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Shareholder class actions shaping the future of Australia's D&O insurance landscape

With the average number of securities class action claims lodged per year rising by four-folds over the last 10 years – equivalent to a 300% increase[1], Australia has become the most likely jurisdiction outside of the United States where a corporation may face significant class action litigation.[2]

The rise in shareholder activism, surge in litigation funding, increased availability and flow of information have all contributed to shareholder class actions becoming an established element of the Australian legal landscape. The growing number of royal commissions and inquiries targeting white collar crime has also put directors and officers under the spotlight.

The surge in shareholder class actions has notably made its mark on the Directors and Officers (D&O) Liability insurance market and the management of such insurance programs in Australia.

So what exactly is a shareholder class action and how did its popularity grow in Australia?

The fundamentals

What is a shareholder class action?

Class action lawsuits provide a means by which the claims of many individuals against the same defendant(s) can be brought by a single representative on behalf of a group of people.

Melita Simic, Managing Principal FINPRO (Financial & Professional lines) at Marsh, explains the two main benefits offered by a class action suit: "Firstly, it allows a dispute involving large numbers of people to be potentially resolved through a single case. Secondly, it can be a solution for circumstances where, despite many people being affected, the size of each person's loss is not economically viable to recover through individual lawsuits."

In Australia, there has been an increasing trend for shareholder class actions (also known as **securities class actions**), whereby shareholders bring class actions against companies and their directors for claims related to investments in the company's shares.

1 Marsh, *Directors & Officers Liability Insurance Market Update*, May 2018

2 Allens, *Shareholder Class Actions in Australia*, February 2017

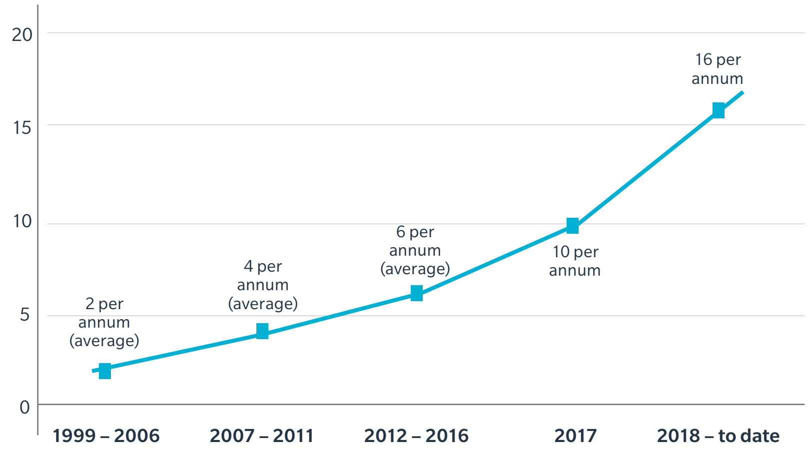
The rise of shareholder class actions

Securities class actions typically follow significant falls in share prices of publically listed companies. The majority of current shareholder class actions are based on the grounds of misleading or deceptive conduct or the failure to fulfil continuous disclosure obligations to inform the market of information that may materially impact a company's share price. (Eg. Hiding negative information such as poor sales or profitability.)[3]

KEY DRIVERS BEHIND AUSTRALIA'S SECURITIES CLASS ACTIONS SURGE:

- Large number of Australians now own shares in companies.
- Institutional investors have substantial shareholdings in other companies as part of their portfolios.
- Increasing awareness amongst shareholders of their statutory rights to take action for loss suffered.
- Availability of court procedures that enable multiple claims to be resolved simultaneously.
- Ability of shareholders to rank equally as unsecured creditors in the case of an insolvent company.[4]
- Availability of litigation funding allowing shareholders to bring actions without being exposed to upfront legal fees. Foreign litigation funding is also on the rise. (Less than 30% of class actions were funded in 2014 compared to more than 60% in 2017.[5])

FIGURE 1 Number of securities class action claims in Australia



SOURCE: MARSH DATA

"Litigation funders are an interesting subject. Whilst they do provide shareholders with funding access to pursue legal actions against corporate giants, their motives have been questionable at times, especially given there's currently no legislation or regulation in Australia which limits the fees that funders can charge," says Craig Claughton, Managing Director and FINPRO Leader at Marsh.

There has been growing concerns amongst industry professionals over the interests of class action promoters taking increasing priority over the interests of actual class members.[6]

In an effort to ensure that the costs are appropriate and proportionate and the interests of plaintiffs and class members are protected, an Australian Law Reform Commission (ALRC) inquiry into class action proceedings and third party litigation funders was announced by the Federal Attorney-General late last year and is currently underway. The inquiry seeks to examine the adequacy of regulation around conflicts of interest, character and fitness requirements for litigation funders, legal costs associated with class actions and the potential of capping the proportion of awards retainable by lawyers and litigation funders.[7]

Marsh recently delivered a submission to provide ALRC with a view on how class actions and litigation funders are impacting the current D&O insurance market.

"Our empirical evidence shows that there's a direct link between the growing size and number of class actions/ resultant insurance claims involving D&O insurance, and the cost and availability of that insurance," says Claughton.

3 http://theconversation.com/whats-behind-the-rise-in-shareholder-class-actions-72356
4 Sons of Gwalia Ltd v Margaretic [2007] HCA
5 King & Wood Mallesons, *The Review: Class Actions in Australia 2016/2017*, April 2018
6 Allens, *Client Update: Attorney-General Announces Class Action Inquiry*, December 2017
7 Ibid 8

The D&O policy dissected

A company's D&O Liability insurance policy is intended to provide cover for liabilities incurred by directors and officers in the performance of their duties, otherwise, their personal assets may be exposed.

Traditionally, a D&O policy contained two insuring clauses – **Side A cover** (also known as *D&O cover*) to insure the individual directors and officers for losses not indemnifiable by the company, and **Side B cover** (also known as *Company Reimbursement cover*) to reimburse the company for amounts paid to its directors and officers as indemnification.

Both Side A and Side B only cover losses incurred from claims made against the individual directors and officers, and not claims made against the company. This is because D&O policies were originally designed to protect individual directors and officers against personal liability and act as the last line of defence for their personal assets.

Over time, as securities entity claims started to gain momentum, so too did Side C cover (also known as *Securities Entity cover*). It became a popular addition under D&O policies in response to an increase in claims made against both directors and officers (who were insured under the policy) and the company itself (who was uninsured).

Side C cover insures losses incurred by the company resulting from claims made against the company for its own liability in relation to its securities, even if directors and officers are not named as defendants.

A D&O policy with Side A, B and C cover protects both the personal assets of individual directors and officers and certain financial obligations of the company. Typically, all three insuring clauses share the same combined aggregate limit under the one policy. However separate limits can also be arranged, albeit at a higher cost.

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Craig Claughton

Insurance implications of securities class actions

The wave of shareholder class action activities has prompted both insured entities and insurers to re-assess their views on Securities Entity cover. Insurers are questioning the sustainability of continuing to offer the cover, and insureds are re-examining their cost-benefit analysis of purchasing the cover.

An insurer's perspective

Insurers today are acutely aware that shareholder class actions have been one of the largest contributors to D&O losses. The number of claims and reported circumstances are currently exceeding the total insurance market premium pool by a significant margin.[8] Furthermore, the much publicised Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has further focused insurers' attention to mitigating their exposure from potential claims and shareholder class actions that may arise out of the Royal Commission.

Insurers' profitability have been heavily impacted due to sustained periods of low premiums and increased claims frequency and severity. D&O securities class action claims and settlements against ASX listed companies have been estimated to cost insurers in excess of $1bn since 2011.[9]

As a result, insurance renewals are being increasingly scrutinised as insurers seek to rebalance their position through premium adjustments to compensate for the claims. This has seen the aggregate cost of D&O insurance for corporate Australia increase by over 250% over the last seven years.[10]

Insurers are also mitigating their exposures by re-evaluating their underwriting appetites through reducing capacity, elevating attachments points, ceasing to offer Securities Entity cover, and some even exiting D&O market segments altogether.

Coinsurance, policy retention and coverage issues are also being closely scrutinised and adjusted to help insurers better mitigate their exposures.

FIGURE 2
Total D&O Insurance Premiums (A$ million) 2011-2018

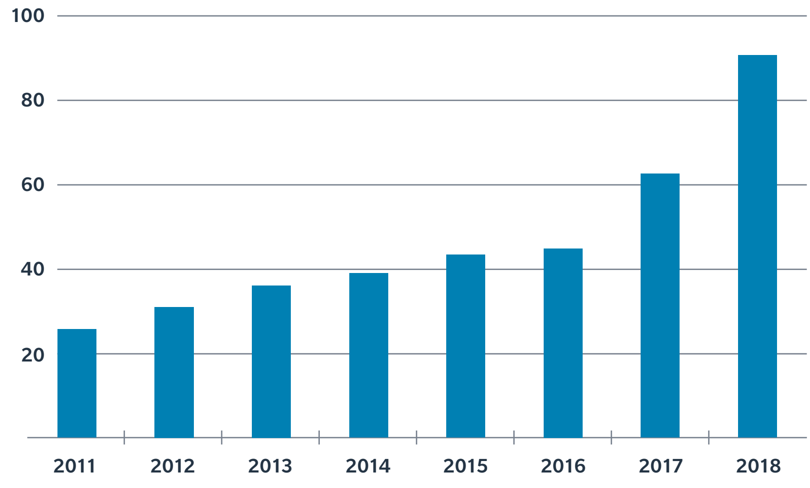
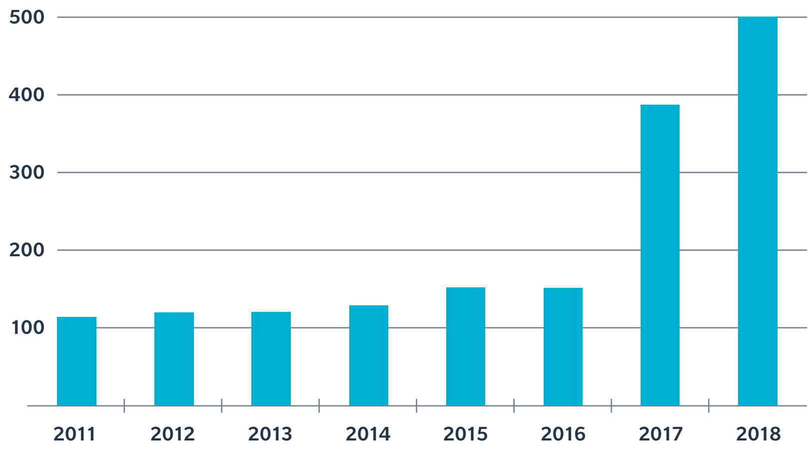


FIGURE 3
Total D&O Policy Retentions (A$ million) 2011-2018



SOURCE: MARSH DATA ON ASX200 CLIENTS, AS AT JUNE 2018

8 Ibid 1

9 XL Catlin and Wotton & Kearney, *Show me the money! The impact of securities class actions on the Australian D&O liability insurance market*, 2018

10 Based on Marsh data on ASX200 clients for 2011-2018, as at June 2018

An insured's perspective

D&O Liability insurance is an important protection mechanism which supports any strong corporate governance regime. It helps to ensure the sustainability of boards and ultimately the organisations they represent.

Having to maintain increasing policy retentions could have a negative impact on a company's available capital and shareholder value; significant premium rises have prompted some companies to reassess their entity cover options; and the steady demise of availability of D&O coverage in general could see corporate Australia struggle to attract, retain and develop capable and experienced directors and officers.

Given the rising cost of Securities Entity cover, companies are weighing up the benefits of having the cover in place (provide balance sheet protection for the company when faced with a shareholder class action) against the potential disadvantage of eroding cover intended for directors and officers in the event of a securities entity claim, since all three insuring clauses (Side A, B and C) typically share a combined aggregate limit.

Significant premium rises have prompted some companies to reassess their entity cover options.

"Directors and officers were traditionally considered to be the primary beneficiaries that a D&O policy was designed to protect. But they can actually lose their personal protection if the company incurs significant losses and dilutes their cover. The combined aggregate limit is typically inclusive of defence costs which can be exorbitant – often upwards of $10m," says Simic.

Additionally, if an insured company (including subsidiaries) becomes insolvent, the existence of entity coverage may result in the D&O policy (and its proceeds) being treated as assets of the company. This can result in liquidators applying the proceeds of the policy to the company's liabilities, effectively making the proceeds available to creditors ahead of the insured directors and officers.[11]

"At best, this could result in delays for the directors and officers to access their policy proceeds, and at worst, they could be left completely uninsured and forced to self-fund any defense, settlement and/or judgment," explains Simic.

While an appropriately worded Order of Payment Provision or specialised insurance products can help to mitigate these concerns, they do not eliminate the risk completely. An **Order of Payment Provision** sets out the order in which policy proceeds are to be paid out to the various insureds under the policy, and typically also stipulates that policy proceeds are the property of the directors and officers rather than a bankruptcy trustee.

"Over the last 10 years, we have seen a spike in interest for specialised alternative arrangements such as Excess Side A policies, as directors seek to secure additional protection for their personal liabilities," says Claughton.

Excess Side A cover offers a standalone limit dedicated to insured individuals that cannot be eroded by entity claims. They generally have broader terms and fewer/less onerous exclusions since the insurer's attachment point is higher (excess layer). The policy is also less likely to be considered an asset of the company in the case of insolvency since the company is not an insured under the policy.

11 Pursuant to section 562 of the Corporations Act 2001 (Cth). Fred Hawke, Clayton Utz, *Side C Securities Cover: The Albatross Around the Neck of Directors and Officers Liability Insurance*, October 2008

Practical tips for boards

Shareholder class actions can pose significant risks to those involved in terms of legal exposure and damage to reputation. Directors and officers need to understand the changing legal landscape, market conditions and the coverages that may or may not be available under D&O Liability insurance, at present and in the foreseeable future.

Understanding who the policy is protecting and the board's risk tolerance level

The fundamental purpose of D&O insurance is to protect a company's directors and officers against personal liability, and is often the last line of defence for their personal assets. As such, when cover is extended to include other parties and exposures, policy buyers need to consider whether these amendments to the policy structure are appropriate. Eg. Directors should consider whether they want to share their policy limit with the company for their exposures to securities related claims.

Whether Securities Entity cover is advisable for inclusion under a company's D&O policy will depend in part on the risk tolerance level of its board of directors.

"One way to tighten cover is to perhaps limit the insured to the main board only. Insureds also need to look at what 'adequate limit' means for them," says Claughton.

Considerations for structuring a D&O policy

Key factors that should be considered when structuring a D&O policy include:

- Sufficiency of a company's assets to cover its indemnification obligations owed to its directors and officers
- Scope and size of a company's operations
- Future prospects and expected growth of a company
- Likelihood of significant transactions for a company, such as merger or acquisition, dissolution or bankruptcy
- A company's claims history and the litigation risk profile of its business and industry

It is important to remember that there are multiple ways to structure a D&O insurance program to ensure it meets the needs of both the corporate entity as well as its directors and officers. As mentioned earlier, alternative products are available to assist and fill any perceived or actual gaps in cover.

Open dialogue with brokers and insurers

Directors should keep an open dialogue with their brokers and insurers to be prepared for any changes in the way their insurers offer D&O insurance, in particular Securities Entity cover.

Any potential matters or circumstances that could lead to a securities class action or claim (no matter how small the possibility) should be notified to insurers as early as possible. A legal counsel should be appointed and the insurer kept up to date, in particular in relation to legal costs.

Insurance renewals should be started early, and with any concerns to be raised earlier rather than later. Transparency and communication are pivotal in helping your broker better prepare and negotiate a desirable renewal outcome or explore alternatives in the event cover is unavailable from incumbent insurers.

Improving D&O risk profile

Whilst many of the current risk drivers affecting premiums are not within control of policy buyers, there are factors to focus on that may improve the premium offered by insurers. The following may positively influence insurers' perception on risk:

- Business complexity and transparency of the company's financial condition
- Internal company controls and review (and subsequent disclosure implementation)
- Director quality and board independence
- Market capitalisation
- Company culture

Looking ahead

Australia's current shareholder class actions landscape is potentially contributing to the destabilisation of a sound corporate governance regime through eroding the availability and raising the cost of D&O liability insurance products for Australian risks.

Significant M&A activity amongst insurers in recent years has further reduced competition and alternative options for insureds. This, coupled with no signs of securities class actions slowing down, means that perhaps we need to consider the possibility of a corporate Australia without the protection afforded by D&O insurance. This in turn could potentially lead to a demise of the quality and availability of directors and officers to act as trustees for future development of corporate Australia.

Notwithstanding this, and putting things into perspective – while securities class action claims are driving a specific response due to their severity in a relatively small Australian D&O premium pool, the frequency of such claims, albeit increasing, still remain below what is experienced in the US. Australia's D&O premiums are, however, beginning to reflect closer to prices charged in the US and some European jurisdictions.[12]

As we expect insurers to continue to readjust upwards in both pricing and retentions, it will be interesting to observe the impacts on insureds' purchasing patterns in the long run.

12 Ibid 1

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