

What risks do directors want covered and what risks are insurers prepared to cover? The insurer's perspective.

Michael Herron, AIG Australia

Preliminary comments

This paper provides some observations on hot button issues for directors and some thoughts on some heavily negotiated policy terms and coverage innovations. For convenience, this paper refers to "directors" as a generic term for insured persons.

An insurer's perspective

It's certainly presumptuous for an insurer to comment on what directors want.

When it comes to Directors & Officers Liability (D&O) policies, however, perhaps the insurer is in a unique position to make some observations. Senior managers and their legal counsel are taking an increasing interest in the D&O policy negotiations and are sharing their views on any perceived deficiencies in cover with the insurers.

This attention is not surprising given some recent high profile indemnity disputes, corporate collapses, shareholder and investor actions with litigation funding, and an active regulator pledging, by reason of resources, an intended deterrent approach of putting "heads on sticks". If you subscribe to the view that any press is good press, D&O insurance now has the sort of profile that most general insurance lines would die for.

I've heard it said by legal advisors who specialise in Directors & Officers Liability (D&O) policies that they have a particular bias in favour of directors. Such a bias is not, however, the sole domain of those who act for directors. This quality is of course absolutely necessary for those who develop and offer D&O insurance.

Any D&O insurer who wants to provide an attractive policy cover must have empathy with the directors who are to be insured. What is interesting is how such bias manifolds from insurer to insurer.

What risks do directors want covered?

In short, directors want to know that they can count on their D&O insurer. Directors are concerned about their personal liability, their livelihood and their liberty. They want their D&O insurer to give them the benefit of the doubt, even if they are facing the most serious allegations.

What risks are insurers prepared to cover?

D&O insurance is provided in a competitive marketplace and D&O insurers want to underwrite business and distinguish themselves from their competitors. This distinction can be demonstrated through price reductions and alternative policy terms to provide the protection & comfort that directors seek in D&O insurance.

The leading D&O insurers recognise the goodwill that attracts to their claims handling and the common interest they have in promoting a partnership approach between insurer and insured.

Hot button issues

There are some issues that get all the attention.

Advance Payment

D&O captured the headlines in 2003 with the New South Wales Court of Appeal decision in *Silbermann v CGU*¹ which found that the insurer had the discretion to refuse to advance defence costs in respect of allegations of dishonest or fraudulent conduct. The same year, the New South Wales Supreme Court in *Gordian RunOff v Wilkie*² applied the same reasoning to a different D&O policy.

These well publicised decisions were described by several commentators as a win for D&O insurers. Not all insurers agreed, however, and while the High Court eventually decided against the insurers in the Wilkie matter, the machinations were seen by some insurers as a great setback for the confidence of insured directors.

The result is that some insurers now put the issue beyond doubt with a condition promising that they may not refuse to advance defence costs even if they consider that fraud or dishonesty has occurred, until such time as the conduct is established by an admission or final determination by a court, tribunal or arbitrator.

Assets and liberty

In the most extreme circumstances, directors may be subject to preliminary actions in which they face being detained, deported or extradited, or having their assets frozen or seized.

D&O insurance cover is available to respond in such an emergency by paying bail bond or civil bond expenses and by funding the cost of proceedings brought by a director to overturn such orders and secure the director's assets and liberty.

In circumstances where a director's livelihood is at risk from disqualification, for example from a finding by the Australian Prudential Regulatory Authority that the director is not a 'Fit and Proper' person, D&O cover is also available to fund proceedings brought by the director to challenge their disqualification (i.e. in the Administrative Appeals Tribunal).³

Investigations

Prior to any formal claim being made against a director which alleges some type of management misconduct, there may be a preliminary information gathering process in the form of a hearing, investigation, examination or enquiry.

It is often said that what happens in the early days of an investigation tends to shape the likelihood, or not, of any subsequent action. The cover provided for costs incurred in preparing for and attending investigations has evolved considerably in recent years as the cover has been tested against the experience of royal commissions, commissions of inquiry and stock exchange investigations. Some D&O policies now give affirmative cover for these types of investigations.

¹ (2003) 57 NSWLR 469

² [2003] NSWSC 1059 (18 December 2003)

³ On 23 August 2006 the Administrative Appeals Tribunal reversed the disqualification by the Australian Prudential Regulatory Authority of seven former trustees of the AXA staff superannuation fund, including the chief executive-elect Andy Penn. See [2006] AATA 710 and "Overlook the spin: APRA got it wrong", Stephen Bartholomeusz, Sydney Morning Herald, 24 August 2006.

In circumstances where the company has in fact incurred and paid the costs of appearances by the directors at an inquiry, a crucial issue has been whether such costs were insured by a D&O policy which only covered those costs that a director was liable to pay.⁴ It has been suggested that this was perhaps a victory of form over substance, but it does highlight the need for effective association with the insurer which may have achieved a different result such as the retention of separate counsel for the directors and the company.⁵

A further issue concerns the mechanism for granting investigation cover. Being a preliminary information gathering process, the investigative body is likely to be at an early stage in determining what allegations are to be made and therefore any investigation cover should not be linked to a Wrongful Act. The trigger can instead be the receipt of a notice from an official body requiring an individual's attendance. It is understood that, even if an individual is co-operating with an investigating body, the individual will be advised to request a notice requiring their attendance to secure the protection afforded by the due process of being compelled to attend to answer questions.

Some insurers offer a sub-limited investigation extension with a retention that applies to both the directors and the company. Usually this extension is unconnected to the insuring clauses and the other terms such as advance payment, claims conditions, severability etc. It is possible, however, to obtain investigation cover as part of the "claim" definition (to which all the policy terms apply) up to the full limit of liability and with no retention for the directors.

Non-Executive Directors

The decision of whether or not to accept a non-executive position will inevitably involve a risks and rewards analysis associated with the prospective position.

Much has been said of the push to ease the governance burden on directors, yet the potential exposure to personal liability appears to be growing rather than diminishing. One consequence is the erosion of a company's ability to attract and retain high quality directors.

Non-executive directors are increasingly requesting details of the D&O insurance arrangements before taking on a new board position. The non-executives are particularly sensitive to the limit of liability purchased as in the event of a catastrophic claim they can be among the last to seek access to the policy.

In a worst case scenario where there is no indemnification from the company and the limit of liability is exhausted, non-executive directors could find themselves funding any defence costs and settlements from their own personal assets.

To help companies attract and retain non-executive directors, a special excess limit (for non-executive directors) can be purchased to provide a 'top-up' protected limit once all other insurance cover is exhausted.

Shareholder and investor class actions

The rise and rise of securities claims has certainly caught the insurers' attention. Much has been made of the latest data emerging from the United States which shows a

⁴ *Intergraph Best (Vic) Pty Ltd v QBE Insurance Ltd* [2005] VSCA 180

⁵ *D&O Developments*, August 2005, Lander & Rogers.

reduction in the frequency of securities class action filings.⁶ This is only half the story. While the case filings may be down, there is also data revealing that the average cost of a private securities litigation settlement is "skyrocketing".⁷

Perhaps more than any other jurisdiction outside the United States, Australia is experiencing its own rise in securities claims in the form of shareholder and investor class actions.⁸ Recent releases by IMF (Australia) Ltd to the Australian Stock Exchange paint a healthy picture for litigation funding, and this is before the High Court's ruling in *Fostif*⁹. The climate is described as a plaintiff friendly regime and the D&O insurers have the claims experience to prove it.

Simple economics demand that cover against securities claims must be adequately priced. Softening rates for D&O insurance can not be sustained for securities claim exposures and premiums for such cover must rise accordingly.

In addition, where cover is provided for securities claims against the company, risk sharing through coinsurance between the insurer and the company is becoming more common. The relative size and financial capabilities of the insured, as well as its appetite for risk, will of course determine whether coinsurance is feasible.

Severability

Scrutiny of severability clauses is becoming a priority issue in any D&O policy review. This is because a non-disclosure or misrepresentation by one insured in the insurance proposal may allow the insurer remedies against all insureds.¹⁰ Also, where a claim is made against several persons, 'innocent' directors may have concerns the dishonest or fraudulent conduct one director will be imputed to all directors.

There does not seem to be a uniform approach to severability from insurers and advisors, however, two variations can be broadly described as 'full' severability or 'limited' severability.

A 'full' severability clause may state that, with respect to the contents of the insurance proposal and for the purposes of the application of the conduct exclusion: no statements made nor any information or knowledge possessed by any insured person, nor act, error or omission of any insured person, shall be imputed to any other insured person. If the policy also covers the company, this full severability clause usually states that only the statements and knowledge of certain specified officers is imputed to the company.

A 'limited' severability clause may state that the knowledge of one insured is not imputed to another insured, except that the knowledge of either the signatory of the

⁶ *Securities Class Action Case Filings, 2006 Mid-Year Assessment*, Cornerstone Research

⁷ *2005 Securities Litigation Study*, PricewaterhouseCoopers

⁸ See "*Big funds in class act*", Annabel Hepworth, Australian Financial Review, 23 July 2006: "Institutional investors are joining a wave of class actions against listed companies, spearheading a push by aggrieved shareholders to pursue legal avenues to recover their losses. Amcor, Telstra, Aristocrat Leisure, National Australia Bank, Sons of Gwalia, Concept Sports, Village Life, Media World Communications and automotive parts manufacturer ION all face class actions."

⁹ *Campbells Cash and Carry Pty Limited v Fostif Pty Ltd* [2006] HCA 41.

¹⁰ See *Advance (NSW) Insurance Agencies Pty Ltd v Matthews* (1989) 166 CLR 606 and *Insurance Contracts Act 1984*, s 28.

proposal form or alternatively the knowledge of certain designated officers is imputed to all insureds.

Don't underestimate the intangibles

Can you be sure that all insurers will apply the same understanding/approach to an issue?

Swapping clauses between insurers: What is perplexing to insurers is that there are many and varied views on what the insurers should do to cover the hot button issues or address any perceived deficiencies. This has resulted in a tendency to mix and match clauses from a variety of sources. Will this approach, however, produce the desired effect?

It is natural that an insurer who has borrowed unfamiliar clauses to insert in its own policy will take a conservative approach in interpreting such clauses. If there is any uncertainty about what is intended by a particular clause, the easy answer could be no! Will your insurer be bold or take a conservative approach?

High anxiety and the need for cool heads

Both directors and D&O insurers have a common interest in running a strong and effective defence to any claim. D&O insurers want to associate with the directors in this respect. An experienced insurer has significant expertise to contribute in dealing with plaintiff firms and will have a broad knowledge of recent settlements and strategies.

Cool heads and claims handling experience counts when it comes to choosing an insurer. Partnership is crucial. Communication is paramount. Experience counts!

This paper is intended to provide commentary and general information. It should not be relied upon as legal or insurance advice. Readers should make their own enquiries and obtain independent advice specific to their circumstances prior to entering into any transaction based on this information.