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Directors’ and Officers’ Liability from an Insurance Perspective

I. Introduction

The fast-moving business world involves complex financial risks for directors and officers (D&Os): Managing globally operating entities exposes them to potential liability claims from a long list of different stakeholders. In any business, financial risks are an unavoidable part of day-to-day operations. Claims against an entity or against its directors and officers can potentially come from shareholders, customers, suppliers, employees, competitors and regulatory or tax authorities. Major corporations may also seek insurance protection for their financial risks arising out of stock trading and listings, business operations, public offerings and M&A activities. Furthermore, emerging risks such as cyber-attacks or data breaches, new technologies and climate change increase the complexity of risk management and the potential for claims against the directors and officers.

Considering the strong media focus on corporate governance, the heightened awareness of shareholder and consumer rights among many stakeholders and the increasing regulatory enforcement activities, adequate insurance solutions are a part of companies’ effective risk management.

II. The D&O Insurance Market

D&O insurance was introduced to the US by Lloyds in the 1930s after the Black Friday in October 1929, when economies were running badly, worldwide stock markets dropped to a historical low and, in consequence, D&Os were facing many shareholder claims. Since the 80s the demand for D&O insurance has been booming outside the US too, especially due to the globalization of the world’s economies and the introduction of corporate governance rules and various consumer and shareholder protection laws.

In its early years in Europe and Asia, D&O insurance coverage was rather narrow. Claims under these policies were rare, and profit margins were attrac-

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tive. In recent years, however, markets have changed significantly owing to fierce competition amongst insurance players, innovative wider policy wordings and premium decreases. In addition, public and regulatory awareness of managers’ behaviour and liabilities has steadily resulted in far higher exposures towards claims.

Worldwide, the D&O insurance market amounts to approximately USD 10.5 billion\(^1\) of premium volume, with the US market representing around 60% of total business. Europe is the second largest region with an estimated market share of 25%, ie USD 2.6 billion. Asia Pacific, Canada and Latin America follow with stable and low single digit figures.\(^2\)

With the recent mergers in the insurance industry, the D&O market has become more concentrated. The top 10, globally operating D&O insurers, such as AIG, Chubb, XL Catlin, Lloyds, Zurich Insurance and Allianz, have a market share of more than 70%.

Market penetration of this product as well as insurance limits vary strongly from country to country, depending on the size, listing and international exposure of the particular company. Nearly all US-listed and the vast majority of Financial Times Stock Exchange (FTSE) 500 companies and larger financial institutions buy D&O insurance due to their high exposure towards shareholder claims and regulatory actions. Insurance limits can easily reach USD 1 billion for these companies. In the private and small to medium-sized entity sector buying rates are estimated to range between 30 and 50%, with insurance limits of USD 5 to 50 million.\(^3\)

However, when considering these figures, one must always keep in mind that since D&O claims and their coverage could be a massive reputational risk for corporations and their managers, D&O issues are often handled strictly confidentially. Besides that, more than 95% of D&O claims are estimated to be settled out of court. Consequently, there are no reliable statistics available for most of the D&O markets around the world (with the exception of highly regulated countries, such as Brazil\(^4\) or South Korea\(^5\), which makes research rather difficult.

\(^1\) Munich Re estimation.
\(^2\) Source: Finaccord, Axco Reports, Munich Re estimations.
\(^3\) Munich Re estimations.
\(^4\) Via SUSEP, the Brazilian government insurance authority (<www.susep.gov.br>).
III. Risk Drivers, Causes of Loss and Emerging Risks

Through the change in litigation mentality, with increasing activism from shareholders and law firms, the worldwide tightening of regulations and corporate governance requirements in recent years, the actual frequency as well as severity of D&O claims have grown. Market experience shows that – depending on the legal environment – every tenth to seventh policy has already been affected by a claim.

Samples of risk drivers for claims against D&O

In particular, high exposure for D&O litigation arises out of:

- Public offerings of securities/IPOs (eg Facebook 2012, US),
- Bribery and corruption incidents (eg Siemens 2006, Germany; Banco Bradesco 2015, Brazil),
- Bankruptcies (eg Worldcom 2002, US; Arcandor 2009, Germany; IKB Bank 2007, Germany),

often being followed by shareholders’ actions, regulator and prosecutor investigations and liquidator claims.

In the majority of the cases, claims against managers are based on

- Non-compliance with laws and regulations
- Negligence
Securities class actions are still the highest exposure for D&O losses in the US. According to Kevin LaCroix, author of the well-known ‘D&O-diary’, however, ‘The Era of Collective Investor Actions Outside the U.S. arrived with a vengeance in 2016 ... For the companies, these developments mean that their D&O claims exposure has expanded...’.

One reason for this are the newly introduced mechanisms for collective redress that were introduced throughout Europe over the last years. They go back to attempts of the European Union to implement a Europe-wide collective redress scheme. When these attempts failed, the European Commission issued recommendations to all Member States in June 2013, to introduce national tools for collective redress, based on certain common principles proposed by the European Commission. While clearly rejecting the US style system of ‘class actions’, these recommendations had the clear objective of making law enforcement more efficient and improving the options for potential claimants.

Several European countries have already adapted their legal systems to allow large numbers of claimants to jointly reach compensation by litigation or settlement. Examples are opt-in class actions in Italy and France, model case proceedings according to the Kapitalanleger-Musterverfahrensgesetz (KapMuG) in Germany, mass settlements in the Netherlands under WCAM and group litigation orders in the UK. In addition, in some jurisdictions, the introduction of contingency fees and litigation funding mechanisms have made it easier to bring shareholder actions. This might further impact the litigation culture in these markets.

In 2016, two large collective redress actions, both subprime related, were settled in The Netherlands and the UK after they had previously been dismissed in the US:

(1) Fortis, a globally active Belgium banking company, got into severe financial trouble after its acquisition of ABN Amro Bank at the beginning

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8 Commission Recommendation of 11 June 2013 on common principles for injunctive and compensatory collective redress mechanisms in the Member States concerning violations of rights granted under Union Law, 2013/396/EU.
9 For more details see WH van Boom/G Wagner (eds), Mass Torts in Europe (2014).
of the financial crisis. As a consequence, Fortis was confronted with a securities class action against its D&Os and the entity itself under the US securities laws in 2008. The plaintiffs alleged a misrepresentation of the value of collateralized debt obligations by the defendants. Using the argumentation of the *Morrison v National Australia Bank* US Supreme Court decision,10 the case was, however, dismissed by the US courts in 2010. Eventually, two US securities law firms brought the case to Europe. Together with a few Dutch shareholder rights groups the activists finally reached a collective settlement agreement in the Netherlands, following the Act on the Collective Settlement of Mass Claims (WCAM) procedure. In 2016 the plaintiffs finally reached an agreement to settle the Fortis shareholder claims for an amount of USD 1,300 million, thereof USD 313 million to be recovered by D&O and POSI (Public Offering Securities Insurance) policies. The settlement has to be approved by the Amsterdam Court of Appeals.11

(2) In April 2008 the *Royal Bank of Scotland (RBS)* issued new shareholder rights, just a few months before the bail out of the bank by the British government. After the failure of shareholder claims in US courts, several investor groups subsequently sued RBS for alleged misrepresentation of the bank’s financial condition in the prospectus. The partial settlement amount of USD 1,222 million in December 2016, already constitutes the largest ever collective investor action recovery in the UK. Compensation via D&O insurance is still open.

**Defence costs**, linked to different types of claims, are another main exposure for the D&O insurance industry, both in frequency and also increasingly in severity. In the US, due to a traditionally highly litigious environment, defence costs already reached double-digit million figures some time ago. Over the last few years, markets in Europe have observed significant increases of defence costs incurred, often in the context of anti-trust, bribery and corruption incidents or complex multinational cases, and especially when US regulatory bodies are investigating (eg ‘Dieselgate’ scandal).

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IV. Insurance Products and Coverage

Directors and officers acting in their capacity as companies’ managers can be held liable with their personal assets. Buying D&O insurance can protect them against financial loss arising from claims due to any actual or alleged negligent wrongful act committed in their function as such (so called ‘Side A’ cover). Coverage for loss of an entity to the extent it has indemnified the D&Os for such loss is normally also included in D&O insurance policies (‘Side B’ cover). Claims against the company itself can optionally be insured, if these are related to securities actions (‘Side C’ cover). Defence costs are a standard part of the coverage.

Structure of a traditional D&O insurance policy

Also, because the legal and liability environments around the globe are very different, standard D&O covers have virtually never been existent or have only been designed for specific niche segments. Hence, insuring the liabilities of D&Os is addressed by a broad array of specific products with distinct characteristics and developments for various industry segments, sizes of companies and jurisdictions.
Options for D&O coverage

D&O covers are also often **tailor-made according to national law specifics.** A few examples for further illustration:

In **Germany**, the highest exposure for D&Os is posed by ‘internal’ liability claims, ie claims by the supervisory board against executive board members. Coverage for so-called insured versus insured claims (ie supervisory board sues executive board) or company versus insured claims (ie by instruction of the annual general shareholder meeting the supervisory board claims against the executive board) is therefore standard.

Another specific criteria of the German market is § 93 II of the German Aktien-gesetz (Stock Corporation Act, AktG), which requires that a certain part of a loss (10%, max 150% of the yearly fixed income of the manager) cannot be covered by D&O insurance.\(^\text{12}\) This attempt by the German legislative to avoid moral hazard has, however, failed. In fact, the resulting gap in coverage can now be covered by a separate policy directly acquired by the director (Selbstbehaltspolice).

In **Italy** and **Belgium**, the law requires defence costs to be compensated by the insurer in addition to the agreed annual aggregate of the insured policy limit.\(^\text{13}\) As insurers hesitate strongly to pay *illimité*, they often limit this exposure with a certain percentage of the actual policy limit.

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\(^\text{12}\) Cf in detail *G Wagner*, Directors’ and Officers’ Liability in Germany (in this book) no 141.

\(^\text{13}\) *A Scarso/M Mattoni*, Directors’ and Officers’ Liability in Italy (in this book) nos 249 and 252.
In France, the Loi de Sécurité Financière demands an automatic, premium-free 5-year extended reporting period that is triggered if the policy is cancelled and not replaced by the insured party. This results in many requests to significantly extend the worldwide standard trigger ‘claims made’ for D&O policies.

V. Outlook and Trends

As described above, D&O insurance recoveries are often not made public to avoid reputational risk. Therefore, the impact of these cases on the D&O market, especially on insurers’ profitability is usually not apparent. Nonetheless, markets are confronted with an abundance of insurance capacity not only coming from established D&O insurers but also from new market entrants with little or no experience in this segment, causing additional strong competition with dangerous impacts on profits. Hence, in particular the commercial D&O insurance segment has been facing a very soft market environment for many years now. Coverage terms are wide and insurance prices low, with continuing reductions. Insurers and brokers are still pushing for even broader terms, such as additional insurance limits per annum (‘reinstatements’) for free or for multi-year policies.

After the subprime crisis, insurance terms and conditions for financial institutions got rather tight due to many D&O and professional errors & omissions related claims following huge financial losses. Despite the fact of more frequent regulatory activities regarding banks (eg due to wrongful rate fixing events, such as the LIBOR or the FOREX scandal with a series of fraudulent acts by banks manipulating interest rates or currency rate fixing), which cause large amounts of fines and investigation costs, insurance capacities and competition have again increased in this segment with premiums going down at the same time. Naturally, any significant and systemic scandal in the financial services industry might reverse this trend in the future.

Other emerging risks might influence future claims activity and the profitability of D&O insurance as well. A few examples:

Over the last few years, the number of cyber incidents – such as massive data breaches and the sophistication of malware – dramatically increased and became almost commonplace, affecting an ever wider range of entities and consumers. While many companies are by now well aware of the importance of cybersecurity issues in general, this awareness does not yet always include cyber related liability risks for D&Os. The failure to implement and/or to control adequate security measures for the entity’s own IT systems or its cloud service providers may lead to financial losses, reputational damage, and finally to claims
against D&Os. A number of current D&O-related litigation cases suggest that an increasing number of lawsuits in this context will eventually be filed. Recent prominent, partly still pending, cases involve US domiciled companies such as Target Corp., Home Depot and Wendy’s.

**Climate change** and related regulatory requirements for corporations might also gain in importance for D&O insurance. There might be a growing potential for corporate boards being held accountable for failures in fulfilling their regulatory and fiduciary duties in this respect. Improper reporting of environmental incidents or the lack of adequately mitigating measures for such occurrences could thus give additional exposure to the insurance of D&O risks.

Taking these trends, which point to tremendous potential for further corporate and personal liability for managers, D&O insurance is expected to remain very dynamic. Evolving regulatory enforcement, worldwide corporate governance requirements, litigation funding and shareholder activism will be the main drivers of loss frequency and severity, causing further demand for insurance coverage. Ever more often D&O insurance underwriters, especially those who are underwriting publicly listed companies, are confronted with increasingly complex risks. Further premium decreases, extensive coverage terms and continuing fierce competition would be the wrong answers to these developments. In fact, high quality levels of underwriting skills, long-time experience and a thorough understanding of those risks will remain essential for gaining a profitable D&O insurance book.