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ALRC Submission Paper

Directors' and Officers' Liability Insurance (D&O)

Submission to the Australia Law Reform Commission's Inquiry into
Class Action Proceedings & Third-Party Litigation Funders

Between 2011 and 2018, the cost of D&O insurance for Marsh's ASX200 clients increased **353%**, with an increase of **202%** in the period 2016 to 2018 (as at 30 June) alone. Over the same period, retention levels for clients have increased **440%** and **331%** respectively, bringing the average retention now to **\$10.65 million**.



Executive Summary

Marsh's submission to the *Inquiry into Class Action Proceedings and Third-Party Litigation Funders* will provide empirical evidence of the impact of class action proceedings and third-party litigation funding on the availability and affordability of Directors' and Officers' (D&O) Liability Insurance. A direct link exists between an increased number of class actions/resultant insurance claims paid and premiums, retentions and availability of D&O insurance.

D&O Liability Insurance is a critical protection mechanism of any strong corporate governance regime that ensures the sustainability of boards and ultimately the organisations they represent. The current state of class action proceedings and third-party litigation funders is undermining the stability of that regime by eroding the availability of insurance coverage and contributing to significantly higher pricing for D&O Liability products offered in the Australian and global insurance markets that write Australian risks.

The type of insurance commonly associated with securities class actions is D&O insurance. Without the protection afforded by D&O insurance, the quality and availability of directors to act as trustees for the future development of corporate Australia could be diminished.

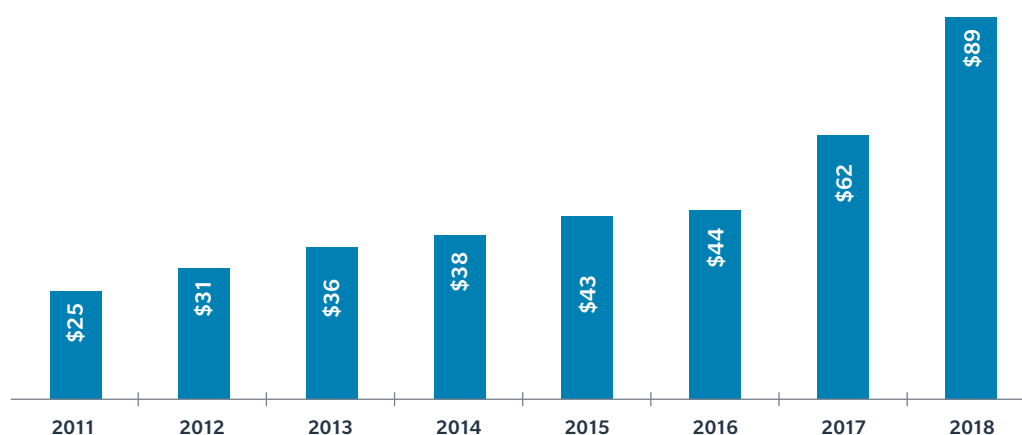
The increased cost of D&O insurance to corporate Australia cannot be understated. Between 2011 and 2018, the cost of D&O insurance for Marsh's ASX200 clients increased 353%, with an increase of 202% in the period 2016 to 2018 (as at 30 June) alone. Over the same period, retention levels for clients have increased 440% and 331% respectively, bringing the average retention now to \$10.65 million.

No less importantly, over the period from 2011 to 2018, the number of insurers providing D&O coverage dwindled. Despite the increased premium spend shown below, insurers have withdrawn from the market because of a steady increase in class action settlements that were the subject of insurance claims under D&O policies.

FIGURE
1

D&O Premium Spend 2011-2018 (Marsh Client data within the ASX200)

■ D&O Premium Spend 2011-2018 (A\$ million)



Main Response

Overview of D&O Insurance:

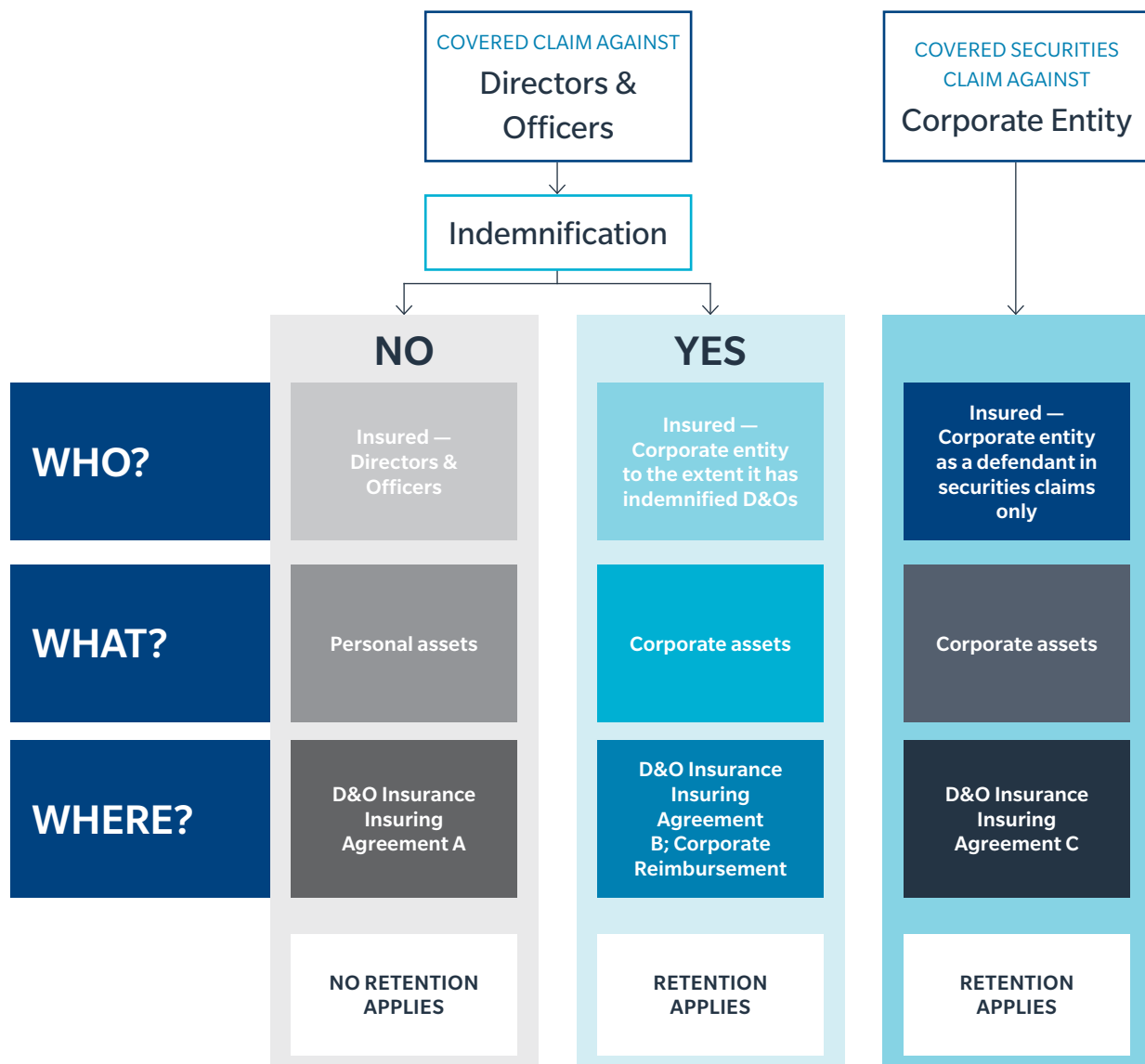
As shown in the illustration below, a D&O policy is made up of three types of coverage:

1. For Individual directors and officers;
2. For the company where it grants indemnity to a director; and
3. For the company's own liability for securities class actions.

The limits of indemnity for D&O policies are commonly shared across the above three coverage types.

FIGURE
2

The Make-up of a D&O Insurance Policy



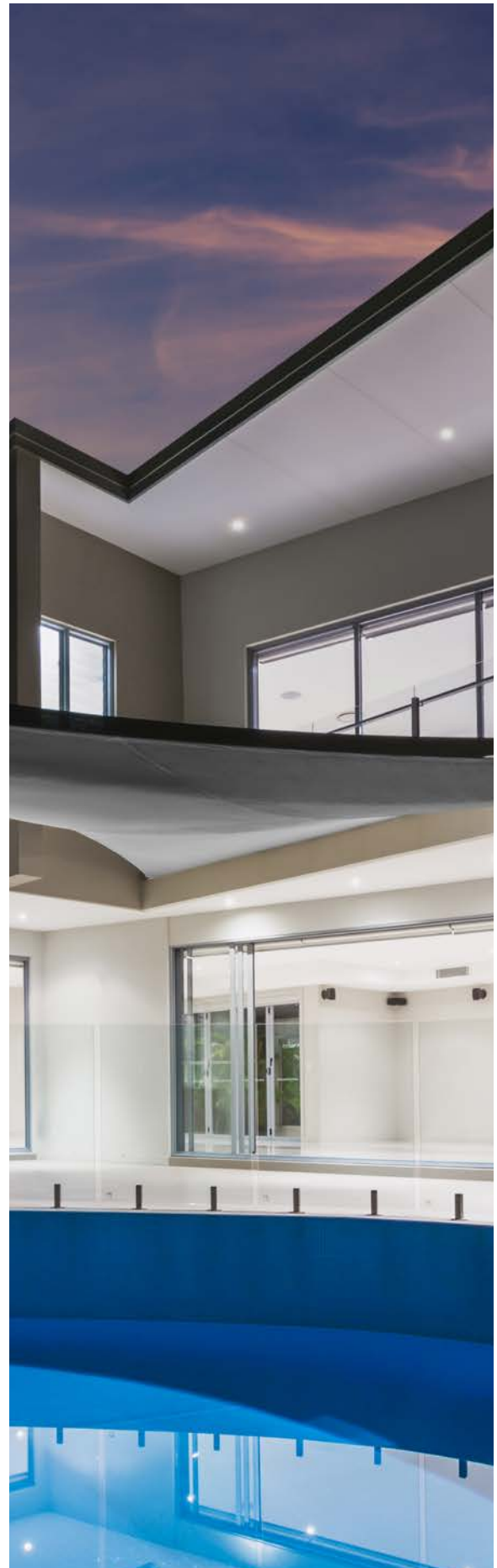
The need for D&O Insurance:

A company D&O insurance policy provides cover for liabilities incurred by directors and officers in the performance of their duties; otherwise, the personal assets of directors or officers may be exposed.

Qualified directors and officers regularly require a company to enter into a deed of indemnity to ensure protection against an ever-increasing scope of personal liability for directors and officers. A deed of indemnity requires a company to procure and maintain D&O insurance to protect an individual director or officer from personal liability in the event of a claim or investigation against the director, officer or company. In some instances, a company cannot indemnify a director or officer under a deed of indemnity, as the insured corporation is prohibited in law from indemnifying an individual.

Without a deed of indemnity and an underlying D&O policy, many qualified individuals will refrain from taking positions as directors or officers. If D&O coverage becomes increasingly unavailable, corporate Australia will lose the depth of experience needed to function in response to regulatory and shareholder demands.

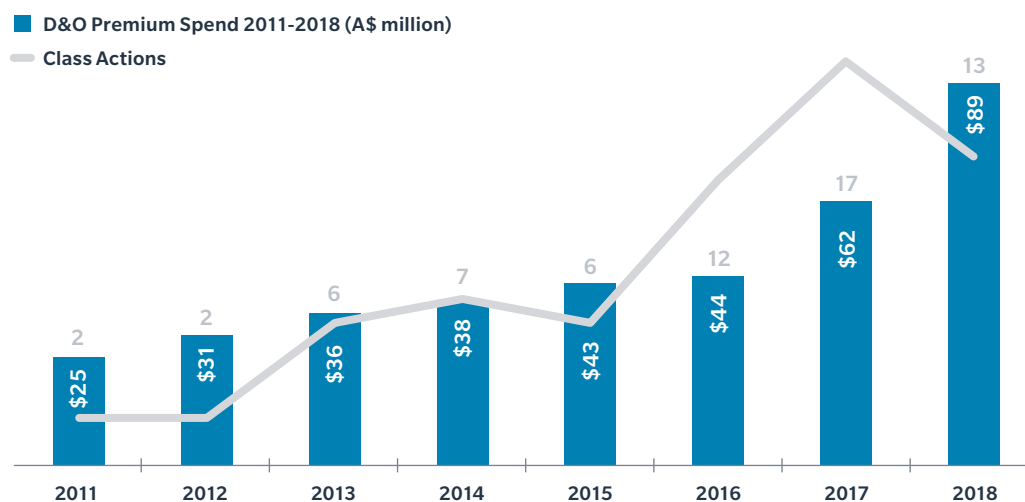
The three coverage types under a D&O policy include the company's own liability for securities class actions. This is commonly referred to as Securities Entity Coverage (or "Side C"). Side C addresses claims, including securities class action claims, made against both the company and individuals. However, because insurers often provide only one shared limit of indemnity, a claim paid under the D&O policy for the company can erode the cover available for directors and officers, and vice versa. For a number of years, directors and officers were concerned about the erosion of limits under D&O policies, but now their concern has shifted to the cost and availability of D&O coverage generally.



Impact of Securities Class Actions – Premium:

FIGURE
3

D&O Insurance Premiums vs. Class Action 2011-2018
(Marsh Client data within the ASX200)

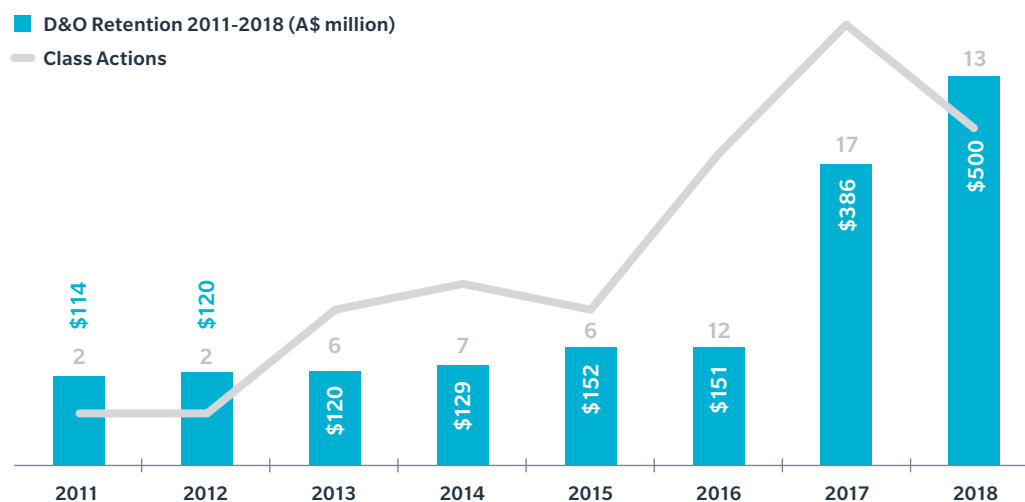


Not surprisingly, faced with increased numbers of securities class action claims under D&O policies, insurers have increased premiums. Indeed, pricing of D&O insurance amongst the ASX200 between 2011 and 2018 increased from \$25.29 million to \$89.41 million, a rise of 353%. From 2016 to 2018, in fact, premiums for the same client group rose from \$44.24 million to \$89.41 million, an increase of 202%. The average premium per client is now \$1.86 million.



Impact of Securities Class Actions – Retention:

FIGURE 4 D&O Retentions vs. Class Action 2011-2018
(Marsh Client data within the ASX200)



Another area in which securities class action claims have impacted D&O insurance is in respect of the retention amounts payable. D&O insurance is subject to a retention (otherwise known as a deductible), which is generally borne by the company. Only after the retention is exhausted will the D&O coverage pay for defence costs or settlement of a claim. As the size and frequency of claims increase, insurers require companies to maintain larger retentions, which has a negative impact on available capital and shareholder value. From 2011 to 2018, retentions increased across Marsh's ASX200 combined from \$114 million to \$500 million, with the average retention now \$10.65 million.

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Impact of Securities Class Actions – Availability of D&O:

One would think that increased premiums and retentions would incentivise insurers to write more D&O coverage, and encourage new insurers to enter into the marketplace. However, the reverse has occurred. Insurers are so concerned with the state of the D&O environment and the risk factors associated with providing cover for securities class actions that many no longer write the coverage at all. That, in turn, has created pressure on those insurers left in the market, which results in fewer options for purchasers and ever yet higher prices.

The impact to insurers is illustrated in the chart to the right which shows that the cost of D&O securities class action claims to insurers now exceeds \$1 billion since 2011.

The list of insurers that have withdrawn from providing D&O to ASX listed companies includes: WR Berkley, AAI Ltd trading as Vero Insurance (part of the Suncorp Group), Lloyd's Novae and Lloyd's Canopus. Other insurers – including XLCatlin, Zurich, Chubb, Allianz and Liberty – have ratcheted back their exposure and become more discriminating about purchasers to whom they will offer D&O coverage. They manage this risk through a variety of mechanisms, including by increasing premiums, increasing retentions, or offering less robust coverage.

FIGURE
5

Securities class actions – Projected Total Cost to Insurers inc. estimated defence costs (A\$ million)

By year of filing/announcement

SOURCE: XL CATLIN / WOTTON & KEARNEY, *Show me the money! The impact of securities class actions on the Australian D&O Liability insurance market*

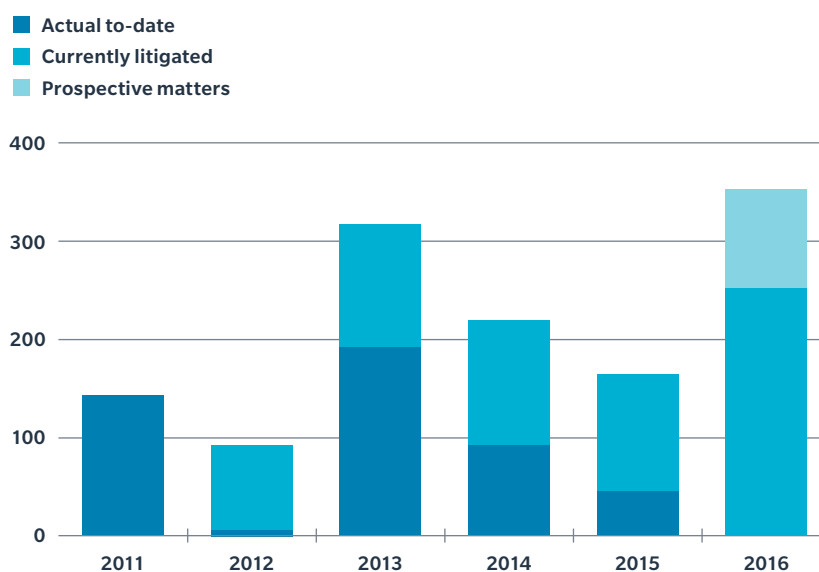
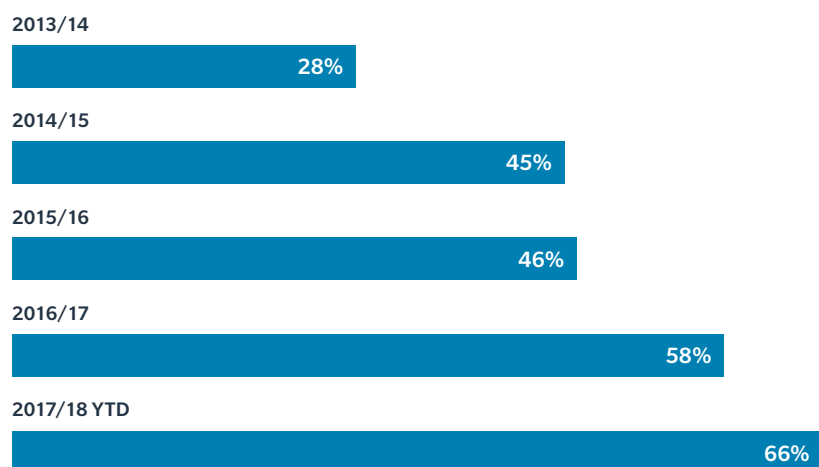


FIGURE
6

Funded class actions

SOURCE: KING & WOOD MALLESONS, *The Review – Class Actions in Australia 2016/2017*.





**The total value of D&O
insurer contributions to
securities class action
settlements since 2011
is estimated to be over
A\$1 billion**

Conclusion

We believe that the D&O market is at a tipping point, and that class action liability and third-party litigation funders are contributing to a situation that has grown increasingly dire. The data over the past seven years suggest that there is a direct link between the growing size and number of securities class action claims involving D&O insurance and the cost and availability of that insurance. Increases in premium of 353%, and a corresponding increase in retentions of 440% – which is what Marsh’s ASX200 clients have experienced – are unsustainable in the long-term. Even worse, claims experience is adversely impacting the appetite of insurers to write the coverage at all, or in a meaningful way to meet market demand. If Australian companies cannot secure sufficient D&O coverage, then they will struggle to attract, retain, and develop capable and experienced directors and officers.

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ABOUT MARSH

Marsh is the world leader in delivering risk and insurance services and solutions to clients. With 32,000 colleagues in 130 countries, we represent the buyers of insurance, working with clients in every industry to help them identify and mitigate risks to their people, assets and investments, which enables them to pursue innovation and create value.

Marsh has operated in Australia since 1953. With over 700 staff, Marsh has offices in every state and territory, producing annual revenue in excess of \$225 million and placing close to \$2 billion in premium volumes into the local and international insurance markets.

Marsh is the risk adviser and appointed insurance broker with regards to D&O risk and insurance for 47 companies within the ASX200, including 8 of the ASX top 10, 23 of the ASX top 50, and 32 of the ASX100. Accordingly, Marsh is well placed to comment and provide evidence about the impact of class actions and third-party litigation funders to D&O coverage. Marsh's ASX200 clients represent a combined annual premium spend on D&O of \$89.4M.

For further information, please contact your local Marsh office or visit our website at marsh.com.

The information contained herein is based on sources we believe reliable, but we do not guarantee its accuracy. The information contained in this submission provides only a general overview of subjects covered, is not intended to be taken as advice regarding any individual situation, and should not be relied upon as such. Statements concerning legal matters should be understood to be general observations based solely on our experience as insurance brokers and risk consultants and should not be relied upon as legal advice, which we are not authorised to provide.

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