MPR | MANAGEMENT & PROFESSIONAL RISKS

Going Local Down in Acapulco: D&O and Overseas Subsidiaries

The question of how to most appropriately address cover for overseas subsidiaries under Directors and Officers Liability ("D&O") policies has circulated for over 15 years. That question is often more acute in territories where 'non-admitted insurance'* is prohibited on some of the more established classes of cover and is further complicated by the less developed nature of local D&O markets and the unique characteristics of D&O itself.

**('admitted' means the company providing the insurance has met the regulations set by the local insurance regulator).*

Whilst a clear and consistent answer remains frustratingly evasive, what is without question is that the most comprehensive way to cover risks in any overseas location is to buy a policy there. International D&O claims can be difficult to manage, with translational dynamics, currency controls, local legal differences and time zones amongst the issues. That said, most D&O or Management Liability ("ML") policies on the market will have 'worldwide' as the territorial default (not to be confused with jurisdiction) and without adulteration the policy would, in theory, respond to a claim from anywhere it might be possible to bring one. It is not accurate to say that a policy will not respond if non-admitted insurance is prohibited (or thought/presumed to be) because the policy ought technically to cover the loss. Whilst it may obviously prove difficult to pay a claim if the insurer is not licensed, there is nothing in the policy that should prevent it from exploring the possibility to do so. The lack of an established D&O market locally or poor levels of clarity in this class of cover is not a good enough reason for the policy not to attempt to legitimately respond. Unhelpfully, there is a scarcity of any meaningful examples on tax treatment of local payments or potential fines to act as a bellwether here. Nonetheless, increased awareness and concerns of local directors regarding their personal liability and the desire to avoid local tax issues or in-claim obstacles (payment of taxes to enable a claim to be paid or limitation/prohibition on insurance or indemnification from outside the country) means questions persist on the issue.

In an attempt to clarify the position, some D&O underwriters have migrated 'FINC' (Financial Interest Clauses*) from other classes of cover, but there is an uncomfortable and unnatural fit with D&O and they do no more than confirm what the position is likely to be in any event (pay the policyholder for loss they are obliged to reimburse to a director). These clauses are also particularly difficult to reconcile against 'Clause 1/Side A' claim scenarios (D&O Deductibles - MPR Underwriting), arguably the strongest motivation for purchasing D&O in the first place.

*(*A FINC is designed to try to protect the financial interest of a policyholder in a subsidiary and (generally) states that insurers will pay loss to the policyholder where insurers are legally prohibited from paying loss to a subsidiary company. In theory, this avoids regulatory and tax issues, and provides a cost effective way for multinational companies to avoid the need for local policies. However, FINC remain untested in claims scenarios and they fail to address any of the issues on tax, language, etc., so do no more than what is accepted to be the position without the existence of the FINC. The theory weakens further in the context of D&O).*

Much of the originating narrative on local policies was dominated by global insurers and brokers, possibly to leverage the extent to which their networks could out-stretch the competition. And yet, much of the prescription failed to cure the underlying condition and stand up to scrutiny. Solutions centred on a 'master' policy in the home country with local 'underliers' issued overseas through subsidiaries or affiliates, often with a $1m limit and a 'difference in conditions' provision written into the master policy. However, these failed to flawlessly address the key difficulties. Issues such as 'cash before cover' have always been tricky, but if the local policy fails to respond, or the limit is reached, the policyholder is precisely back where they started and in a position of no obvious advantage. There is no difference to paying $1 in excess of a $1m limit as there is to pay the first $1 without the policy existing, or failing, in the first place. To compound matters, the limited number of insurers who offer master policy capability are inconsistent in their approach to dealing with particular jurisdictions, coordination between a master and local policies, dealing with tax issues and local policy issuance. The result is often a confused and time consuming process resulting in many organisations abandoning this approach entirely.

Understandably perhaps, all of this feeds into the inconsistency of approach, and response. Much with the choice of which limit to buy, there is no standard outcome that will suit every organisation. Some are content to rely on the worldwide cover provided by the parent D&O policy whereas others may choose to purchase local policies in every country where there is an official in the territory. In the space between lies a variety of approaches with each contingent on the characteristics and scale of operation in each specific territory. If a formal subsidiary with a management board exists, this will be persuasive, and the ability to make local, independent decisions is often a key factor in the purchase process. As important as this is the attitude to risk management and compliance, along with the willingness to devote resource to an area for which there is no commonly accepted approach. Choosing a D&O insurer with global footprint is often preferred, and yet the purchase in local markets by local subsidiaries can be neater, quicker and often much less expensive, with the option to include other covers (Employment Practices or Entity Cover, for example) that are not available via the master D&O only cover. Some may set a size determinant or decide on a sliding scale of perceived risk and likelihood of foreign tax penalties or challenges to the indemnification process (or even rules on indemnification existing at all). Whilst standard approaches do not exist, they have evolved and are likely to drop into three broad categories:

1. **Rely on the default position under the 'master' policy:** where non-admitted cover is not allowed (at least in theory), attempts can be made to pay the policyholder for the reflective loss or payment direct to individuals can be investigated, but if there are restrictions, then local payment might be difficult, or even impossible. As long this is known and accepted up front, it can be the least complicated approach;

2. **Select some, but not all, countries in which to purchase local policies:** this might be done in countries where the physical presence is greatest or those which are strategically important, or where regulation is known to be tighter;

3. **Buy polices locally in every country with directors/officers:** this is the most comprehensive approach, but also the most costly and time consuming. It can be done with one of the limited number of insurers with the capability or can be more easily achieved by local purchase in the same way a UK subsidiary of a foreign owner typically buys cover. This has the added advantage of the greater product reach for other covers within the ML framework and offers substantially more choice and control, both at home and abroad.

The reality is that very few companies decide they need a local policy in every location where they have a director or officer. It is far more common for organisations to take the decision to rely on the worldwide cover provision, accepting the risk of gaps or failure in some places. Whatever the decision, it is manifestly sensible to go through a country-by-country analysis and determine which might merit a policy of its own. It may also be the case that rate reductions can be achieved if certain territories are excluded, in the knowledge that the premium offset may help to fund a purchase overseas. Local D&O markets continue to develop and mature and products are widely available in most territories, so that option is increasingly accessible. At the same time, clarity can still be hard to find and in many of the countries that potentially prohibit non admitted D&O cover, local laws fail even to address indemnification, which is the foundation upon which D&O policy architecture is drawn. All of this means that the frustration and absence of a one-size-fits-all solution is likely to persist for the foreseeable future.

This information is descriptive only. The precise cover provided is subject to the terms and conditions of the policy as issued.

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Want to find out more?

Call: 0161 241 3550
Email: enquries@mprunderwriting.com

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