MARSH JLT SPECIALTY

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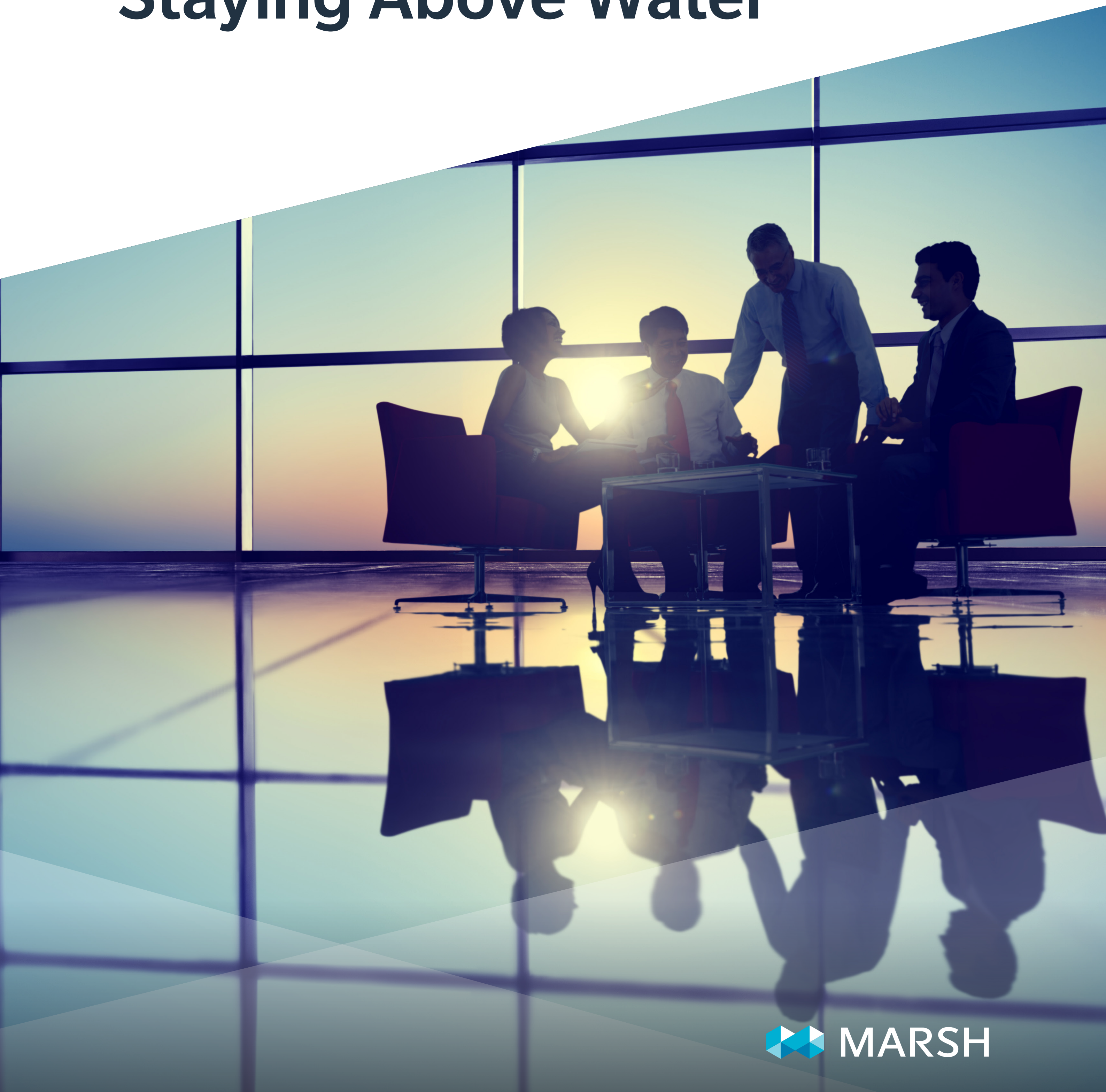
The D&O Insurance Wave: Staying Above Water



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Introduction: litigation and a hard market make for a perfect storm

Australian directors and officers, the companies they represent, and those insuring them are all grappling with what the insurance industry calls a hard market. Over the first three quarters of 2019 we saw D&O premiums rise 75% on average; this is on top of an 88% average increase in 2018.[1] This increase actually represents a range of between 30-40% and a staggering 600%. Over the last seven years, premiums have risen on average by 250%.

What's more, there are no signs these increases are slowing. Capacity is also difficult to fill, meaning some D&O programs have lower limits and a narrower scope of cover, at greater cost.

Australian companies have been purchasing D&O insurance for their directors for over three decades. During that time, prices have been very competitive, prompting Australian companies to buy comparatively more cover than their counterparts overseas. Although industry players recognised that prices and coverage were unsustainable, consistent market conditions did not inspire changes in either.

Over the last few years, however, a dramatic increase in shareholder litigation has led to significant claims against insured companies. In an estimated annual premium pool of between A$250 million and A$450 million, cumulative claim settlements of over A$1.8 billion[2] have forced insurers' hands.

Historical under-pricing of D&O insurance, combined with the rise in class actions, has led to a rapid hardening of the Australian D&O market.

Corporate Australia is feeling the brunt of the reduced availability and affordability of D&O insurance. Companies and directors are faced with the difficult decision to potentially reduce limits or remove components of D&O cover. In this environment, the challenge for companies is in finding the right balance between the mounting cost of insurance and having the right level and mix of protection, for directors and the organisation.

It should also be considered that these impacts are not limited to Australian Securities Exchange (ASX) companies alone; non-listed Small and Medium-sized Enterprises (SME's) as well as charities' are all impacted as insurers look to 'remediate' their entire D&O portfolios.

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[1] Marsh ASX-client data, November 2019

[2] Durkin, Patrick and Pelly, Michael, "Myer judgment will have 'chilling effect' on boards", Financial Review, 25 October 2019.

Realities of a modern-day director

More responsibility, more exposure

A decade ago, sitting on the board of directors of a company was the pinnacle of any ambitious corporate professional's career path. But a role once considered highly respected and desirable is now subject to growing general-public mistrust, heightened scrutiny (from both regulatory bodies and the media), and increasing personal liability exposure.

More and more, directors are finding themselves responsible for the management and oversight of the business and operations at an increasingly granular level, where they can be found liable simply by virtue of their position, and seemingly regardless of their actions.

As set out in the Corporations Act 2001 (Cth), a key responsibility of a director is to act in the best interests of the company. Traditionally, this meant maximising shareholder value. But the community's expectations of a director's duties are shifting. No longer is a board considered responsible for acting solely on shareholders' fiduciary behalf; instead it must attend to the needs of its organisation's wider stakeholders: customers, employees, and the environment.

An Australian director is potentially exposed to over 600 pieces of legislation. With directors taking on more onerous responsibilities comes a higher exposure to risk and personal liability.

Casting a wider net

Damage caused by, or perceived to have been caused by, a company to its wider stakeholder network can no longer be excused by the board's commitment to increasing shareholder value. Recent examinations of the Australian banking, insurance, and superannuation sectors point to behaviours at the executive and board level that society no longer deems acceptable:

> "The Royal Commission has shown how the idea of corporate management seeking profit maximisation at any cost — under the guise of preferring shareholders' interests — can be at a cost to customers, which in turn has had a negative impact on the reputation of companies and directors, and the share price. Ultimately, shareholder interests were affected by the lack of consideration of the interests of stakeholders.[3]"

And shareholders are expressing their disquiet. Australia has become the most likely jurisdiction outside of the United States in which a corporation may face significant class action litigation.[4]

Recent escalation of both the number and value of class actions is deeply concerning. Australia has seen a four-fold increase in the average number of securities class action claims per year over the last 10 years.[5] This number is still on the rise. The average class action seeks between A$50 million and A$75 million in compensation — and there have been a number of ASX shareholder claim settlements exceeding A$100million. ASX200 firms stand a one-in-10 chance of facing a class action every year.[6]

Exacerbating this state of affairs is the expectation of continuous disclosure, even where no legal obligation to provide such disclosure exists. To assuage a testy shareholder base (as well as the public, regulators, and the media), a board is under increasing pressure to keep the market informed of decisions that may affect the organisation's reputation. At the same time it must safeguard the corporation's regular business activity during an incident: "There is a balance required of directors not acting too hastily, leading to possible mistakes in an announcement (James Hardie (2012) HCA 17), against the need to disclose information immediately.[7]"

In this environment of heightened scrutiny and more onerous legal exposure, the D&O market finds itself in the midst of a perfect storm: greater risk, higher premiums, lesser coverage, increased retentions and lower limits.

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3 Comments ascribed to Judith Fox MAICD of the CEO Australian Shareholders' Association in "Up for debate: Is it time to reassess director duties?" Company Director, December, 2018. https://aicd.companydirectors.com.au/membership/company-director-magazine/2018-back-editions/december/royal-commission-director-debate

4 Allens, Shareholder Class Actions in Australia, February 2017

5 Marsh, Directors & Officers Liability Insurance Market Update, May 2018

6 McKay, Ewen. "The Hard Market – are we there yet? An update on the D&O space." AXA, October, 2019.

7 "Continuous disclosure requirements – Board performance" Australian Institute of Company Directors, 2016 https://aicd.companydirectors.com.au/-/media/cd2/resources/director-resources/director-tools/pdf/05446-2-5-director-tools-bp-continuous-disclosure-requirements_a4_web.ashx

Prospects for the D&O market

Losers on both sides

Shrinking capacity in the D&O market takes two forms: fewer insurers providing cover, and existing insurers reducing their exposure by reducing limits and/or removing certain covers. This makes it harder for brokers to fill program limits and for clients to find appropriate cover.

It is not just publicly listed companies that are experiencing premium increases and reduced capacity. Effects of the hard market and shareholder class actions have rippled through all D&O policies, as well as the management liability package policies commonly purchased by small to medium-sized businesses. Companies across Australia, regardless of industry and size, are all sustaining the impacts.

Given the costs of litigation now pervading the market and absent any structural change to the legal environment, premium increases are somewhat inevitable. However, some instances of disproportional primary pricing versus excess layer pricing from insurers have been observed.

Some clients will naturally feel they are at the mercy of insurers. Insurers, on the other hand, are losing money with the increase in securities class action claims. As mentioned, the premium surge is also part of a correction following historically low premiums in the Australian insurance market.

No change in the forecast

Whether the intersection of rising premiums and more class action claims is sustainable remains unknown. Indeed, the actions of directors remain in sharp focus for litigious shareholders. The Australian investment market has grown rapidly in the past three decades, with 60% of Australian adults now holding investments outside their institutional superannuation fund.[8] This maturation has inevitably led to a higher level of vigilance on the part of institutional and individual investors concerned about not only the performance of their investments, but the decision-making behind them.

Loath to simply tolerate losses incurred through poor governance or misconduct, investors will seek to recoup them, and the means by which to do that is increasingly the class action, through which individual investors can prosecute their common claims in aggregate, in the hope of more efficiently and effectively seeking justice through the legal system.

Australian Law Reform Commission review

Citing the increasing prevalence of both shareholder class actions and the third-party funding of such actions — as well as the absence of conditions on, and regulation of, those third parties — the Attorney-General of Australia in December 2017 asked the Australian Law Reform Commission (ALRC) to investigate "whether and to what extent class action proceedings and third party litigation funders should be subject to Commonwealth regulation".[9]

In its report, the ALRC made 24 recommendations, including that amendments be made in the law to limit the number of competing class actions, and that litigation funders be subject to greater oversight.

While acknowledging that "something is not quite right" in the current environment of shareholder litigation when considering the link between the increase in class actions and its effect on D&O insurance, the ALRC did not go so far as to condemn the system outright.[10] None of its recommendations has yet been implemented, and the appetite in government to declare the system broken enough to fix has not been evident.

Shareholder-funded litigation is therefore not only active, it is likely to remain so over the long term. Companies and their directors will consequently continue to grapple with higher costs of D&O insurance, as well as shareholder litigation. Moreover, the ability of companies to attract and retain qualified directors is likely to fall if the companies can neither secure affordable insurance nor offer directors sufficient protection for liabilities associated with their directorships.

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8 "ASX Australian Investor Study", Deloitte Access Economics, 2017, https://www.asx.com.au/documents/resources/2017-asx-investor-study.pdf 4 Allens, Shareholder Class Actions in Australia, February 2017

9 "Integrity, Fairness and Efficiency—An Inquiry into Class Action Proceedings and Third-Party Litigation Funders: final report", ALRC Report 134, Australian Law Reform Commission, December 2018.

10 "D&O is 'canary in the coalmine' for law reformers", Insurance News, 25 January 2019, https://www.insurancenews.com.au/daily/do-is-canary-in-the-coalmine-for-law-reformers

Navigating the hard market

Companies continuing to renew their existing cover are paying considerably more. For coverage of between A$100 million and A$200 million, larger corporate entities are spending circa A$2 million – A$5 million where they previously spent circa A$500,000 - A$800,000.

For some industries or sectors, the premiums are even higher: now on average between A$10 million – A$15 million. There has also been pressure on excesses (with some now upwards of A$100 million) meaning companies are holding much of the risk insurers used to hold.

With no signs of abatement in shareholder class actions, or in the hardening D&O insurance market, how can Australian directors and companies navigate this challenging environment?

Renewal conversations are very different now compared to those held as recently as two or three years ago. In seeking coverage, an organisation should focus on being proactive and being prepared.

Renew, or review?

Rather than simply renewing an existing policy or buying cover out of habit, a company should be examining each component of its coverage to thoroughly understand what it covers. Directors and companies must understand whether the amount (limit) of cover they buy is affordable, and whether each coverage component is needed, in respect of the company's budgetary constraints and its risk appetite.

In a soft market, an organisation's goal will be to secure as broad coverage as possible without affecting the premium. And because insurers compete for business and want to expand their portfolios, they have historically been willing to offer broader coverage and extensions. In a hard market, on the other hand, securing coverage concerns determining the scope and level of cover the company actually needs, because it will pay for every component.

An increase in actuarial-based decision-making is now evident in D&O renewals. Clients are using benchmarking data, such as Marsh's D&O IDEAL tool, to test the appropriateness of the amount of cover they purchase in relation to the nature and size of their business. "This is of particular relevance at a time when companies have historically over-purchased D&O limits in a soft market," says Craig Claughton, Head of the Financial and Professional Practice, Marsh JLT Specialty. "Over the last 12 months, a number of our clients have come to this conclusion, with the help of D&O IDEAL, and have since reduced their overall D&O policy limit, which has helped to manage premium cost."

It will also be interesting to see if any of the policy provisions designed to maximise protection for directors and officers and ameliorate the effects of Side C cover will be called into play — provisions such as a priority of payments clause or clauses that deal with severability.

A priority of payments clause (also referred to as an order of payments clause) specifies the order in which payments are to be made under a D&O policy, with insured persons' non-indemnifiable loss prioritised over the corporate entity. Such clauses were designed to protect insured persons' interests in D&O policy proceeds, especially where there may be competing interests for the proceeds of the policy.

A severability provision acts to preserve insurance coverage for an innocent director or officer, notwithstanding improper conduct by other insureds covered in the D&O policy.

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[11] This article provides a general overview of typical D&O policies. We recommend that you read the policy terms, conditions and exclusions before deciding whether a particular policy suits your needs.

[12] "What is directors and officers insurance"?, Australian Institute of Company Directors, https://aicd.companydirectors.com.au/resources/all-sectors/directors-and-officers-insurance/what-is-directors-and-officers-insurance

The Side C conundrum (for listed companies):

Although Side C has become a staple coverage component of a D&O policy for publicly listed companies over the last 20 years, some companies have taken the decision to never purchase this cover. Reasoning that Side C is not the traditional basis of a D&O policy, companies purchasing this cover can dilute the policy limit available principally intended to protect their directors and officers. The existence of Side C cover may also prove problematic in the case of company insolvency, with the potential for the policy and any proceeds from it being treated as assets of the company.

Securities class action (and therefore Side C) claims are arguably the biggest culprit for attracting D&O premium increases, and arguably the existence of Side C cover may itself encourage more shareholder class actions. Companies that do purchase Side C cover must now, for the first time, contemplate whether to keep this cover. The dilemma therefore is whether to forgo insurance for the company, particularly in circumstances where directors have an overriding duty to act in the best interests of the company.

“Although many of our clients from the ASX200 are contemplating reducing or removing Side C cover, we haven’t seen one of those clients give up Side C cover just yet,” says Craig Claughton, Head of the Financial and Professional Services Practice (FINPRO), Marsh JLT Specialty. “With the way the market is heading, a possible reality in five years from now may be that Side C cover is simply not purchased anymore.”

Companies also need to seriously consider alternative structures for their D&O policies — not only to manage costs, but also to strike the right balance between coverage tailored to their business needs and risk appetites. Alternative products (such as an Excess Side A) are also available to fill actual or perceived gaps in coverage.

Key questions directors and companies should consider:

- What is the impact on the premium of removing Side C cover from a D&O policy? This hasn’t been tested so far, so it will be interesting to see the market response.
- Will removing entity cover (Side C) affect shareholder class action behaviours? Does removing entity cover simply shift the target from the company to individual directors? (Meaning, will shareholders and litigation funders start pursuing individual directors as opposed to the company in their class actions?)
- If a company withdraws from Side C coverage in the hope of managing cost, will it be even more expensive to reinstate the cover later?

D&O Coverage: Components and Definitions[11]

Side A	PAYS ON BEHALF OF THE INDIVIDUAL DIRECTORS’ AND OFFICERS’ LOSSES INCURRED IN CONNECTION WITH CERTAIN WRONGFUL ACTS MADE AGAINST THEM, WHERE THE DIRECTOR IS NOT INDEMNIFIED BY THE COMPANY.
Side B	REIMBURSES THE COMPANY FOR CERTAIN INDEMNIFICATIONS PAID TO DIRECTORS AND OFFICERS AND LEGAL COSTS IN CLAIMS MADE BY THIRD PARTIES FOR WRONGFUL ACTS.
Side C	PROVIDES COVER TO CORPORATIONS FOR THEIR LIABILITY IN RELATION TO CERTAIN CLAIMS MADE AGAINST THEM IN RELATION TO THEIR SECURITIES.[12]

[11] This article provides a general overview of typical D&O policies. We recommend that you read the policy terms, conditions and exclusions before deciding whether a particular policy suits your needs.

[12] “What is directors and officers insurance”?, Australian Institute of Company Directors, https://aicd.companydirectors.com.au/resources/all-sectors/directors-and-officers-insurance/what-is-directors-and-officers-insurance

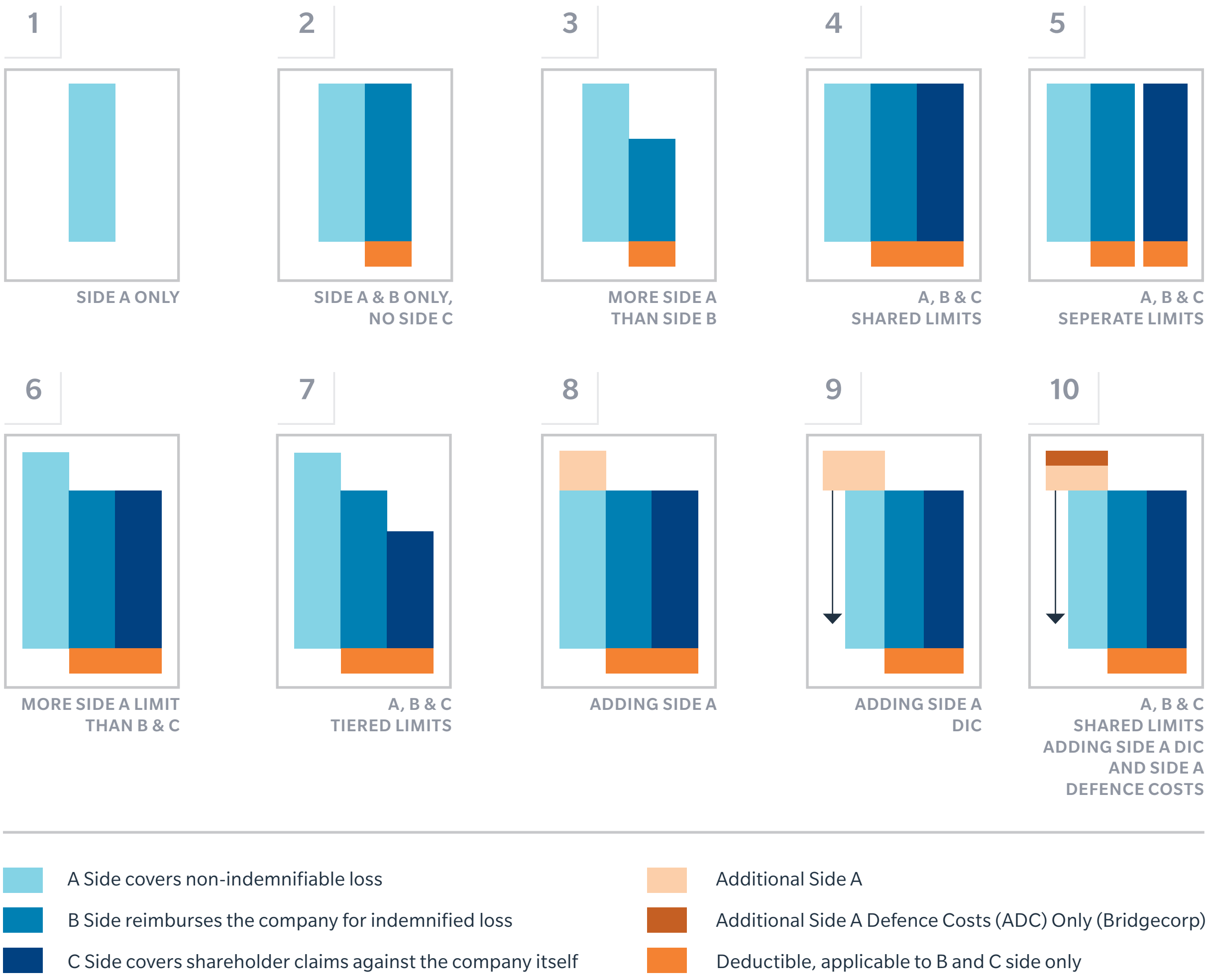
Options for structuring a D&O policy program

A program is the combination of policy components a broker in negotiation with an insurer puts together for the insured. There are many ways a D&O policy can be constructed. Typically, they are based on the following structures:

1. Sides A, B, and C, with shared limits:
2. Sides A and B, with a separate Side C limit:
3. Sides A and B only; no Side C:
4. Separate/excess Side A limit:

As seen in Figure 1, the ratios of side coverage can be equal or differ, and deductibles/excesses can be applied to one or more components.

FIGURE 1 Ways to Structure a D&O Program



Managing rising premiums

While most companies continue to buy the same level of cover despite rising costs, others are taking on significantly larger excesses. These self-insured retentions are largely driven by insurers, but companies are also using them to combat premium increases and manage costs. For ASX-listed entities, the typical self-insured retentions are in the order of A$5 million – A$15 million, with extreme examples reaching up to around A$225 million.

This may reduce premium costs on the P&L, but what is the true cost of managing the increased risk in-house?

If a higher self-retention level is adopted, companies need to establish a plan and processes for managing claims that fall below the policy retention. They also need to ensure their rights are not prejudiced in the event a very large claim exceeds the policy limit. For example, where an insurer may prefer to settle a claim and reduce their costs.

Companies considering these means of managing higher premiums should consider for example:

- Whether they are sufficiently capitalised and experienced to absorb the risk and manage it in-house.
- When, how, and from whom they should enlist professional help.

High self-insured retentions also expose insurers to potentially significant risk given it has little control over the management of claims below the retention. Once the claim reaches the policy retention, the impact on the insurer will largely depend on how well the client has managed the below-retention losses thus far.

Using a broker to ride out the wave

Clients feeling uneasy about renewing or re-assessing their D&O coverage should consider third-party assistance. An insurance broker can help clients examine their D&O insurance needs and set up a policy program that balances needs against affordability. Brokers can steer clients through the process of exploring coverage and structure options, using data and scenario testing to guide decision-making.

A broker that maintains solid relationships and volumes with insurance companies will exercise its leverage in the current marketplace, achieving outcomes an individual organisation might not have access to.

Brokers may also offer other value-adding services, such as market and industry insights, thought leadership, claims advocacy, cyber expertise, and data analysis. Brokers regularly address companies' boards of directors on these matters. Furthermore, they may have reach into international insurance markets, where risks may be presented differently and have programs structured to match.

Outlook for the future

The conclusion to draw from current D&O market conditions and recent developments is sobering: insurance premiums are high and rising, shareholder litigation will continue, and a company that wants good directors will need to pay for them.

Over the next 12-18 months, Marsh sees a continuation of the D&O market's correction in Australia, as well as a hardening of the global insurance market. It will not be easy to get cover. The increase in premiums and retentions and the decrease in insurer capacity and coverage will persist, so companies need to be adaptable and amenable to managing both their risks and their expectations of costs and coverage.

The challenge of finding the right balance between cost and coverage also has implications for a company's other insurance policies. Are budget constraints stemming from D&O premium increases, forcing companies to forego new coverages.

Companies need to thoroughly question and understand all aspects of their insurance cover in order to make informed purchasing decisions. Unfortunately these decisions may be to reduce or even give up certain covers. Such a decision should be backed by the use of benchmarking data to help determine an organisation's ideal level of cover.

Companies need to demonstrate to insurers and company stakeholders that they can sustain higher retention levels (without affecting their capital); have the resources to manage losses and claims below the retention; and have plans and procedures in place in case of a shareholder class action.

If we are responsible risk managers, we must also contemplate a future in which cover is simply not available or affordable. What then? If D&O coverage becomes unavailable, the alternative is simply to not buy D&O insurance at all. The implications are grave but clear: deeds of indemnity may not be able to be fulfilled in relation to any requirements to arrange insurance protections, and boards may be unable to attract and retain high-quality directors. Whether these prospects are damning enough to inspire meaningful changes in the landscape of corporate litigation is as yet unclear (particularly in light of the recent Myer decision[13]); in the meantime, we can be certain that rough seas lie ahead.

[13] TPT Patrol Pty Ltd as trustee for Amies Superannuation Fund v Myer Holdings Limited [2019] FCA 1747

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