SPECIAL REPORT

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The implications of Brexit on D&O risk

British Prime Minister Theresa May has made it clear: Brexit means Brexit.

But for businesses in every sector precisely what impact the referendum result will have on their operations is much harder to fathom. But fathom it they must if they are going to stay on top of their directors' and officers' (D&O) risk.

Leaders have now had plenty of time to make plans. Any company not able to demonstrate its preparedness is going to look exposed and the last thing investors want to hear anyone saying is: "We don't know. We'll wait and see."

Brexit has the potential to be a serious event for the unprepared. "If business leaders mismanage this risk, if they miscommunicate it to the market, they could be held accountable," says John Hopper, UK head of financial lines at AIG.

"It's as simple as that. If you say things today that later turn out to be untrue, you will be held responsible. The stakes are high in all sectors from finance to retail and across all areas of those businesses and, as a result , D&O needs to be a boardroom issue."

FUNDS CLOSED

An early example of one way that Brexit could change D&O risk emerged soon after the referendum result was announced, with the closing of many big commercial property funds as investors rushed to withdraw capital. This may have affected the value of those funds.

Nick Williams, head of Kennedys Law insurance division, says: "It follows that any decisions made by D&Os in the period leading up to 23 June that were dependent on such valuations may now come under attack and lead to claims.

"The directors and officers of companies that failed to plan adequately for a leave vote in the Brexit referendum may be vulnerable. It may be claimed that they failed in their obligations by not taking adequate precautions."

In this environment it is vital to stay one step ahead. Boards must identify their principal risks, assess them and get assurance from management that they are being adequately managed.

"Directors are facing greater scrutiny and demands for sharper governance," says Airmic deputy chief executive Julia Graham.

"In a world of greater complexity, with change at increasing velocity fuelled by technology, whatever sector forms the context of the directors' business, the role of director is 'high octane' and one where the role demands transformation, not evolution. Evolution infers time – time is not on their side.

"D&O liability insurance cover should be a board agenda item.

"Directors should consider a legal health check is undertaken across their wordings with brokers and insurers. The FRC Code, Cyber and, now, Brexit all have potential director exposures. Boards should not be complacent and be confident they understand them."

Since the EU referendum there have already been significant changes and there will be more to come over the next few years. Trends and step changes in the business context will emerge.

John Ludlow, executive director of Leading In Risk, says: "Shareholders have a right to expect that their boards are on top of both these opportunities and threats.

"Failure to reasonably protect or take opportunities that others see may leave directors liable.

"Now is not the time to be complacent. Business models need to be reviewed in the new and emerging context for business in the UK. Changes, threats and opportunities need to be identified, assessed and prioritised. All business strategies then need to be reviewed and refreshed."

To do this, risk and strategy managers need to work together with senior managers to identify risks to the business model, strategy, markets and stakeholders such as suppliers, staff, and partners.

"They need to prepare to support the board to assess the risks fully, then work with senior managers across the business to develop strategies for the board to consider," says Ludlow.

PLANNING FOR CHANGE

Any changes need to be absorbed into the business planning cycle and change programme.

"If significant change is envisaged, a Brexit transformation programme may be necessary," says Ludlow. "It may be necessary to beef up the quarterly business review to consider the risks as they emerge."

Risk managers should be aware that their "risk register" may not be the best way to present new information to the board.

Institute of Risk Management Technical Director Paul Hopkin says it is the responsibility of the risk manager to make the information dynamic, relevant and aligned with the business model and strategy of the company, rather than a static snapshot that produces a list of risks that seem disconnected from board member priorities.

"The fact that UK boards are challenged with the obligation to develop a longer-term viability statement has resulted in better engagement of board members with risk management and enhanced the board discussion of risk," he says.

But while leaders may be more aware of risk, many are still unclear on how they might be affected by it, says Mark Simpson, head of consultancy at Armour Risk Management. "There's lots of information and misinformation but little that's concrete yet."

For this reason it's also the risk manager's job to help make sure firms have the right D&O cover in place, says Leslie Kurshan, head of product development in the financial and professional practice at Marsh.

"Brexit presents management challenges, which in turn creates D&O risk. Now is the time to review your executive protection programme to make sure that it is robust and that you understand your obligations in relation to it.

"[It] should be reviewed regularly and considered in the context of real life risks.

"With regard to D&O insurance, the inquiry should go beyond confirmation that the company purchases the policies and the amount of the limits in place," Kurshan says. "The terms of D&O policies vary widely, particularly in relation to cover for evolving risks like informal and internal investigations."

And, for the cover to be useful, key people need to understand their obligations under it, so that they comply with the terms.

"Be sure that you understand what needs to be notified and disclosed to insurers so that rights under your insurance aren't inadvertently lost for failure to do so," warns Kurshan.

It's also worth remembering that Brexit may not only affect what cover is needed – but also where that insurance is bought.

At the moment, companies can buy their D&O cover from a UK-based carrier that will cover their European operations. But, depending on the negotiations, it may be that in the future an insurer will no longer be able to provide this service from London.

"In those circumstances, companies wanting to buy D&O that would be effective around their European operations might need to purchase individual policies in EU countries issued by an insurer licensed to operate in all those territories," says Williams.

But in the coming months and years perhaps the biggest risk for individual companies – and the broader economy – is that decision-makers simply stop taking their businesses forward. Smart firms will use their D&O insurance as an enabler.

"If company boards decide to delay all strategic investment pending a clearer picture it is feasible that this would lead to two or three years of complete inaction," says Williams.

"Inaction for that length of time would probably be the worst possible approach.

"It may be, therefore, that the best approach is 'business as usual', but on the basis that when a decision is made, consideration should be given and matters arranged so that adjustments can be made at short notice to take into account changes in trading relationships with EU countries."

Prepare and protect, but stay nimble. And remember: risk and opportunity are two sides of the same coin. **SR**

'IF BUSINESS LEADERS MISMANAGE THIS RISK, IF THEY MISCOMMUNICATE IT TO THE MARKET, THEY COULD BE HELD ACCOUNTABLE'

Brexit and trade credit risk

Uncertainty and financial planning are never easy companions. But Brexit means all firms need to find ways to help them coexist.

While it now seems that much of the doom-laden pre-referendum rhetoric was an exaggeration and we are unlikely to see the kind of financial meltdown we saw in 2008 – with the associated international credit crunch – there are still real risks to trade credit.

"We are looking at a protracted period of uncertainty and volatility," says Neil Ross, AIG regional manager EMEA for trade credit.

"We are likely to see a high level of insolvencies, of projects put on hold – and of losses. All of this will affect trade credit and firms need to manage this risk more proactively.

For example, it is possible that credit vulnerability and credit claims in the UK could increase markedly, "particularly in relation to the construction sphere", says Nick Williams, head of Kennedys Law insurance division.

"It seems reasonable to anticipate that many projects will be put on hold and a snowball effect could easily occur."

In those areas that attract international players the considerable fall in Sterling may well add to a counter-balancing flood of money from abroad, but in most of the UK that may not be significant.

Some might argue that, traditionally, credit risk management is the responsibility of the corporate treasurer in a large company. But in a Brexit scenario it's clear that the risk manager needs to be intimately involved in navigating their employer through these difficult times, especially because of the importance of insurance in securing a successful outcome.

"[Risk managers] must support the assessment of credit risk and should also ensure that directors' and officers' (D&O) underwriters are kept informed of changed circumstances," says Mark Simpson, head of consultancy at Armour Risk Management.

"The risk manager needs to understand the issues and support consideration of risk factors when the company seeks to gain access to additional capital."

FINDING NEW MARKETS

While the knock-on effect of the UK leaving the EU is impossible for businesses to quantify with meaningful accuracy, it is likely that small and medium-sized businesses – those that do not have the scale to shift their trading patterns or adapt to new market conditions easily – will be among those hardest hit, says Ross.

"The likely consequences of Brexit will be the need to find new sources of business or to step up trade in less familiar markets," he says.

"If firms are going to become more export- focused they will need to position themselves more effectively. And they are going to have to think seriously about how they manage their credit risk."

One way to do this is with trade credit insurance (TCI), which offers companies a degree of certainty over their cash-flow. TCI provides protection for companies that sell goods or services on credit terms and are exposed to the risk of non-payment as a result of a domestic or export customer's insolvency, protracted default or political risks that may prevent the buyers from fulfilling their payment obligations.

MANAGEMENT TOOL

"Managers responsible for buying insurance know about property and casualty risks, but often don't know about the moveable feast that is trading risk," says Ross.

"Or that TCI is not just a commodity but a highly effective management tool to help companies avoid taking on other companies' risks, and thus minimise bad debt."

In recent years, TCI has become widely seen as a discretionary purchase. Market penetration is relatively low – around 20% in the UK. This is partly because, in the fallout from the 2008 banking crisis, trade credit products were accused of being "fair weather friends", with some providers arbitrarily pulling cover just as it was needed most.

"But the market has moved on significantly since then," says Ross. "Innovation has been led by greater proliferation of excess of loss, non-cancellable cover, which stops credit insurers from reining back or withdrawing their credit limits."

Brexit is making this type of cover more essential than ever, both as a protector and a business tool providing a competitive edge.

For example, those firms that export heavily into the EU could in future face a situation where that trade is governed by separate legal regimes and limited by trade agreement.

D&O/TRADE CREDIT INSURED V INSURED

A significant problem for directors and officers of firms without trade credit insurance (TCI) could be that their D&O policy limits are spent defending claims arising from the firm's failure to purchase TCI, meaning that there could be nothing left for the benefit of the director in the event of a "real" claim, according to Noona Barlow, head of liabilities and financial lines claims, Europe at AIG.

"We have seen several similar claims against directors as a result of a company's failure to have any trade credit insurance," she says.

"The facts in each claim scenario are very similar. Usually, the policyholder sues one or more directors as a result of losses arising from non-payment by customers, frequently as a result of the insolvency of the customer.

"In each case the allegations suggest that the director or directors granted credit or increased credit limits without internal authority and/or that they failed to obtain adequate security from the customer."

PROTECTING KEY STAFF

One of the main risks associated with Brexit is the potential for changes to the residency status of key expat staff that may affect their ability to work- and having the right insurance is critical to addressing this uncertainty.

To meet this need AIG recently launched an addition to its D&O policies that will cover legal challenges in the event of permanent residency applications being rejected pre Brexit, and the subsequent challenges to repatriation orders post-Brexit.

Separately, the new addition will also cover legal costs for executives living in the UK and EU to fight a repatriation order as a result of termination of the UK's EU membership.

Should the legal challenge to the repatriation order be unsuccessful, the addition will also cover reasonable relocation costs of repatriation.

Faced with possible changes in access to EU markets, many firms are looking to export further afield. But this will mean tolerating longer payment terms. Not only to allow for longer shipping times, but also to stay competitive.

"If you look at every sector, every year payment terms have increased by 2.5-3%," says Ross. "If you go back 10 years, 45 days was standard.

"Now it's 90 or even 150. Being able to offer long terms has become a marketing tool, and that has to be financed. Working capital will have to increase."

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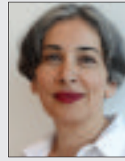
But, while many traditional banks were happy financing trade into the EU, they may be much less happy about markets in Africa or Asia – unless trade credit cover is in place.

In these circumstances, the right insurance could be the difference between getting a bank's support in a time of change, and being left adrift.

The expectation is that Brexit will take time to work through.

Protecting working capital and receivable assets is essential in this environment: firstly to ensure that a company remains competitive and profitable, but secondly to protect the board from the kind of D&O claim that could deliver the coup de grace to a firm trying to adapt fast to Brexit. **SR**

MARKET INSIGHTS



NOONA R A BARLOW
Head of liabilities and financial lines claims, Europe, AIG

Since the financial crisis, we have seen an increase in the level of claims activity involving directors and officers (D&O) and it is important for all companies to understand that this may affect them.

To get a better perspective of what was happening we undertook a review of our large loss activity, particularly with respect to D&O claims. Given that we deal with such a large volume of claims, we have a unique overview of claims activity in the market.

To do this we reviewed more than 300 D&O claims from across the UK/Europe on which we had significant reserve activity, from September 2008 to March 2016. We found that:

- Not surprisingly, almost 25% of those claims were bankruptcy related.
- Almost 17% of the claims were insured v insured claims, in which the policyholder sues directors for wrongdoing that has negatively affected the company.
- Almost 15% of the claims were criminal investigations/proceedings.
- Almost 15% were related to regulatory investigations, an area in which we have seen increased activity.

The regulatory number may actually be significantly higher, since we often see regulatory activity in addition to other types of claims activity. For example, the SEC investigates at the same time that shareholders bring investor actions. Since the financial crisis, we have seen increased activity by regulators against directors and officers, perhaps in an effort to ensure better corporate governance and to ensure that we do not have a repeat. In addition, regulators such as the Department of Justice and the FCA have publicly stated their intention to hold individuals to account.

We also considered loss location of claims and were interested to note that 33% of the claims we looked at had a loss location – the place where the claim was brought – somewhere other than the country where the policy was issued. This highlights the globalisation of the market we operate in and also the increased exposure for directors where their organisations transact business in multiple locations.

Finally, although many people believe D&O claims activity in the UK/Europe is a public company phenomenon, we are also seeing private and non-profit companies face high-value D&O claims, suggesting that all directors, regardless of the nature of the business they work in, face significant exposure from claims and need the support of an experienced insurer to assist them in this challenging market.