

D&O Insurance – Who Needs It?

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- **What's Going on in the World and New Zealand?**
- **What is D&O Insurance?**
- **Who is it for and why should you buy it?**

- Cascade of defaults by US homeowners led to \$US750 trillion of write downs
- Securities valued by the performance of pools of subprime mortgages plummeted in value, leading to losses for investors
- 210 securities class action law suits filed in US in 2008; 19% increase on 2007 (*Towers Perrin & Cornerstone Research, US*)
- US\$6billion cost to D&O Insurers (*Financial Times* 23/06/09)



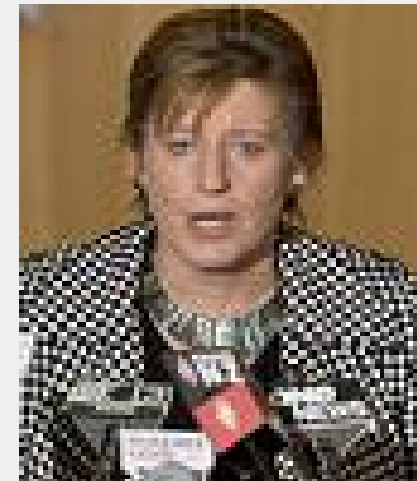


- Our banking system fared much better
 - Of the top 11 banks in the world 4 are Australasian
Jane Diplock (Commerce Commission Speech to Rotary 22/06/09)
 - “Our less complex [banking system] came through well, helped by sound parent banks, good regulations here and in Australia, good management, and a little luck” *Alan Bollard NZ Herald 29/08/09*
- Worsening Economic conditions - cash became illiquid; median house prices dropped; increase in unemployment; reduction in company profitability; worsening government debt.



- Preceded by a Decimation of the finance sector
 - 30 failed finance companies (receivership; liquidation or debt moratorium)

2006	3	(eg Western Bay; Provincial; National)
2007	11	(eg Five Star; Nathans; Bridgecorp)
2008	10	(eg Dorchester; St Laurence; Lombard)
 - Billions of dollars of investors' funds lost
 - Political, social and legal consequences (Commerce Select Committee Inquiry; calls for much for greater regulation/accountability)



- Culture Change in the attitude of society to litigation
 - Templates provided by employment claims (no win no fee); leaky building litigation
 - Emergence of collective action groups such as Frozen Funds Group and EUFA
 - Representative/class Actions (real or apparent)
 - 32 Blue Chip representative actions
 - Any more?



- Massive increase in Receiverships/Liquidations

	2005/06	2006/07	2007/08
Receiverships	291		238
Liquidations	3893	3991	626
			7715

(Companies Office website)

- Significant increase in the regulatory legal costs spend

	2005/06	2006/07	2007/08
Commerce Commission	3.7m	10.6m	3.9m
Litigation Fund			
Securities Commission	.292m		
Litigation Fund			



What is D&O Insurance?

- Species of liability cover which has two aspects:
 - Individual cover to director for “Loss” arising from “Wrongful Act” (where not indemnified by the company)
 - Company cover where the company indemnifies the director
- “Claims Made” cover like Professional Indemnity policy
- Liability has to arise from a “Wrongful Act”. Frequently broadly defined to include errors or omissions, negligence, breach of duty in capacity as a director/officer
- Modern D&O policy is much more than indemnity from civil claims



- Significant expansion of cover so that it is common for policies to also cover:
 - Employees and Deemed Directors;
 - Limited Employment Practices Cover, ie director/officer's liability to employee;
 - Outside Directors Extension may be available
 - Defence costs associated with:
 - Attendance at an official investigation, examination or inquiry into the affairs of the company (eg coroners inquests; disciplinary tribunals);
 - **successful** defence of a criminal prosecution
 - Health and Safety prosecution;
 - Pollution Claims





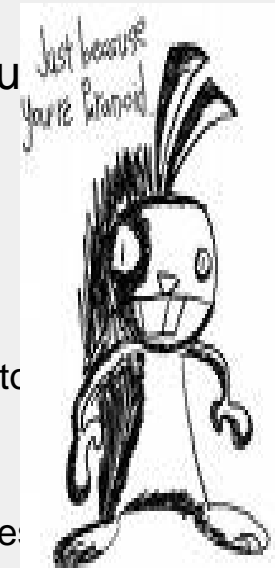
Who Is It For? Why Should You Buy It?



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Who is it for? Why should You buy it?

- When a director/officer is sued the first line of defence is the company.
 - The director/officer's personal wealth is at the mercy of the company's fortunes
 - When the director/officer owns the company then the indemnity is circular ie it is coming from his/her own pocket.
 - SMEs should have a **higher** not lower rate of take up of D&O insurance than large corporations.
 - Paranoia is healthy, particularly in periods of economic stress.
 - **Insolvent Trading** (ss 135 & 136 Companies Act 1993)
 - Proceedings by a receiver/liquidator are an exception to the "Insured v Insured" exclusion. The greater the risk of corporate failure the greater the need for D&O cover
 - Liquidators pursue directors of big **and** small companies
- Case Studies – *Goatlands* and *Hill Country Beef v Sharplin*



○ **Shareholder Derivative Actions**

- Another exception to the “Insured v Insured” exclusion
- Brought in the company’s name against the director for breach of duties owed by the director to the company (ss165-168 Companies Act 1993)
 - 32% of D&O actions in the US are shareholder derivative actions
 - Case Study – *Thorrington v McCann*

- **Employment Claims** - Biting the hand that feeds
 - Overseas this represents a very significant exposure – 43% of D&O claims against private companies in the US are employment related (*Towers Perrin D&O Survey 2007*)
 - Previous period of staff shortages led to longer duration for employment contracts and an emphasis on performance based discretionary remuneration. With the global recession, performance has fallen, redundancy and terminations have increased, giving rise to a greater risk of suit.
- **Crossing International Borders** - Increases the risk of something going wrong due to a lack of proper advice or understanding of jurisdiction specific laws or expectations.
 - Case Study (G v C)



- **Transactional Risks** – whenever a company enters into a transaction related to capital raising, acquisitions or refinancing there is a risk of misrepresentation, inadequate disclosure or a failure to follow proper process. Risk may be **greater** for SMEs due to lack of professional advice and informality.
- **Regulators Action** – regulators do not differentiate between large and small companies.
 - Capital Raising. (eg liable to repay the allotment if there is an irregularity in the allotment of a securities or misleading advertisements)
 - Misleading Statements to the public or competitors (penalties and damages)
 - Anti-competitive behavior
Case Study – *Giltrap Motors v Commerce Commission* \$100,000 penalty
 - Health & Safety prosecutions of directors

Who is it for? Why should you buy it?

- **Fraud** on the part of management can expose innocent directors to suit either by a third party or the company itself
 - Case Study – *FXHT Fund Managers (liq) v Oberholster*
- **Competitor Actions**, such as interference with business, breach of intellectual property rights, misleading/deceptive conduct or anti-competitive behaviour.

Conclusion – What does all this mean?



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Conclusion – What does this mean?



Conclusion – What does this mean?

- The current economic conditions in the world and NZ are malign,
- Poor economic conditions increase the risks to any business owner.
- A change in NZ's attitude to litigation was already underway before recent events, but it has been given additional impetus by the finance company collapses. This collapse effected a massive loss of investor funds, but more importantly, has contributed to cultural change.
- The dramatic increase in receiverships/liquidations, aggressive competition, deterioration in employment conditions and active regulators pose risks for SME which equal, and in some respects exceed that of large corporate.
- D&O insurance should be regarded as an essential wealth protection device for business owners, large and small.