

■ D&O insurance: The dangers of collective cover

Recent developments in European case law raise some serious questions about the protection afforded to individual directors by Directors and Officers (D&O) Liability policies.

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

Nevertheless, directors need to be aware that the actions of their co-directors may impact on their own coverage leaving the innocent director uninsured.

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

A full severability clause may state that in regard to the contents of the insurance proposal form and for the purposes of application of exclusions, statements made, and the information or knowledge possessed by one insured person (or their acts, errors or omissions) will not 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 iron-clad guarantee that an insurer will not attempt to rescind a policy. However, the aim of a full severability clause is to preserve coverage for innocent individuals. Courts have generally interpreted full severability as limiting an insurer's right to rescind coverage to circumstances where individuals have made misrepresentations in the application form, or who otherwise have had knowledge of an underlying fraud.

Recently reported cases in Spain and Germany have cast a shadow over the operation of severability clauses. In those countries, courts have not recognised the notion of severability, with a Dusseldorf court voiding an entire D&O policy because of the actions of several senior directors.

These developments have undoubtedly created uncertainty in the European D&O market and raised questions as to whether companies should be continuing to purchase 'collective' policies on behalf of all of their directors, or whether individual contracts

for each director are a better alternative. Similarly, it could be time for Australian companies and directors to ask themselves the same question.

Mark Parris, a director of specialist insurance broker Risk Partners, believes that severability clauses have the potential to be an issue for insurers and directors in the Australian marketplace as well.

"Right now you have a booming economy, a broadening of D&O coverage, increased capacity and a lowering of policy premiums," Parris says. "But when the market turns – which it will – insurers will find they haven't priced their policies to account for the risks of litigation in the future."

Parris further believes that: "The legal and regulatory environment that directors face is becoming increasingly litigious. With the development of litigation funding, increased class actions, recent cases such as Sons of Gwalia and James Hardie, and ASIC's general propensity to pursue directors individually, sooner or later insurers are going to have to face big claims in a market where the premium pools are low. In a highly competitive market something has to give – and most likely insurers will explore and potentially exploit policy exclusions and other means of reducing their liabilities. There will also be a toughening up of policy terms and conditions."

The recent emergence of personal D&O liability contracts highlights the market's increasing concerns about the gaps in traditional D&O coverage. Personal D&O policies provide the same sort of coverage as a traditional D&O policy but the cover is only for individual company directors – not for a group of directors.

Purchasing individual cover can eliminate the problem of severability as well as many of the other hazards of a shared policy such as exhausted policy limits or sharing counsel.

Developments in corporate litigation in recent years have made the negotiation of D&O contracts a complex business. Astute directors need to understand the cover available and be aware of the need to protect their individual interests as well as those of the company and board.

For more information on D&O insurance go to www.companydirectors.com.au and click on 'Member services' and then 'Business Connections'.

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