

D&O'S CLIMATE change

Mark Parris explains why the shifting climate in the D&O market makes now a great time to re-negotiate your cover.

SMART DIRECTORS WILL take advantage of the current soft cycle in the D&O insurance market to ensure that they have insurance protection which provides optimum cover in the event of a claim.

Strong equity markets, yielding good investment returns, mean that the pressure is off insurers to increase premium rates. When combined with a claims environment marked by low loss ratios, the result is a soft market, characterised by low insurance premiums, excess capacity and competition amongst insurers.

The current environment is unsustainable in the long term. That's why it's a good idea for directors to be consulting with their broker to review their existing D&O coverage and to benchmark it to find the best available terms, concentrating on coverage, not just price!!

However, a number of factors are emerging as potential threats to the current soft market. Some of these include:

Potential class actions

Historically, the tide has turned in insurance markets where the threat of class actions has been perceived to increase. Commentators speculate that an increase in insurance premiums and a tightening up of policy terms may be on the way in the D&O market, as judicial developments signal a change to the way litigation is conducted in Australia.

The High Court-findings in *Campbells Cash and Carry v Fostif and Sons of Gwalia v Margaretic* have been widely seen as giving the green light to class action litigation and to litigation funders. Indeed, the number of litigation funders in Australia is on the rise. In the future, companies and their directors are also likely to face better-resourced and more aggressive litigation. The increased costs of litigation may also lead to more settlements, all of which is bad news for D&O insurers.

Social responsibility

The notion of corporate social responsibility is gaining momentum in Australia. Indeed, the ways in which companies conduct themselves and the extent to which they are perceived to assume responsibility for the consequences of their actions will be a subject which will attract a lot of attention in the coming years.

Environmental concerns are a perfect example of this - we are already seeing companies under pressure to provide greater transparency in their actions with continuous disclosure becoming ever more important.

Companies such as National Australia Bank, Woolworths and Starbucks Australia are already posting details of their Corporate Social Responsibility (CSR) programs on their websites.

In the US, litigation on these issues is on the rise. In California, the Government has issued legal proceedings against local car manufacturers seeking damages for environmental damage inflicted by carbon emissions.

Locally, the James Hardie case highlights the growing pressure on companies and directors to take responsibility for their actions.

The Government recently asked the Corporations and Markets Advisory Committee (CAMAC) to look at whether the *Corporations Act* should be revised to clarify the extent to which directors may take into account specific classes of shareholders or the broader community when making decisions. It was also asked to look at whether certain types of companies should be required to report on the social and environmental impact of their actions on the environment. CAMAC's finding was that the current formulation of directors' duties allows sufficient flexibility to take different interests and broader community considerations into account. The more appropriate response, CAMCAC found was specific legislation in the relevant area - for example, environmental or social - to cover all relevant parties.

So what does all this mean for insurers? In the US market some D&O insurers are already requiring companies to disclose information about their environmental and social risk management strategies, right down to whether they have a carbon accounting or reporting system.

While the effects of climate change are just beginning to be felt in the D&O market, this promises to be an issue that is with us for a while. One plaintiff law firm has reportedly sent letters to the boards of 145 companies, putting them on notice of climate change risks. By putting directors on notice of their duties, the path is paved for future litigation if they fail to comply with those duties.

So when it comes to negotiating a D&O contract, what issues should directors be considering? It is fair to say that D&O insurance has evolved a great deal since its introduction in Australia in the 1970s. Policies have been greatly enhanced and changes have been made to reflect legislative developments and legal precedents.

Corporate indemnity

Most D&O policies respond once the company indemnifies its director. If the company will not provide that indemnity because it is unable to by law (for instance, where there are allegations of fraud) then a director can be left with no coverage. Indemnities are usually drafted by the company's lawyers, with the company's interests in mind. If a company becomes bankrupt, then typically the D&O policy becomes part of the company assets, leaving the directors exposed. If a company is bought out by a private equity firm, for example, the value of the indemnity may be lost. Because of this, company directors should ensure that the indemnity provided by the company is as broad as possible within the

law. An appropriate Personal D&O policy may also provide comfort to an insured where the company indemnity is in question.

Non-executive directors

In order to attract and keep the best non-executive directors in the current legal environment, companies must demonstrate a commitment to risk management and a comprehensive insurance program.

A key issue for non-executive directors coming onto a board is the limit of liability purchased by the organisation. Where litigation is already on foot, there is the potential for exhaustion of insurance limits. If the company fails to indemnify, non-executive directors may find themselves personally liable for any defence costs and settlements.

For those directors sitting on a number of boards, the administration of the various insurances provided by the different companies may be daunting. Some non-executive directors may relieve the pressure by purchasing a Personal D&O policy which provides individual protection in the event of a claim.

Severability

Insurers have traditionally used severability clauses in D&O policies to give protection to individual directors. While an insurer may, in some circumstances, have the right to rescind the policy due to the wrongful acts of a director, severability of cover provides that the wrongful acts of one director are not imputed to another.

Not all insurers have a uniform approach to severability, but the clauses usually fall into two categories: "full severability" or "limited or partial" severability.

A full severability clause may state that in regard to the contents of the insurance proposal and for the purposes of the application of the conduct exclusion, statements made and information or knowledge possessed by an insured person nor their acts, errors or omissions will be imputed to any other person.

A partial severability clause may state that the knowledge of one insured person will not be imputed to another except the knowledge of either the signatory to the proposal form or certain specified insured persons.

The existence of "full severability" wording is not an ironclad guarantee that an insurer will not attempt to rescind a policy, but its aim is to preserve coverage for innocent individual insureds. Courts have generally interpreted full severability language as limiting an insurer's right to rescind coverage to circumstances when individuals have made knowing misrepresentations in the application or who otherwise have had knowledge of underlying fraud.

However, recent case law in Spain and Germany has cast a shadow over the operation of variability clauses. In these countries, courts have not recognised the notion of severability, with a Düsseldorf court voiding an entire D&O policy because of the actions of several senior directors.

These developments have created uncertainty in the European D&O market and raised questions as to whether insured companies should be continuing to purchase "collective" policies on behalf of all of their directors or whether individual contracts for each director are a safer bet.

This issue is one which could potentially turn ugly for insureds if the D&O market hardens. Directors should carefully scrutinise the wording of their policy with their advisors to ensure that the severability clause is as broad as possible.

Visit the Member Services area of AICD's website to access further information on D&O insurance - www.companydirectors.com.au 

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