D&O Liability Insurance: Inflection moment

SABZ ADVOGADOS

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Brazilian picture and D&O implications

Pedro Souza

Brazil faces one of its most remarkable moments. Its last year's political scenario reflects a social eruption handcrafted by years of promiscuous public-private relations. The deep colonial roots of such landscape are, however, far beyond the aim of this study. Therefore, let's focus on the legal layer.

In the Administrative Sanctioning field, fines and punitive measures regarding exchange and capital markets were intensified to raid specific operations (see chart 1). Environmental sanctioning procedures are growing stricter since 2015 Samarco's dam collapse and its various side effects.

In the labor law field, a deep reform was introduced by the government in a 75-year-old union-based regulation bringing a more liberal outlook. However, labor courts interpretation on such new rules is something to be observed.

Despites the clear changes in written Law, the deepest and most revolutionary innovation is setting in the Law operator's mindset. The *Zeitgeist* emerging from a 'willingness for a fair and better country' shapes stricter guidelines among prosecutors, policemen, public defenders and – which is the most dangerous – judges.

In Tax and Criminal law fields such operators' voluntarism is more evident.

As federal and local government's taxation is limited by population tax intolerance, tax authorities needed to increase collection without changing law during current Brazilian economic crisis.

The situation put in motion a "theses based taxation". Creative interpretations of constitution, tax laws and regulatory norms changed consolidated tax authorities' understandings.

On top of it, tax rule's elision is, paradoxically, being performed by the tax authorities as instrument of tax collection. The result was a record amount in total inspection value against taxpayers of R$ 205 billion in 2017.

As the raid for tax revenues climb, administrators have become collateral targets. The imposition of sanctions on them under alleged attempt for evasion has been an efficient though cruel method to bargain a rapid and non-resisted payment by the companies they manage.

In the criminal field, a half century well-built guarantee's system was ruined in last five years as the predominance of fact (and the way public opinion sees it) is guiding the judgement rather than the compliance for the rule of law.

On the fringes of such institutional typhoon, Brazilian Insurance Agency (Superintendence of Private Insurances – SUSEP) decided to set new regulation on D&O insurances. A 15-year-old mature free market is now trying to learn from a brand new canned-coverage ruling. The comfortable marketplace of policies subscribed as 'all-risks' is stealthily being replaced by a 'nominated risks' logic. The utmost good faith ruling the relations between insurer and insured had never been so mandatory – mainly in contracts formation. ■

CRUNCHING THE NUMBERS

Market Evolution
D&O Insurance in Brazil

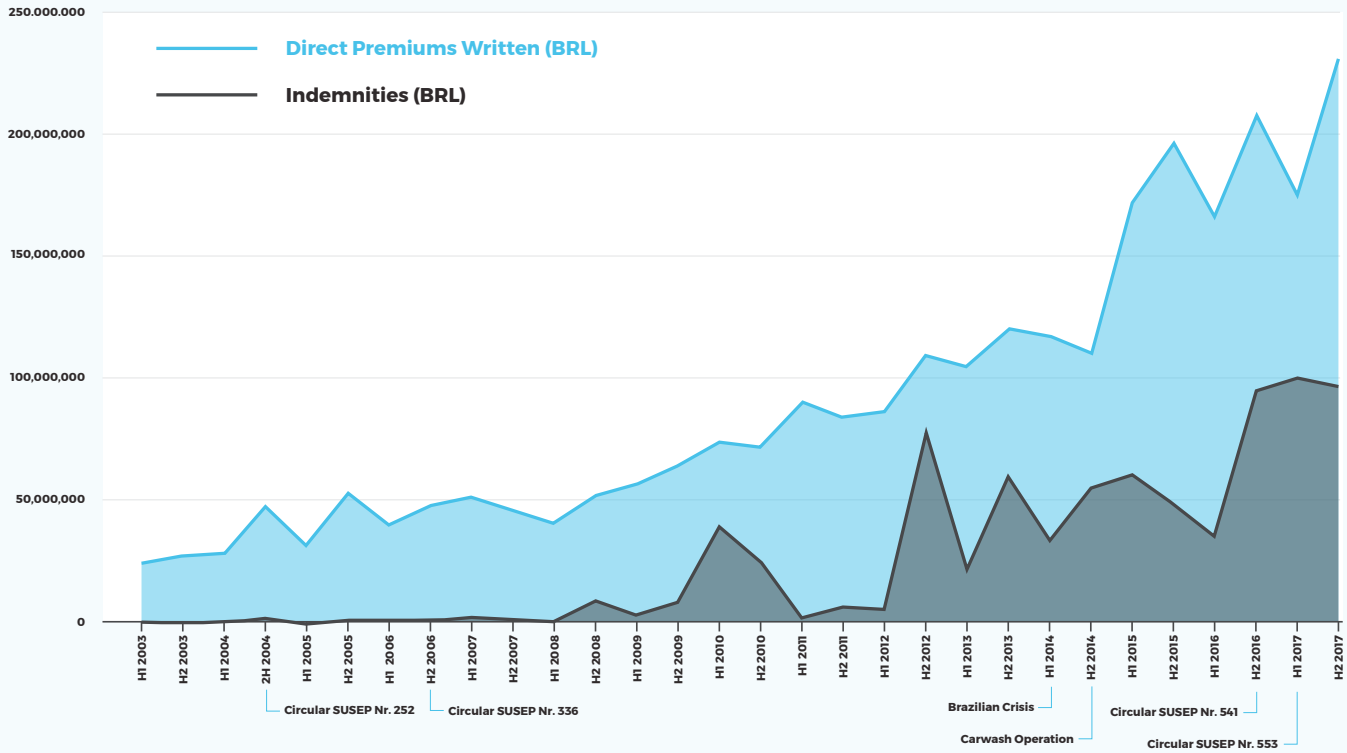

Figure 1
Source: SABZ with data from SUSEP

Environmental Liability Insurance in Brazil
Including D&O coverage

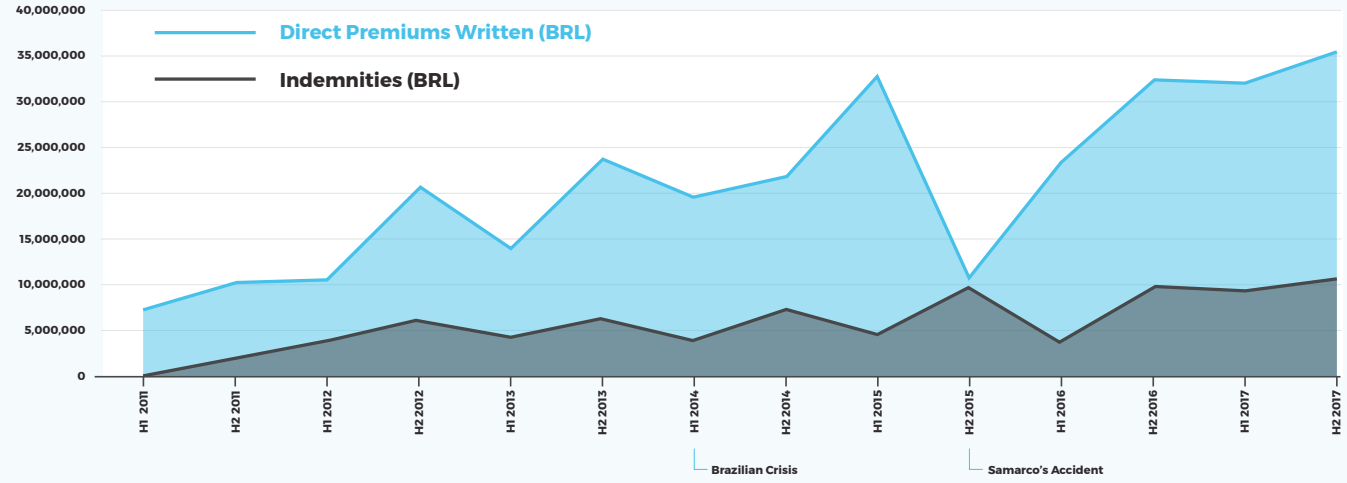

Figure 2
Source: SABZ with data from SUSEP

STILL CRUNCHING THE NUMBERS
D&O litigation in Brazil

STATE	PLAINTIFF	SUBJECT	AVERAGE	OUTCOME
São Paulo (TJSP) 8 cases	**Insured Person (D&O)** 4 cases **Policyholder (Company)** 4 cases	**Known Circumstances Prior Policy Underwriting** 4 cases **Prior Known Claims + Dishonest Conduct** 2 cases **Reduction of the Deductible** 1 case **Prior Known Circumstances + Period of Coverage:** 1 case	**49 months** (1 case still ongoing)	**Insured Wins** **Prior Knowledge not Proved** 2 cases **Insured Wins** **Proof of Prior Notification** 1 case **Insurer Wins** **Proof of prior knowledge + Dishonest Conduct** 2 cases **Insurer Wins** **Proof of prior knowledge** 2 cases **Insurer Wins** **Deductible Applied as Prescribed in the Policy** 1 case
Paraná (TJPR) 4 cases	**Insured Person (D&O)** 4 cases	**Definition of Insured Person** 2 cases **Costumer vs. Supplier relationship (abusive clauses)** 1 case **Costumer vs. Supplier Relationship (abusive clauses) + Definition of Insured Person** 1 case	**65 months** (2 cases still ongoing)	**Insured Wins** **Proof of being an Insured Person** 2 cases **Insured Wins** **Consumer Relationship Accepted** 1 case **Insured Wins** **Consumer Relationship Accepted + Proof of Being an Insured Person** 1 case
Rio de Janeiro (TJRJ) 3 cases	**Insured Person (D&O)** 2 cases **Policyholder (Company)** 1 case	**Dishonest Conduct** 2 cases **Prior Known Actions** 1 case	**53 months** (2 cases still ongoing)	**Insurer Wins** **Proof of Dishonest Conduct** 2 cases **Insured Wins** **Dishonest Conduct not Proved** 1 case
Distrito Federal (TJDF) 1 case	**Policyholder (Company)**	**Known Circumstances Prior Policy Underwriting**	**22 months**	**Insurer Wins** **Facts Preceded the Retroactive Coverage Period**
Rio Grande do Sul (TJRS) 1 case	**Insured Person (D&O)**	**Known Circumstances Prior Policy Underwriting**	**90 months**	**Insurer Wins** **Proof of Prior Knowledge**

* There are cases still ongoing. In such cases, the considered duration was counted from the lawsuit distribution until the present date. ** Only cases reaching state or superior courts were considered

D&O in Brazil

Timeline

2004

04/26/2004

Circular SUSEP Nr. 252
Introduces ground rules for claims-made policies in Brazil.

2005

Banco Santos Case:
Banco Santos' controller declares bankruptcy and files a lawsuit claiming D&O coverage for defense costs.

10/20/2005

2007

01/22/2007

Circular SUSEP Nr. 336
Expands ruling upon Circular Nr. 252.

2008

Sadia S.A. Case I
Brazilian Securities and Exchange Commission files an administrative procedure against the former CFO and other high executives of Sadia S.A. for reckless derivative deals; the executives use D&O to cover their defense costs.

12/02/2008

2009

06/18/2009

Sadia S.A. Case II
Sadia S.A. files a lawsuit against its former CFO demanding compensation for losses incurred due to derivative deals; ultimately denied because CFO's financial statements had been approved by the company's annual general meeting.

2013

Triunfo Case
05/03/2013

Former board member of Triunfo Participações e Investimentos S.A. files a lawsuit claiming D&O coverage for defense costs; ultimately denied because of alleged insider trading acts.

2014

03/20/2014

Operação Lava Jato

Federal Police of Brazil installs "Operação Lava Jato" (Carwash Operation), a nationwide anti-corruption investigation.

2016

Circular SUSEP Nr. 541
10/14/2016

Attempts to introduce ground rules for D&O Insurances. It faces heavy criticism from insurances market.

2017

02/14/2017

Triunfo Case Ends

Superior Court of Justice (STJ) decides the 1st D&O case (REsp 1.601.555/SP). The court applies the contract's and insurance's general concepts in a clear consistent manner bringing legal certainty to D&O insurances in Brazil.

02/24/2017

Circular SUSEP Nr. 546

Lifts the validity period of Circular Nr. 541.

05/23/2017

Circular SUSEP Nr. 553

Introduces ground rules for D&O Insurance policies in Brazil reflecting some of the demands presented by the insurance market after Circular Nr. 541.

LEGAL ISSUES

Redesigning D&O insurance – New guidelines and possible outcomes

Rodolfo Mazzini

D&O insurance has fresh history in Brazil. It was introduced during the 1990's by translation of international policies to Portuguese, but it took until late 2000's to widespread.

During the last 10 years, awareness of the existence of D&O highly increased among companies. It led insurers to develop products fitted out for the Brazilian market, resulting in a sales spike after Operação Lava Jato, a nationwide anti-corruption investigation captained by the Federal Police.

On November 20th, 2017, when D&O market had already established its cruising *modus operandi*, Circular Nr. 553, published by SUSEP on May 23rd, 2017 ("Circular Nr. 553"), came into full effect, imposing all products to change.

While refraining from a complete overhaul, the Circular Nr. 553 does bring substantial changes to D&O's definitions and guidelines. The extensive list of definitions introduced in Section 3 has been suffering heavy criticism, which we find well-deserved: most terms are useless, inapplicable in the context of D&O, or even technically wrong. Thus, it is highly recommended that insurers continue using their own glossary, except when it challenges Circular Nr. 553.

It is praiseworthy, however, the definition of *Perda Indenizável* (Indemnifiable Loss), which finally puts defense costs as covered by D&O putting to rest the previous debate about its role as an accessory cover.

Circular Nr. 553 also reintroduces the possibility of covering fines and penalties imposed by administrative or judiciary bodies due to unintentional infractions, which was prohibited since 2012 by recommendation of Federal Attorney General's Office abide by SUSEP.

Considering the current regulatory scenario in Brazil, coverage for fines and penalties is the number one priority to any executive, mainly because of how thin is the line between the legal and the natural person's liability.

Furthermore, recent widespread corruption events and subversion of norms that regulate financial markets have led the government to enhance authorities power to supervise capital markets, allowing much heavier fines and cumulative penalties.

Finally, Circular Nr. 553 introduces the possibility of a natural person directly hiring a policy, avoiding the need for a company to intermediate the coverage, which may be useful if the employer does not have a policy or if there is disagreement with the executives' acts.

In summary, the new guidelines bring about some important changes, most notably the coverage for fines and penalties, but they came about far too late, at a time that Brazilian D&O was already flourishing by its own self-made rules. As such, regulation may get in the way of the process in motion, forcing insurers to take a step back and invest time and money to adapt their products. ■

Side A vs. Side B coverage – Rash imported solutions

Rafael Edelmann

Side A and Side B coverage are two typical D&O Insurance's mechanisms of payment.

D&O's typical vehicle is Side A Coverage which grants direct coverage for officers' liability losses. It provides direct indemnification despite any participation of the company's policyholder when a claim occurs.

Side B Coverage is the corporate reimbursement section of the D&O Insurance. Such Coverage is triggered when the company covers the costs incurred by any insured person regarding its liability as administrator.

Such two different ways of operating D&O indemnification follow Legal constraints on the relationship of a company with its officers which is common in many countries but not in Brazil. Such constraints separate indemnifiable losses from non-indemnifiable losses allowing or forbidding a company to assume its administrator's losses related to its duties.

Therefore, for cases where the corporate organization is not legally required to indemnify the directors and officers Side A coverage acts. Moreover, it is also triggered if the company becomes financially insolvent, cannot legally indemnify or refuse to indemnify the insured person.

Side B coverage regards those legally imposed indemnifiable losses working as a company's reimbursement.

Such sections have been misinterpreted by Brazilian insurance operators and translated poorly into national policies. Such defect results in unclear wordings and misconceptions are made by policyholders, insured persons, brokers and insurance companies as well.

Brazilian D&O Insurance Policies incorporated the idea of Side A and Side B coverage in a fungible way. Without any material difference companies and administrators could choose between them with no clear criteria.

Something quite questionable is that such policies besides bringing an induction for Side B impose almost regularly a deductible price for such coverage... it sounds like a balance sheet's bottom line improvement measure.

In the last few years, however, such operation has suffered a different approach. Brand new Brazilian policies impose indemnity to be paid preferably via Side B Coverage, regardless of any requests made by the company or the insured person. The most likely reason is the idea that involving the company in all and every claim brings a better governance to it. However, there is also the idea that putting the

company in the claim's front grants a safer return of any amounts paid if necessary (*e.g.* if a coverage exclusion arises).

Something quite questionable is that such policies besides bringing an induction for Side B impose almost regularly a deductible price for such coverage, but not for Side A's. Although it makes sense in countries which establish the indemnifiable vs. non-indemnifiable losses regime – as long as the first ones are much more recurrent –, in Brazil it sounds like a balance sheet's bottom line improvement measure.

In regulatory side, Circular Nr. 553 establishes Side A Coverage as the main coverage for D&O Insurance placing it as the general rule. Side B Coverage is placed as exception. Nevertheless, it is not a clear requirement that it should work this way, especially considering the request that all the coverages shall be presented as special clauses, including the basic ones such as Side A and Side B Coverage alongside with the extensions and optional extensions for coverage.

Such scenario imposes two main challenges for Brazilian D&O Insurance Market. Firstly, insurance companies shall clearly understand and expose the legal and microeconomic reasons for distinguishing Side A and Side B Coverages. Secondly, underwriters, policy brokers and specialized lawyers shall consider the insurance companies' reasoning to properly place the policyholders needs.

Understanding and duly setting policyholders needs is the only way of providing Brazilian market with a better, clearer, more coherent and comprehensive product which provides officers with adequate coverage for the liability risks they face on duty. ■

Fines under the spotlight – Managing D&O in administrative sanctioning procedures

Pedro Souza

The combination of rocket rising legal standards for fine application and regulatory allowance for fine's coverage brings two opposite vectors on D&O microeconomics thus in the legal aspects of such contracts. On the providers´ side there is a supply shrinkage, represented mainly by insurance companies' awe for extraordinary severe losses.

On the costumer's side there is a demand pressure – aligned with insured's average fears – based on willingness for fines coverage at (almost) any price.

Such equation inducts one *prima facie* conclusion: either fine coverage's premium tends to climb or the insured maximal importance and the conditions for such coverage might impoverish.

That is for sure a policy's subscription issue, which shall be appointed through crystal clear communication between the involved parties. It is legitimate that insurance companies look carefully to such coverage until it is clearly stabilized which are the new punishment standards by the authorities, which shall occur in the next 3 to 5 years. In the policyholders' side, it is not a big issue having a limited coverage for fines if the individual insured is fully aware of it.

The main importance of having such coverage regards the alignment between insurance company and insured on how to manage a claim which has a fine as a possible outcome. Without any coverage for fines, it is hard to explain by other means other than the insurer's utmost *bona fide* that a settlement or any kind of agreement must be considered in order to extinguish a fine's based claim. The reason is simple: in the worst-case scenario the fine would be imposed and the insured would have to pay for it without any help from the insurer.

Having a fine payment as a possible output for the insurer, all and any effort to reduce or avoid the fine (such as a settlement agreement) becomes automatically an insurer's interest. Managing a fine's oriented claim becomes common ground in insurances relationship.

Active arguing defense attorneys deeply connected with D&O gears were never so necessary.

A possible perverse consequence of allowing D&O Insurance to cover fines and penalties is that authorities carrying punitive power might feel dissuaded from accepting settlement proposals by the insured parties – or at least consider accepting them only at much higher values than before –, because they now have access to the deep pockets of the insurer to face up to fines.

While judicial case law's collection in Brazil is well-organized, public and has online availability in most judicial courts, there is a poor and disperse material in the administrative ones. Constructing a wide

administrative case law collection would be helpful to tackle eventually arbitrary authorities' actions.

Mapping when, how and the cost of any administrative punishment allows better acting in sanctioning procedures. Currently, lawyers are hired to create specific prognosis matrix and advise clients on administrative procedures.

As long as most administrative decision stays private, new intelligence on claim's managing is necessary to block any nefarious opportunistic behavior. To make such actions operational, it has never been so important knowing intrinsically every D&O gear.

In such ephemeris, those who are not at the table will probably be on the menu. ■

NEW OUTLOOK FOR ADMINISTRATIVE SANCTIONS AFTER CORRUPTION SCANDALS

Emanoel Lima

The latest Brazilian corruption scandals, especially involving the major local meat-processing company – the publicly held corporation JBS/Friboi – which resulted in insider trading indictment of its controlling parties, strongly contributed to improve local normative rules regarding administrative sanctioning in financial and capital markets.

The foremost normative adjustment implemented was Law Nr. 13,506, of November 13th, 2017, which regulates the administrative proceeding in Brazilian Central Bank ("BACEN") and Brazilian Securities and Exchange Commission ("CVM"). The new legislation defined infractions, penalties, coercive measures, and alternative settlement agreements applicable to institutions supervised by BACEN and CVM, which will be highlighted herein.

Classification of punishable acts. The aforementioned Law carried out a significant reform in Law Nr. 6,385/76 (Securities Market's Law) and also introduced a new array of punishable acts. Hence, the new definition of insider trading incorporated the use of relevant information not yet disclosed to the market by any person. Previously, only those who had an obligation of confidentiality could incur in insider trading acts.

Increase of fines. In addition, the Law has considerably increased the fines limit amount to be imposed by BACEN and CVM, which shall be closely watched by any D&O provider. The highest fines are now the greater between (i) R$ 2 billion or 0.5% of the company's revenues, for BACEN, and (ii) R$ 50 million, twice the value of the irregular operation, three times the value of the economic advantage obtained, or twice the losses suffered by the investors, for CVM.

Administrative Settlements. The new legislation introduced the possibility of legal entities and individuals to implement conduct adjustment agreements to reduce their penalties through "Termos de Compromisso" (Term of Commitments), in the sphere of BACEN and "Acordos Administrativos" (Administrative Agreements), in the sphere of CVM and BACEN. The Term of Commitments does not represent confession or recognition of unlawfulness act, yet will suspend the administrative procedure. Conversely, the Administrative Agreement presupposes the confession of the infraction and may extinguish or reduce a penalty.

CVM and BACEN have published individually their own rules to regulate the procedures introduced by Law Nr. 13,506/2017. A clear understanding of such rules by D&O's insurer, insured and policyholders is fundamental to avoid traps that may result in financial losses. ■

PERSPECTIVES

**Pedro Souza,
Rafael Edelmann
and Rodolfo Mazzini**

The present paper shows that a tangled social scenario coupled with an official attempt to organize Brazilian market of D&O brought a complicated frame for pairing up insurance companies' offers with insureds interests.

A brief conclusion on the resulting vectors shows risk averse insurance companies supplying risk averse Directors and Administrators. There is no ready-made solution for such mismatch. Without carefully shaping D&O Policy clauses, D&O premium will rise without any perception of improvement in the products by the policyholders or insureds.

Some actions are mandatory to be followed to mild this unpleasant road:

1 Both insured and insurer shall exercise to the fullest their utmost *bona fidei* during the contract formation. All and every information shall be fully disclosed in order to anticipate any dispute. Specialized Lawyers on any of the involved sides play a relevant role on such context;

2 Directors and administrators shall be warned about the purposes of fine's coverage, which is nothing but encouraging the administrator's best efforts within the best practices when running any enterprise;

3 Authorities shall be involved in institutional discussions disconnected from concrete cases, in which they will be asked about their objective criteria to impose fines and to analyze settlement convenience;

4 Corruption and environmental loss cases shall be better studied and understood to separate the diamonds from the dirt. A shared database filled by brokers, lawyers, underwriters and public related authorities (*e.g.* SUSEP officials) is something to be considered;

5 D&O insurance's premium price and also wording constraints shall be established by insurers – whenever possible – in a prospective way rather than looking at the rearview mirror.

A brief conclusion on the resulting behavior vectors shows risk averse insurance companies supplying risk averse Directors and Administrators. There is no ready-made solution for such mismatch. D&O insurance's premium price and also wording constraints shall be established by insurers – whenever possible – in a prospective form rather than looking at the rearview mirror.

About SABZ insurance team

SABZ Advogados has always focused on understanding clients business purposes as a starting point for every legal work. With professionals trained in multidisciplinary skills, our team stands out for offering intelligent and business-oriented legal solutions.

In the last ten years our insurance team has been well recognized in every insurance business class. In Financial Lines Insurances (mainly D&O and E&O) the firm is recognized for designing vanguard solutions on behalf of insurance companies and also policyholders.

The firm has been involved in the development of new products and also in adapting existing solutions to the clients business. In pre-litigation field, we have been involved in many regulations of claims of procedures enacted by Brazilian Securities and Exchange Commission (CVM), Brazilian Pension Funds Agency (PREVIC), SUSEP and other agencies.

In the litigation field, the firm has been defending the market's best practices. It is not coincidence that more than 20% of D&O's existing cases herein mentioned (see chart on page 5) were led by our firm, including the most relevant leading case defined by Brazilian Superior Court of Justice (REsp 1.601.555/SP).

The reflections herein mentioned arise from a non-stop law practice which is daily fed by our clients' needs. Our passion for solving problems and for the insurance market results in constant innovation.

The aim of every reflection backing up the present paper is to create conditions for the development of a healthy environment for D&O solutions. Legal certainty is one of the pillars of a vigorous market, which is somehow linked to a prosperous Country, our utmost aspiration.

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