From Infancy to Maturity – Financial Lines Insurance in Australia, the past, present and future

Ray Giblett and Timothy Chan[1]

"The Antipodes were drifting, though where they were drifting no one knew."
Geoffrey Blainey *The tyranny of distance: how distance shaped Australia's history*, Macmillan, 2001

1 Introduction

1.1 Insurance plays an important economic role by transferring risks associated with business, enabling transactions and the provision of services that would not otherwise proceed. Financial lines insurance is concerned with a particular type of liability insurance – that which covers pure financial loss due to events unrelated to personal injury or property damage. The purpose of this paper is to assess the current state of the financial lines market in Australia, with acknowledgement of its history, and consider what the future might hold.

1.2 The existence of insurance in the modern era can be traced back to the 14th or 15th centuries when London merchants from northern Italy introduced marine insurance.[2] However, back then, the western world had not yet discovered Australia. European settlers first arrived in Australia in 1788, predominantly made up of convicts from England. These settlers established colonies in Australia.

1.3 English law governed the colonies until 1 January 1901, when they became states and together formed the Commonwealth of Australia.[3] Given Australia's isolation from the rest of the world, it is not surprising that marine insurance was of significant interest to merchant traders at the time. Indeed, the first Commonwealth Act to regulate insurance contracts was passed in 1909 and related to marine insurance - the *Marine Insurance Act 1909* (Cth).

1.4 Since that time, the growth of the Australian economy and evolution towards a services-focused nation has driven the growth and establishment of a mature financial lines market. In addition to the traditional professional indemnity and directors' & officers' policies, the market now provides capacity for the full gamut of financial lines risks including management liability, warranty and indemnity, and cyber liability.

2 Types of financial lines insurance in Australia

The Australian market provides the full suite of financial lines insurance, although there are varying degrees of underwriting capacity available. We list some of the most prevalent below.

Professional indemnity

2.1 Professional indemnity (**PI**) insurance provides cover for businesses and individuals who provide professional services.[4] It covers claim and defence costs made by third parties against professionals. This includes accountants, lawyers, engineers, architects, and IT

[1] The authors gratefully acknowledge the assistance of Megan Lingafelter, lawyer at Norton Rose Fulbright, in the preparation of this paper.
[2] Greg Pynt, *Australian Insurance Law: A First Reference* (Lexis Nexis Butterworths, 4th ed, 2015), 44.
[3] However, the influence of English law and appeals to English courts were not wholly abolished until the *Australia Act 1986* (Cth).
[4] Broadly defined to require "no more than advice and services of a skilful character according to an established discipline", see *GIO General Ltd v Newcastle City Council* [1996] NSWSC 322, [40].

specialists.[5] Over time, the focus has been on settling these claims rather than defending them at a protracted court hearing.

2.2 In the 1980s, policy limits were quite low, for example, $2 million. A large policy limit in those days was $10 million. Today, it is common to see a $20 million policy limit, although limits can be as high as $500 million (often utilising foreign capacity) for large financial institutions.

Directors' & Officers' liability

2.3 Originating from the United States in the 1930s, insurers introduced Directors' & Officers' (**D&O**) insurance to Australia in the 1970s. D&O insurance initially covered wrongful acts committed by directors.[6] At first, D&O cover was purchased by subsidiaries of US based companies with an Australian presence.

2.4 However, after the Black Monday stock market crash of 1987, there was increased interest in D&O insurance. This was also driven by high profile decisions in the Australian courts imposing significant penalties on directors for breaches of directors' duties.[7]

2.5 There are generally three 'sides' of cover offered locally, conveniently called sides A, B and C. Side A provides direct indemnification of directors and officers for claims made against them. Side B reimburses the company for indemnification it has provided to the directors (eg pursuant to a deed of indemnity).

2.6 Side C was not commonplace until the late 1990s and covers breaches of securities laws. It is the cover that generally responds to securities class actions.[8] Australia's corporations legislation, the *Corporations Act 2001* (Cth), imposes multiple duties on directors. Sides A and C can be purchased standalone in the Australian market, with side C sometimes replaced by a prospectus liability (**POSI**) cover (see section 2.15 below).

Cyber

2.7 Cyber insurance provides cover for cyber incidents that may affect a business, such as hacks, information theft, data breaches and ransomware events.

2.8 Although first introduced in the Australian market in the early 2000s, initial take-up was slow. However, amendments to Australian privacy laws in March 2018 have driven cyber insurance uptake in Australia. It is increasingly viewed as an essential policy for both small and large businesses and a variety of policies are available.

2.9 The amendments to the privacy laws require businesses to notify the Office of the Australian Information Commissioner, a statutory regulator, of certain breaches of privacy law. Since the laws came into effect, 305 incidents have been reported to the regulator.

2.10 Cyber insurance has been a challenge for underwriters and actuaries given the lack of historical data available. The market provides capacity for companies that may have sophisticated requirements as well as smaller companies. Like other insurance products, underwriters need to take into account varying needs and risks depending on the size and complexity of the business.

[5] However, if an insurer issues a PI policy knowing the insured's activities, it is difficult for it to argue that the activities did not involve "professional services". See, eg, *Suncorp Metway Insurance Ltd v Landridge Pty Ltd* [2005] VSCA 223

[6] It now generally extends to any matter claimed against a director in their capacity as such.

[7] See, eg, *Daniels v Anderson* (1995) 37 NSWLR 438 and *ASIC v Adler* [2002] NSWSC 171.

[8] XL Catlin, 'Show Me The Money! The impact of securities class actions on the Australian D&O Liability Insurance Market' (16 October 2017).

Warranty & Indemnity

2.11 Warranty and indemnity (**W&I**) insurance (also known as Representations and Indemnity insurance) is cover that is tailored to the needs of mergers and acquisitions transactions. It provides cover in the event that a warranty or indemnity given by the seller turns out to be false or misleading. The cover can be taken out by either the buyer or the seller.[9]

2.12 Initially introduced in Australia around the dawn of the new millennium, primarily through a single broker, uptake was modest. However, over the past decade the number of providers has increased dramatically and W&I cover is now relatively standard on most M&A transactions.

Employment Practices Liability

2.13 These covers, often included as additional benefits in a management liability policy (see below), are also available as standalone products in the Australian market. Employment practices liability cover provides protection to employers for claims made against them by employees, such as for discrimination, wrongful dismissal and workplace harassment.

Kidnap/Ransom/Extortion Cover

2.14 Kidnap cover protects high-risk employees from kidnapping for ransom or extortion. The insurance may also protect the company against threats made against it, for example, threats to contaminate its products or divulge company secrets. Given the relatively low risk in Australia, the local demand is comparatively modest.

Prospectus Liability

2.15 Prospectus liability insurance provides cover for claims of misleading or inaccurate prospectus information in a public offering of securities, including the defence costs associated which such claims. These claims may be aimed at management, prospectus underwriters, controlling shareholders and the company itself. The cover enables companies to ring-fence their prospectus liability exposure.

2.16 With local challenges to side C cover offered as part of a D&O policy (considered further below in the context of securities class actions), standalone POSI cover is in increasing demand.

Financial Institutions Bond Insurance and Electronic/Computer Crime

2.17 Financial institutions bond, also known as banker's bond, protects the institution against fraud loss caused by employees or third parties. This includes counterfeit physical currency, funds transfer fraud, and dishonest acts of employees. This overlaps with Electronic/Computer Crime insurance, which provides cover for fraud undertaken by employees using computing systems.

2.18 Electronic/Computer Crime insurance is not limited to financial institutions, although large financial institutions are the primary buyers. Given the concentration of financial institutions in Australia, the market is relatively narrow.

2.19 A current issue facing insurers is the extent of cover available under a crime policy where the fraud is conducted using a cyber-attack, such as fraudulent authorisations on a computing system.[10] In these situations, a standalone cyber policy may also cover the same loss. Cyber and privacy breaches are also an increasing issue for D&O insurers.

[9] For more detail, see Jyoti Singh and Ray Giblett, 'W&I Insurance – insuring a smooth transition' (2016) 32(2-3) *Insurance Law Bulletin* 30.
[10] See eg, *Medidata Solutions Inc v Federal Insurance Company* USDC-NY 15-CV-907.

Management Liability

2.20 Management liability insurance has emerged and grown in popularity in Australia over the past two decades as a 'one size fits all' insurance package for small to medium sized businesses (and not-for-profits). At its most basic level, management liability insurance is a D&O policy with additional 'add-ons' for claims made against the company relating to wrongful employment practices, kidnap/ransom/extortion cover and crime.

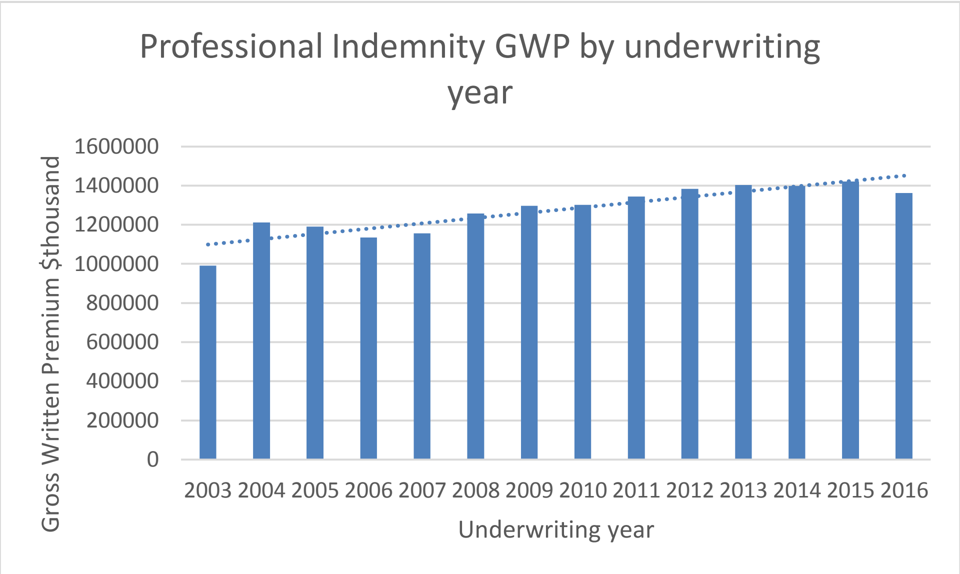
2.21 Some management liability policies have also evolved to insure cyber risks, although a standalone cyber policy is becoming more commonplace.

3 Size and health of the Australian financial lines market

3.1 The Australian Prudential Regulation Authority (**APRA**) collects and reports on data pertaining to the size of the Australian insurance market by requiring insurers carrying on a business in Australia to provide statistics directly to it. From this data, the gross earned premium across all lines of insurance for the most recent financial year ending 30 June 2018 was $45.6 billion, of which $5.7 billion related to commercial lines insurers' business.[11]

3.2 While segregated data for financial lines in Australia is not readily available, the Asia Pacific region (of which Australia is a member) accounts for 23% of the property and casualty market, and has been the major driver of growth in the global P&C market, recording average growth of 9% p.a. since 2013.[12]

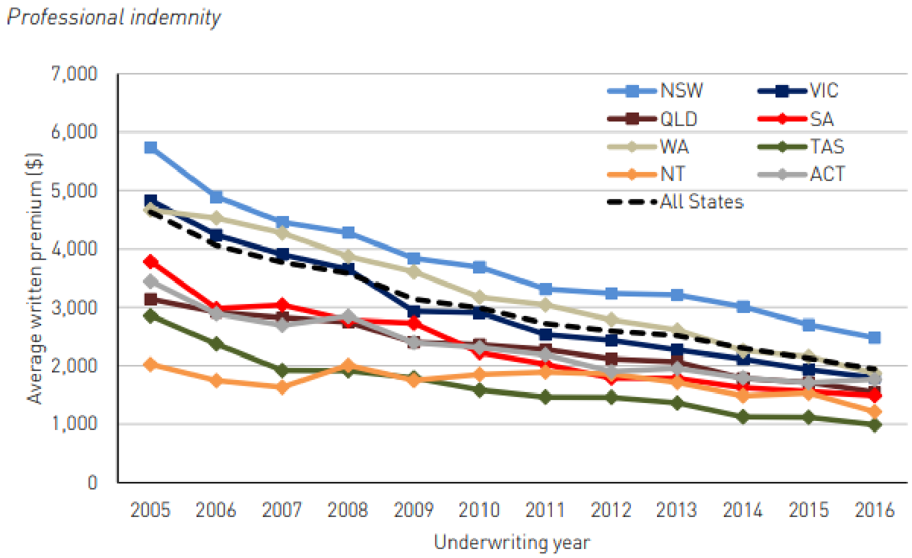
3.3 According to the APRA National Claims and Policies Database (**NCPD**), GWP in the professional indemnity space has shown static premium growth. The table below shows the gross written premium of Australian regulated insurers in the period 2003 to 2016, which is the most recent publically available data. The NCPD defines professional indemnity to include policies covering professionals, directors' and officers' liability, and medical indemnity insurance.



Data sourced from National Claims and Policy Database, APRA.

[11] According to APRA, 'Annual General Insurance Institution-Level Statistics Glossary', commercial lines insurers' business includes some non-financial lines insurance business such as commercial motor vehicle, industrial special risks and aviation.
[12] McKinsey & Company, 'Global Insurance Industry Insights: An In-Depth Perspective' (7th ed, 2017), 8.

3.4 While aggregate GWP seems to be increasing, this appears to be due to an increasing number of risks being written. The average written premium has been on the decline. The soft market is perhaps due to competition and saturation. The below graph from the NCPD overview report published on 26 September 2018 shows the average written premium of Australian regulated insurers from 2005 to 2016.[13] As can be seen, the average written premium has not risen beyond pre GFC levels.



3.5 APRA also publishes comprehensive insurer data in December each year. At the time of publishing, the most recent insurer specific data available was from December 2017, which showed that the top five players in the insurance space generally based on gross earned premium were QBE Insurance Group Limited, Insurance Australia Group Limited, Suncorp Insurance Holdings Limited, Allianz Australia Limited and Chubb Holdings Australia Pty Limited.[14]

4 Statutory intervention

4.1 Insurance Contracts Act – section 54

4.2 While the Australian insurance market has evolved from its UK roots, the Australian legislature has more keenly embraced statutory intervention compared to the UK.[15] The *Insurance Contracts Act 1984* (Cth) (**ICA**) was the result of environmental factors at the time, being the rapid pace of local industrialisation and the need to protect the insurance market.[16] The ICA was a 'world first' piece of legislation that was primarily concerned with consumer protection.[17]

4.3 Among other things, the ICA codified the duty of disclosure and duty of utmost good faith,[18] set out protections relating to fraudulent claims, and stipulated procedures relating to the cancellation of policies.

[13] Australian Prudential Regulation Authority, 'Statistics: National Claims Policy Database Overview For The Period 1 January 2003 to 31 December 2017 (issued 26 September 2018)', 9.
[14] Australian Prudential Regulation Authority, 'Annual General Insurance Institution-Level Statistics December 2017'.
[15] The UK has only recently introduced the *Insurance Act 2015,* which came into force on 12 August 2016.
[16] Pynt, above n 2, 110.
[17] Ibid.
[18] The statutory/contractual duty of utmost good faith has been underutilised and rarely fruitful for insureds, for example see *CGU Insurance Ltd v AMP Financial Planning Pty Ltd* [2007] HCA 36.

4.4 However by far the most controversial provision is section 54, headed ‘Insurer may not refuse to pay claims in certain circumstances’. The introduction of the provision caused a reluctance to underwrite D&O insurance in Australia. The effect of section 54 is that an insurer cannot refuse to pay a claim due to an act or omission of the insured or some other person, if the act or omission did not cause or contribute to the loss. However, the insurer can reduce the amount it pays in relation to the claim to the extent of any prejudice the insurer has suffered.

4.5 This provision had significant ramifications for underwriting of financial lines business in Australia, particularly financial lines products underwritten on a ‘claims made and notified’ basis such as PI and D&O. Ordinarily, notification of claims or circumstances to insurers during the policy period is critical to availability of indemnity under the policy. However, the introduction of section 54 had the effect of potentially extending the time for which a policy could still respond, arguably rendering it more like an occurrence-based policy.

4.6 For some time, it was unclear whether section 54 operated to preclude insurers from denying a claim where notification of a claim or circumstance was not made until after the period of insurance, for acts that occurred during the policy period, even though the insured was aware of such circumstances during the policy period. This was because it was unclear whether the relevant omission could be a failure to exercise a right under the policy.

4.7 This ambiguity was resolved in 2001 by the High Court of Australia in *FAI General Insurance Co Limited v Australian Hospital Care Pty Limited*[19]. In this case, the insured was an operator of private hospitals and took out professional indemnity insurance with FAI General Insurance Co Limited. During the period of insurance, which started at 4pm on 20 June 1991 and ended at 4pm on 20 June 1992, the insured received notification that one of its clients, Dr Tampoe, was considering whether it was going to bring an action against the insured for treatment that the hospital had provided.[20] Condition 3 of the policy stated that if an insured notified the insurer during the policy period of ‘an occurrence which may subsequently give rise a claim’, the policy would nevertheless respond even if the action was commenced after the policy period (**Deeming Provision**).

4.8 However, no notification of this potential claim circumstance was given to the insurers during the policy period. Furthermore, Dr Tampoe did not make a claim against the insured until December 1992, which was outside the policy period. In the absence of statutory intervention to the contrary, the policy wording would prevail. The claim by Dr Tampoe against the insured, when made in December 1992, would not fall within the provision for indemnity in the policy. Nor would it be covered under any new policy in place at the time of the claim due to the common known circumstances exclusion.

4.9 However, section 54 states that an insurer cannot refuse to pay a claim due to an act or omission of the insured or some other person, if the act or omission did not cause or contribute to the loss. It was therefore questionable whether the insured’s failure to notify insurers was an omission falling within the provision.

4.10 After much consideration of previous case law, the High Court held that the relevant act or omission could indeed be the failure to notify the insurer about the potential claim circumstances during the policy period under the Deeming Provision. Under the policy, but for this omission the policy would respond and section 54 prevented the insurer from refusing to pay the claim on this basis. There was no suggestion that the insurer’s interests had been prejudiced.

4.11 Following the *Australian Hospital Care* case, underwriters in the market began removing deeming clauses from policies. However, the insured may still rely on section 40(3) of the

[19] [2001] HCA 38.
[20] Ibid, [15].

Insurance Contracts Act 1984 (Cth), which is similar in effect apart from its interaction with section 54.[21]

4.12 Where a deeming clause exists in the insurance contract, section 54 will preclude an insurer from denying coverage if an insured has simply failed to notify circumstances to the insurer during the policy period and a claim is made against the insured after the policy period. However, if there is no deeming provision in the insurance contract and reliance is merely placed on section 40, section 54 will not operate to prevent the insurer from denying liability for a claim made outside the policy period.[22] That is, the insurer may deny the claim.

4.13 Accordingly, financial lines policies issued in Australia have to take into account this peculiar operation of section 54 if underwritten on a claims made basis. The result is that most PI policies do not contain a deeming clause whereas many D&O policies have retained them.

4.14 **Civil Liability (Third Party Claims Against Insurers) Act 2017 (NSW)**

4.15 Australia has not been immune to the legislature's push to join insurers to proceedings, giving plaintiffs direct access to insurance monies. This may be particularly useful for insureds in cases where the defendants do not have any financial capacity. The UK recently enacted similar legislation.[23]

4.16 The origins of direct access to insurance monies commenced in NSW in 1946 with section 6 of the *Law Reform (Miscellaneous Provisions) Act 1946* (NSW), which was always awkward and has since been repealed. It was originally intended that section 6 would prevent an insured from claiming a lump sum from the insurer and then spending it all, or even disappearing, so that the claimant could not recover anything. It did this by imposing a charge on all insurance monies that an insurer could potentially be liable to pay on behalf of the insured for damages or compensation.

4.17 Section 6 was problematic because it was not clear how it would operate, such that a court of appeal judge called for it to be "completed redrafted in an intelligible form".[24] The provision was particularly troublesome for financial lines insurers, as it was unclear how the charge should be interpreted, when it would arise,[25] and whether it prevented insurers from advancing defence costs on behalf of their insureds.[26] It was also unclear whether section 6 applied to insureds seeking funds from the reinsurer where the insurer has failed to pay.

4.18 The position in NSW was that the charge over insurance money would not prevent directors from accessing defence costs under a D&O policy despite the third party claim potentially exceeding the policy limit.[27] However, the highest court in New Zealand came to a contrary conclusion after considering the equivalent provision in that jurisdiction.[28]

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[21] Section 40(3) states that where the insured gave notice in writing to the insurer of facts that might give rise to a claim against the insured as soon as was reasonably practicable after the insured became aware of those facts but before the insurance cover provided by the contract expired, the insurer is not relieved of liability under the contract in respect of the claim, when made, by reason only that it was made after the expiration of the period of the insurance cover provided by the contract.

[22] See *Gosford City Council v GIO General Ltd* [2003] NSWCA 34.

[23] *Third Parties (Rights Against Insurers) Act 2010.*

[24] *Chubb Insurance Company of Australia Ltd v Moore* [2013] NSWCA 212, [55].

[25] The charge descended when the relevant event occurred. For claims made policies, the policy in place when the claim was made often did not exist when the underlying event occurred and therefore s 6 had no effect. See eg *Chubb Insurance Company of Australia Ltd v Moore* [2013] NSWCA 212.

[26] Australian Law Reform Commission, *Third Party Claims On Insurance Money: Review of s 6 of the Law Reform (Miscellaneous Provisions_ Act 1946,* Report No 143 (2016), 11.

[27] *Chubb Insurance Company of Australia Ltd v Moore* [2013] NSWCA 212.

[28] *BFSL 2007 Limited (In Liquidation) & Ors v Steigrad* [2013] NZSC 156.

4.19 For some time, the uncertainty led insurers to create 'companion policies' to accompany side A policies. These companion policies provided cover exclusively for defence costs and expenses if the traditional D&O policy did not respond because of a statutory charge under section 6. Alternatively, insurers offered 'costs-only' limits in circumstances where the policy was subject to a charge.

4.20 Section 6 was repealed on 1 June 2017 and a new procedure for third parties was introduced. The *Civil Liability (Third Party Claims Against Insurers) Act 2017* (NSW) enables a claimant to seek leave from a court to recover the amount of insured liability from the insurer.[29] The Act specifically provides that the insurer stands in the place of the insured person as if the proceedings were proceedings to recover damages, compensation or costs. The Act does not impose any charge like its predecessor and does not apply to contracts of reinsurance, thereby resolving many of the issues that section 6 caused.

4.21 The courts have considered what the requirements are for an insurer to be directly joined to the action. These criteria were set out in *Bede Polding College v Limit (No 3) Limited and Anor* [2008] NSWSC 887. The criteria generally are:

(1) that there is an arguable case against the insured party;

(2) there is an arguable case that the insurance policies would respond to the claim brought by the claimants against the insured party; and

(3) there is a reasonable possibility that if judgment is obtained the insured party would not be able to meet it.[30]

4.22 However, satisfaction of these three criteria alone is not sufficient to warrant an exercise of the court's discretion. The limits of when the discretion should not be exercised was tested in the case of *Rushleigh Services Pty Ltd v Forge Group Limited (In Liquidation) (Receivers and Managers Appointed)* [2018] FCA 26.

4.23 In that case, it was accepted that the three criteria set out in the *Bede Polding College* case had been satisfied.[31] However, the D&O insurers submitted that the court should not exercise its discretion to grant leave because:

(1) there would be irreparable prejudice due to significant costs of defending proceedings which they were not familiar with, resulting in insurers facing a forensic disadvantage;

(2) there was no utility because insurers had already agreed to indemnify the insured; and

(3) joinder of insurers would circumvent the effect of an earlier decision.

4.24 Justice Markovic ruled that all three grounds were insufficient to deter the court from granting leave. Firstly, the additional costs insurers said they would incur did not constitute prejudice because an insurer will always know less about the underlying facts, matters and circumstances giving rise to a claim, compared to the insured itself. The policy also required the insured to cooperate with the insurers in relation to any litigation and there was no evidence to the contrary in practice. Secondly, there was utility in granting leave because the plaintiff had been barred from pursuing the insured directly.[32] Thirdly, the

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[29] See s 4.
[30] *Bede Polding College v Limit (No 3) Limited and Anor* [2008] NSWSC 887, [6].
[31] Ibid, [59].
[32] The insurers referred the court to the case of *DSHE Holdings Ltd (receivers and managers appointed) (in liq) v Abboud; National Australia Bank Limited v Abboud* [2017] NSWSC 579. In that case, the court had refused to grant leave under the predecessor provision to the *Civil Liability (Third Party Claims Against Insurers) Act 2017* (NSW) because the insurers had agreed to indemnify the directors. Even though there

judge ruled that although the earlier decision in *Rushleigh No 1* prevented the plaintiffs from pursuing Forge, it did not relieve Forge of liability itself, liability which insurers could potentially meet.

4.25 Accordingly, the court has a very broad discretion whether to grant leave to join insurers directly to proceedings. While the existence of an insurance policy must first be established by the party bringing the joinder proceedings,[33] the cases show that there are a multitude of factors that a court needs to consider when deciding whether or not to grant leave.

4.26 This has a significant impact on financial lines insurance policies. Section 6 had limited application to claims made policies given the policy often did not exist when the charge descended. The new provision has resolved this issue by allowing direct joinder of insurers to proceedings and not using the mechanism of a charge.

Statutorily required insurance

4.27 Like other jurisdictions, lawmakers in Australia have also used statute to impose mandatory professional indemnity insurance for various professions in Australia. The purpose is to ensure that consumers may have recourse to professionals (and in turn, their insurers) for negligent acts or omissions. However, apart from these requirements, it is not compulsory in Australia to hold financial lines insurances, including D&O insurance.

4.28 Where there is an obligation to hold professional indemnity insurance, these are generally imposed by the relevant regulator or professional body for each profession. These include accountants, doctors, solicitors, insurance brokers and financial advisers. The regulators or professional bodies specify minimum cover required under each policy and minimum policy limits. Accordingly, this has led to professional indemnity insurance tailored to the needs of each profession.

4.29 Australian Financial Services Licence (**AFSL**) and Australian Credit Licence (**ACL**) holders are also required to hold professional indemnity insurance to ensure that retail clients can be compensated for losses caused by an AFSL or ACL holder breaching their obligations, unless alternative arrangements have been approved by the regulator.[34] AFSL holders include anyone who deals with a financial product or provides a financial service. ACL holders are those that engage in credit activities. AFSL and ACL holders are regulated by the Australian Securities and Investments Commission (**ASIC**).

4.30 AFSL and ACL holders are required to ensure that they have ‘adequate’ professional indemnity cover. In 2015, ASIC conducted a review of the state of the PI insurance market for AFSL and ACL holders.[35] The outcome of the review, interestingly, was that the PI insurance available in the market did not meet ASIC’s requirements in key areas. For example, ASIC required defence costs to be in addition to the minimum limit of indemnity, that policies require at least one automatic reinstatement and not contain certain fraud or dishonesty exclusions. ASIC also identified capacity constraints in the market, with AFSL and ACL holders finding it difficult to find cover if they had previously made claims or were a relatively smaller player in the market.[36]

4.31 The outcome of the report was that ASIC worked with insurers to ensure that their policies were compliant with the regulatory requirements for AFSL and ACL holders.

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was the possibility of separate proceedings being required if insurers later denied indemnity on the basis of an enlivened dishonesty exclusion, leave should not be granted ‘just in case’ that would happen.

[33] See *Mrdajl v Southern Cross Constructions (NSW) Pty Ltd (In Liq)* [2018] NSWSC 161.

[34] *Corporations Act 2001* (Cth), s 912B(1).

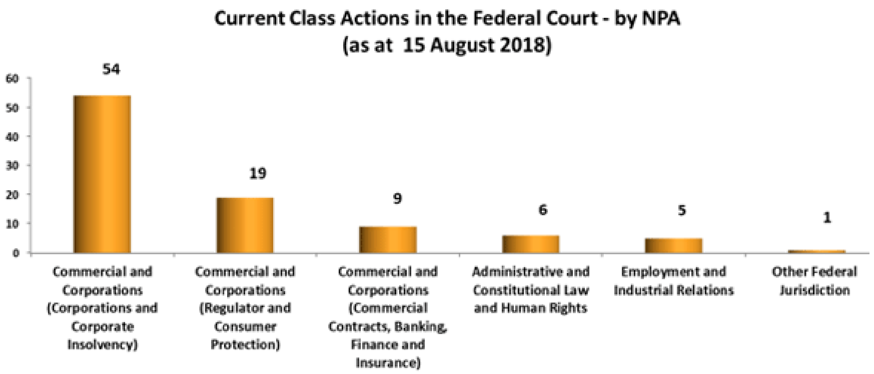
[35] Australian Securities and Investments Commission, *Professional Indemnity Insurance Market for AFS Licensees Providing Financial Product Advice,* Report 459 (2015),

[36] Ibid, 28.

4.32 There are generally no statutory requirements to maintain other financial lines covers such as D&O, crime or cyber policies.

5 Securities class actions and impact on D&O policies

5.1 Following in the steps of the United States, shareholder class actions have also been on the rise in Australia. At the time of writing, there are 54 class actions in the Federal Court of Australia in the commercial and corporations list. This is partly due to the growth in litigation funding, following the High Court's approval of such arrangements in 2006.[37] Another driver has been the presence of Side C cover, which has arguably encouraged shareholder class actions. The below graph shows the breakdown of current class actions currently on foot in the Federal Court of Australia.[38]



5.2 A significant turning point occurred in 2016 when the full Federal Court decided that a class action could be conducted on a 'common fund' basis. That is, litigation funders can spread the cost of prosecuting a class action across the entire group, and seek a funding commission from the recovery of every group member, even those who have not entered into a funding agreement. Accordingly, it may be profitable for funders to encourage large 'open class' actions.

5.3 Class actions are often brought on behalf of shareholders against directors of companies. Potential areas of liability include:

(1) misleading representation in takeover;

(2) misleading and deceptive representations and disclosure violations;

(3) breaches of continuous disclosure requirements;

(4) misleading statements as to prospects of technology;

(5) misleading statements as to prospects of technology;

(6) misstatements in a prospectus;

(7) inappropriate advice; and

(8) publication of financial results containing misleading and deceptive representations.

[37] See *Campbells Cash and Carry Pty Lttd v Fostif Pty Limited* [2006] HCA 41.
[38] Federal Court of Australia, *Current Class Actions in the Federal Court – by NPA* (15 August 2018), <http://www.fedcourt.gov.au/law-and-practice/class-actions/class-actions>.

5.4 Side C cover was originally introduced as a profitable area with insurers actively encouraging companies to transfer their risk in this area to them. However, the profitability of side C cover has taken a plunge in recent times due to a number of high profile high value class action settlements. It is estimated that side C cover is currently 250% under-priced in respect of ASX listed insureds.[39] The gross loss ratio for securities class actions settlements exceeded 100% in three of the four years to 2016 .[40] Professional indemnity gross loss ratios have been 70% or higher in every quarter since June 2016, sometimes as high as 139%.[41]

5.5 As a result, insurers are exercising caution in writing this line of business because of the high expense associated with class action defences and settlements. It has been estimated that the average class action settlement is A$50 million, with another $8 million in legal and defence costs.[42] However, there are some notable outliers. For example, a $200 million settlement was reached in the Centro action.[43] The most high profile class actions tend to affect publically listed companies where shares are more easily acquired and traded, and who have to comply with continuous disclosure obligations under the exchange's listing rules.

5.6 Accordingly, the D&O insurance market has tightened significantly for publically listed companies and volatility is predicted in the short-medium future.[44] The Australian insurance market has experienced low or stagnant premium growth, and without significant premium re-alignment, side C cover for mid to large publically listed companies is expected to continue to be volatile and at low capacity.[45] Furthermore, the cost of D&O insurance has increased by more than 200% in the period 2016-2018. A number of insurers have withdrawn from providing D&O insurance to ASX listed companies altogether.[46] The result of this is that insureds are looking to the London market to cover the capacity shortfall.

5.7 However, capacity limitations are not only affecting side C cover. Insurers are also expecting insureds to increase retentions for side B cover, which is reimbursement of directors and officers (eg. under deeds of indemnity). Generally, the D&O insurance market is under-priced by 100%.[47] This is despite the pricing of D&O insurance amongst the ASX200 increasing by 353% from $25.29 million to $89.41 million between 2011 to 2018. The average premium per client is now $1.86 million.[48]

5.8 At the time of writing, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services is underway. The Royal Commission has the task of inquiring into the conduct of financial services entities and compliance with laws of Australia. As part of the inquiry, non-compliance with financial services laws has been exposed and attracted significant media attention. It has also enlivened many financial lines insurance policies, with defence costs funnelling into the inquiry.

5.9 Some plaintiff law firms have sought to capitalise on this public interest by launching class actions against superannuation funds and banks.[49] In Australia, all employees are required to have a percentage of their pay paid into a superannuation fund, which is not accessible

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[39] Marsh, 'Directors & Officers Liability Insurance Market Update', (May 2018), 2.
[40] *Supra* n 8, 12.
[41] Australian Prudential Regulation Authority, 'Quarterly General Insurance Performance Statistics August 2018', Table 1l.
[42] *Supra* n 8, 9.
[43] Leonie Wood, 'Court Approves Centro's $200m class-action settlement', *The Sydney Morning Herald (online),* 20 June 2012 <https://www.smh.com.au/business/court-approves-centros-200m-class-action-settlement-20120619-20m2m.html>.
[44] AON, 'Directors & Officers (D&O) Insurance Market Insights - Q2 2018'.
[45] Australian Law Reform Commission, *Inquiry into Class Action Proceedings and Third-Party Litigation Funders,* Discussion Paper 85 (June 2018).
[46] Marsh, 'ALRC Submission Paper – Directors' and Officers' Liability Insurance', July 2018, 6.
[47] Marsh, above n 39, 2.
[48] Marsh, above n 46, 4.
[49] Slater and Gordon, 'Get your super back', <https://www.slatergordon.com.au/getyoursuperback>.

until certain preconditions are met, such as retirement. Some of these superannuation funds have been operated by major banks in Australia, and the class action alleges that the superannuation funds have not been operated appropriately and have charged excessive fees. If the class action goes ahead, a large number of people would be included in the class given the widespread use of superannuation funds in the market.

5.10 Many other class actions have been foreshadowed against banks and insurers as a result of the Royal Commission. Financial lines insurers will likely be responding to these actions.

5.11 One solution that has been considered by Australian insurance market commentators is to put strict conditions on when a company may disclose it has side C cover, as it is believed that the uncertainty as to whether a pot of gold sits behind the company would dampen the allure of commencing an action. Some companies have decided not to take out Side C cover at all in a bid to avoid being a target of litigation, or increasing their retention.[50] Marsh has reported that retention levels for some insureds have increased from $114 million to $500 million, with the average retention now $10.65 million.[51] The increasing reluctance to underwrite side C cover, especially at levels below $100 million, has also led to upward premium pressure which may price some entities out of the market, or lead them to seek capacity elsewhere.[52]

Law reform

5.12 The Australian Law Reform Commission is currently reviewing the class action and litigation funding landscape and the final report is due on 21 December 2018. The terms of reference of the inquiry includes examining the role that third party funding entities play in the commencement and maintenance of class action proceedings, absence of comprehensive regulation, and the importance of ensuring costs are appropriate and proportionate.[53]

5.13 It is also examining whether continuous disclosure obligations, which are obligations imposed on entities listed on public stock exchanges, have affected securities class actions in Australia. One of the ALRC's proposals is for the Australian Government to commission a review of continuous disclosure and misleading and deceptive laws as they relate to corporations being the target of shareholder securities class actions, and its impact on the D&O market in Australia.

5.14 The outcome of the inquiry, and further proposed inquiry if it takes place, may directly affect the class actions landscape in Australia. This would consequently affect the profitability of underwriting D&O insurance in Australia.

6 Cyber insurance and privacy legislation

6.1 Like many other jurisdictions around the world,[54] Australia has also recently passed mandatory data breach notification laws. This has led to an uptake in cyber protection insurance, given that traditional D&O and management liability policies would generally not respond to breaches of privacy law caused by a third party hacking incident.

6.2 The amendments to the *Privacy Act 1988* (Cth) took effect on 22 February 2018 establishing a federal "Notifiable Data Breaches" scheme (**NDB Scheme**) in Australia. Broadly speaking, the NDB scheme applies to government agencies, private sector organisations with annual turnover greater than $3 million, and not for profit organisations

[50] AON, above n 44.
[51] Marsh, above n 46, 5.
[52] Marsh, above n 39.
[53] Australian Law Reform Commission, 'Terms of Reference – Inquiry into Class Action Proceedings and Third Party Litigation Funders', <https://www.alrc.gov.au/inquiries/class-action-funding/terms-reference>.
[54] Eg. EU General Data Protection Regulation 2016/679, in the United States, each state has passed specific legislation with varying levels of protection.

with annual turnover of greater than $3 million. Entities with a turnover at or below this threshold are also covered if they fall into certain categories such as health services, trade in personal information, or are credit reporting bodies, employee associations or have opted in to participate in the scheme.

6.3 In addition, organisations that provide services to the Commonwealth, operate a residential tenancy database, report under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006*, conduct a protected action ballot or retain information under the *Telecommunications (Interception and Access*) *Act 1979* are also required to comply with the NDB Scheme insofar as they provide those services.

6.4 The obligations that the NDB Scheme imposes can be onerous, time consuming and costly. The NDB Scheme requires entities to investigate data breaches expeditiously, notify individuals at likely risk of serious harm, and notify the Australian Information Commissioner. It is likely that entities would like to seek legal advice prior to undertaking this step, given that a data breach may signify a breach of an entity's obligations under the *Privacy Act 1988* (Cth).

6.5 During the first quarter of operation, there were 63 notifications reported to the Office of the Australian Information Commissioner under the NDB scheme. This jumped to 242 in the second quarter of operation. Approximately 60% involved malicious or criminal attacks.[55]

General Data Protection Regulation

6.6 It is also worthwhile noting that while Australia's NDB Scheme applies to entities operating in Australia, so too does the European Union's General Data Protection Regulation (**GDPR**), which came into force on 25 May 2018. The GDPR requirements are arguably more stringent than the NDB Scheme. The GDPR applies to any entity with an establishment in the European Union (**EU**), offering goods and services in the EU or monitoring the behaviours of individuals in the EU.

6.7 Under the GDPR, an entity is required to notify a supervisory authority within 72 hours after becoming aware of a personal data breach.[56] The information required includes the nature of the personal data breach, contact details of data protection officer, consequences of data breach, and measures taken or to be taken to address the personal data breach. The fines applicable under the GDPR are also quite significant, being up to 20 million euros or 5% of the company's annual global turnover, whichever is greater.

6.8 However, in relation to both the NDB Scheme and the GDPR, it is unclear how active the regulators will be in prosecuting violations of privacy legislation. There is little claims experience to utilise because of the relatively new nature of both schemes, and for Australia, the extraterritorial application of the GDPR has not been tested.

Insurance policies

6.9 Standalone cyber insurance policies in the Australian market generally provide cover for IT, legal, crisis response, public relations, regulatory investigations and defence costs associated with events captured by the NDB Scheme and GDPR. They may also provide coverage for business interruption caused by a cyber incident. Prior to the popularity of standalone cyber policies, similar protections were built into some management liability policies. Such management liability policies may not provide cover that is as comprehensive as standalone cyber insurance. The main cyber response policies do not seem to discriminate between the expenses incurred under the NDB Scheme or GDPR.

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[55] Office of the Australian Information Commissioner, 'Notifiable Data Breaches Quarterly Statistics Report: 1 April – 30 June 2018' <https://www.oaic.gov.au/privacy-law/privacy-act/notifiable-data-breaches-scheme/quarterly-statistics-reports/notifiable-data-breaches-quarterly-statistics-report-1-april-30-june-2018>.
[56] Article 33, GDPR.

6.10 It remains to be seen whether privacy related class actions will become commonplace in Australia. No such judgments have yet been handed down, unlike in the United Kingdom and United States. Whilst there is provision under the *Privacy Act 1988* (Cth) for a representative complaint to be made to the Office of the Australian Information Commissioner, there is arguably also scope for D&O insurance to respond where failures to safeguard personal information can be attributed to wrongful acts of directors and officers of the company.

6.11 Cyber insurance remains one of the fasting growing segments of the financial lines market in Australia.

7 Financial lines market distribution

7.1 The distribution of financial lines insurance in Australia has traditionally been heavily intermediated, with brokers playing a large role in placing insurance with underwriters. APRA statistics show that up to 45% of total business written by APRA authorised insurers was placed through an intermediary.[57]

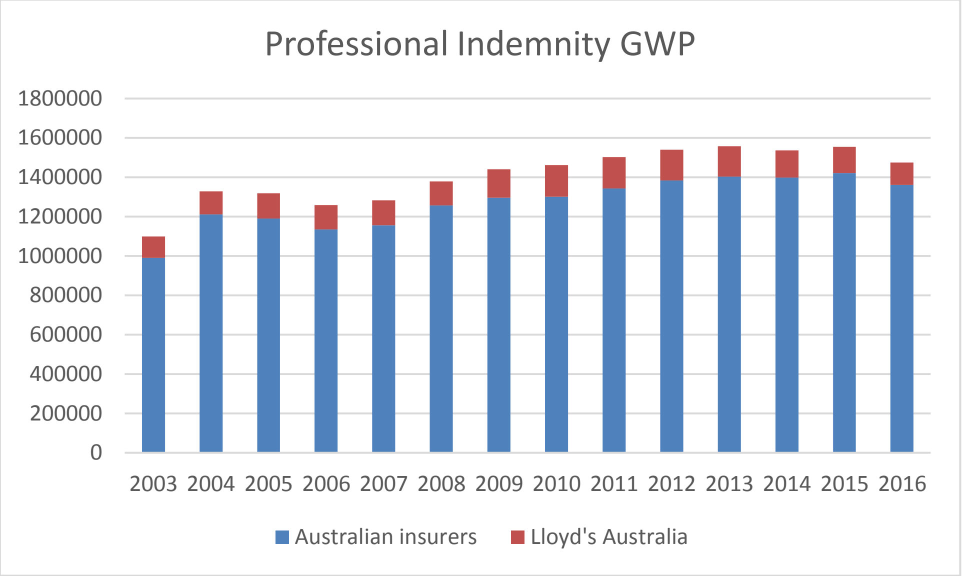
7.2 The market consists of Australian insurers, foreign insurers and Lloyd's market participants. Foreign insurers can operate in Australia by establishing a local branch and obtaining a local licence to operate from APRA. In limited circumstances, foreign insurers may operate in Australia without APRA authorisation. These circumstances include contracts for high-value insureds, atypical risks, or risks that cannot reasonably be placed in Australia.[58]

7.3 Reinsurers are treated differently in Australia. Foreign reinsurers can write Australian risks without APRA authorisation provided liability is undertaken offshore. However, the reinsured in Australia will need to comply with APRA's prudential standards which impose a capital charge if reinsurance recoverables are from non-APRA-authorised reinsurers. This capital charge may be reduced if the reinsured holds collateral from the reinsurer. The effect of this is that non-APRA-authorised reinsurers will often provide collateral. APRA has strict requirements about what collateral is acceptable for the purposes of reducing the capital charge.[59]

7.4 In terms of intermediaries, underwriting agencies are a prominent feature of the Australian financial lines insurance market, with approximately 120 underwriting agencies currently operating in Australia. Traditionally, underwriting agencies have been set up to service particular risks, however some have been acquired by brokers or insurers in an effort to increase market share and access particular market segments.

7.5 Lloyd's syndicates are able to write business in Australia through an underwriting agency, Australian service company, or from London via a Lloyd's broker. Lloyd's underwriters are not required to obtain an insurance licence to operate in Australia.[60] As can be seen from the graph below, Lloyd's underwriters still only have a relatively small market share in Australia, perhaps due to the fact that such underwriters are focused on atypical risks where there is insufficient underwriting capacity from domestic insurers.

[57] APRA's definition of 'intermediary' captures all Australian Financial Services Licence (AFSL) holders who are authorised to deal in general insurance products. Subject to some exceptions, a person must be an AFSL holder or an authorised representative of an AFSL holder in order to deal in general insurance products.
[58] *Insurance Act 1973* (Cth) s 3A, *Insurance Regulations 2002* (Cth), ss 4B – 4E.
[59] For more information, see *APRA Prudential Standard GPS 114*.
[60] *Insurance Act 1973* (Cth), s 9.



Data sourced from National Claims and Policy Database, APRA

7.6 In the SME space, there is a trend for the online sale of standard financial lines policies. However, it is unlikely that online distribution platforms will be replacing the role of brokers any time soon for financial lines. This is due to the advice that insureds require to determine their policy requirements and the specialist skill needed to put together a proposal to underwriters.

8 Conclusion

8.1 The introduction and development of financial lines insurance in Australia has been rapid. Australia has a highly sophisticated market covering all major risk types. In some areas local wordings have led the way, such as the provision of full policy limit D&O cover for fines and penalties. Wordings and their interpretation also have a peculiarly local flavour due to the early implementation of the *Insurance Contracts Act 1984* (Cth).

8.2 The financial lines market in Australia, although mature, has reached a significant turning point. While the market provides the full spectrum of financial lines products, substantial underwriting constraints exist especially in the D&O market for listed entities. This is due to historically low premiums and the active class actions landscape in Australia.

8.3 The banking Royal Commission and the outcome of the Australian Law Reform Commission's Inquiry into Class Action Proceedings and Third-Party Litigation Funders may require financial lines insurers to adapt to a new regulatory landscape. Furthermore, as the cyber insurance market matures, we may begin to see changes in premiums and policy wordings as data becomes available regarding claims experience.

8.4 Challenging but exciting times lie ahead for the Australian financial lines market.