

INSURANCE

RISK

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## HKCGI Guidance Note – Beyond Pricing Considerations for D&O Insurances

The governance professional will know that directors' and officers' (D&O) insurance is an important risk mitigation tool. The governance professional will also know that not all D&O coverage is the same and that there are exclusions and deductibles. Certain items, for example, fraud or certain regulatory fines, cannot be covered. Therefore, care needs to be exercised in the selection of D&O insurance. However, the governance professional might not be aware of some of the more pertinent issues that go beyond pricing, and the purpose of this guidance note is to highlight some of these not-so-readily apparent but practical issues.

The governance professional would no doubt run or contribute to a normal diligence process to select the appropriate D&O coverage with input from reputable brokers or other financial advisers. By understanding the pertinent issues under this guidance note, the governance professional should more effectively select which insurer to select over what D&O risk coverage

by asking appropriate questions. However, there is no one-size-fits-all, and the governance professional might have other considerations specific to their organisations.

As the operating environment becomes increasingly challenging, organisations' risks will become more complex. Against the background of the heightened expectations of directors from shareholders and regulators, Boards should focus more on how these risks can be managed and mitigated. As indicated above, D&O insurance is one way of mitigating these associated risks for the directors.

### Risk Trends

We start with some common emerging risk trends that might be useful for the governance professional to know. These are based on questions raised by brokers in the marketplace.

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- **Cyber and data loss risk.** Cybersecurity appears to be a daunting new risk, and every director should have a general understanding of cybersecurity risks and what they mean for directors' duties and responsibilities. As boards are in charge of ensuring a company's compliance with proper financial systems and controls, cybersecurity should also be part of a board's overall duties, including oversight of appropriate risk mitigation strategies, systems, processes and controls. Officers should also implement appropriate cybersecurity and related mitigation strategies.
- **ESG disclosure.** From climate change litigation to diversity and inclusion, ESG issues are a key source of emerging liability for directors and officers. Investors and consumers increasingly expect companies to actively address ESG considerations while businesses face an evolving and expanding range of ESG-related disclosure requirements and regulations. While not commonplace in Hong Kong, climate-related litigation has seen significant exposure on directors and officers, in particular, regarding allegations of greenwashing.
- **Insolvency Risk.** Insolvency is a real threat to all companies, and it can originate from various factors such as bad cash flow management, excessive expenditures, client failures, etc. High inflation, high-interest rates, and looming recessions in some countries put businesses under pressure. Higher insolvency risk brings multiple liability exposures for directors and officers, who are always under intense scrutiny for company fallouts.
- **Geo-political Risk.** An observation is that D&O policy typically does not cover geo-political risk. Other insurance products could cover specific perils, including civil unrest, but not under D&O insurance. Insurance brokers or other insurance professionals should be consulted on risk coverage.

The above is not exhaustive, but governance professionals should be aware of emerging risk trends that brokers and other insurance professionals are increasingly being asked about on D&O coverage. There might well be other risks particular to an organisation. The key message is that the governance professional needs to be aware and able to ask more relevant questions.

### Coverage Assessment

After understanding emerging trends, the governance professional should know the relevant issues to consider in coverage assessment.

- **Cyber.** When a cybersecurity breach occurs, the actions of the board and senior management may be under scrutiny. Board members may breach their fiduciary duties to the company and its shareholders if they fail to oversee the cybersecurity and data protection controls. Additionally, the actions of the board and senior managers may also come under scrutiny after a cybersecurity or data breach incident about how they handle notification to the regulators, shareholders, and customers whose personal data may be affected.

It is thus important to pay attention to the cyber coverage in your D&O policy: for example, whether there is a cyber exclusion, silence on cyber security incidents, or offering affirmative cyber cover, as well as the drafting of these clauses. For D&O insurance with affirmative cyber coverage, this could potentially extend the costs of regulatory investigations of directors for breach of their duty of care, skill, and diligence for cybersecurity oversight (discussed below). However, D&O policy does not cover the costs of data recovery and/or ransom payment, which is a typical coverage under Cyber Insurance Policy.

- **Insolvency.** Whether the D&O policy contains an insolvency exclusion provides that the

insurer cannot pay under the policy 'for loss directly caused by, arising out of, attributable to or in any way connected with any insolvency event'. The interpretation of such extensions will depend on the particular claim's drafting and nature. 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'.

- **Investigation.** Most D&O policies these days cover legal expenses relating to formal interviews or document production costs when a director or senior manager is brought into an official investigation in their capacity. Further to the official investigation cover, some policies will only include cover for internal investigations carried out in response to a request from an official body. Policies that align with current practice should include costs incurred at the pre-investigation stage, costs associated with dawn raids and the costs involved with self-reporting to official bodies. However, there might be exclusions to pay regulatory fines or other non-permitted indemnities at law.
- **Order of Payment.** D&O policies should contain an order of payment clause, also known as the priority of payment clause, favouring directors and officers over the company. An order of payment clause is important since a typical D&O policy covers non-indemnifiable loss of Insured Persons (Side A), indemnifiable loss of Insured Persons (Side B) and the Insured Entity where it is the defendant in securities litigation (Side C). If multiple parties are involved in a claim, this clause becomes relevant where the limit of liability might be insufficient to the estimated total loss.

However, different jurisdictions apply different rules regarding the payment and potential exhaustion of D&O policies. These include the first judgment rule, the first to settle rule,

and equitable allocation. The governance professional should be generally aware of these rules and seek advice on the issue.

- **Insurer Selection.** Is there a right to select the insurer and insurance panel for the D&O program? The following items will explain this further.
  - o **Financial Rating.** An insurer's financial strength is important because it indicates the insurer's ability to meet its financial obligations in good and bad economic conditions. Three main rating agencies publish financial ratings of insurance companies: Standard and Poor's, A.M. Best, and Fitch Ratings.
  - o **Consistent Approach.** Some insurers tend to enter into and/or pull out from particular products or segments following the hard and soft market cycle. Whilst such insurers may be able to offer lower prices during good times, the insured should select an insurer who will stay in the market in both good and bad times, as well as a more consistent approach in pricing and underwriting appetite. For example, an insurer can decide not to cover certain risks at short notice, leading to a scramble for insurance coverage. Thus, the track record is important.
  - o **Claims Reputation.** When a D&O claim occurs, directors and senior managers hope to experience all promises when purchasing the policy. Thus, knowing the insurer's reputation for a smooth claim process and paying claims is important.

For example, the governance professional might want to ask questions including whether the insurer has its own experienced claims staff or whether it uses outside law firms for its claims, whether the insurer has claims staff or

service team in the countries or regions the insured operates, how many D&O claims the insurer handle and pay in the past five years, etc.

### Questions to Ask Before Becoming Board Directors

The governance professional should know that sophisticated and experienced directors and officers nowadays would not join a public company unless that company provides adequate protection, including D&O coverage. Their questions, which the governance professional might be asked to help answer, could include the following, which also serves as a recommended checklist on D&O coverage that goes beyond the pricing decision:

- Is there an indemnification agreement to specify the indemnification to the maximum extent permitted by law and the procedures individuals must follow to obtain indemnification?
- Whether D&O Insurance will step in when the company refuses or cannot indemnify the directors and senior managers?
- Does the policy include an order of payment clause that expressly provides that insured persons seeking loss payment have priority of claims for coverage overpayment to the entity?
- Is the D&O policy limit adequate? Should such an event occur, has the program designed a catastrophic event to maximize protection for the company and its directors and officers?
- Does the D&O policy respond to emerging risks, such as cyber, ESG, bankruptcy, and if so, what are the exclusions?
- Are there additional limits in place for NEDs/ INEDs?
- Is lifetime run-off coverage in place for directors or officers resigning for reasons other than an M&A transaction?
- Does the insurer have its own experienced claims staff, or does it use outside law firms for its claims?
- Does the insurance company have an office in Hong Kong or the Chinese mainland for easy contact in urgent cases?
- Does the policy allow the company to request an extra period, say 12 months, in case the insurance company intends not to renew the contract for whatever underwriting consideration?
- Does the insurer have claims staff or service team in the countries or regions where the insured operates or have the stock trading?
- How often has the company changed their D&O insurers in the past five years?
- How many D&O claims did the insurer handle and pay in the past five years?