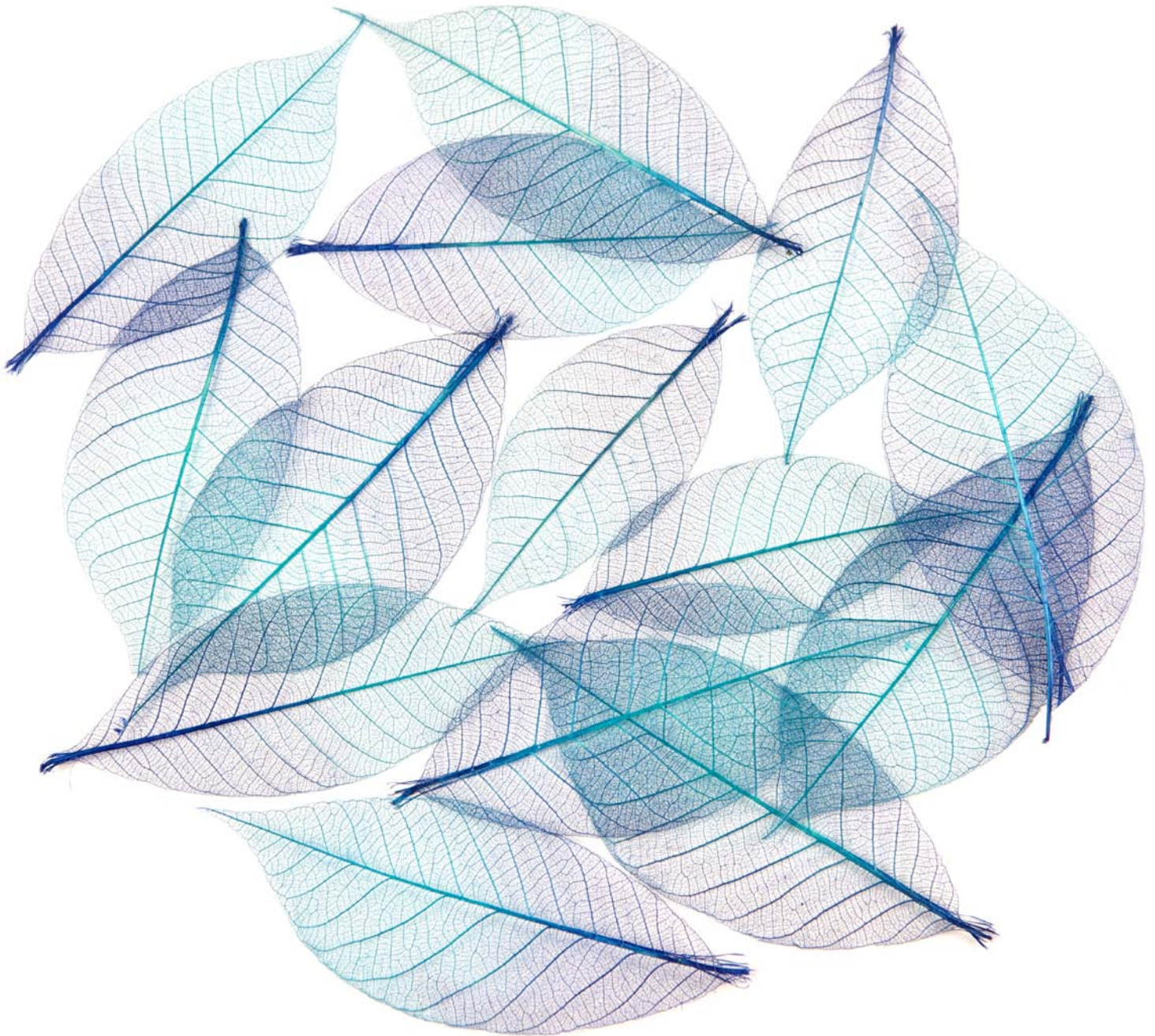


ALLEN & OVERY



Directors' liability

D&O: The changing face of personal exposure

A survey conducted by Allen & Overy
and Willis Towers Watson | May 2016

Willis Towers Watson 



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Introduction

Welcome to our fourth report in a series on directors' liabilities from the international law firm Allen & Overy and the global advisory and broking company Willis Towers Watson. This exercise began in 2011, when we first decided to investigate how directors and high-ranking officers in public and privately-held corporations were feeling about their exposure to risk, at a time when it seemed that such individuals were facing an unprecedented level of scrutiny. Fast-forward to 2016, and the clarion calls for personal accountability in the boardroom combined with an increasingly complex international regulatory and enforcement environment, and the growing threat of criminal and civil court claims, have resulted in even greater pressure on corporate leaders.

Over the following pages, we have sought to dig deeper than ever before into the issues that are keeping directors and officers awake at night. We have surveyed more than 125 senior individuals in public and private companies, including directors, non-executive directors, in-house lawyers, risk officers and compliance professionals. We thank them all for their assistance as we endeavour to create a market barometer.

With the benefit of three surveys now behind us, we have assembled a valuable data set on boardroom sentiment, and can begin to point in this fourth report to themes and trends that have developed over the past five years, as well as emerging topics of interest or concern. We continue, too, to drill deeper into the numbers, with this year's analysis contrasting the views of those in public companies with those in private companies; those in UK focused companies with those in more international ones; and financial services with other industry sectors.

The clear message which emerges is that it is now well understood that regulators are actively seeking to hold individuals to account, operating under the premise that good corporate behaviour is best achieved by focusing on those in charge, and by making those people feel more personally accountable.

More than ever before, a significant minority (one in four of our respondents) have already experienced a claim or investigation involving a director of their company. Perhaps unsurprisingly, today, directors continue to tell us that their biggest fears revolve around the risks they face in relation to regulatory and other investigations and inquiries. Yet concerns as to cyber-attack; data loss; anti-corruption legislation, and criminal and regulatory fines and penalties are not far behind. Indeed for the first time cyber liability and data loss feature prominently in our survey results.

But there are many new risks on the horizon, and not all of them are appreciated by our respondents. In this year's survey we drew our respondents' attention to several pieces of legislation that serve to further enhance personal liabilities. For example, just 42% of those who completed our survey were aware of new criminal law requirements on all private companies, under the Small Business Enterprise and Employment Act 2015, to maintain a Persons of Significant Influence Register, for example, and to lodge that information with Companies House.

Under the Companies Act 2006 there are already over 200 offences for which directors in the UK can be held personally liable, and new legislation comes into force on an almost monthly basis that increases board member exposure. The purchase of Directors' and Officers' Liability insurance by employers gives business leaders some comfort that coverage may be available for funding their defence in the event of litigation arising, but such arrangements are complex and bring their own issues. Many employers supplement these policies with the provision of an indemnity against liabilities that their directors may incur during the course of their duties.

But despite such protection, our respondents continue to tell us that they want policy terms that are clearer and easier to follow, and this year they go further, expressing an even greater concern that their D&O policy and/or company indemnification, will be able to respond to claims in all jurisdictions.

We hope you find our coverage and analysis of this market useful. Should you require any further information on any of the issues raised here, please do not hesitate to get in touch with your usual contact at either Allen & Overy or Willis Towers Watson.



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Key findings

A number of key themes emerge from the statistics and analysis contained in this report:

More than one in four respondents to our survey (27%) has **experience of a claim or investigation** involving a director of their company. For public companies, this increases to 39%, while only 10% of private companies have encountered such claims.

Only 56% are aware of the UK Government's stated plan **to extend the Senior Managers Regime** to all financial intermediaries and asset managers in the UK. When looking at the financial institution respondents, 27% were not aware of this plan.

Nearly a third has experience of a **cyber-attack or loss of data** significant enough to have been brought to the attention of the board in the last 12 months.

Only half know that spending on **promotional activities relating to the EU referendum** could engage campaign finance rules, and expose directors to criminal liability.

Nearly 60% are unaware of new requirements for private UK companies to maintain a **Persons of Significant Influence Register** and lodge it with Companies House. Again, when we dig deeper into these figures, 65% of private companies did not know about these requirements.

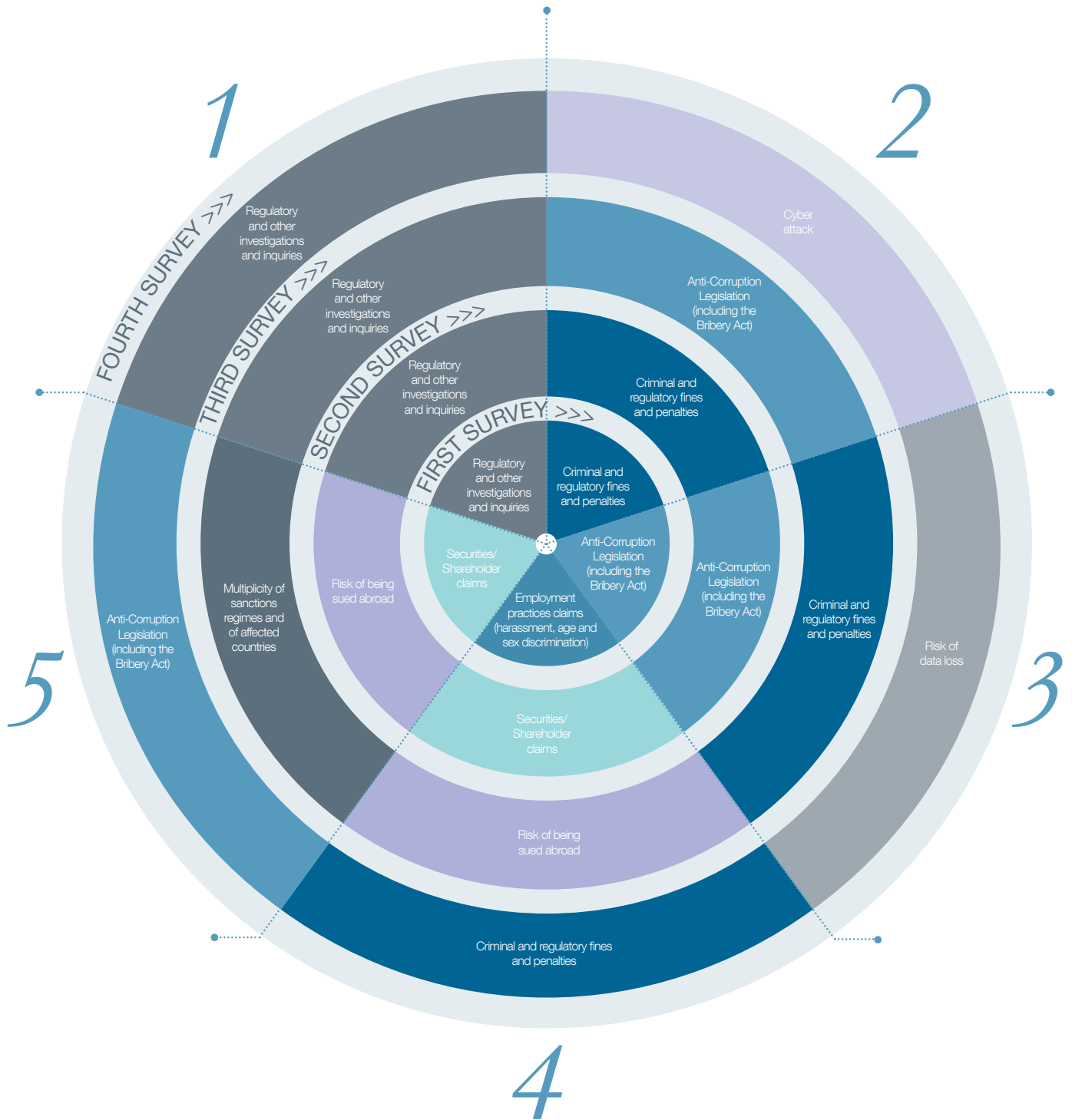
There is an increased perception of the **potential for conflicts of interest** between and among directors and the company, especially of public companies in the financial services sector.

Regulatory and other investigations and inquiries are again considered to be the greatest risks facing businesses and their directors, but are now followed by cyber attack and data loss as major new concerns.

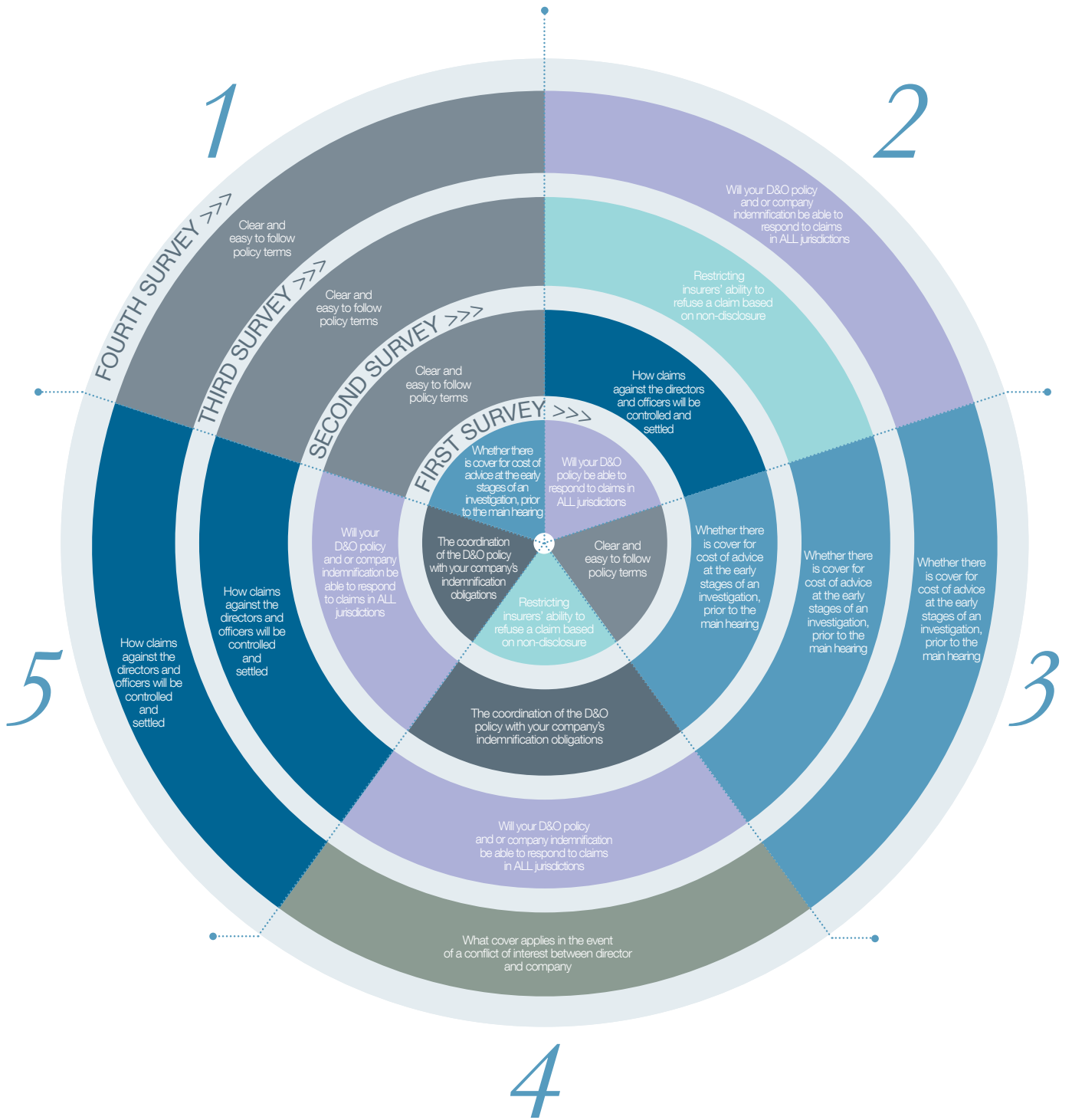
When it comes to D&O policy coverage, directors are most concerned that their policies will **respond to claims in all jurisdictions**; that there should be **clear and easy-to-follow policy terms**; and that there is cover for the cost of advice at the **early stages of an investigation**.

There is plenty of evidence in the media almost daily on the frequency of cyber-attack on companies. That itself is hardly newsworthy. Our survey, however, focused only on those attacks which were serious enough to have been drawn to the specific attention of the board. Worryingly and despite this, almost one in three respondents said they had experienced such an attack.

TOP FIVE RISKS FOR DIRECTORS, BETWEEN 2011-2016



TOP FIVE POLICY COVERAGE ISSUES, BETWEEN 2011-2016



An evolving legal and regulatory landscape

In each of our last three reports on the status of directors' liabilities in the UK and abroad, we have analysed the way in which regulators and policymakers around the world have been focusing their attentions on company directors and officers as a means to influence corporate behaviours. Driven by public and shareholder pressure, and the lessons learned from the global financial crisis, enforcement agencies have prioritised individual responsibility in the face of corporate wrongdoing, and have promised to come down hard on offenders. The Yates Memorandum issued in 9 September 2015 by the U.S. Deputy Attorney General, which makes it abundantly clear to state prosecutors that their focus should be on personal accountability in the boardroom, is a paradigm example of this phenomenon.

It should not be thought, however, that the regulatory and prosecutory focus on individuals has contributed to a downturn in the eye watering levels of fines and penalties exacted, in particular, on the financial services sector. In 2015 alone the UK's prosecutors and regulators have imposed not far short of a billion pounds worth of fines, penalties and related orders on companies. This includes a fine of GBP126 million for failure to adequately ensure safe custody of client assets and GBP226.8m in connection with LIBOR and EURIBOR related misconduct.

We have witnessed a proliferation of new regulations affecting directors and officers in recent years, and this shows no signs of abating. Since we began publishing this series, directors in the UK have become personally liable for offences that

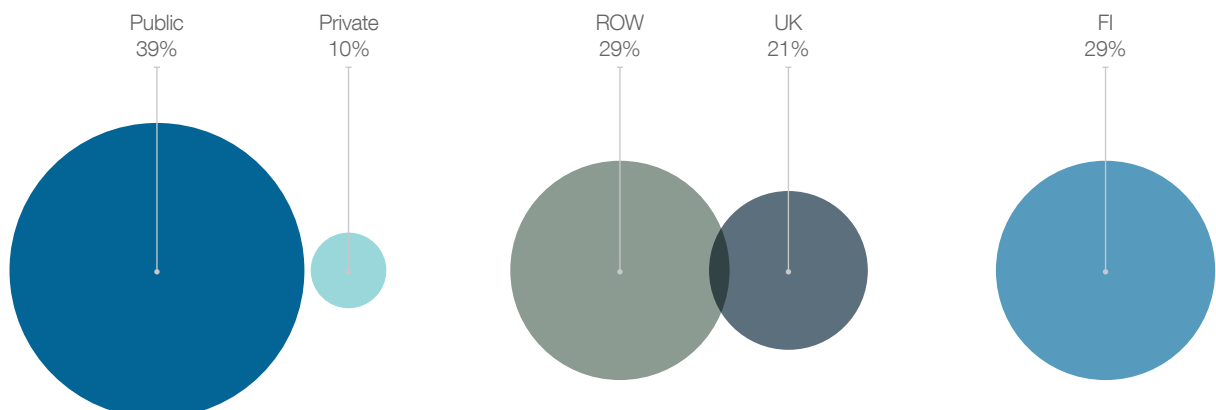
include bribery, corruption and fraud; competition and antitrust matters; environmental law; health and safety; tax; sanctions; money laundering; financial reporting requirements; and Dodd-Frank and other extra-territorial U.S. legislation.

As such, while the principle that a company is a separate legal entity from its leaders remains a key tenet of the English legal system, it would be unsurprising if directors and officers feared the expanding extent of their personal liability.

For the fourth time in a row, our respondents tell us that the greatest risk they face remains the threat of regulatory and other investigations and inquiries, with 71% of all those questioned considering such a risk to be significant for their business and its directors.

Have you had experience of a claim or investigation involving a director of your company?

Yes



“There is also perhaps a question of bandwidth or attention span deficit here among directors.”

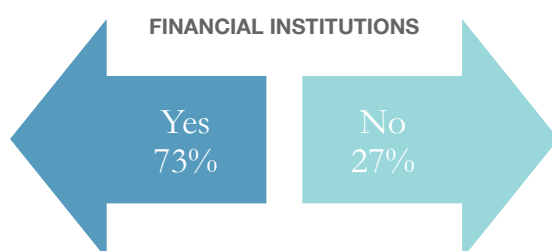
And this year we find growing evidence of such fears playing out in practice, with 27% of our respondents saying that they have had experience of a claim or investigation involving a director of their company. This figure rises to 39% of public companies, as against 10% of private companies, and to 29% for those companies that are global or conduct most of their business outside the UK, against 21% for firms that do most of their business in the UK. Those working in financial services are also more likely to have experience of a claim, with 29% of respondents in that sector saying they had done so.

Fears about anti-corruption legislation, including the Bribery Act, and about criminal and regulatory fines and penalties, also continue to feature in the top five worries keeping our respondents awake at night, as they have done in each of our previous surveys.

And despite the swathe of regulation that we have seen implemented in the wake of the crisis, rule makers show no sign of relaxing their approach. As such, it would be unsurprising if directors, officers, and the legal and compliance professionals who advise them, found it difficult to keep abreast of new liabilities entering the statute books.

There is also perhaps a question of bandwidth or attention span deficit here among directors. In other words, there are only so many issues which board members can keep at the front of their minds. For example, corporate manslaughter does not feature prominently among the directors’ liabilities concerns (13%). Yet in February 2016 definitive sentencing guidelines were issued in the UK which set high tariffs for this type of offence. For example, the starting point for companies with a fairly modest turnover of GBP50m, whose breach means that they are in the “very high culpability” bracket of GBP4m.

Are you aware of the UK Government’s stated aim to extend the newly introduced Senior Manager Regime to all financial intermediaries and asset managers in the UK?



The Senior Managers Regime

The UK’s new Senior Managers Regime came into force in March 2016, bringing with it significant changes to the way in which senior individuals working in financial institutions are regulated. The regime focuses on individuals who hold key roles and responsibilities in relevant firms, and has required institutions to allocate and map out responsibilities, and prepare Statements of Responsibilities, for individuals carrying out senior management functions.

While individuals who fall under the regime will continue to be pre-approved by regulators, firms will also be legally required to ensure that they have procedures in place to assess their fitness and propriety before applying for approval, and at least annually thereafter. As such, not only do firms have significantly increased responsibilities in relation to individuals who fall within the regime, but a much wider group of individuals will now be subject to a new Code of Conduct, and therefore exposed to the risk of potential Financial Conduct Authority (FCA) or Prudential Regulatory Authority (PRA) enforcement action.

In his speech delivered at the Mansion House Banquet in July 2015, the Governor of the Bank of England, Mark Carney, set out clear plans to extend the new regime to all financial intermediaries and asset managers. We asked our respondents whether they were aware of this stated aim to extend the regime, and only 56% of those that we spoke to knew of the plans. Awareness was higher, as one might expect, in the financial services sector, with 73% of respondents knowing about the changes to the regime, but even there we found that more than one in four respondents, or 27%, were unaware of the plan to extend the regime.

Carney said last year: “To give these measures teeth, key elements of the Senior Managers Regime should be extended to all firms active in FICC markets, including dealers and asset managers. That means all senior managers would have clearly defined responsibilities and would be answerable for training, certifying and monitoring the material risk takers they supervise. The FCA should oversee compliance, redeploying resources to focus on Senior Persons. In turn, these individuals would be on the hook for promoting compliance within their organisations.” He went on to add, somewhat ominously for directors and officers, that, “the Age of Irresponsibility is over.”

Such an approach is just the latest evidence of a growing theme of individualisation of exposure and personal accountability, particularly in the context of financial services, that looks likely to continue to expand into other areas of regulation.

Campaign finance rules

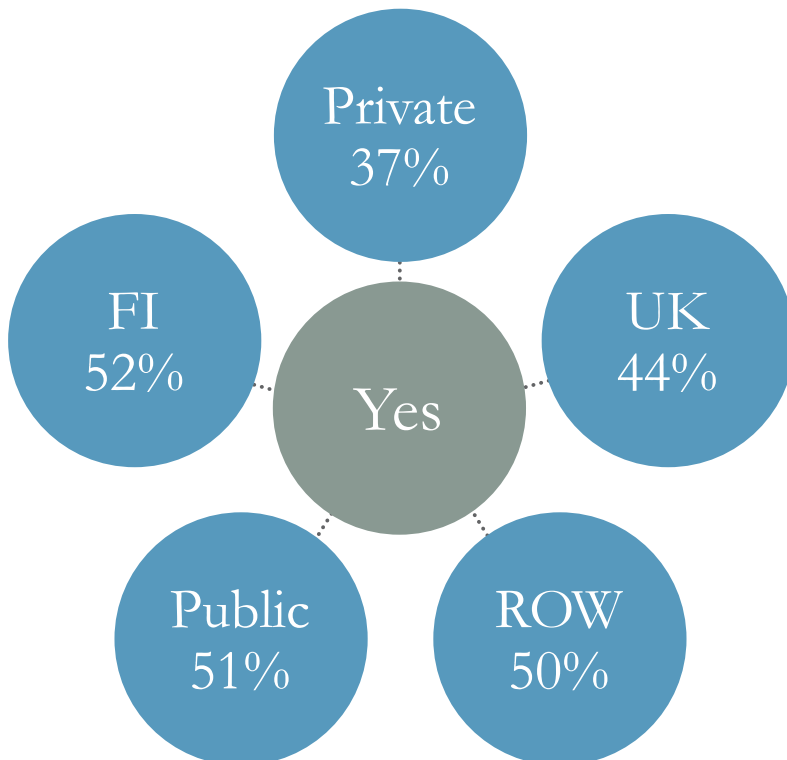
British voters will go to the polls on 23 June to vote on whether or not the United Kingdom should withdraw from the European Union, and the campaigns are already being hotly contested. Brexit is a significant issue for companies that do business in the UK and Europe, and as such, many business leaders have felt the urge to take a public stand on the issue. But doing so can trigger complex UK election laws, and give rise to personal liabilities, that directors may be unaware of. We asked our respondents whether they knew that any spending on promotional activities regarding the EU referendum could engage campaign finance rules, or Companies Act requirements for shareholder approval, and that a director failing to observe the rules could face criminal liability and have to pay the company back for any unauthorised expenditure. We found that only half of the people surveyed were aware that this was the case, demonstrating how little these rules are understood.

Again, when we delve deeper into these numbers, we find that 51% of public companies are aware of the potential exposure around campaign finance rules, as against just 37% of private company respondents. Furthermore,

when we strip out companies that say they conduct the majority of their business either globally or outside the UK, we find that just 44% of the remainder – the UK companies – are aware of the threat. For more internationally-minded firms, the awareness rises to 50%.

UK election laws require companies that spend more than GBP10,000 in expenses on referendum communications, either for or against, to register with the Electoral Commission and file reports. Furthermore, because the law takes a broad approach to calculating expenses, companies need to have a compliance framework in place addressing communications during the regulated period, which started 10 weeks before the vote, on 15 April.

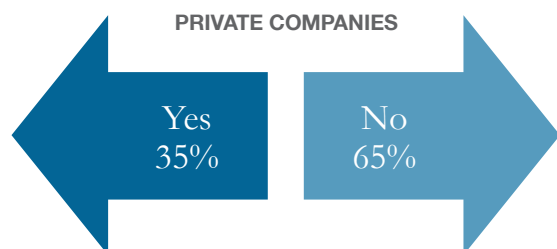
The Brexit referendum is subject to different regulations to last year's UK general election, so any research, roundtables, conferences, dinners, debates or polling around the referendum, or any information related to the vote published on firm websites, blogs or social media, could breach the rules. In theory, breaking election rules could result in large cash penalties or up to a year in prison.



“breaking election rules could result in large cash penalties or up to a year in prison.”

Are you aware that any spending on promotional activities regarding the EU referendum could engage campaign finance rules and/or Companies Act requirements for shareholder approval and that a director failing to observe these rules may face criminal liability and/or have to pay the company any unauthorised expenditure?

Are you aware of new requirements on all private UK companies under the Small Business Enterprise and Employment Act 2015 to maintain a Persons of Significant Influence "PSC" Register and lodge the information at Companies House?



Persons of Significant Influence

Another piece of new legislation that appears to have entered the statute books in the UK under the radar is the Small Business, Enterprise and Employment Act 2015, which received Royal Assent on 26 March 2015. This is a multi-tentacled and complex piece of legislation, most of which is now in force. For example, it includes a wide range of measures that have an impact on company directors, in areas such as appointment and disqualification, insolvency, company filing requirements and aspects of employment law.

It certainly underlines the fact that personal accountability is a key theme.

We asked our survey participants how many of them were aware of the new requirements coming in under the Act, and in particular the need for all private UK companies to maintain a Persons of Significant Influence Register, and lodge information with Companies House. Only 42% of our respondents were aware of the new rules, revealing a lack of awareness of this new piece of legislation. When analysing the responses from private companies, just 35% were aware of the significance of this act, demonstrating that even the very companies to which these rules apply are not aware of the requirements.

Arguably the most radical change included in the legislation is the requirement, which was introduced in January 2016, that most companies in the UK (with the exception of those listed on the Main Market of the London Stock Exchange, or on the Alternative Investment Market) start keeping a register of people with 'significant control' over the company. Broadly, a person with significant control is defined as someone who:

- holds, directly or indirectly, more than 25% of the shares in the company or its voting rights;
- holds the right, directly or indirectly, to appoint a majority of the board of directors of the company; or
- has the right to exercise, or actually exercises, a significant influence or control over the company.

Companies will be legally required to take reasonable steps to identify such persons, and companies and directors will commit an offence – punishable by imprisonment or a fine – if they fail to take steps to investigate its registrable persons and registrable relevant legal entities.

There will also be a legal duty on registrable persons to provide information to the company in certain circumstances to ensure the necessary information is recorded in the company's new register. They also have a similar obligation to notify the company of relevant changes to the information in the register and will commit an offence under the Act if they do not comply with these obligations.

Conflicts of Interest

The themes of transparency and individual accountability which underlie many of the new pieces of legislation and regulation summarised above point to another phenomenon which has not been lost on the respondents to our survey. In circumstances where individuals increasingly need to be prepared to defend themselves from attack, there is greater scope for conflicts of interest both among board members themselves and as between them and the company.

Overall, 40% of our respondents were concerned about the cover which applies in the event of a conflict of interest between directors and the company. This figure decreases to 32% of public companies, as against 35% of private companies, and to 36% for those companies that are global or conduct most of their business outside the UK, against 40% for firms that do most of their business in the UK. In respect of our financial institution respondents, this figure significantly increases to 49%.

This is a complex subject raising issues of confidentiality and legal professional privilege and one which challenges the principle of collective board responsibility. The bottom line, however, is that the number of occasions on which executive and non-executive directors are likely to need to have recourse to legal advice which is independent and separate from that of the company and indeed their fellow board members is likely to rise.

New liability concerns

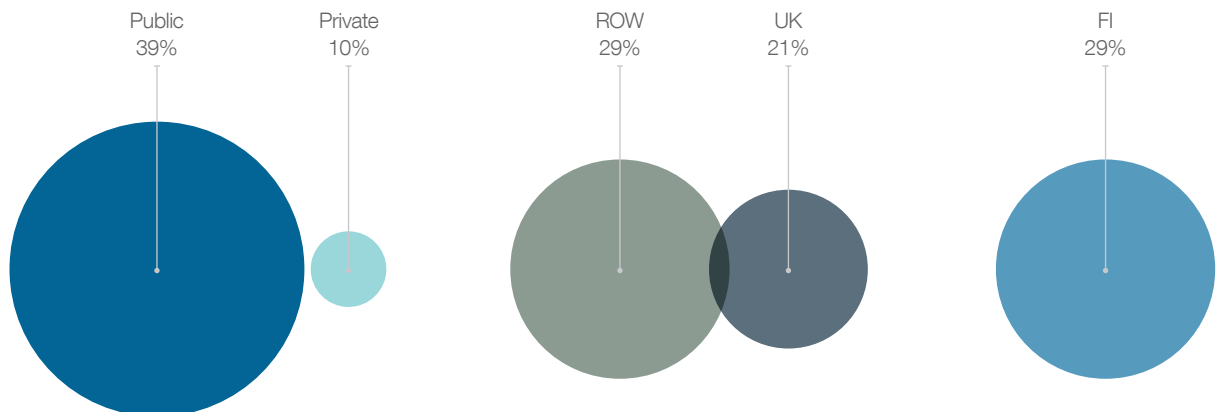
Cyber-attack and data loss

For the first time, cyber liability and data loss feature prominently in our survey. We asked our respondents whether their companies had experienced a cyber-attack, or loss of data, significant enough to be brought to the attention of the board, in the last 12 months. We were surprised to find almost a third of our respondents answering yes to that question: 31% had experienced such a breach, and in the last year alone.

The legal framework against which these concerns are set will change fundamentally over the course of the next two years. These changes will inevitably further fuel directors' liability concerns in this area. They come as a result of the General Data Protection Regulation which will enable people to control their personal data better and the Data Protection Directive for the police and criminal justice sector which will ensure that the data of victims, witnesses, and suspects of crimes, are duly protected in the context of a criminal investigation or a law enforcement action.

To your knowledge, has your company experienced a cyber-attack and/or data loss significant enough to have been brought to the attention of the board in the last 12 months?

Yes



Summary of the impact of the General Data Protection Regulation and the Data Protection Directive

In summary:

Companies will have to notify the national supervisory authority of serious data breaches as soon as possible so that users can take appropriate measures. No such obligation currently exists in the EU but a similar obligation which has existed in the U.S. for some time has given rise to some very expensive remedial action needing to be taken by companies who have suffered cyber-attacks under which the personal data of many thousands of individuals have been compromised.

There will be a significant extension of data privacy laws from companies who are data controllers to those who process data. At the moment only the former are liable in damages for breaches in the EU, whereas when the regulation comes into force data processors will be held jointly liable.

Subject to an exemption for small and medium size enterprises, it will be mandatory for companies to appoint data protection officers with responsibilities for ensuring compliance with the new legislation.

The right will be given to consumers to have their personal data corrected if inaccurate, and their right to remove irrelevant or outdated information will be expanded. This “right to be forgotten” extends a concept enshrined in the EU’s existing privacy laws. Consumers will for the first time have the right to stop a firm using data when they close an account.

“...cyber-attack and the risk of data loss are rising up the agenda when it comes to the risks feared by directors”

Draconian penalties for serious breaches of the new Regulation will be enforced. Fines of up to 4% of global sales can be imposed on companies. Additionally a new Network and Information Security Directive will come into force at around the same time as the Regulation. Under this new Directive, businesses in member states with an important role for society and the economy—referred to in the directive as “operators of essential services” —will have to take appropriate security measures and to notify serious incidents to the relevant national. Penalties will be imposed for non-compliance of up to 2% of global turnover.

Yet even before the implementation of these new laws, according to our survey, the underlying exposures seem to be growing fast. Public companies already feel more exposed than private ones, with 37% of public company respondents reporting a serious breach, as against just 20% of private companies. When we look at companies that do the majority of their business in the UK, we find them to be slightly more exposed, with 35% reporting a breach as against 26% of those operating more globally or outside the UK. And likewise those working in financial institutions seem more vulnerable, with 35% having experienced a cyber-attack in the past year significant enough to bring to their board's attention.

While these figures appear to illustrate a clear and present danger, they also come in the wake of efforts by the UK's financial authorities to get to grips with cyber resilience, especially in the financial services sector in recent years. The FCA, PRA and Bank of England issued a questionnaire to the 36 firms that make up the core of the UK financial system – including the largest UK and foreign banks active in London, and the key payment and settlement systems, clearing houses and exchanges – to find out how they organise their cyber defences, and to take stock of resilience across the sector.

70% of public companies rank cyber risk as a top five concern

49% of private companies

We note that whereas 70% of public companies put cyber-attack as a top issue, only 49% of private companies take the same view. Since we can think of few reasons why public companies are inherently more likely to be attacked than private ones, we wonder if the gravity of this threat is being underestimated.

This is certainly an area where directors and officers can find themselves personally exposed. For any company that relies on computers – and that means just about any company – cyber risk is real, serious and unavoidable, and as such, the threat of a liability attack against directors cannot be eradicated. Directors should therefore take steps to inform themselves of the risks posed to their companies, and to mitigate those risks, for the basis of their defences should the company be attacked. Again, personal accountability is paramount, and the key legal point here is that directors cannot delegate their duties of supervision.

The UK government has published guidelines for non-executive directors to help them in assessing the measures being taken to enhance cyber security in the companies they oversee. The guidance lists useful questions that board members should ask, such as:

- Do I really understand the cyber risks my company faces?
- What questions should I ask myself?
- What should I ask my board colleagues?
- What should I be asking the audit and / or risk committees?

Ensuring that all decisions, communications and actions regarding cyber security are well documented will aid directors and officers in their own understanding of the risks facing the company. This also creates a useful document trail which can assist, should anything go wrong and the company's processes come under scrutiny.

“What is notable is that public companies view this threat as more significant than private companies (73% versus 59% ranking it top five)”

Regulatory investigations

Alongside cyber risk, only the risk of regulatory and other investigations and inquiries currently weighs heavier on the minds of our respondents, where, overall, 71% rank it as a top five concern. This threat of investigations has been the primary concern for our respondents in each of our last three surveys, and it clearly shows little sign of abating. What is notable is that public companies view this threat as more significant than private companies (73% versus 59% ranking it top five), and those working in financial institutions are the most concerned (with 83% prioritising it as a risk).

Outside of regulatory investigations, anti-corruption legislation (including the Bribery Act) and criminal and regulatory fines and penalties round out the top five worries for our respondents, both having featured heavily as serious concerns in our surveys in the past.

Other risks

Beyond the primary risks, namely, cyber-crime, regulators and criminal investigations, several other threats to personal liability continue to concern our respondents. One such worry is the multiplicity of sanctions regimes, and of affected countries, which is a particular concern for those respondents working in public companies. Employment practices claims (for harassment, age and sex discrimination, for example) are also of concern to more than a quarter of our respondents (and to 37% of those working in companies that do the majority of their business in the UK).



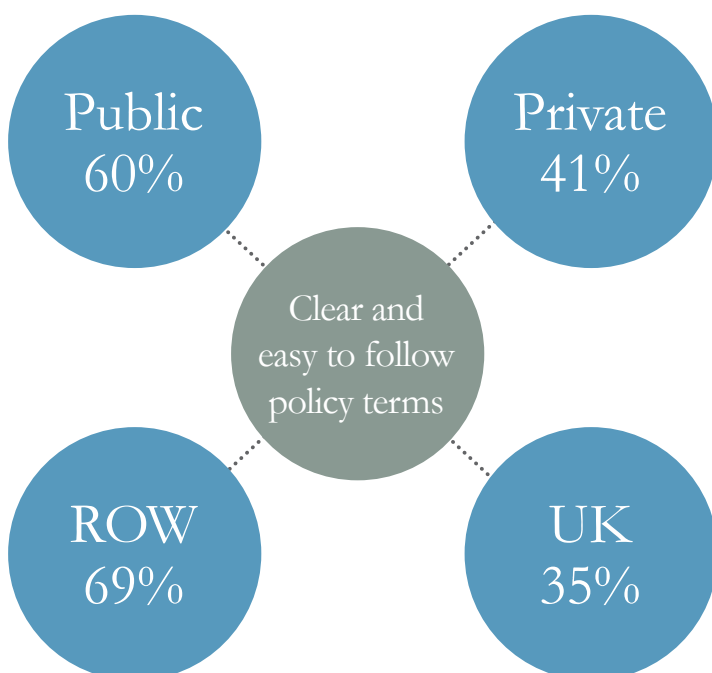
Protecting directors and officers

With directors and officers facing so much personal exposure – to the extent that it can be difficult for them to keep track of the laws that apply to them – it is not a surprise that D&O policy coverage and related company indemnities are becoming more of a focus of attention year-on-year. We asked our respondents once again what they considered to be the most significant policy coverage issues for them and their businesses, and for the fourth time we found that clear and easy-to-follow policy terms were one of their top priorities. It perhaps suggests that more still needs to be done by the insurance industry to deliver this result.

The extra-territorial nature of the risks directors face has moved up the agenda this year, however, and now equals 'clear and easy to follow policy terms' as our respondents' number one concern. The worry of whether or not a D&O policy, or a company indemnification, will be able to respond to claims and investigations in all jurisdictions has risen up the agenda of our survey participants, and was ranked as a top five concern by 59% of those asked. It was of particular concern to those working in public companies (60%) rather than private (41%), and, unsurprisingly, to those doing the majority of their

business outside the UK (where 69% considered it a significant D&O area, versus just 35% in businesses operating predominantly in the UK).

Interestingly and by contrast, the fear of being sued abroad has diminished from 47% to 23% if we compare this year's results to the previous survey. These findings are not necessarily inconsistent though since whilst the risk of being involved in a civil suit abroad may not have increased, the same cannot be said of the risk of becoming embroiled in an investigation or other proceeding.



“The worry of whether or not a D&O policy, or a company indemnification, will be able to respond to claims in all jurisdictions has risen up the agenda.”

“More than half of our respondents expressed concern about insurance cover for investigations when asked to identify their five biggest worries, and it has been a top three issue in each of our three most recent surveys.”

Coverage for investigations

Every year we find our respondents concerned about coverage for the cost of advice incurred at the early stages of an investigation, prior to any main hearing, and this year is no exception. More than half of our respondents expressed concern about this area of D&O insurance when asked to identify their five biggest worries, and it has been a top three issue in each of our three most recent surveys.

Here we are talking about regulatory visits and notification obligations, where from an insurer’s point of view it can often be difficult to pin down the focus of an investigation to one individual. As we have seen, the costs that can be racked up for legal advice for individuals at the start of investigations can be substantial, and with regulatory and enforcement so heavily focused on senior management, this is a growing area of expense, particularly as matters become more and more complex and increasingly international. Moreover, and as already observed, an increased incidence of conflicts of interest is likely to lead to the need to instruct a greater number of independent lawyers to advise on contentious issues.

Nevertheless, insurers do not traditionally cover the early stage of an investigation, because they regard their coverage as being for claims and formal investigations. It can also prove tricky to distinguish between the costs of defending the entity and the costs of defending the individual before formal proceedings have been issued, and insurers are not interested in covering the company’s costs under a D&O policy. This is where there is a risk of lines between entity and individuals in a coverage context being blurred – when the issue of who is responsible for paying the costs arises, the insurer is not going to cover the entity. Then individuals can potentially find themselves caught in a gap between the two, and indeed this is another area of growing concern for our respondents.

The need for coverage in the early stages of an investigation, and for that coverage to be separate from the company’s representation, becomes more of an issue as regulators drive deeper into organisational hierarchies in search of those responsible. Individuals may increasingly wish to feel they are covered to seek independent advice if they come under particular scrutiny from regulators. New policies are now available that

cover the early “business as usual” stages of investigations, but the limits of that cover need to be specific and delineated.

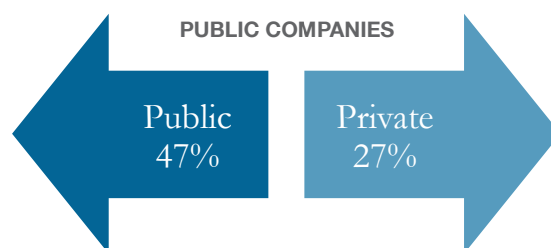
Some policies allow for particular bolt-on elements to cover directors and officers if the police turn up at the door and take them away in a dawn raid. Again, this emergency cover, for the very early stages of a process, comes with very specific wording, but it is available to those seeking such coverage.

Taking control

The other major concern expressed by our survey participants this year relates to concerns about how claims will be controlled and settled. This can be a vital issue in particular for directors or officers who find themselves in a tight spot and want to have as much control over their defence as possible. If insurers are fully in control, their motivation and desired outcome for settling a claim may be different from the relevant director’s motivation and desire, and as such there may not be an alignment of interest with the individual concerned. Again, this fear about how claims against individuals will be controlled and settled has consistently featured as a top five concern in our last three surveys, and this year’s analysis shows that this is a particular concern for those working in public companies (where 47% rank it as a top five D&O issue, versus 27% in private companies), and in financial institutions (where the figure is also 47%).

The degree to which an insurer can run a case remains an issue, and different policies are drafted in their own unique ways. While it is usual for the insurer to require consent for legal fees, and before agreement of a settlement, beyond that there is room for negotiation and policy terms vary.

How claims against directors and officers will be controlled and settled: a top five D&O issue.



“From August 2016, fundamental changes to the laws on material non-disclosure will be brought to insurance policies governed by English law under the Insurance Act 2015...in essence, the duty of utmost good faith will be replaced with a duty to make a ‘fair presentation of the risk’.”

Non-disclosure

One coverage issue that has moved down the agenda this year is a call to restrict an insurers' ability to refuse a claim based on non-disclosure. But while this may no longer be a top five concern, as it has been in previous surveys, we still find that more than a third of our respondents are taking it seriously. The issue here is that directors and officers worry that they might not have been asked the right questions at the time the policy was taken out, or that they may not have thought something was relevant that it later turns out should have been disclosed. The level of concern on this issue has dropped – with 37% seeing it as a major concern as against 50% in our last report – and perhaps suggests that, with so much more risk awareness, firms are putting better systems in place to make it easy for people to report what they know, and to ensure this is fed up into the disclosure when the policy is entered in to.

When we look more closely at the constituencies most concerned about non-disclosure invalidating policies, we see public company respondents more concerned than private companies, and UK-centric firms more alive to the issue than those with more global operations.

From August 2016, fundamental changes to the laws on material non-disclosure will be brought to insurance policies governed by English law under the Insurance Act 2015. It is beyond the scope of this report to deal with these changes, but in essence, the duty of utmost good faith will be replaced with a duty to make a “fair presentation of the risk”. No one yet quite knows what that means and it is likely to prove a fertile ground for litigation. Insurers will have the opportunity to ask questions. If they fail to do so, they may find that they are unable to avail themselves of a range of new proportionate remedies; the most challenging of which in terms of D&O insurance may enable them to reduce the amount they pay out in direct proportion to the additional premium they claim they would have charged had their questions been properly answered. In practice, insurers' internal guidelines may well dictate that they insist at inception on answers to specific questions and/or a signed statement from the insured as to what they have done to make “a fair presentation of the risk”. We shall be keeping a careful eye on developments in this area in future surveys.

“It is important to understand that where policies provide cover for amounts in the tens of millions of pounds, which might appear large, this represents an aggregate sum covering all insureds and often the company too.”

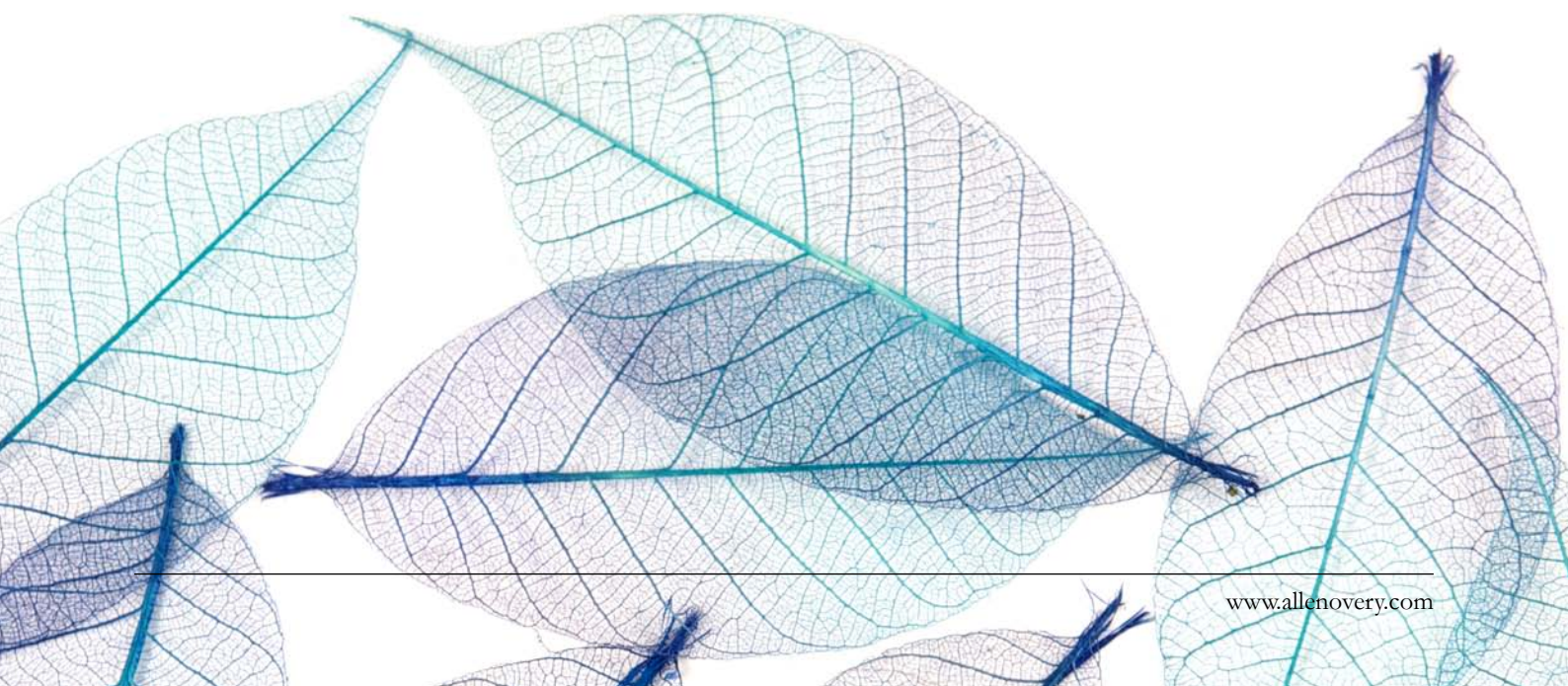
Who is insured

Finally, given that regulators are interested both in more junior staff and senior management, a broad definition of who is insured can in itself give rise to issues, because records are often not kept up-to-date. More than one in four of our respondents (27%) identified this as an issue, while a smaller number (18%) expressed concern about the sharing and hence rapid depletion of the aggregate limit.

These are both important issues that should not be overlooked. Keeping accurate records as to the seniority of individuals as they move through the business can be important, and this particularly applies to those working in overseas offices, where the equivalent control function status may be difficult to determine. As enforcement agencies and litigants look further along the chain of command, companies will want to consider covering more people, while recognising that it is not always a good thing to have everyone covered, because the aggregate limit gets stretched.

It is important to understand that where policies provide cover for amounts in the tens of millions of pounds, which might appear large, this represents an aggregate sum covering all insureds and often the company too. Therefore, if there are either a number of claims against the board members or one claim against many individuals (or even in some situations the company), that limit can be quickly exhausted.

What we find when we subject our survey results to greater scrutiny is that those working in public companies worry more than those in private companies about clear policy terms, what will happen in the event of a change in control, and what happens to the cover if the company becomes insolvent. Respondents in UK-centric firms, on the other hand, are more concerned than their more global counterparts about what happens to cover when they retire, how disputes between the company and insurers will be handled, and the risks of non-disclosure.



Practical tips on D&O and indemnities

Coordinating with indemnification

In addition to D&O policies, the other main way in which directors and officers can obtain cover against the costs of legal representation is if their company chooses to indemnify them. There are legal restrictions governing what businesses are allowed to indemnify their directors and officers against, but indemnities covering the costs of legal representation at regulatory investigations are permissible.

Where such indemnities exist, questions of who pays legal expenses may in practice arise in situations where directors find themselves adverse to the company. A policy therefore needs to address clearly what is, and is not covered, by the indemnity, so that the indemnity can provide an effective additional layer of protection to complement D&O insurance.

With more than one way of getting protection, this year a quarter of our respondents (24%) pointed to the coordination of the D&O policy with the company's indemnification obligations as an issue for them. Ensuring this coordination works requires someone to have looked at both policies together, to understand that they will operate effectively in tandem.

Some practical considerations

The interaction between D&O insurance and contractual indemnities can give rise to confusion in circumstances where cover is needed. This in turn can cause directors to believe that they have coverage, despite failing to review indemnity terms when starting employment. When issues arise, it can be difficult for directors to accept weaknesses in their indemnity policies, and conversely, companies can find themselves dealing with people with broad indemnities given upfront who have not met their obligations.

To avoid this situation, companies should make every effort to ensure that the list of individuals covered by both D&O policies and indemnities is kept up to date. Otherwise, individuals believe that they are covered, only to find out at the critical moment that they are not.

This means paying attention not just to directors but also to the officers in D&O policies; it is often pretty clear who the

statutory directors benefiting from cover are, but the term officers can be applied and interpreted much more broadly. Again, this means having a process in place to properly record changes in directorships, job titles and roles, and to ensure people are given full information on their cover when they assume new positions or move through the organisation. Consistency of approach to individuals of the same rank within a business can often get lost as people take on new roles and contracts are not renewed, but should be given careful consideration.

On the part of individuals, directors can assume that they are covered by indemnities precisely because they hold directorships, but in fact the Companies Act focuses on what directors can be indemnified for, rather than stipulating that they must be covered. One of the ways a director can mitigate this risk is by ensuring that they are covered by contractual indemnities in their letter of employment, rather than waiting until the day comes when the cover needs to be tested.

In the event that claims are made under contractual indemnities, issues can arise in circumstances where clawback provisions apply, over when it is appropriate for the company to demand repayment of costs in the event of a successful prosecution. In these cases, it often falls to remaining directors to decide how to react, balancing the costs against the threat of damaging the company's reputation in any publicity that may surround the situation. Better drafting of contracts on this point can alleviate some of the confusion when the business is in the spotlight.

The key message for both individual directors and officers and their employers is the great value that should be placed on getting D&O policies and indemnifications right at the outset, and keeping them up to date through the course of an individual's career. Things that are overlooked in the good times can cause big problems should problems arise, not only for the individual left exposed, but also for the company, which will never benefit from a messy and confused situation with its own employees in an instance of regulatory investigation or litigation.

D&O insurance policies: the cover they provide

A D&O insurance policy can provide protection in the form of:

- defence costs cover (civil, regulatory and criminal proceedings), with no repayment risk in the event of the director being found to have acted wrongfully unless they are found to have acted dishonestly or fraudulently;
- cover for director/officer liability to the company or an associated company. The law precludes a company from providing a director with indemnity protection in respect of liability to the company itself, so a D&O insurance policy can provide a broader range of indemnity protection than a company indemnity can do;
- a source of indemnity protection that is independent of the company, thus removing the conflict problems that arise when the company is involved in the claim against the director; and,
- a source of indemnity that is available even if the company has become insolvent (rendering any corporate indemnity valueless).

But a D&O insurance policy will be subject to policy exclusions and an aggregate policy limit that does not appear in typical indemnity arrangements, and a D&O policy is subject to an annual renewal and renegotiation process.

Indemnity contracts: the cover they provide

An indemnity agreement can, subject to its terms, provide protection in the form of:

- an uncapped indemnity;
- no policy exclusions (though most indemnities do include a number of conditions);
- no insurer payment refusal/default/insolvency risk; and,
- a long term indemnity assurance, which is not subject to annual renegotiation, and thus to the risk of change or cancellation.

But restrictions imposed by law on the scope of what is permitted by way of indemnification to a director mean that an indemnity contract for a director is likely to be more limited in its scope, and that defence costs are only available as incurred on the basis of a loan, which could potentially have to be repaid if the director's defence fails.

Risks that neither D&O insurance nor company indemnity can cover

Neither a D&O insurance policy nor a corporate indemnity will provide a director or officer with indemnity protection against:

- (i) liability arising by reason of the director's dishonest, fraudulent or criminal conduct; or,
- (ii) criminal fines or regulatory penalties.

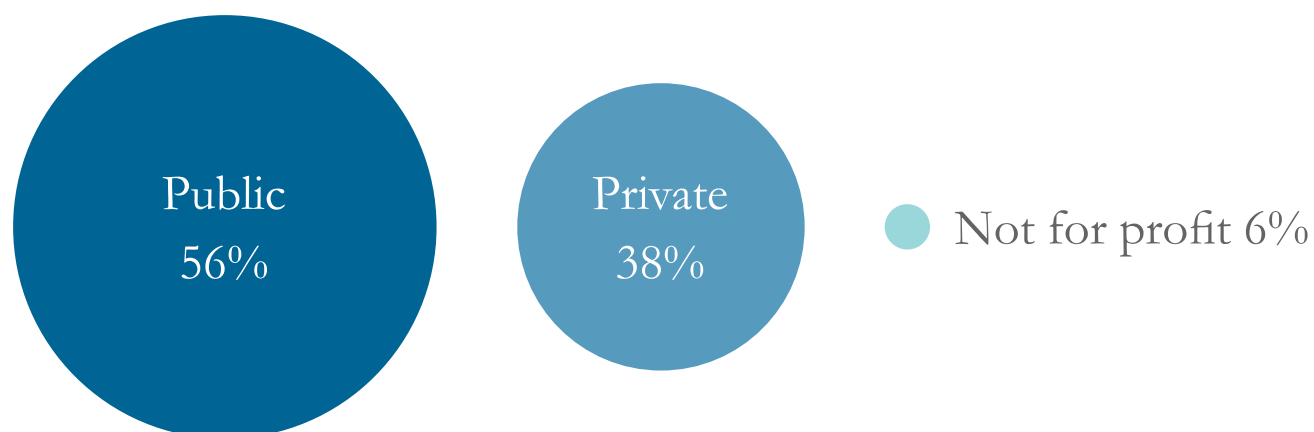
Methodology

The changing face of personal exposure – our key findings

When conducting our survey, we received responses from more than 125 individuals – comprising directors, non-executive directors, in-house lawyers, risk experts and compliance professionals. We asked about their experience of claims, their current levels of protection, and their concerns around liability going forward.

The majority of our respondents, 56%, worked in public companies, as compared with 38% from private companies. In terms of international reach, 39% worked in companies that conducted most of their business in the UK, while 35% described their businesses as global. Further, 42% of our respondents this year are from financial institutions.

Respondents



“The majority of our respondents, 56%, worked in public companies, as compared with 38% from private companies.”



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