CORPORATE INSURANCE TRENDS 2014

TRENDS AND TENDENCIES IN D&O

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IS THERE MORE TO DISCLOSE?

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BUILDING A BRIDGE – OVER TROUBLED SECTION 6 WATERS

MITIGATING RISK IN M&A TRANSACTIONS IN AUSTRALIA

ARBITRATIONS AND UNDERWRITING RISKS

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OVERVIEW

Although we are seeing the tail end of many of the claims which arose from the Global Financial Crisis, the sophisticated plaintiff's bar and ever-developing class action landscape means that companies and their officers will continue to experience an active and dynamic risk landscape.

We are delighted to bring you a collection of articles highlighting some trends and key issues for financial lines insurers and their insureds in 2014.

In this publication, we highlight D&O trends, including the potential impact for directors of cyber liability, and we examine the issue of reliance in the context of class actions. We also consider changes to the duty of disclosure and the underwriting risks associated with arbitration agreements.

Finally, as merger and acquisition activity increases, buyers and sellers to transactions are increasingly looking to shifting the risks of those transactions to their insurers. Our article on "Mitigating Risks in M&A Insurance" sets out a snapshot of common issues we identify in these transactions, advising both the parties to the transaction but also their warranty & indemnity insurers.

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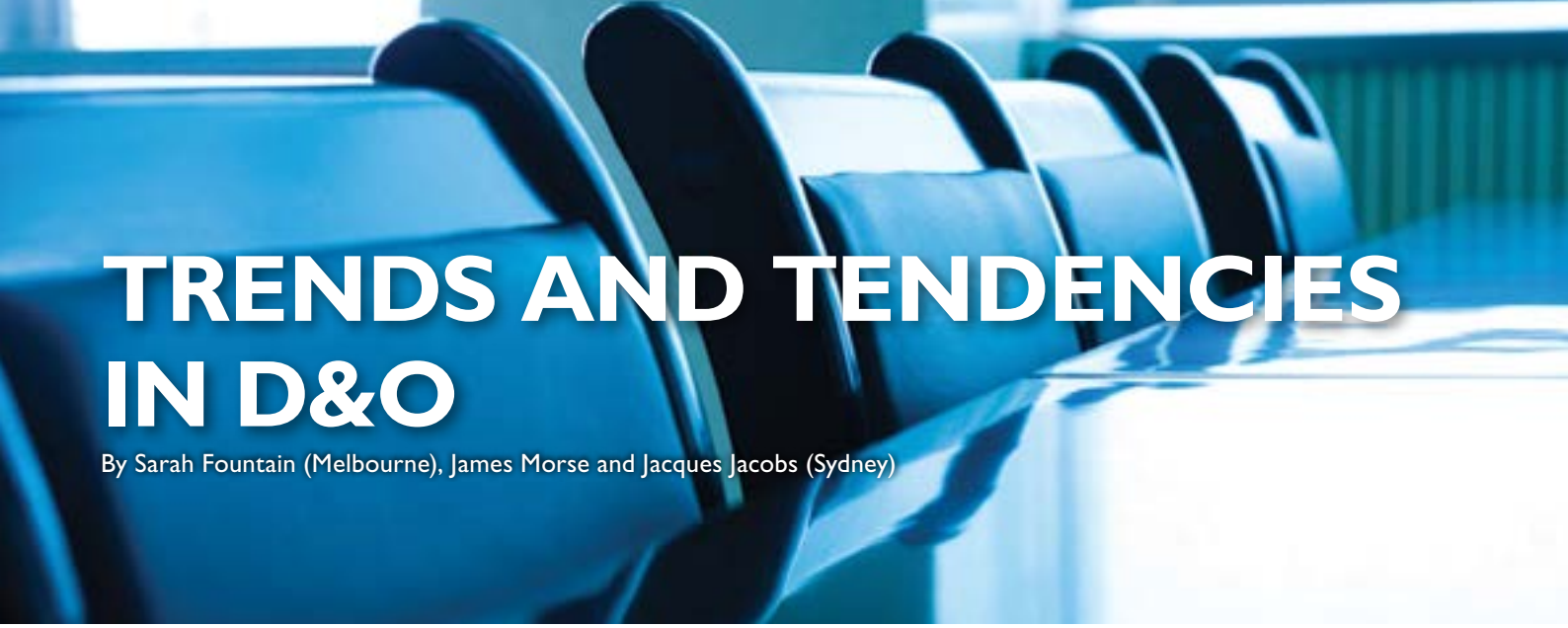

TRENDS AND TENDENCIES IN D&O

By Sarah Fountain (Melbourne), James Morse and Jacques Jacobs (Sydney)

There is a remarkable interplay between the expectations that are placed on directors, and the potential for directors' business making decisions to be negatively impacted by the fear of liability. In this article, we look at what is shaping – and will continue to shape – that interplay, particularly following the global financial crisis.

REGULATORY RISK

The penalties being imposed by courts now are higher than they have been. For example, in *ASIC v GE Capital Finance Australia* [2014] FCA 701, the parties agreed a penalty of $1 million, but the Federal Court considered that was inadequate and imposed a higher penalty of $1.5 million. Likewise, in *ASIC v Newcrest Mining Limited* [2014] FCA 698, penalties totalling $1.2 million were agreed by the parties as appropriate and imposed by the Court. These were the highest penalties ever imposed for breaches of continuous disclosure requirements.

Companies and directors will not get a reprieve anytime soon. We expect this trend of imposing harsher penalties will continue, particularly if the Government adopts the recommendations in the Senate Economics References Committee's recent report on the performance of ASIC (which noted that the current civil penalties are insufficient and proportionately low given the seriousness and impact of civil penalty matters, particularly when compared with penalties available in other jurisdictions and to other Australian regulators).

Of course one cannot ignore the potential impact of the Federal Government's focus on de-regulation and budget cuts (ASIC's budget for 2014-15 has been cut by 12 percent and the ATO is expected to lose more than 2,300 staff). However, to our mind, whilst such changes will place increased pressure on resources involved in regulatory investigations and enforcement, we do not expect a drastic reduction in overall regulatory activity, particularly given that there is – and will continue to be – increased cooperation and information sharing between regulatory bodies, both nationally and internationally.

EMPLOYMENT PRACTICES LIABILITY (EPL) RISKS

If you are a director, the mere mention of EPL is probably enough to send shivers down your spine. The experience of the last few years suggests that, if a company has not been subject to an EPL claim, it probably knows one that has. Whilst this past experience may lead some people to think that EPL risks are now "overcooked", we do not share that view.

Australia is still subject to a relatively complex legislative regime that, whilst providing employees with various (and appropriate) rights, also imposes considerable obligations upon employers. In our view, the recent increase in EPL claims is not solely due to a growing incidence of breaches by employers, or an increase in the severity of breaches. Rather, we see the increase in EPL claims being predominately due to employees having an increased awareness of their rights and their employer's obligations, whether through the publicity of disputes or through educational programs run by regulators and industry bodies. This view is supported by the fact that most EPL claims still involve a relatively low quantum.

As public awareness continues to increase, and until such time as the present economic uncertainty subsides, an increase in the frequency of claims is still expected. However, we do not expect to see a drastic increase in the quantum of such claims, at least in the near future.

CYBER RISKS

If a company's directors are not asking the right questions or doing enough to ensure the security of data and minimise the risk of cyber attacks, they may be at risk of personal liability in the event of a cyber attack. Indeed, in the same way that a lack of accounting knowledge on the part of a director was no defence in *ASIC v Healey* (2011) 196 FCR 291, lack of technological knowledge is unlikely to be a defence to a claim arising out of a cyber attack.

We are now seeing directors take proactive steps to gain a reasonable working understanding and appreciation of cyber risks, and talking about these risks at board level. They are well aware that they do not know all the answers, but they are making sure that they know the right questions to ask relevant people within their business and their advisers, and to ensure that adequate steps are being taken to address those risks.

We expect that directors will continue to improve the depth and breadth of their knowledge around cyber risks. Whilst there is a noticeable increase in publically available information on the topic, we are increasingly seeing directors actively seek out specific advice with respect to those cyber risks that are explicitly relevant to their business operations, and the best way to manage those risks. There is little doubt that this will continue, and will increase significantly once a few of the high profile cyber claims are litigated.

CLIMATE CHANGE RISKS

Australia's carbon tax may have been abolished but that does not mean companies can ignore climate change. Climate change is one of the most significant emerging risks facing businesses, and will affect all business in the future, whether directly or indirectly.

For example, a company that is heavily reliant on water but fails to adequately assess those risks and implement appropriate strategies, could face action by its shareholders. It is also easy to see how such an action could extend to the directors of the company for alleged breaches of director's duties. It is only a matter of time before shareholder class actions resulting from a company's failure to take adequate measures to protect against climate change become relatively commonplace.

Whilst we are therefore seeing an increased awareness amongst directors of the risks of climate change on their companies, we also expect that insurers will start asking questions about their insured's climate change policies. Indeed, Lloyd's has recently called on insurers to take into account climate change when looking at risks. It will therefore not be long until the responses to such questions drastically affect premiums and, potentially, whether cover is even available.

CLASS ACTIONS

Now that the claims based on the immediate effects of the global financial crisis have largely worked their way through the system, we expect that the subject matter of class actions will change from securities-based litigation, to a broader scope of claims, including in relation to the areas identified above.

Yet such broader claims will cause additional problems for those funding or bringing the proceedings, including how to properly identify the relevant class(es) of persons. Indeed, this issue is already raising its head with respect to the potential class actions against banks and financial advisors, arising out of allegedly poor financial advice – given across a variety of products, to numerous persons, in a number of different ways and at various times.

These and other issues are therefore causing certain proponents within the industry to support a comprehensive reform of class action litigation in Australia. However, whilst the push for class action reform remains alive and well, the movement has not yet produced any real fruit – and, given the current political stance on the issue, we do not expect that it will, at least in the near future.

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CYBER RISKS AND THE IMPACT ON COMPANY DIRECTORS

By Jacques Jacobs and Nitesh Patel (Sydney)

Cyber risk and data integrity should be a key consideration of corporations' risk management strategies and boards of directors are expected to take responsibility. Recent suits against directors demonstrate how the failure of directors to implement appropriate privacy and risk management policies are being scrutinised and being cast as breaches under traditional duties imposed on directors, such as continuous disclosure duties and duties of care and diligence.

The recent derivative action commenced by a shareholder in the district of New Jersey (USA) against certain directors and officers of Wyndham Worldwide Corporation (Wyndham) epitomises the "new frontier" of claims against directors arising from cyber-attacks and data breaches.

The Wyndham action arises from three data breaches between 2008 and 2010 and follows a Federal Trade Commission (FTC) investigation into the breaches where it is alleged the Company failed to maintain reasonable and appropriate data security for consumers' sensitive personal information in breach of the *Federal Trade Commission Act*.

It is believed that over 600,000 payment records were stolen due to the breaches, many of which were exported to a domain registered in Russia and used to allegedly accumulate fraudulent charges in excess of US$10 million.

The lawsuit relevantly alleges that directors and officers failed to take reasonable steps to maintain appropriate data security measures to protect sensitive consumer information, ensure that the company and its subsidiaries implemented adequate information security (privacy) policies and ensure that its management system server used up to date and properly configured operating systems and software.

In addition to the above, shareholders and customers who relied on privacy policies that were not properly implemented may resort to misleading and deceptive conduct legislation, such as the *Australian Consumer Law*. Of significant concern for directors is the potential ease by which such actions may be brought. The Wyndham derivative action was brought shortly after the recent decision issued by the U.S. District Court in *FTC v. Wyndham Worldwide Corp*, where the Court confirmed the FTC's authority to investigate and prosecute companies that fail to protect consumers' privacy by failing to maintain appropriate data security standards. Similar powers have been afforded to the Privacy Commissioner under the Australian Privacy Principles (APP), which came into force on 12 March 2014 and govern privacy and data protection throughout Australia.

Past experience in other areas show that potential litigants may "piggy back" off the findings by these government agencies, which will provide them with evidentiary ammunition regarding data and privacy policy failures by companies to launch any actions.

Cyber resilience and associated risk management (including insurance) will become an increasingly important item on the agenda of Boards of directors. Directors need to take active steps to ensure that robust privacy and data protection policies are in place and also are being actively implemented to protect themselves from future litigation arising from a data breach.

However, a critical aspect of a Board's risk management function is to ensure adequate insurance policies are in place to manage a company's risk. It will be important to ensure that any insurance policies cover the cyber risk to directors personally, but also the risks faced by the company itself.

In terms of their personal liability, directors have traditionally relied on D&O policies to respond to claims against them. It is important that they understand the limitations of cover afforded by some D&O policies for cyber claims. This of course will depend on the terms of the policy.

Companies and directors must be aware of exclusions and endorsements in their D&O policies and need to ensure it provides adequate cover for claims arising from data breaches and cyber-crime. For example, some policies exclude significant risks, such as claims arising from hacking.

Most traditional policies will not protect a company from the risks associated with a data breach and/or cyber-crime incident. Insurers have introduced cyber policies to fill this void, which can include cover for penalties by government agencies, investigation/incident response costs, notification costs, third party claims against the company and business interruption.

Cyber policies have been designed to be flexible as Insurers have recognised that the nature and scale of the exposure faced by each company can differ significantly. A company's risk profile is intimately connected with the industry a particular company is involved in and its business model. To maximise a company's cyber resilience, it is important to ensure that relevant insurance policies are tailored specifically to the cyber risks that it faces. For example, online retail sales companies holding credit card information need greater cover than accounting firms with online access to their systems.

All this points to a need for Boards of directors to be intimately aware of their company's risk management policies around data protection and privacy. This includes ensuring that it has appropriate insurance policies in place that specifically address their company's risk profile.

Directors will turn to their insurers and brokers to assist them in identifying the specific risks their company is exposed to and then designing and tailoring their insurance policy programmes to maximise their company's cyber resilience.

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IS THERE MORE TO DISCLOSE?
CHANGES TO THE DUTY OF DISCLOSURE

By Sophie Devitt (Brisbane)

There has been a history of promised amendments to the *Insurance Contracts Act 1984* (Act) since the government announced a comprehensive review of the Act in September 2003. This included the drafting of the *Insurance Contracts Amendment Bill 2010* which never made it past the House of Representatives due to the 2010 election.

Other than the introduction of a standard "flood" definition, it was not until 2013, when the government reintroduced the amendments contained in the 2010 Bill (with some refinements) by way of the Insurance Contracts Amendment Bill 2013 (Amendment Bill 2013) that we witnessed significant proposed changes to the Act.

The Amendment Bill 2013 was passed by parliament on 20 June 2013 and received royal assent on 28 June 2013 becoming the *Insurance Contracts Amendment Act 2013* (Amendment Act 2013).

The amendments introduced by the Amendment Act 2013 include changes to the general duty of disclosure and the duty of disclosure for "eligible contracts" (Disclosure amendments). The aim of the amendments is to make it easier for consumers to understand and comply with the duty especially at renewal of household/domestic insurance contracts. The question is whether these amendments will have the desired impact.

The amendments seek to recognise the critical importance of the disclosure provided by a prospective insured to the insurer's assessment of whether it will accept the risk and offer terms and whether to offer renewal terms.

It is useful to look at the mechanics of the Disclosure amendments to understand their likely impact on the insured and the insurer.

Part IV of the Act sets out the statutory code for the duty of disclosure for policies of insurance caught by the Act. The Act distinguishes between "eligible contracts" and other contracts of insurance. The amendments primarily impact upon "eligible contracts."

The classes of insurance that fall within the definition of "eligible contracts" are:

- motor vehicle;
- home buildings;
- home contents;
- sickness and accident;
- consumer credit; and
- travel.

Regulation 2B of the *Insurance Contracts Regulations* allows an insurer to opt-in to the "eligible contracts" disclosure obligations on new business by informing the insured before the policy commences of the nature and effect of section 21A of the Act.

Traditionally insurers have focussed on the risk at the time the policy is first incepted as there was no distinction between an "eligible contract" and other contracts of insurance upon renewal. The general duty of disclosure applied upon renewal. The amendments to section 21A and the introduction of section 21B will refocus the insurer in terms of protecting their rights throughout the life of the policy.

The changes to section 21A and the introduction of section 21B is premised on the fact that insurers have a mature understanding of the risks they are insuring in these classes of insurance and can easily identify the information that is of critical importance to their assessment of the risk. Insurers will no longer be permitted to ask "catch all" questions for "eligible contracts."

It also reflects a public policy position that the insurer is the best placed party to the contract of insurance to understand and know these risks.

Section 21B introduces a similar process to section 21A for renewals. On renewal, an insurer will have the option of asking specific questions of the insured or seeking confirmation of any matter previously disclosed by the insured in relation to the contract. If the insurer does neither, it will be deemed to have waived the duty of disclosure with respect to the renewal. This does not waive the duty with respect to an earlier non-disclosure.

If an insured does not correct information it has been asked to confirm at the time of the renewal then it will be deemed the information is correct. If this is not the case then the insurer will have remedies available to it under the Act.

An insurer will need to be more proactive on renewal of an "eligible contract" if it wishes to protect its remedies for non-disclosure. This will likely mean changes in the insurer's processes to comply with these amendments.

The Disclosure amendments will apply for new policies written from 29 December 2015 and for renewals from 29 December 2015. However, there are transition arrangements which allow insurers to opt-in to section 21B by informing the insured of its effect and application to the policy.

The Explanatory Memorandum for the Amendment Bill 2013 states the purpose of the amendments is to clarify the duty of disclosure for both the insured and the insurer. We consider the changes introduced, particularly with the introduction of section 21B, do provide an insurer with a clearer process to hold an insured accountable for failing to meet the duty of disclosure. However, we expect the interpretation of these amendments will be strict and as such, the insurer will need to comply strictly with the notice requirements so as not to restrict its remedies for non-disclosure.

The insurer does not have an obligation to give the notices if a broker is acting on behalf of the insured. This creates a heightened risk to the broker if they do not specifically clarify with the insured any changes from previous information provided to the insurer and confirmation sought from the insurer.

The risk to the insurer is asking specific questions upon inception of an "eligible contract" but failing to either confirm the information provided upon renewal or to ask further questions at renewal leading to the insurer waiving the duty of disclosure and extinguishing its rights for innocent non-disclosure. These changes do not impact upon the insurer's rights with respect to fraudulent non-disclosure.

GENERAL DUTY OF DISCLOSURE

There have also been changes to the general duty of disclosure which includes the mixed subjective/objective test to clarify what information must be provided. The changes introduce a list of non-exhaustive factors to determine whether a reasonable person would know the matter to be relevant to the insurer.

The existing test is as follows:

(1) Subject to this Act, an insured has a duty to disclose to the insurer, before the relevant contract of insurance is entered into, every matter that is known to the insured, being a matter that:

  (a) the insured knows to be a matter relevant to the decision of the insurer whether to accept the risk and, if so, on what terms; or

  (b) a reasonable person in the circumstances could be expected to know to be a matter so relevant.

The changes to section 21(1)(b) are as follows:

(1) Subject to this Act, an insured has a duty to disclose to the insurer, before the relevant contract of insurance is entered into, every matter that is known to the insured, being a matter that:

  (a) the insured knows to be a matter relevant to the decision of the insurer whether to accept the risk and, if so, on what terms; or

  (b) A reasonable person in the circumstances could be regarded to be a matter so relevant, having regard to factors including, but not limited to:

    i. the nature and extent of the insurance cover to be provided under the relevant contract of insurance; and

    ii. the class of persons who would ordinarily be expected to apply for insurance cover of that kind.

The exposure draft of the *Insurance Contracts Amendment Regulation 2014 (No. 1)* sets out the new general duty of disclosure notice to be provided to an insured. Significantly there is no reference to the two factors listed in section 21(1)(b)(i) and (ii). At best these factors are a guide.

We do not expect these amendments will cause a significant shift in the application of the general duty of disclosure unless there are substantial changes to the proposed notice set out in the exposure draft.

The Disclosure amendments outlined above will have an impact on the renewal of "eligible contracts" and it is critical for insurers to have processes in place that minimise the risk of waiving the duty of disclosure and limiting their remedies for non-disclosure.

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CLASS ACTIONS AND RELIANCE

LEARNING FROM THE US "FRAUD ON THE MARKET" THEORY

By Naomi Miller (Melbourne)

Since the decision of the US Supreme Court in *Basic Inc v Levinson* (Basic) in 1988, plaintiffs in US shareholder class actions have relied on a "fraud on the market" presumption of reliance. Under this presumption, members of the class do not need to prove that they individually relied upon a misleading statement or conduct, but merely that the market was distorted by that alleged information.

All eyes have been on the US Supreme Court again, who were recently asked to reconsider the "fraud on the market" principle. On 23 June 2014, the Court handed down a decision in *Halliburton Co et al v Erica P. John Fund Inc* (Halliburton), in which the presumption was upheld 6:3.

However, procedural amendments were introduced, to allow the presumption to be rebutted at the pre-certification stage of a class action. This will arguably make it harder for US shareholder class actions to proceed.

The Supreme Court's intervention dovetails with the current approach of Australian Courts to reliance, under which generalised, indirect forms of reliance by class action plaintiffs have largely been rejected. There remains room at the margins for novel arguments in relation to indirect causation, and some Australian plaintiffs may take comfort from the US Supreme Court's refusal to wholly overturn the "fraud on the market" theory.

THE BASIC PRESUMPTION

US securities legislation prohibits making a material misstatement or omission in connection with the purchase or sale of any security. While there is no express cause of action established, an implied private cause of action exists. One of the requirements that must be made out is reliance.

In *Basic*, the US Supreme Court changed the landscape of shareholder class actions, by accepting that the market price of shares reflects all publicly available information, including any misrepresentations. Therefore, to prove reliance, a plaintiff merely had to show that:

- the alleged misrepresentations were publicly known and material;
- the stock traded in an efficient market; and
- the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed.

Plaintiffs did not need to show that they were individually aware of the misrepresentation, or that they directly relied on it in their trading decisions.

THE HALLIBURTON DECISION

In the *Halliburton* case, the plaintiff alleged that Halliburton and one of its executives made a series of misrepresentations to inflate the price of its stock. The plaintiff alleged various violations of the *Securities Exchange Act 1934*, including that Halliburton had made misrepresentations in relation to its potential liability in asbestos litigation, its expected revenue from certain construction contracts, and the anticipated benefits of its merger with another company. Halliburton subsequently made a number of corrective disclosures, which the plaintiff contended caused the company's stock price to drop and investors to lose money.

As usual, the plaintiff relied on a "fraud on the market" approach, arguing that the market was distorted, but not putting forward direct reliance.

Halliburton called on the Supreme Court to overturn the *Basic* presumption, arguing that it was out of step with contemporary economic theory. Halliburton urged the Court to reject the notion that all investors rely on the integrity of the market price. Instead, it argued that some investors are conscious that stock may be under or overvalued, and attempt to beat the market. In this way, those investors are not susceptible to any distortion in the market. The Court rejected this argument, noting that market professionals generally consider most publically announced material statements about companies in their trading decisions.

Halliburton also sought to argue that the *Basic* presumption contravenes Congressional intent, as it allows plaintiffs to circumvent proof of reliance. The Supreme Court concluded that whilst the *Basic* presumption provides an *alternative* means of satisfying the requirement of reliance, and whilst it may be seen to lower the threshold for plaintiffs, it does not alter the scope of the cause of action as such.

A PROCEDURAL COMPROMISE

Although the Supreme Court left the "fraud on the market" theory intact, it effectively modified the US process for class action certification, by finding that the *Basic* presumption can be challenged and rebutted at pre-certification stage. This means that a defendant can now take the plaintiff to task on the elements of the Basic test before the class is even constituted.

IMPLICATIONS FOR AUSTRALIAN CLASS ACTIONS – PUSHING THE INDIRECT CAUSATION BARROW?

No shareholder class action has ever gone to judgment in Australia – all have settled so far. However, it may be only a matter of time before an action is pursued to judgment, and "fraud on the market" is judicially considered in Australia.

In the Banksia class action, currently before Justice Ferguson in the Supreme Court of Victoria, debenture holder plaintiffs are attempting to push the bounds of indirect causation in a way strongly reminiscent of the *Basic* presumption. Of the 16,000 debenture holders currently said to constitute the open class, not one has come forward to say that they read or relied upon allegedly misleading prospectuses issued by Banksia and signed off by Banksia auditors.

The plaintiffs insist that they do not have to plead reliance, as the relevant provision (section 729(1) of the *Corporations Act*) is yet to be judicially considered and has (yet) to been held to require proof of reliance. Instead, the Banksia plaintiffs focus on the distortion of market information in the regional area of Victoria in which Banksia predominately operated – akin to a "fraud on the market" approach.

In numerous other decisions, such as *Digi-Tech (Australia) Ltd v Brand* (2004); *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* (2008); and *Woodcroft-Brown v Timbercorp Securities Ltd* (2013), analogous indirect reliance arguments have been rejected by Australian courts. This may mean that Australian courts will give short shrift to a "fraud on the market" approach. Time will only tell.

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BUILDING A BRIDGE
OVER TROUBLED SECTION 6 WATERS

By Belinda Randall (Melbourne)

Since the watershed *Bridgecorp* decisions in New Zealand and the 2013 decision of the NSWCA in *Chubb v Moore* ([2013] NSWCA 212), there has been continuing uncertainty (and some warranted anxiety, we would suggest) amongst Australian directors and their D&O brokers and insurers regarding the efficacy of combined limit policy coverage defence costs.

Whilst the NSWCA provided some welcome comfort and certainty to the vexed "section 6" issue in *Chubb v Moore*; this decision (at the time of writing) remains subject to a special leave application, which may or may not proceed for determination by the High Court. The application was listed for hearing on 14 March 2014 and then 20 June 2014 but was stood over on both occasions. The next hearing date at the time of writing is potentially 17 October 2014. Absent a High Court finding, and in light of the highest (Supreme) Court in NZ adopting a starkly different decision to the NSWCA, insured professionals and insurers should continue to take a cautious approach to cover and be mindful of the possibility that defence costs cover *may* not be available where the amounts claimed exceed relevant limits in combined limit policies and insurance proceeds are subject to an asserted charge.

Leaving aside the legal and policy arguments surrounding the purpose and jurisdictional scope of section 6 of the *Law Reform (Miscellaneous Provisions) Act 1946* (NSW) (and its equivalent provisions in NZ, the ACT and NT), there are serious practical consequences for both Australian directors who are sued (often in multi-million dollar class actions) and D&O insurers, if the recent trend of claimants seeking to assert a section 6 charge over combined limit insurance policies continues. This trend presents a real threat (and, in our view, a costly and potentially opportunistic distraction) to the efficient and just conduct of large scale commercial litigation involving insured parties in this country, at a time when greater streamlining and certainty is required for professionals (especially directors) who are sued and their liability insurers. The effect of valid charges over insurance proceeds may preclude insurers from paying out defence costs in the interests of its insureds – this is nothing less than a calamitous state of affairs.

Recent experience has shown that section 6 issues are most likely to arise when directors and officers are defendants to class actions. Section 6 charges were asserted in the *Centro Properties* class action and the *Great Southern* group proceedings in Victoria and Western Australia. The *Chubb v Moore* decision arose in the context of the *Great Southern* group proceedings. As matters currently stand, insureds involved in litigation should be able to access defence costs under their D&O policies (pending a judgment or settlement) and insurers may pay defence costs without attendant risk (specifically, the risk of later being found to have made defence costs payments on an ex gratia basis and without an erosion of policy limits). However, to the extent there is uncertainty in Australia about the scope and application of section 6 (and we say there is, despite the *Chubb v Moore* decision and in view of the High Court not having spoken on the issue), where a claim is for an amount exceeding a policy limit (as often is the case on class actions), payment of defence

costs will potentially be made at an insurer's risk of paying extra sums over the policy limit. This is an untenable situation for D&O (and PI) insurers and will likely affect the approach to the funding, conduct and resolution of class actions on grounds that may well be extraneous to the merits of each case. This is not, in our view, a constructive development in the conduct and resolution of financial lines disputes in this country.

The matters that were the subject of the decision in *Chubb v Moore* and the *Bridgecorp* decisions are of such significance to the current litigation and PI/D&O insurance landscape in Australia that, in our view, the High Court needs to rule upon them sooner rather than later, failing prompt legislative change (in each of NSW, ACT and NT), which would appear unlikely in the short term. The NSWCA remarked in *Chubb v Moore* that "*section 6 should be repealed altogether or completely redrafted in an intelligible form, so as to achieve the objects for which it was enacted*". There is much to be said for such an approach. Whilst the decision in *Chubb v Moore* should mean that there is no preclusion on insurers meeting reasonable defence costs of Australian directors under claims made policies, our prediction is that claimants will continue to assert charges over policy proceeds and pressure test the reach and authority of the NSWCA decision. The cost of purporting to assert a section 6 charge is minimal (only a letter is needed to put insurers on notice of a purported charge and no declaration from a court is required) and the potential benefit to be gained by claimants is, in our assessment, disproportionately great. In those circumstances, despite the grave ramifications for directors and D&O insurers, it can be expected that the section 6 "waters" will continue to be tested. In our view this derogates from the contractual rights between insured professionals and their insurers (and the primary commercial purpose and benefit of a D&O policy), and the ability of (particularly) directors and company officers to defend significant claims against them.

So, what should be done in the meantime to provide further certainty and comfort to directors, their insurers and brokers (who will need to carefully consider advice given to their clients)?

"Insurers, in conjunction with insureds and brokers, need to consider and proactively address the terms of current D&O and PI policies to deal with the risks created by the assertion of section 6 charges."

Specifically, insurers on risk in Australia and New Zealand need to be aware of the potential effects of a statutory charge and the differences that apply in these jurisdictions to defence costs advancement under combined limit liability policies.

We would argue that the potential minefield of issues and consequences caused by the assertion of section 6 charges over the proceeds of combined limit D&O policies are best avoided (or, at least, minimised) if directors' insurance arrangements are structured to provide for separate limits (or stand-alone coverage separate to D&O policies) for defence costs. Separate defence costs policies will advance defence costs in the event a statutory charge has attached to the D&O (or PI) policy.

"This is not an issue that we see as going away in the short term, if there is no High Court ruling on point. Further, there would appear to be an opportunity (and perhaps necessity) for the insurance, legal and corporate spheres to work together and lobby law makers to address the section 6 issue once and for all."

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MITIGATING RISK IN M&A TRANSACTIONS IN AUSTRALIA

By James McCarthy and James Morse (Sydney)

WARRANTY & INDEMNITY INSURANCE

Having acted on more global M&A deals than any other law firm since January 2005, DLA Piper has had significant first hand exposure to the global growth in the market for warranty and indemnity insurance (W&I Insurance).

In Australia, we have witnessed a significant growth in the capacity of the domestic market and a significant reduction in premiums to the extent that W&I Insurance is no longer a boutique product, but rather it is now the default risk allocation mechanism in private M&A transactions in Australia.

We expect this trend to continue well into the future and, on that basis, set out below a snapshot of common features/aspects, based on our experience across a broad range of matters.

1. ACTING FOR A SELLER

Where we act for a Seller, we often recommend the use of W&I Insurance as it allows our client to eliminate its long liability tail by exchanging a contingent future liability (where the amount and timing of the liability is unknown) for a present fixed insurance premium which can be allocated between the parties as part of the purchase price. Our clients find W&I Insurance particularly attractive where they are:

(a) in an auction process and want to increase the attractiveness of the target by offering reasonable warranties and indemnities, but where they do not want to assume the contingent liabilities associated with those warranties and indemnities;

(b) seeking a clean exit from a transaction and want the sale proceeds to be free from any restrictions so that those funds can be used for future investments, to repay investors and/or to exit the industry or investment cleanly. In these circumstances, W&I Insurance eliminates the need for the Seller to:

(i) have a portion of the sale proceeds tied up in an escrow account or withheld under a retention arrangement to cover contingent liabilities where such amounts are usually significantly larger than the premium which is payable for W&I Insurance; or

(ii) provide a parent guarantee or a letter of credit.

In this scenario, we assist the Seller to engage with an insurance broker, to draft the appropriate W&I Insurance clauses in the Sale Agreement and to ensure that the W&I Policy is in place as at signing.

2. ACTING FOR A BUYER

Where we act for a Buyer, our clients find W&I Insurance particularly attractive where they are:

(a) having difficulty quantifying a particular risk associated with the Target and where the W&I Insurer has greater expertise in determining the present value of that future risk;

(b) concerned about their ability to enforce the warranties and indemnities in the Sale Agreement because the Seller:

(iii) is distressed and there are doubts about the Seller's ability to satisfy a future warranty claim;

(iv) is located in a different jurisdiction and difficult to enforce against;

(v) has a significant proportion of its assets in the transaction; or

(v) is likely to transfer the sale proceeds up the corporate tree or to an overseas parent,

(c) acquiring a management team as part of the transaction and the Buyer does not want to run the risk of bringing a warranty claim which could harm the reputation of, or distract, the continuing managers;

(d) in a competitive bid scenario and wishes to acquire a competitive edge by agreeing to a Sale Agreement with no escrow/retention; and

(e) buying assets from a private equity Seller which is not comfortable in having a long liability tail but which may be willing to contribute to the costs of a Buyer-side W&I Insurance Policy.

In this scenario, we assist the Buyer in negotiating the responsibility for payment of the costs associated with the W&I Insurance, in drafting the W&I clause in the Sale Agreement, in working with the Insurer to get the Insurer comfortable with the risks associated with the transaction and in ensuring that a W&I Policy, which includes terms acceptable to the Buyer, is in place as at signing.

3. ACTING FOR AN INSURER

In addition to assisting our M&A clients through the process of obtaining W&I Insurance, we also have significant experience in acting for Insurers providing W&I Insurance. In this scenario, where we are not engaged by either party to an M&A deal, we are well placed to apply our M&A knowledge to assist the Insurer understand the nature of the risks associated with a particular M&A deal.

In this scenario, we are typically engaged by the Insurer a week or two from signing. We engage our corporate, tax and other specialist teams as required to review the transaction and diligence documents with a view to identifying key areas of risks for the Insurer. We then prepare a suite of questions to the Insured and, after obtaining answers to those questions, we prepare an analysis for the Insurer which describes the key risks facing the Insurer.

We then work with the Insurer to mitigate their risk, including in obtaining further disclosures from the Insured and in negotiating the scope of coverage of the W&I Policy. This negotiation typically focuses on exclusions, the appropriate definition of disclosure materials and deemed amendments to warranties.

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ARBITRATIONS AND UNDERWRITING RISKS

HOW WELL DO YOU KNOW YOUR INSURED'S AGREEMENTS?

By Claire Martin and Richard Edwards (Perth)

In the construction industry it is common for parties to agree to refer any disputes arising under the contract to arbitration. Insurers should consider the consequence of these agreements when assessing a client's risk profile as not all arbitration agreements are equal.

"Decisions taken on the terms of an arbitration agreement can have a profound effect on a party's substantive rights and the ultimate outcome of a dispute."

A valid arbitration agreement is one where the parties agree to submit to the jurisdiction of the appointed arbitral tribunal, to the exclusion of the courts, except for limited matters. The agreement generally covers issues such as the law that will be applied, the procedural rules to be followed (including the appointment of the tribunal), the seat and venue for the arbitration, whether arbitrators can be removed or replaced, whether appeals are permitted and whether parties can claim their costs. Decisions taken on these issues can have a profound effect on a party's substantive rights and the ultimate outcome of the dispute.

CHOICE OF LAW

Agreements normally provide that any disputes will be determined in accordance with the law (including legislation) in force in the place where the contract is made. In Australia, the Commonwealth, States and Territories have in place legislation that gives effect to the UNCITRAL Model Law on Arbitration. In Western Australia, for example, the *Commercial Arbitration Act 2012* (WA) governs arbitrations between parties resident in WA. If there is no agreement on the law to be applied, then private international choice of law rules apply. This can be messy when parties contract in different countries.

CHOICE OF RULES

The choice of procedural rules can have a profound influence on a party's substantive rights. They can influence which arbitrators are appointed, what language is to be used, whether pleadings are used, what document disclosure (if any) is given, what process is adopted for expert and factual witness evidence, the duration of the arbitral process and the time given to each party to present its case. For example, the Hong Kong International Arbitration Centre Administered Arbitration Rules 2013, allow for parties to be joined to an arbitration – a concept that is seen by many as novel.

THE ARBITRATION SEAT AND VENUE

The selection of the seat of the arbitration is significant as it normally determines the law governing the arbitration procedure and the involvement which the courts exercising supervisory jurisdiction over the arbitration will have. The seat may also dictate the procedure and laws applying to the enforcement of the arbitration award. Insurers should be aware of the Insured's choice of seat as other jurisdictions, outside of Australia, can vary significantly in terms of the authority of the local courts to intervene in the arbitration.

The selection of the venue is the location where the hearing is to take place. The seat of arbitration and the venue of the arbitration are not required to be the same location. However, choosing a venue without allocating a seat will generally indicate that the parties intended the law governing the jurisdiction where the arbitration is being held to also govern the arbitration procedure.

REMOVAL OR REPLACEMENT OF ARBITRATORS

In general, the parties to an arbitration agreement may appoint as many arbitrators as they want, or whoever they please, to arbitrate their dispute. If the parties choose an incompetent, unsuitable or unfit person they are free to do so. Unless the parties agree to reconstitute the tribunal, there is little that a party can do to remove an arbitrator once appointed. If the parties cannot agree on an arbitrator then the appointing authority nominated under the agreement will appoint an arbitrator. The arbitrator appointed by the authority may not have the desired set of legal skills to deal with the dispute.

Under the Commercial Arbitration Acts, a party can apply to the court to remove an arbitrator for misconduct, undue influence or unfitness. This remedy will be granted only where there has been or will be "real dereliction of duty" on the part of the arbitrator such that it is clear that the arbitration cannot properly proceed to award.

Mere procedural errors by the arbitrator are insufficient to warrant removal. If the arbitrator is not, or may not be, impartial, and the party was not aware of this fact before the arbitrator was appointed, a party may challenge the grounds of the appointment before a court on grounds of misconduct.

LIMITED RIGHTS OF APPEAL

The statutory regimes governing arbitration disputes in Australia provide for very limited rights of appeal from an arbitrator's decision. That means there is no real opportunity to correct what one party may feel is an erroneous arbitration decision. The courts are also mindful to make decisions in relation to arbitration disputes in a way which promotes the legislative intention of the Commercial Arbitration Acts, namely to facilitate the fair and final resolution of commercial disputes by impartial arbitral tribunals without unnecessary delay or expense. Allowing the parties recourse to judicial means of relief is contrary to this legislative intention.

OTHER CONSIDERATIONS

In addition to considering those usual matters that arise in each arbitration agreement, insurers should also consider the following:

- If arbitration is compulsory the parties will be forced to resolve the dispute by arbitration even when one of the parties no longer wants to resolve a dispute by arbitration.
- Discovery (if allowed at all) may be limited with arbitration and crucial documents may not be produced, where as they would be required to be in litigation.
- If a relatively small sum of money is in dispute the arbitrator's fees and other arbitration costs (hearing venue hire, transcript, travel) may make arbitration uneconomical.
- Rules of evidence may prevent evidence from being admissible in a Court, however, an arbitrator may consider that evidence where the rules of evidence do not apply. Therefore, an arbitrator's decision may be based on evidence that a judge would not consider at trial.
- Generally arbitrators are required to follow the law of the jurisdiction which the parties have agreed will apply to the dispute. However, the degree to which the arbitrator is required to follow the law as opposed to exercising his or her own discretion is unclear. Sometimes arbitrators may consider the fairness of the respective parties' positions in preference to a strict application of the law. This may result in a less favourable outcome for a party that has a clear legal entitlement or defence.

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