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### **Broadening Responsibilities of Directors**

#### *Directors' and Officers' Liability Insurance as a Product in a Market Context*

#### **Introduction**

This seminar examines directors' and officers' liability ("D&O") insurance as a product in a market context.

To achieve its purpose, this seminar addresses:

- (a) the constituent insuring clauses in D&O insurance;
- (b) the manner in which D&O insurance is purchased/structured;
- (c) the D&O insurance market as regards:
  - (i) premium size;
  - (ii) capacity;
  - (iii) participants;
  - (iv) business segments; and
  - (v) competition between insurers; and
- (d) what the future holds in store.

#### **What is D&O insurance?**

D&O insurance is a specialist form of liability insurance.

Under this insurance, insurers generally cover:

- (a) directors and officers for their legal liability as directors and officers which their corporations may not indemnify them for-this form of cover is known in the market as Side A cover; and
- (b) corporations for the indemnity which they may grant to their directors and officers for their liability as directors and officers-this form of cover is known in the market as side B cover. It is important to note that although this "side" covers the corporations as opposed to the directors and officers, it does not respond to claims made against the corporations. It still only responds to claims made against the directors and officers.

D&O insurance policies for listed corporations often also cover the corporations for their liability for claims made against them in relation to their securities. This is known in the market as side C cover.

#### **How is D&O insurance purchased/structured?**

D&O insurance is purchased by insurance brokers on behalf of corporations and their past, present and future directors and officers.



Generally, the larger the corporation, the higher the limit of indemnity for the corporate program. Limits in excess of \$25 million are usually layered, with separate primary and excess insurers subscribing to separate primary and excess layers (commonly about \$25 million each). In Australia that subscription is usually 100% per layer, whereas in London the subscription is often on a co-insurance basis, London being more of a syndicated market than Australia.

## **D&O Insurance Market**

### ***Premium Pool***

The D&O insurance market in Australia has an annual premium pool of more than \$200 million.

### ***Capacity***

It also has a theoretical capacity of more than \$400 million per corporate program. However, as insurers position themselves according to different market segments (about which more below), the consequence of which is that some insurers do not underwrite certain segments, that theoretical, total market capacity can seldom be accessed by a single corporation in Australia.

That said, the market in Australia is currently well-supplied with D&O risk capital and most corporations are able to procure sufficient capacity in Australia in the prevailing market conditions. To the extent that the capacity is exhausted in the Australian market and has to be topped up (e.g. for corporations in industries, such as financial services, which are undersubscribed), London is usually able to satisfy that need. On rare occasions, the Bermudian market is accessed (more for specialist cover than simple excess capacity).

### ***Market Participants and Business Segments***

The market participants are insurers and insurance brokers which have made strategic decisions to enter the D&O insurance product segment in the insurance market. Owing to the complex nature of the risk and the product, the insurers and insurance brokers use specialist underwriters and brokers to trade in the insurance.

The D&O insurance product segment is further segmented into:

- size;
- industry;
- geographical; and
- listing status,

segments.

In some segments insurers generally have similar appetites, e.g. in the SME segment (a size segment), which means that such segments are oversubscribed.

In respect of other segments, insurers have very different appetites, e.g. corporations with an American exposure (a geographical segment) or in financial services (an industry segment) are undersubscribed.

In the large corporate segment, which is usually made up of multi-layered corporate programs, insurers also have different appetites for primary and excess layers and, where there is co-insurance, for leading or supporting a particular layer. The primary layer segment is generally undersubscribed in Australia. The first excess layer segment is well-subscribed, especially by insurers which believe that defence costs are the major risk for directors and officers and this layer therefore has a favourable



risk-reward ratio. Higher excess layer segments are oversubscribed (by insurers which believe that D&O risk is not a risk of great severity).

### ***How do insurers compete within segments?***

Insurers compete against each other within their chosen segments on their products, price, claims service and security. As this seminar is meant to address the product, it won't explore insurers' positioning on price, claims and security.

In the SME segment, D&O is rapidly converging with other products, e.g. professional indemnity/errors and omissions, employment practices liability and crime insurance, into packaged products. This convergence suits the needs for low-cost, efficient transactions for this segment. In this segment, the D&O section of the packaged policy comprises sides A and B only. The D&O cover is off-the shelf, rather than tailored, especially as transaction costs have to be kept to a minimum.

In the major corporate segment, leading insurers have recently revised their broad form products to provide the widest cover seen in years.

Side C is still being offered as part of the D&O product package. Whilst side C cover is not being offered on a stand alone basis, the growth of shareholder class actions against corporations might lead to side C being priced separately or even as a separate stand-alone product.

Side A is available as a stand alone product, usually on an excess basis, however it has not been widely purchased, probably because:

- (a) there is currently insufficient premium and coverage trade off for simply buying side A compared to buying side A and B (and C) cover combined; and
- (b) priority of payments clauses give directors and officers priority over the corporations in terms of payments where both sets of parties are entitled to indemnity.

More insurers are now offering stand-alone prospectus liability insurance cover which provides:

- (a) prospectus-specific cover;
- (b) side A, B and C cover;
- (c) separate capacity; and
- (d) multi-year, non-cancellable protection.

Many corporations believe that the separate capacity and the multi-year non-cancellable policy period outweigh the lower cost option of simply including the prospectus cover under an annual D&O program.

## **Future**

### ***SME Segment***

Product convergence in this segment is likely to continue owing to the distribution and cost synergies in such a low cost, transactional segment.

This segment is also likely to remain oversubscribed in the short to medium term with more insurers and underwriting agencies entering into it, especially in the belief that this segment has and will continue to have a benign claims profile.



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With continued product convergence and oversubscription in this segment, price will remain an important differentiator.

### ***Large Corporate***

Coverage in this segment is likely to remain broad in the short to medium term.

However, owing to shareholder class actions against corporations and the recent *Fostif* decision in favour of litigation funding, consideration might be given to pricing side C cover separately or, even, writing it as a stand-alone product.

The excess layer segment is likely to remain oversubscribed, although not in the American and financial services segments.

There is also likely to be more competition in the primary layer segment, as insurers which have established themselves in the excess segment, expand into the primary segment. As premiums are already low, products are already broad and security is already high in the primary segment, it will be interesting to see how insurers continue to compete in this segment. Claims services might justifiably enjoy greater attention as a differentiator than in the past. After all, D&O insurance is purchased to protect against claims rather than to comply with regulatory, contractual or professional association requirements as is often the case with certain other liability insurance lines.

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