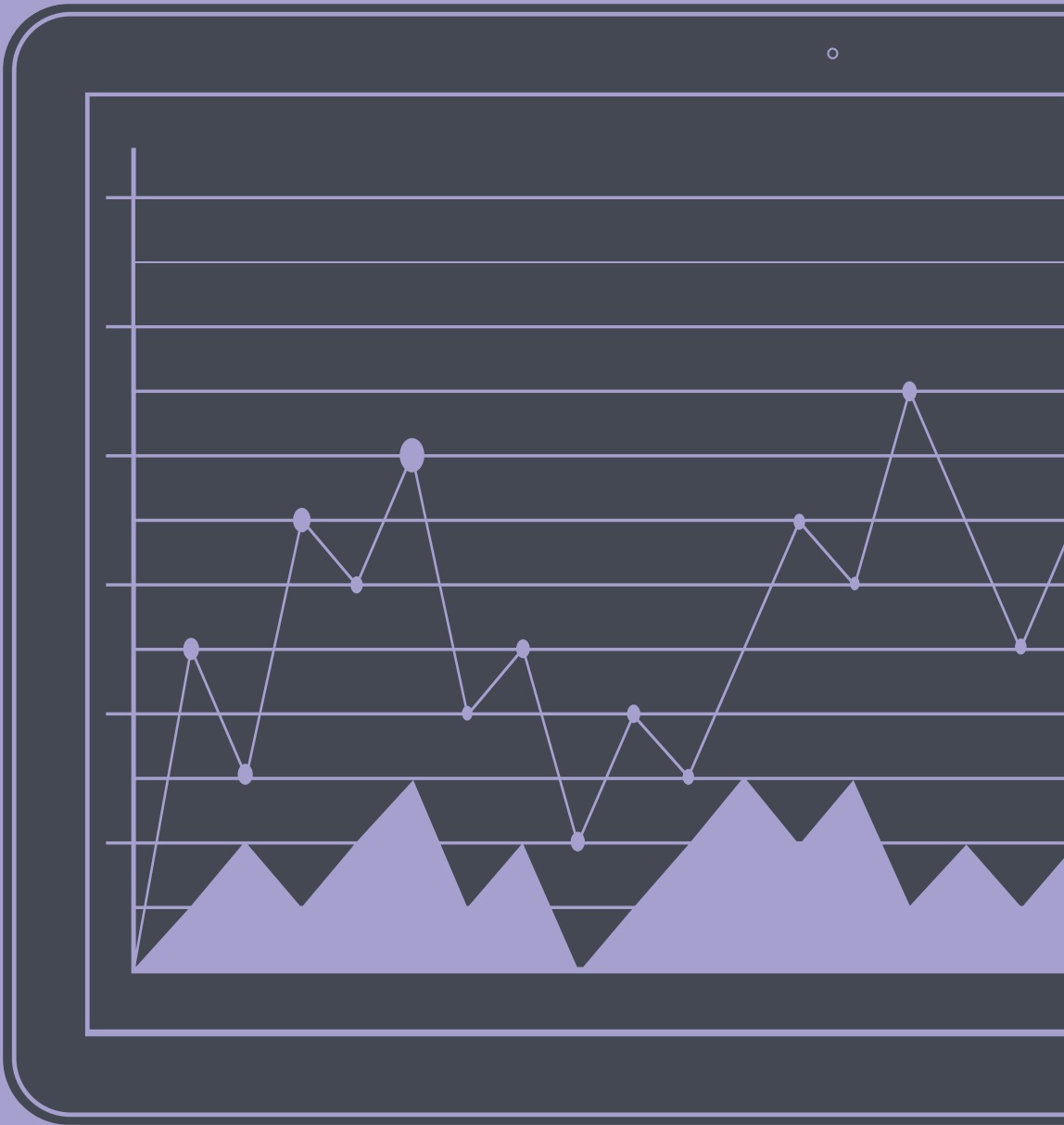


# Show me the money!

The impact of securities class actions on the Australian D&O Liability insurance market



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## Introduction from Wotton + Kearney and XL Catlin

**Welcome to the second instalment in the XL Catlin/ Wotton + Kearney white paper series on securities class actions and their impact on the Australian Directors' & Officers' Liability (D&O) insurance market.**

The objective of this series of white papers is to assist in establishing a foundation of common knowledge for a market-wide discussion on how a sustainable future for D&O insurance in Australia can be assured.

The first white paper "How did we get here? – The history and development of securities class actions in Australia", can be found on [xlcatalin.com](http://xlcatalin.com). This second white paper will examine the impact of securities class action claims on the Australian D&O insurance market, both in a historical context and looking forward having regard to the current "pipeline" of active claims. This impact will be considered with reference to the size (i.e. premium pool) and profitability of the D&O insurance market.

The third and final paper in this series, to be released in the near future, will canvass a range of potential strategies to restore underwriting profitability and longer term sustainability to this important class of insurance.

XL Catlin and Wotton + Kearney would welcome any constructive feedback on this white paper series and look forward to an ongoing discussion about the future of the D&O insurance market in Australia.

XL Catlin and Wotton + Kearney extend their thanks to Finity Consulting for allowing the use of some of the data from their NCPD Market Analytics report in this white paper.

## Revisiting the first white paper

XL Catlin and Wotton + Kearney's first white paper: "How did we get here? – The history and development of securities class actions in Australia" provided a comprehensive introduction to the emergence of securities class actions in Australia and their increasing prevalence across federal and state jurisdictions. The paper was designed as a user-friendly guide for the insurance market in navigating the developing legal landscape and providing assistance in understanding the history and current state-of-play of securities class actions in Australia.

It began by examining what constitutes a securities class action and discussed how they have evolved to become the most widely discussed and commonly filed type of class action in Australia. In 2016 alone, securities class actions accounted for 31% of total class actions filed in Australia.

The paper explored the different players involved, including litigation funders, with Australia having arguably the most advanced litigation funding environment in the world. There was an examination of plaintiff law firms and how they work with representative plaintiffs and the plaintiff class. It also canvassed the types of actions filed, the allegations commonly made and the relative ease in which causation can be proved by the plaintiff class.

The paper discussed the jurisdictions in which securities class actions can be filed in Australia, with the Queensland Supreme Court coming online 1 March 2017, increasing the number of available forums for securities class actions to four. There was also a comparison of the Australian securities class action environment with overseas counterparts, noting that, for our relative size, Australia has developed arguably the most liberal class action regime in the world.

It went on to note some of the most significant securities class action settlements reported which, since the first action settled in 2003, in total now exceed AUD1.5 billion (an

updated figure since the release of the first white paper), with many more in the "pipeline".

There was discussion regarding the costs associated with each stage of the proceedings, with the average cost of defence on the rise due to the increasing prevalence of filed actions.

The paper concluded by offering some insights into the process of launching, filing and settling a securities class action case, and began to explore the impact on the D&O market.

## The development of D&O insurance and the introduction of "Side C" cover

In order to understand the significance of securities class actions to D&O insurance it is helpful to consider the history of this class of insurance in Australia.

D&O insurance was introduced in Australia in the 1970s. The market developed through the 1980s and early 1990s, reaching relative "maturity" by the mid-to-late 1990s. This insurance class was traditionally structured in two "sections":

- Directors' & Officers' Liability, which covered individual directors and officers for personal liability arising whilst acting in such a capacity. This section of cover is often referred to as "Side A"; and
- Company Reimbursement, which covered the insured company for their liability to indemnify their directors and officers in respect of their personal liability whilst acting in such a capacity for the company. This section is often referred to as "Side B".

By the late 1990s, litigation experience in the USA pointed to a particular issue with D&O insurance in situations where a claim was made against both a company and its directors.

As a D&O policy only covered the liability (including defence costs) of the directors, and not that of the company, disputes arose as to the allocation of defence costs between the insured directors and the uninsured company.

This was seen as being particularly problematic for securities-related claims. D&O insurers responded by extending cover under D&O policies to include the liability of the company for such claims where they were maintained against both the directors and the company. This aspect of D&O cover is referred to as "Side C".

Coincidentally, Side C cover started gaining traction in Australia around the same time as the first securities class actions emerged (but long before they gained any frequency).

In the competitive market environment of the last decade or so, the requirement for a concurrent claim against both the directors and the company has generally been dropped from Side C coverage here in Australia. This development is somewhat ironic, given that this cover was only introduced to counter the allocation problem created by such joint claims.

## Some qualifying remarks on our numerical analysis

The following sections of this white paper use a range of data on securities class action numbers, settlement values, insurer contributions to settlements, and the size of the D&O market for the purposes of analysing the impact of securities class actions on the D&O insurance market. There is no single reliable source for this information and some of it is not publicly available.

Accordingly, the necessary data has been compiled from a range of sources and includes anecdotal information, together with some "educated estimates". XL Catlin and Wotton + Kearney acknowledge that there is a degree of uncertainty around some of the relevant information, and have endeavoured to adopt a conservative and cautious approach where estimation has been required.

As a result of this methodology, it is likely that some of the estimates and projections regarding settlements and the cost to insurers are understated, whilst premium estimates may be overstated. It is therefore likely that the following analysis understates the actual impact of securities class actions on the D&O insurance market. The picture is probably worse than that painted in this white paper.

Similarly, there may be some inconsistency between this white paper and other published reports regarding the years to which some class actions are allocated. The scale of any such inconsistency (plus or minus one year), is unlikely to be material given the focus of the analysis is on longer-term trends rather than year-on-year outcomes.

## The trend in the frequency of securities class actions in Australia

The first white paper in this series contained a chart<sup>1</sup> showing new securities class actions filed by year from 1999 to 2016. The data used for that chart classified "competing" class actions as separate actions. Competing class actions occur where more than one plaintiff law firm (usually backed by competing litigation funders) file concurrent actions based on the same, or essentially similar, allegations. This approach complicates the analysis we are pursuing in this white paper as, historically, competing actions that survive to settlement have tended to be settled simultaneously. It is also not uncommon for one (or more) of the competing actions to be discontinued prior to, or as part of, settlement.

There are also strong indications that the courts will increasingly encourage, at a minimum, the co-ordination of hearings and settlement negotiations in respect of competing actions (as the Federal Court has recently ordered with the competing class actions against Bellamy's Australia).

For all these reasons, the analysis in the following sections of this white paper will combine competing actions for the purposes of counting class action numbers.

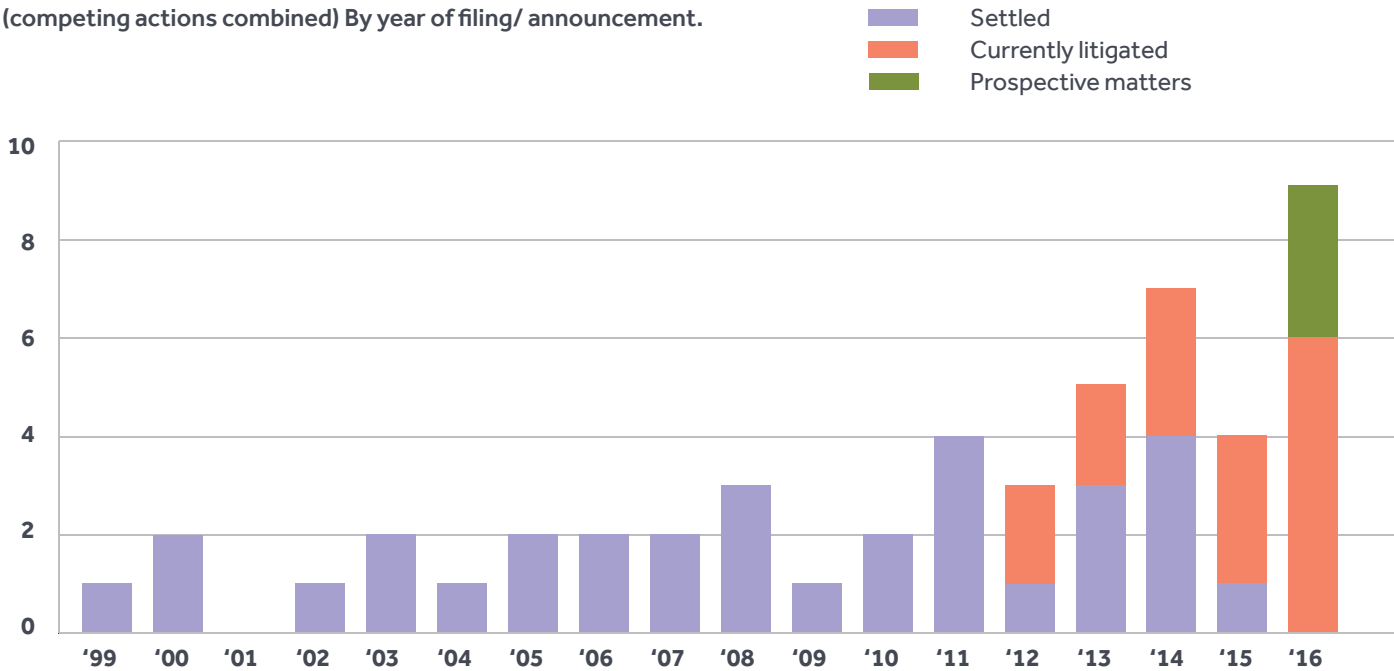
1. p. 10 - How did we get here? The history and development of securities class actions in Australia – XL Catlin/ Wotton + Kearney - May 2017

**Chart 1** revisits this topic showing the number of actions by status at the time of writing:

- Actions settled;
- Actions currently being litigated; and
- Prospective actions where plaintiff law firms and/ or litigation funders have publicly announced their intention to pursue an action, but where legal proceedings have not yet commenced.

Chart 1

**Number of securities class actions**  
(competing actions combined) By year of filing/ announcement.



It is clear from **Chart 1** that even after allowing for the trend of an increasing number of competing class actions in recent years, the annual rate of commencement is trending upwards significantly from 2011. Table 1 provides a comparative analysis of the average annual frequency of securities class actions.

// Chart 1 would indicate that the frequency of actions continues to trend upwards with 2016 reaching an (as yet) all-time high of 9 actions filed or announced. //

**Table 1**

**Securities class actions**

Average annual frequency (competing actions combined)

1999 to 2016	Pre – 2011	2011 Onwards
3	2	6

This table emphasises the fact that 2011 was an inflection point for the development of securities class actions in Australia, with the average frequency of actions from 2011 onwards tripling in comparison to the preceding period, and double that of the overall historical frequency.

As observed above, **Chart 1** would indicate that the frequency of actions continues to trend upwards with 2016 reaching an (as yet) all-time high of 9 actions filed or announced.

Early indications are that the number of such actions in 2017 will match or even exceed that for 2016, suggesting that the average frequency of class actions in later years is not stabilising but continues to trend upwards as more plaintiff lawyers and litigation funders push into this space.

It is clear then that there is an increasingly adverse trend in the frequency of securities class actions.

However, do securities class actions necessarily result in adverse outcomes for defendant companies (and directors) and their D&O insurers?

**Class action outcomes  
– final judgment vs. settlement**

No Australian securities class action has ever reached the stage of a final court judgment finding liability for the claim proven or otherwise. There has been one successful defence of a shareholder claim alleging breach of continuous disclosure obligations (Babcock & Brown, 2016), but the matter is distinguishable in that it was technically a group

action rather than a class action and was successfully defended due to technical construction issues regarding the applicable disclosure.

A number of securities class actions have had what could be described as successful outcomes for defendants, although all of these relate to procedural or strike-out applications. However, in most of these cases the matter was refiled or was only one of a number of competing class actions against the defendant.

Historically, only around one in ten filed securities class actions are discontinued in some way. Nine out of ten actions have proceeded to some form of settlement resulting in a cost to the defendants and/ or their D&O insurers (albeit just defence costs in a small number of cases).

**Class action outcomes  
– defence costs**

Any securities class action pursued to the stage of filing or beyond will necessitate the incurring of defence and investigation costs by the company (and where applicable its directors). Where the company holds Side C cover the D&O insurer will pay these costs (subject to no exclusions coming into play), once the applicable retention has been exhausted. If the directors have been joined as defendants in the class action, the Side A and Side B sections of cover will also be triggered.

Wotton + Kearney's experience suggests that to get to the mediation stage, defence and investigation costs are now typically around AUD10 million and rising. Whilst historically such costs have been significantly lower in some cases, there are also numerous examples where they have significantly exceeded this amount (up to AUD20 million). There is no reason to suggest that the trend of increasing defence costs will moderate in the near future, particularly with the increasing prevalence of competing class actions and other interlocutory proceedings where procedural law continues to be developed.



## Average settlement values

The first white paper also included a chart<sup>2</sup> showing settlement values for a selection of 17 securities class actions settled between 2003 (the GIO action – the first securities class action in Australia) and 2016, ranging from AUD30 million to AUD200 million.

In fact, there have been 32 such actions settled to date for amounts ranging between less than AUD1 million to, as previously cited, AUD200 million (the Centro action). Some of these settlements were confidential, so the details are uncertain, including the extent to which D&O insurers contributed to such settlements. There is also an element of uncertainty around the extent to which insurers have contributed to some known settlements, as this information is not always publicly available. However, careful analysis of both publicly available and anecdotal information on all 32 settled matters allows an estimation of average historical settlement values as set out in **Table 2**.

**Table 2**

### Securities class actions

Estimated average settlement values to-date (AUD)  
(competing actions combined)

Average Settlement	Average Insurance Contribution to Settlement	Average Total Cost to Insurers including estimated defence costs
AUD50 million	AUD32 million	AUD40 million

There are several factors that give rise to the historical disparity between the average settlement and the average contribution by D&O insurers:

- some defendant companies did not carry any Side C cover

- in their D&O insurance programmes, hence there was no insurer liable to contribute to the applicable settlement;
- some defendant companies did not carry sufficient Side C policy limits to cover the full amount of the agreed settlement, limiting the D&O insurance market's contribution;
- in a small number of cases, policy terms and conditions excluded the applicable claim or coverage was declined for disclosure-related reasons; and
- in some claims, other parties, such as auditors, were also joined and contributed to settlement. (However, in Wotton + Kearney's experience, these claims are limited and the size of the contribution by others is not usually significant compared to the Side C contribution, unless the defendant company was impecunious and had limit/coverage issues as noted above.)

Changed Side C buying behaviour may impact on the extent to which these factors will affect the relative contribution of insurers in respect to current and future class action claims.

## Total settlement values

**Chart 2** (page 10) shows the total estimated settlement values by year of filing/ announcement since 1999. Values for settled matters are based on historical data and anecdotal information, whilst values for current and prospective claims are calculated using the historical average settlement value from **Table 2**.

To-date, the total value of securities class action settlements since 1999 is estimated to be around AUD1.58 billion, excluding defence costs.

The standout feature of this analysis is that in four of the six years in the period from 2011 to 2016, total estimated or projected settlement values exceed AUD250 million, whilst only one year (2003) prior to 2011 exceeded this amount. The 2003 experience was driven by only 2 settlements, the Aristocrat action and the National Australia Bank action, both of which exceeded AUD100 million. Based on historical

average settlement values, total settlement values for 2016 are projected to be around AUD446 million, the highest annual total on record.

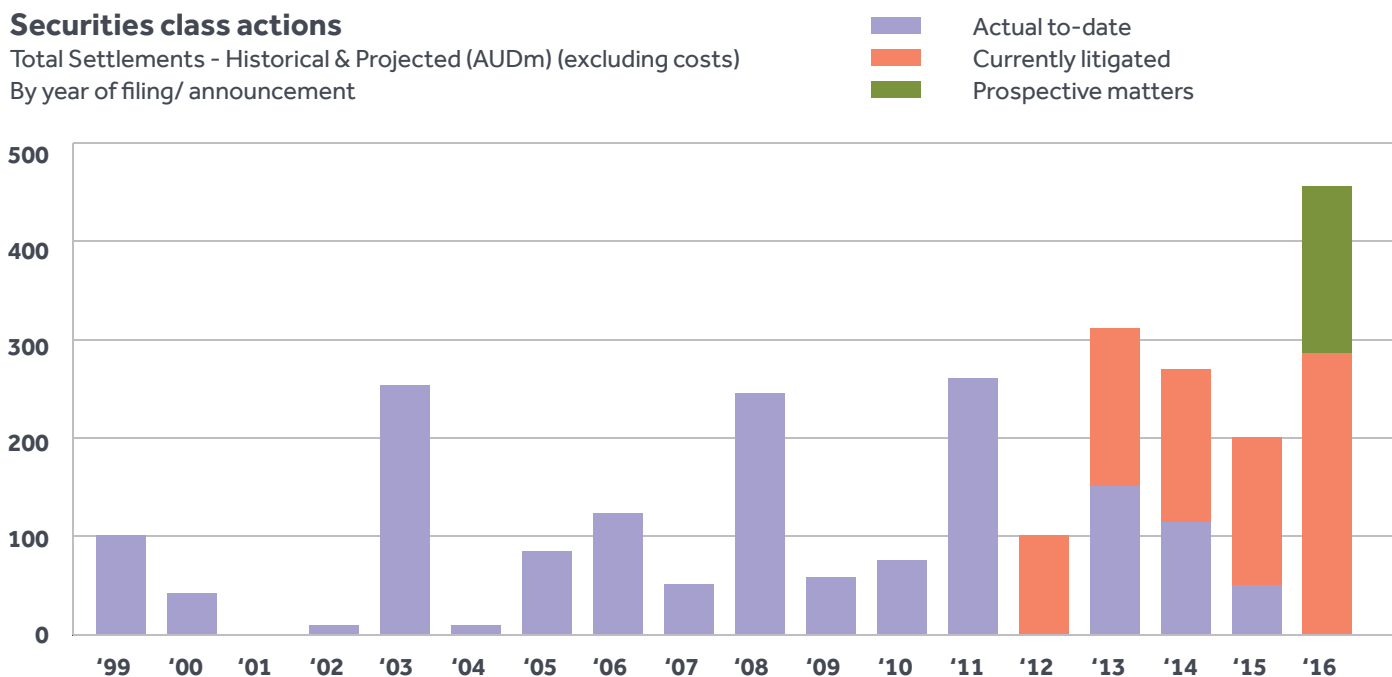
These projections point to a significant and sustained deterioration in total annual losses arising from securities class actions since 2011.

// To-date, the total value of securities class action settlements since 1999 is estimated to be around AUD1.58 billion //

## Chart 2

### Securities class actions

Total Settlements - Historical & Projected (AUDm) (excluding costs)  
By year of filing/ announcement



## Total cost to D&O insurers

It will come as no surprise that the adverse trend in settlement values in recent years is also reflected in the projected total D&O insurer contributions to settlements shown in **Chart 3**. This analysis is limited to the period 2011 to 2016 for two reasons:

- to protect potentially confidential and/ or proprietary information relating to some prior years' settlements; and
- this period is most relevant to understanding the current D&O market dynamics.

As with the projections of total settlement values in **Chart 2**, contributions for settled matters are based on historical data and anecdotal information whilst contributions for

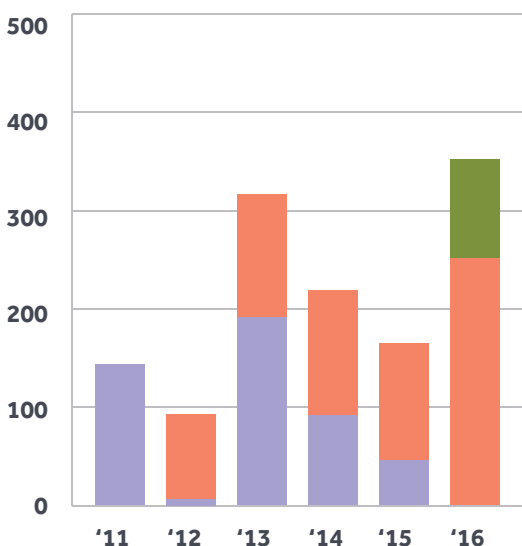
current and prospective claims are calculated using the average cost to insurers from **Table 2**. To-date, the total value of D&O insurer contributions to securities class action settlements since 1999 is estimated to be just over AUD1 billion excluding defence costs, and around AUD1.28 billion including defence costs. The striking feature of this chart for D&O insurers is that in three of the six years in the period from 2011 to 2016 the projected total cost to D&O insurers exceeds AUD200 million, and in 2016 it is projected to reach an all-time high of around AUD378 million.

So, here is a measure of the direct impact of securities class actions on the Australian D&O market, but what does it mean for insurers, and how does the growing cost impact D&O market dynamics?

## Chart 3

### Securities class actions

Projected Total Cost to Insurers inc. estimated defence costs (AUDm)  
By year of filing/ announcement



// To-date, the total value of D&O insurer contributions to securities class action settlements since 1999 is estimated to be just over AUD1 billion //

## Size of the Australian D&O market

Estimating the size of the Australian D&O market is a little tricky. The Australian Prudential Regulation Authority (APRA) maintains the National Claims & Policy Database (NCPD) to which all locally authorised insurers must regularly submit detailed policy and claims data for certain classes of insurance, including D&O.

This data is useful. However, the NCPD does not contain any useable data pertaining to placements with Lloyd's or unauthorised foreign insurers (UFIs).

Offshore placements constitute a significant proportion of the Australian D&O premium pool so it is necessary to estimate the applicable gross written premium (GWP) placed in Lloyd's and elsewhere in order to obtain a measure of overall market size.

The NCPD data also aggregates the data for some other related classes of insurance under the D&O banner, the most significant being Management Liability (ML). For the purposes of this white paper it is necessary to consider the D&O premium pool excluding ML as the latter has evolved into a separate class of insurance, and certainly does not provide any Side C cover as it is generally targeted at private companies and non-profit entities.

**Chart 4** shows the following for the period 2011 to 2016:

- estimated D&O market GWP calculated using GWP data from the Finity Consulting NCPD Analytics report (excluding 2016) that excludes ML and has been adjusted to include estimated GWP placed into the London and other offshore markets;
- estimated market GWP for ABC placements only – i.e. those policies primarily exposed to securities class action claims; and
- projected total cost to insurers of contributions to securities class action settlements.

As indicated, the estimated D&O market GWP in 2016 is around AUD300 million (excluding ML), whilst ABC market GWP is estimated at AUD210 million for the same period.

## Impact on D&O insurers – underwriting result

**Chart 4** clearly illustrates that in three of the last four years the projected total cost to insurers of contributions to securities class action settlements exceeds estimated total market GWP derived from ABC policies i.e. the gross loss ratio (GLR) exceeds 100% on securities class actions alone before any other claims are considered. Indeed, as shown in **Table 3**, the cumulative total cost to insurers over the period 2011 to 2016 exceeds the cumulative ABC GWP for the period. The cumulative GLR for the period exceeds 100%.

To ensure acceptable overall market profitability, the GLR should not exceed around 60% (allowing for distribution costs, internal costs, cost of capital and an acceptable profit margin). These results show that the D&O market has been deeply unprofitable over the last 6 years based on class action claims alone. In fact, there is only one year (2012) in the past six that may be potentially profitable for the overall ABC market. It is the market realisation of these facts that is driving the current hard cycle in the ABC segment of the Australian D&O market.

Of course, there are other types of D&O claims that will further impact on the profitability of D&O insurers, although not as significantly as class action claims. **Chart 5** (page 14) shows the following comparative GLR's for the period 2011 to 2016:

- overall D&O market GLR from class actions only;
- estimated overall ABC GLR from class actions only; and
- estimated overall ABC GLR from all claims (including additional 30% loss ratio for other claims).

The chart also shows the 60% target GLR or acceptable "profitability threshold" and dramatically illustrates how chronically unprofitable the ABC segment of the Australian D&O market has been for the last six years.

Chart 4

Securities class actions

Market GWP vs Projected Total Cost to Insurers inc. estimated defence costs (AUDm). By year of filing/ announcement.

- D&O Market GWP
- ABC GWP (est)
- Projected total cost to insurers

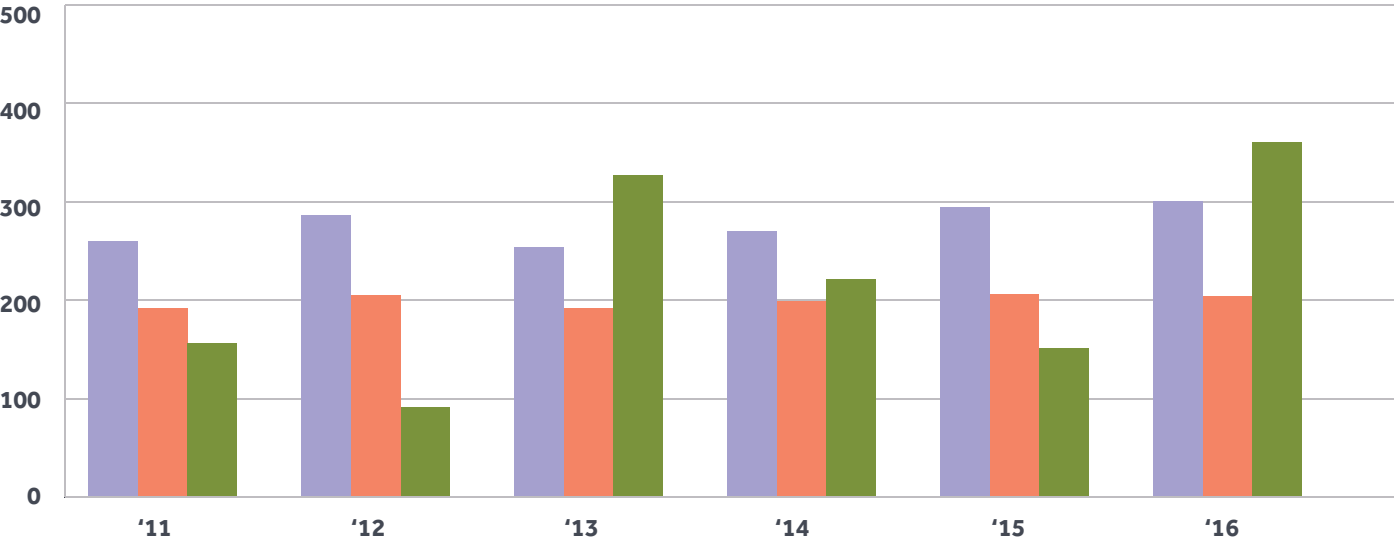


Table3

Securities class actions

Cumulative GWP vs Projected Total Cost to Insurers 2011 to 2016 (AUD)

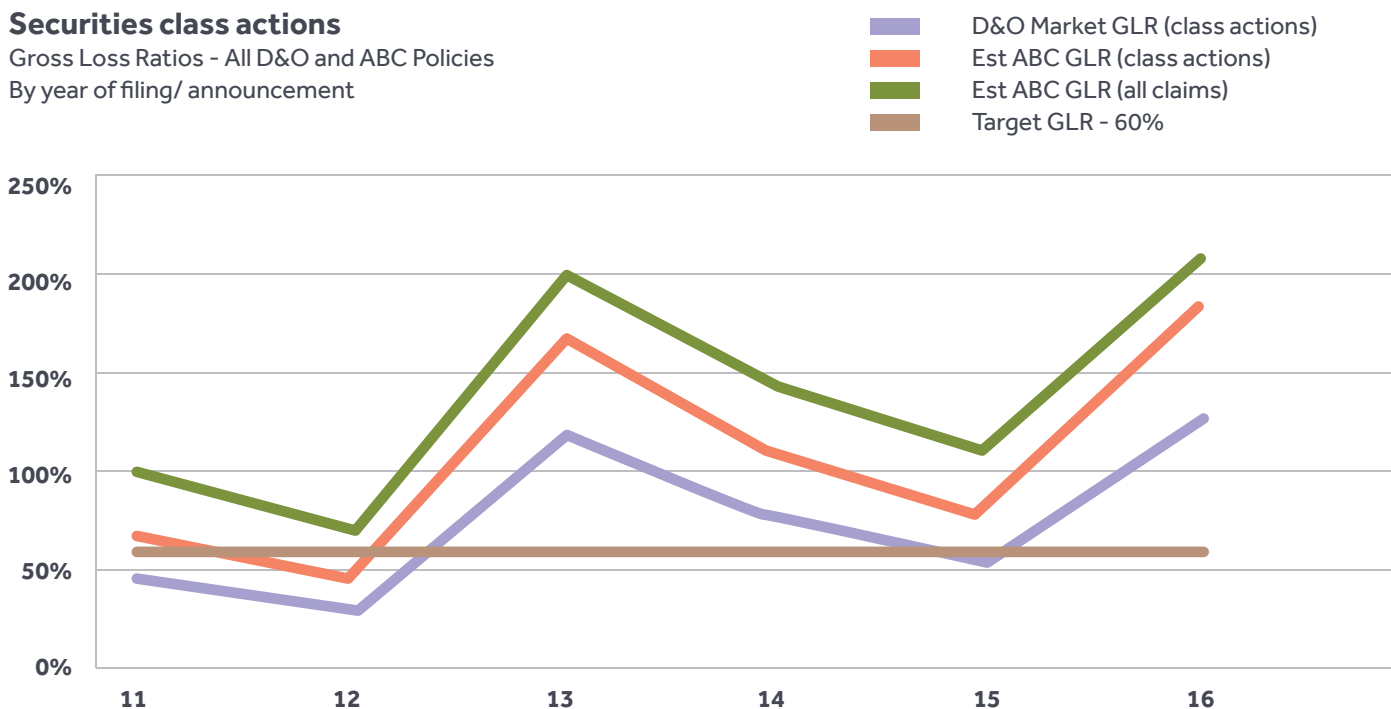
Market GWP	Estimated ABC GWP	Total Cost to Insurers inc. estimated defence costs
AUD1,719 million	AUD1,203 million	AUD1,315 million

// Recent market developments would indicate that most D&O insurers are now endeavouring to restore some semblance of profitability to their D&O portfolios after years of market losses. //

## Chart 5

### Securities class actions

Gross Loss Ratios - All D&O and ABC Policies  
By year of filing/ announcement



## Implications for D&O premiums

Recent market developments would indicate that most D&O insurers are now endeavouring to restore some semblance of profitability to their D&O portfolios after years of market losses.

But what will it take to achieve this?

One obvious measure, which is already in play in the D&O market, is to increase premium rates, particularly for Side C cover. How much is enough?

All other factors holding constant, using the above premium and claims estimates for 2016 as a base and including a 30% additional loss ratio allowance for claims other than class

actions, then applying a 60% target GLR, the required ABC market premium pool would be around AUD735 million.

With the 2016 ABC premium pool estimated at around AUD210 million, this analysis implies that average premium rates for ABC D&O will need to increase by a factor of around 3.5 (on 2016 levels) in order to re-establish a profitable D&O market (assuming all other factors remained unchanged).

Of course this approach is rather simplistic and ignores the effect increased premiums will have on D&O insurance programme structures and limits, which in turn may change the future loss experience of insurers. However, it does provide some guidance as to the extent of the under-pricing in the ABC segment of the Australian D&O market for the last six or more years.



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