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By Mark Brookes, Partner and
David Fisher, Solicitor
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Recent developments in D&O insurance

In brief
An increase in securities class action claims has put D&O policies under the microscope.
Are directors obtaining the best protection for their potential liabilities?

The recent economic climate has proved a significant factor in facilitating change in the landscape of D&O insurance with D&O insurers experiencing an increase in claims, particularly company securities claims, resulting in higher levels of exposure for both insurers and insured directors and officers. With this in mind, we take a look at the effect on side C cover in the D&O insurance market.

Side C cover

Directors' and officers' insurance policies operate for the benefit of a corporation's past, present and future directors and officers. The cover traditionally afforded is twofold. Firstly, directors are personally covered for any liability for which the corporation is prohibited (by virtue of law or the company's articles) from indemnifying them against (side A cover). Secondly, the corporation is covered for the indemnity it grants a director in respect of any personal liability incurred in the performance of the director's duties (side B cover).

Over the past two decades it has become common practice to include in D&O policies *Securities Entity* cover, also known as side C cover, which provides cover to the corporate entity for any liability arising out of shareholder claims. In soft market conditions, side C cover has traditionally been included in a D&O policy for little, if not any, increase in the policy premium thereby aligning the directors' and the company's interests in a single policy. Such cover was initially received gratefully by directors as providing extra cover for the corporate entity at no extra charge.

In recent times we have seen a sharp increase in shareholder claims, particularly class actions, against corporations that experience a downturn in share price. Those corporations then look to the side C cover afforded under the D&O policy for coverage. Such claims, which can stretch into the hundreds-of-millions of dollars, have the potential to quickly erode the limit of cover available under a D&O policy, thereby leaving directors and officers exposed to significant uninsured risk in respect of any future claims against them within the policy period. That risk was often not contemplated by directors when accepting D&O policies that included side C cover.

Competing interests

Directors hold the position of the controlling mind of the corporate entity and accordingly are required to balance the competing interests of providing adequate coverage for liability attributable to them as directors of the company and cover for the entity's own liability with respect to securities claims. The question arises as to how that balance is best achieved? Through a single combined policy or a policy for side A & B cover and a separate policy for side C cover.

Given the common practice that has occurred in the D&O market in the last 20 years, directors presenting a D&O policy to the board or to the shareholders with the express exclusion of side C cover may feel vulnerable to criticism for not acting in the company's best interests (requiring the purchase of a further policy to cover liability arising out of securities claims at an additional premium). This is especially so considering that in most cases the premium payable on the D&O policy will be substantially the same with or without side C cover.

A further issue may arise when the services of an insurance broker are engaged. Invariably, directors will look to the broker to advise on the appropriate levels of cover under a D&O policy. However, when a policy includes side C cover, the broker may potentially be providing advice for two interrelated, yet opposing, interests.

It is an arguable assumption that the company's

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directors are the broker's client, given that the primary purpose of a D&O policy is to provide coverage for personal liability attributed to directors of the corporate entity. However, when advising on a D&O policy with the inclusion of side C cover, the broker may also be acting for the company itself and careful consideration should therefore be given to clearly identifying the client and the appropriate levels of cover provided under such a policy.

The way forward

In the last decade securities class action claims have gained considerable momentum. In August 2003, GIO settled a securities class action claim for $97 million and more notably in August 2008, the Federal Court approved the $144.5 million settlement of the Aristocrat securities class action. The situation only seems to be intensifying, with the ASX Rules specifying strict continuous disclosure requirements and the increase in litigation funding. There are a number of notable class action securities claims currently on foot, including claims against AWB, Centro and Multiplex, to name a few.

The D&O market has therefore changed in recent years. In a significant move some insurers have (or are looking to) remove side C cover from D&O policies and offer it in a separate 'companion' policy. The result is a director focused policy unaffected by corporate entity liability that should provide more adequate coverage for directors' liability and a separate specialised policy to cover the entity's exposure to securities claims.

It remains to be seen whether other insurers will follow this lead, however it is likely that this is just one example of how insurers will be looking to manage their levels of exposure in a changing claims environment. One thing that is certain however is that directors and officers should be increasingly mindful of the levels of cover afforded under their current D&O policy and the potential exposure to uninsured risk that may arise in the event of significant side C cover claims.

Authors

Mark Brookes
Partner
T: +61 7 3000 8301
mbrookes@carternewell.com

David Fisher
Solicitor
T: +61 7 3000 8386
dfisher@carternewell.com

Other members of CN|Insurance

Philip Glaister
Special Counsel
T: +61 7 3000 8382
pglaister@carternewell.com

Nola Pearce
Senior Associate
T: +61 7 3000 8427
npearce@carternewell.com

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