Greater incidence of shareholder activism and class actions means insurance is increasingly occupying the minds of directors. Domini Stuart explains how boards can prepare for a significant claim event.

Feature

UNDER COVER

There are good reasons why insurance is top of mind for many directors. Class actions are steadily rising and there is the growing threat of cyber-crime.

In addition, the recent harmonisation of occupational health and safety legislation in some states has imposed new obligations on many boards, while there is also the added danger that an employee or former employee will sue for discrimination, harassment or other illegal employment practices.

However, it is not just directors of large companies who need to be concerned. A company doesn't have to be listed for its directors to be sued and face the possibility of personal bankruptcy. It doesn't even have to be making a profit.

"Some directors of not-for-profit organisations, particularly the smaller ones, have been flying under the radar in terms of protecting themselves," says Ramesh Singh, head of international financial lines at Australia XL Insurance Company.

Singh adds that recent attention on some companies has helped to highlight the issue. "There has been a media spotlight on how these organisations are run and I think that has helped to make directors more aware of the obligations that come with the job."

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"IT'S VITAL THAT DIRECTORS AND THEIR ADVISERS WORK WITH THEIR INSURERS TO CRAFT APPROPRIATE COVER."
Mike Pryce

Complex cover

Directors' and officers' insurance (D&O) has long been a director's main line of defence but it remains poorly understood – not least because of its complex, "three-sided" structure, as outlined below:

Side A provides cover for individual directors for wrongful acts carried out in circumstances which mean the company cannot indemnify them. There might have been an allegation of fraud, for example, or, most commonly, the company is in liquidation.

Side B reimburses a company which paid a claim on behalf of a director and so provides protection for the balance sheet.

Side C protects a listed company against claims arising out of continuous disclosure and other breaches of the securities market. It was designed to align the interests of the company with the directors in the common defence of an action but, in Australia, where securities actions generally target only the company, it has the potential to erode the directors' entire D&O policy limit. Some directors are not aware that this insurance could prove to be worthless, or give rise to a serious conflict of interest if the board has to decide whether the company should make a side C claim.

There is also an argument that the very existence of side C cover encourages class actions by providing what might be seen as a pot of gold for all to share. Some directors are opting for a separate side C policy which protects only directors and would pay out even if all of the limits within the company's D&O policy were exhausted.

"This is becoming more popular as savvy purchasers recognise the risks associated with securities actions," says Mike Pryce, regional manager, Australasia financial lines at AIG. "Directors should all scrutinise their policy to see what impact a side C claim would have on their personal coverage," adds Singh.

He continues: "They should also feel confident that all of their key exposures are covered and that they understand the coverage of the indemnities being provided by the organisation. Anyone joining a board, even at the request of their current employer, needs to ask what due diligence

"A KEY PERSON COULD BE THE CHAIRMAN OR A DIRECTOR OF THE COMPANY, THE CEO OR A SENIOR MANAGER."
Anthony Brown

the firm undertakes in considering insurance placement. And all directors should check the policy annually as terms and conditions can change over time and between carriers."

Insurance evolution

D&O is also continuously evolving to meet changing needs. "Leading insurers are developing ways of moving away from the arduous administrative process of annual proposal forms," says Pryce.

"They recognise that the time could be better spent engaging with the C-suite to gain a deeper understanding of the risk environment they have to manage. For example, analysts such as Credit Suisse are investigating whether diversity and inclusivity in a company can be used as an indicator of corporate performance."

Cover for cyber-crime is still relatively new. "Just a few years ago, no-one had heard of it," Pryce continues. "Today, across all organisations, the topic of data privacy and managing cyber exposures is dominating the boardroom – and rightly so. Insurance solutions are part of a broader risk-management framework that must be considered."

Pryce adds that in light of the recent Sony Pictures and Target

"THE BEST TIME TO BUY IS WHEN YOU'RE WORKING FULL-TIME AS AN EMPLOYEE."
Bernard Fehon

THINGS DIRECTORS NEED TO KNOW ABOUT D&O COVER

1. Is the insurer reputable and financially sound?
2. Can you meet the claims manager of your directors' and officers' insurance (D&O) provider in person?
3. Are the policy limits high enough?
4. Has there been proper disclosure?
5. What are the precise terms of the policy?
6. What is excluded?
7. When does the insurer pay defence costs?
8. If it came to a court case, would you be able to appoint your own lawyer?
9. Do you have to renew the policy every year?
10. Are your name and occupation written correctly on the policy? If they're not there, you're not insured.

UNDERSTANDING PROTECTION

Personal protection

Income protection (IP) insurance can provide an income while you're recovering from an illness or injury that prevents you from working. However, if you're already a full-time professional director it may be harder to acquire than you expect.

"The best time to buy is when you're working full-time as an employee," says Bernard Fehon CFP MAICD, manager of InvestBlue in Penrith, NSW. "If you're working fewer than 20 hours a week when you apply you may not even be eligible for this type of insurance. The best option for most directors is an agreed-value policy, where the benefit is based on your salary at the start of the agreement. An indemnity policy will require you to substantiate your recent income when you make a claim – probably the last thing you would want to worry about."

Protection for the family

We're living longer, and this is having a direct influence on when some people take out life insurance cover as well as how long they want to keep it.

"Many directors are intending to work and carry debt for longer, so they are purchasing or topping up cover later in life," says Anthony Brown, chief executive officer (CEO) of NobleOak Life. "Many of our recent clients are over the age of 50 and, as a response to client demand, we have amended our life insurance product range so that people can now renew their cover until the age of 99."

Protection for the business

Key person insurance helps to compensate for the loss of an individual whose knowledge, creativity and ability are critical to the viability or economic growth of a business. "A key person could be the chairman or a director of the company, the CEO or a senior manager or, for example, someone with specific research or technical skills or important contacts," says Brown.

Depending on the type of cover, key person life insurance pays out when the insured person dies or suffers an illness or injury so severe that they will never work again.

"The amount of cover required will depend on the size and type of the business, as well as how quickly the key person could be replaced, if at all," says Brown.

"THE MOST SIGNIFICANT CHANGE IS THE EXPANSION OF D&O INTO A FULL MANAGEMENT LIABILITY FORMAT, WHICH ADDS EXTRA COVER FOR SMALLER BUSINESSES."
Paul George

hacking events in the US, the hacking of Australian internet service provider Melbourne IT and its subsequent impact upon the business and its leadership, it's vital that boards understand the direct and downstream exposures they face.

"Most companies do not have the IT, legal and public relations skills in-house to deal with the impact of a loss of data through employee error, sabotage or hacking. The newest insurance products can now bridge this gap, helping businesses to get back on track with the least possible disruption."

Insurance companies have also responded to a massive increase in the number of companies operating in a multinational environment. "These companies need to consider the impact of more rigorous corporate governance and increased regulatory activity in many overseas jurisdictions," says Singh.

"A single D&O policy offering global protection may no longer be enough. It's critical that directors work with insurance providers who understand local laws and regulatory frameworks to ensure that a claim doesn't breach regulations or that a payment won't be hindered in some way."

Expanding cover for SMEs

Increased competition has resulted in a more comprehensive product offering for private companies and small and medium enterprises (SMEs).

"I'd say the most significant change is the expansion of D&O into a full management liability format, which adds important extra cover for smaller businesses," says Paul George, managing director of MGA Insurance Brokers.

"Today's management liability policies generally include fidelity, employment liability and crime and statutory liability, which provide protection against the many risks associated with issues such as workplace accidents, employment disputes, employee theft and commercial disputes."

Until recently, most cyber risk products were designed and priced for large companies. Now insurers have recognised that the threats are just as relevant to smaller businesses.

Some management liability policies provide elements of cyber insurance, though many SMEs are turning to the new, specifically-designed policies which offer a broader range of cover.

"Like the bigger organisations, they're looking for business interruption cover that can help them get their business up and running again as soon as possible," says Pryce.

However, the expansion has had a downside in the shape of increased volatility. "The broader cover has attracted large numbers of claims and played a big part in eroding the limit of D&O coverage," says Singh."We are now seeing markets reducing capacity and some providers exiting the space as a result."

For directors of companies of all sizes, effective protection begins with a thorough understanding of the risks and exposures. "It's vital that directors and their advisers work with their insurers to craft the appropriate cover," says Pryce. ■