Management Liability

The Evolution of a Revolution

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1.0 Executive Summary

Management Liability Insurance is one of the more complex and confusing insurance products in the Financial Lines Insurance market. It's hard to find a policy under 40 pages long, but why is this critical product so confusing, and why are the policies so long? Why has the market experienced a sharp correction in pricing and appetite recently and what does this mean for Small and Medium sized Enterprises (SMEs)?

When first launched, Management Liability Insurance was a revolutionary new way for SMEs to purchase Financial Lines products. Over a decade on, how has the revolution evolved and in what direction is it evolving?

This paper attempts to unravel some of the mysteries surrounding Management Liability Insurance by explaining what the product is designed to cover with reference to case studies and industry data, by detailing how the product developed over time and how the Financial Lines market is likely to develop into the future.

Furthermore, this paper discusses DUAL's experiences in underwriting this class of business and why for some, Management Liability isn't the panacea to all their problems.

For the purpose of this White Paper, 'small' is deemed to be an organisation that employs less than 20 employees and 'medium' is a organisation with 20 to 199 employees, which mirrors the way in which the *Corporations Act 2001* (Cth) defines small and medium sized organisations.

2.0 The History & Development of Management Liability Insurance

Rewind 10 years and Management Liability Insurance barely registered a blip on brokers' radars with estimates of less than 1% of Australian SMEs purchasing any type of Financial Lines Insurance product. Financial Lines underwriters had developed a multitude of innovative products to cover off a range of management exposures. Insurance policies such as Crime Protection, Directors and Officers Liability, Employment Practices Liability, Statutory Liability and Supplementary Legal Expenses policies were just a few of the policies available to companies wanting to offset their operating risks in an increasingly litigious local market.

Whilst the Financial Lines Departments of underwriters were successful in marketing these products to corporate clients, they were less successful in marketing them to SMEs.

Leading underwriters researched and investigated why SMEs didn't purchase stand alone products. Some of the key reasons included:

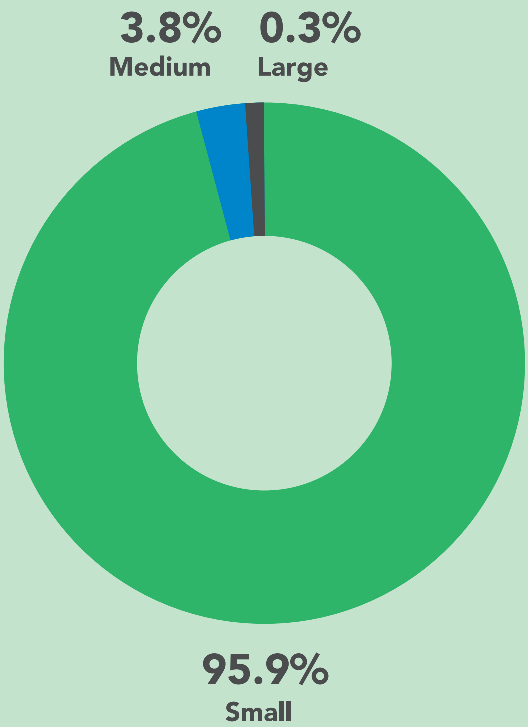
- The price barrier;
- The paperwork – If you buy 5 or 6 stand alone policies, that's 5 or 6 proposal forms you need to complete. With some proposal forms hitting the 15 page mark, that's a lot of paper work;
- The self insurance myth – "I can fund my own defence" and "It won't happen to me";
- A real lack of awareness amongst SMEs in understanding that they could offset some of their management exposures by purchasing an insurance product; and

- SME's just didn't see the value of purchasing Financial Lines insurance policies containing many covers which were perceived as less relevant for their operations.

Eventually, underwriters developed a solution to provide affordable Financial Lines Insurance products to SMEs by packaging up numerous products into one standardised form, with a shared aggregate limit of liability. The first Management Liability policies were composite products, where the stand alone products which Financial Lines underwriters offered were bolted together to form one new policy. Exposures were limited by combining all of the coverage sections in one aggregate limit, so that the cost could be kept to a minimum, thereby reducing the price barrier. By having one Policy, you only needed one proposal form, reducing the paperwork.

Whereas stand alone Financial Lines Insurance products contained a broad range of extensions to the base cover, SMEs did not generally see the relevance of all of the additional extensions, and so, the cover in Management Liability Insurance policies was a much simpler form of the stand alone policies upon which they were based. A simple format, with affordable prices that was easy to transact; it was a formula which lead to the explosion in growth of the Management Liability Insurance market in Australia to an estimated A$100m premium pool today and which has the potential to grow even further.[i]

Distribution of Total Business Numbers by Size



Data source: ABS Cat. No. 8165.0 and DIISRTE calculations

The total number of actively trading businesses at the time that the Australian Bureau of statistics conducted its survey (above) was 2,132,412. As you can see from the above, the overwhelming majority of businesses in Australia fall within the "SME" market segment. DUAL estimate that at the time of writing less than 15% of these organisations purchase Management Liability insurance, which highlights the enormous growth potential with this product class.

3.0 Management Liability Insurance: What Does it Actually Cover?

There are numerous Management Liability Insurance policies in the Australian market place, each with its pros and cons and its own coverage sections, however most Management Liability policies extend cover to the following broad insurance covers:

- Directors & Officers Liability
- Employment Practices Liability
- Statutory Liability
- Tax Audit Costs
- Cyber & Privacy Liability
- Entity Coverage
- Crime Protection

Some Management Liability policies also cover more exotic exposures, such as Kidnap Ransom and Extortion Insurance, Trustees Liability and private capital raisings; however the list above represents the most common grouping of Financial Lines coverage sections and extensions available in the market.

3.1 Directors & Officers Liability (D&O)

The Directors & Officers Liability coverage section is designed to provide coverage for Directors and Officers of an SME for loss on account of wrongful acts committed or allegedly committed in the execution of the director or officer's duties.

The Directors & Officers coverage section of a Management Liability Policy will advance defence costs to Insured Persons on account of a claim made against them, in their Insured capacity. It will not cover claims made against them in their uninsured capacity. For example, oppression on the minority claims brought under Section 232 of the *Corporations Act 2001* (Cth.) are often an example of when a claim made against a director won't be covered. Quite often in SMEs, the directors also have significant shareholdings in the company. If allegations of oppressive conduct are made against a director who is also a shareholder, then they are sometimes made against them in their capacity as a shareholder, rather than a director. That is to say, that it was their conduct in their capacity as a shareholder rather than a director, which was oppressive. Claims brought against Insured Persons in their uninsured capacities are unlikely to be covered under a traditional D&O or Management Liability Policy.

Many Management Liability policies have been extended to broaden the definition of Director or Officer to include coverage for all employees of the organisation. This is as a direct result of the national harmonisation of Work Health & Safety Laws, which extend legal liability for breaches to all employees of an organisation. It is a matter for individual Insureds and their brokers to weigh up the benefits of extending Insured Person cover to everyone within an organisation and to choose a product which fits the needs of the organisation and provides the requisite level of coverage. It's important that brokers and Insureds check and are comfortable with the definition of 'Insured Person' in the policy before making a decision to purchase a Management Liability Policy.

Cover is included for financial loss, including adverse judgments for awards of damages, costs orders and pecuniary penalties. Whilst the definition of Insured Person is quite broad in a Management Liability Policy, some of the exclusions applicable in some Management Liability wordings disappeared from stand alone Directors & Officers Liability Policies several years ago. Furthermore, Management Liability Policies do not contain some of the more complex extensions of coverage, which are included in stand alone Directors & Officers Liability Policies, such as insolvency cover or cover for capital raisings. Notwithstanding the differences though, the cover provided in Management Liability Insurance policies is generally considered appropriate for the insurance needs of Insured Persons of SMEs.

One of the more common examples of a claim that can be brought against a director or officer is a claim for insolvent trading, however this isn't the only type of claim that can be brought against a director or officer. In ASIC's most recent Enforcement Outcomes Report, it was reported that during the period of July 2013 to December 2013, ASIC achieved a total of 334 enforcement outcomes. That is, they successfully prosecuted 334 sets of proceedings.[ii]

According to the COAG Reform Council, there are over 700 Commonwealth, State and Territory laws imposing personal liability on the 2.1 million company directors in Australia.[iii] A sample of some of the civil penalties applicable are provided in the table below.

Comparison of Maximum Civil Penalties in Australia[i]

Act	Maximum penalty for an individual ($AUD)	Maximum penalty for a body corporate ($AUD)
Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (Cth) (AUSTRAC)	$3.4 million	$17 million
ASIC Act (ASIC)	$340,000	$1.7 million
Australian Consumer Law (ACCC)	$220,000	$1.1 million
Competition and Consumer Act 2010 (Cth) (ACCC)	$500,000	Greater of $10 million, 3 times the value of benefits obtained, or 10% of annual turnover
Corporations Act 2001 (Cth) (ASIC)	$200,000	$1 million
National Consumer Credit Protection Act 2009 (ASIC)	$340,000	$1.7 million

CASE STUDY

ASIC Brings Criminal Charges Against Former Kleenmaid Directors

Based on Queensland's sunshine coast and employing about 200 staff, the Kleenmaid group of companies operated the Kleenmaid brand of kitchen appliances and was an importer and distributor of whitegoods, operating 22 outlets Australia-wide including 15 franchise stores and 7 company-owned stores.

The former directors appointed voluntary administrators on 9 April 2009 with liquidators reporting Kleenmaid Group had consolidated debts of $97 million, including $26 million in customer deposits.

On 12 February, 2012, almost three years after Kleenmaid was placed in voluntary administration, ASIC launched legal action against the company's directors for alleged insolvent trading and fraud.

The directors were charged with 18 counts of criminal insolvent trading of debts totalling more than $4 million together with $13 million of fraud committed against Westpac Bank. Two directors have also been charged with withdrawing $330,000 from the company's bank accounts two days before it went into voluntary administration.

Insolvent trading attracts a maximum penalty of five years' jail and/or $200,000 fine, whilst fraud carries a maximum penalty of 12 years' jail.[iv]

ASIC alleges that around March 2008, the directors continued to trade Kleenmaid despite knowing that the company was insolvent around this time. The prosecution is ongoing.[v]

Brokers should note that many Management Liability policies contain insolvency exclusions which would negate cover in the above scenario. Whilst underwriters have the ability to remove the insolvency exclusion, a rigorous underwriting process is applied and underwriters generally require copies of recent audited financial statements for review and acceptance prior to the removal of the exclusion. On the other hand, Directors & Officers Liability Policies generally don't contain insolvency exclusions unless specifically applied via endorsement.

> *"Kleenmaid Group had consolidated debts of $97 million"*

3.2 Employment Practices Liability (EPL)

Employment Practices Liability coverage (or EPL cover as it is commonly called) is designed to protect employers from claims against them by their employees. The most common type of claim that is made under a policy that includes EPL cover is the unfair dismissal claim, although more and more frequently claims are being made for adverse action, or for general protections disputes, which are relatively new causes of actions, which weren't available under the WorkChoices legislation.

WorkChoices, the industrial relations system implemented by the Howard Liberal Government, was a scheme which sought to improve workforce productivity by reducing the time which small businesses spent fighting industrial actions. One example of how the WorkChoices regime attempted to achieve this end was by applying an exemption for small businesses for unfair dismissal claims. So an employer who employed less than 101 employees was exempted from complying with unfair dismissal laws.

WorkChoices proved to be a highly unpopular initiative, which eventually contributed to the election of the Rudd Labor Government in 2007. Shortly after the ALP's election, WorkChoices was abolished and the Fair Work Act was introduced, replacing it.

Just over half of all unfair dismissal claims arbitrated by the Fair Work Commission are now being resolved in the employee's favour. Recent research conducted by the University of Canberra indicated that some 17,000 unfair dismissal claims are now being processed each year compared to about 6,000 under WorkChoices and about 7,000 under the previous Workplace Relations Act provisions. [vi] The last 7 years has seen a continued and consistent increase in the number, type and severity of employment practices claims that are being brought against Australian companies.

Employment Practices Liability coverage is designed to assist employers in defending themselves for claims made against them by their employees. EPL cover will help with defence costs, and will also assist to fund adverse settlements not otherwise excluded. Many Insureds and brokers fail to realise that a policy which provides coverage for employment practices liability breaches does not provide any cover for amounts which an Insured otherwise would have been liable for under the contract of employment, award or enterprise agreement. Contractual and legal liabilities can not be avoided by simply purchasing a policy of insurance.
Some of the matters that EPL cover is not intended to respond on are:

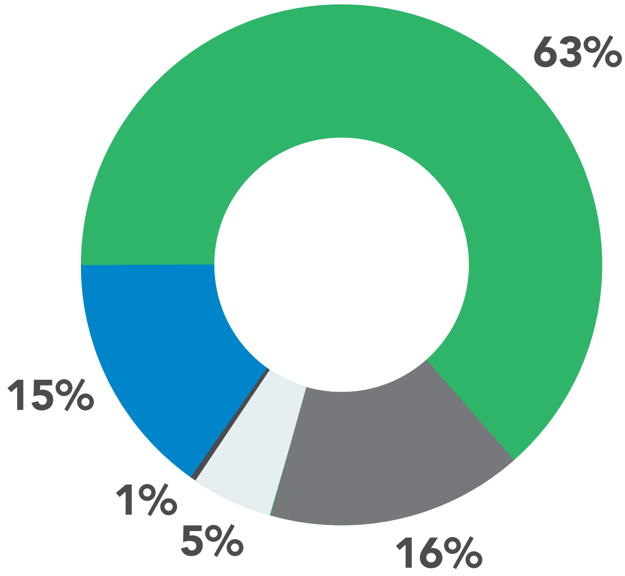
- Contractual damages;
- Payments under awards;
- Notice periods;
- Back pay;
- Redundancies.

Unfair Dismissal Lodgements[vii]

Location	2011-12	2012-13	Annual Variation %
Adelaide	906	1,037	14
Brisbane	2,639	2,747	4
Canberra	250	256	2
Darwin	168	170	1
Hobart	292	275	-6
Melbourne	4,713	5,018	6
Newcastle	49	196	300
Perth	1,233	1,346	9
Sydney	3,752	3,743	0
Wollongong	25	30	20
Total	14,027	14,818	6

Unfair Dismissal - Finalisation[viii]

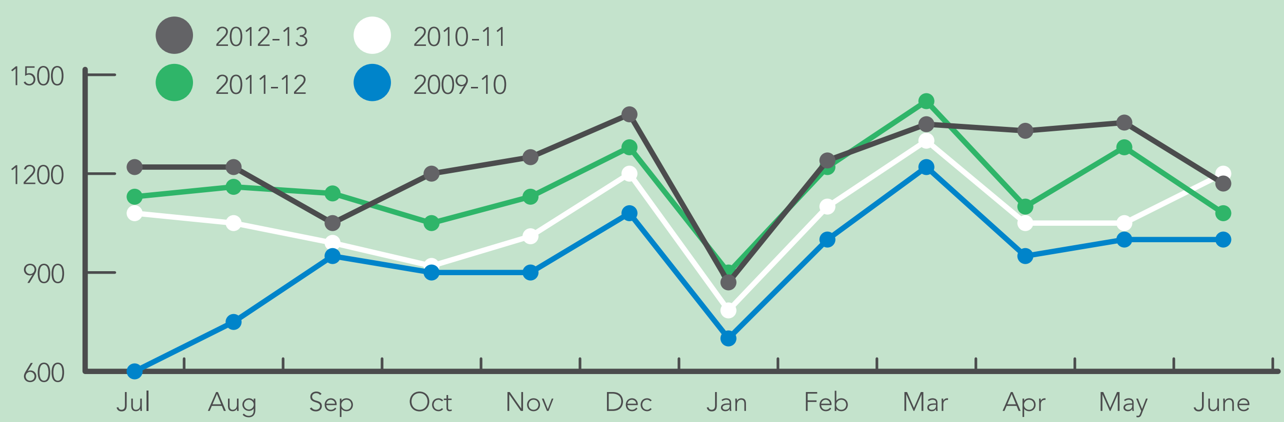
Claims Settled, Withdrawn or Determined No. of Matters



- Prior to conciliation
- At conciliation
- After conciliation and before a conference/hearing before a Commission Member
- After conference/hearing and before decision/order
- By final decision/order

Total 13,945

Unfair Dismissal Applications by Month[vii]



CASE STUDY

Dr Mark Colson v Barwon Health [2013] FWC 8734

On 30 May 2012 Dr Colson was dismissed from his employment with Barwon Health where he had worked as an anaesthetist since 1998. Barwon Health summarily dismissed Dr Colson from his employment because of serious misconduct. The matter had previously been heard and determined by Commissioner Roe in February 2013. In his decision Commissioner Roe found that Dr Colson's dismissal had been unfair and ordered his subsequent reinstatement. However given his contributory misconduct, did not order back-pay to be paid.

Following an appeal by Barwon Health to the Full Bench, it was determined that Commissioner Roe had made a number of significant errors of fact in his consideration of whether there was a valid reason for the termination of Dr Colson's employment and that there were a number of erroneous findings in the Commissioner's consideration of the allegations against Dr Colson.

The Full Bench concluded that there were valid reasons for the termination of Dr Colson's employment, however these reasons could not be regarded as serious misconduct justifying summary dismissal. The Full Bench therefore concluded that the termination of Dr Colson's employment was harsh, particularly having regard to his lengthy period of service and the significant impact of the termination on his reputation and his ability to find future employment in the region where he lives.

The Fair Work Commission awarded Dr Colson the sum of $59,050.00.[ix]

"The Fair Work Commission awarded Dr Colson the sum of $59,050.00"

3.3 Statutory Liability (SL)

Statutory Liability coverage is designed to protect an Insured from statutory breaches. If an allegation of a statutory breach is made against an Insured, the Management Liability Policy will respond to advance defence costs to the Insured to defend the allegations that have been made. Market leading Statutory Liability coverage will include "final adjudication" language, which presumes innocence, and Insured's are therefore entitled to have their defence costs advanced until proven otherwise. The presumption of innocence is one of the most fundamental tenements of our democracy and Statutory Liability Insurance policies seek to uphold the presumption of innocence by treating everyone equally until final adjudication. In simple terms it means that the underwriter will not make a judgement on whether the conduct exclusion will operate until the Court has handed down its findings.

Statutory Liability Insurance is not a get out of gaol free card. It is not designed to allow people or organisations to commit criminal acts and escape unpunished. It is designed to assist insureds in defending proceedings that may be brought against them by funding their defence and in the event that a civil fine or penalty is levied against them for an offence which doesn't have a mental element (mens rea[x]) then and only then, would the Statutory Liability cover respond.

The most common form of claim under the Statutory Liability coverage section relates to occupational health & safety prosecutions (or Work Health and Safety under the new laws), however the Statutory Liability coverage section provides so much more than just work health & safety claim defence. There are thousands of Commonwealth, State and Territory Acts regulating everything from food preparation to plumbing. Unless there is a specific exclusion in the Policy which excludes claims under a certain Act the Policy will respond.

The types of claims that are generally excluded under a Management Liability Policy include Claims brought under the *Australian Competition and Consumer Act*, Criminal Codes, pollution claims and in certain cases, claims arising from the insolvency of an organisation.

CASE STUDY

Inspector Christensen v P & M Quality Smallgoods Pty Ltd [2013] NSWIRComm 91

On 6 February 2010, a worker sustained superficial burns when he cut through a butane gas line, causing a fire, whilst cutting part of a floor.

After a WorkCover investigation the defendant, P & M Quality Smallgoods Pty Ltd, was charged with a breach of section 10(1) of the *Occupational Health & Safety Act 2000 (NSW)*.

On 11 October 2013 the defendant was convicted by the Court and fined $110,000.

Section 10(1) of the *Occupational Health & Safety Act* is a strict liability offence, therefore, had P&M Quality Smallgoods purchased a Management Liability Policy, or a Statutory Liability Policy, it is likely that the Policy may have responded to advance defence costs. If the Policy contained coverage for fines and pecuniary penalties, the penalty of $110,000 may also have been covered. The Policy also may have picked up the adverse costs order awarded against P & M Quality Smallgoods Pty Ltd.

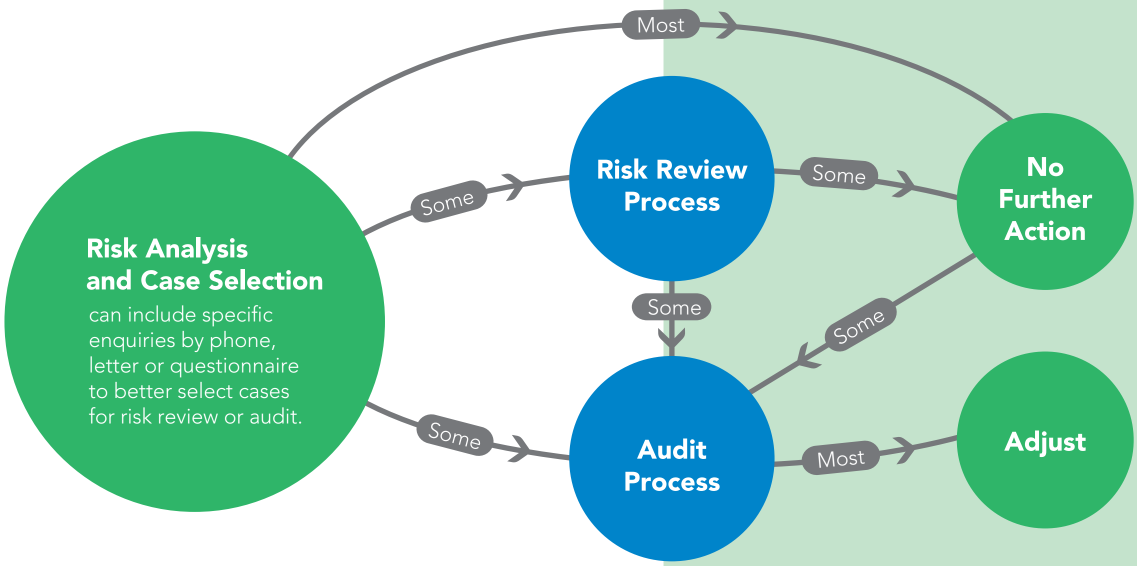
> *"The defendant was convicted by the Court and fined $110,000"*

3.4 Tax Audit Costs

Tax audit costs are just that, they fund the fees of a tax professional to assist an Insured when they are being audited. The Tax audit costs cover is a basic entry level cover for SMEs to give them a level of assistance in the event of defined events, namely a Tax Audit. Some Management Liability Policies only provide coverage for audits conducted by the Australian Taxation Office, which means that an audit conducted by a State Revenue Office is excluded. A Tax Audit is something quite different from a Risk Review, and Management Liability Policies are generally clear in what they are intending to cover. DUAL recommend that insurance brokers do not immediately assume that a Management Liability Policy, which includes a level of Tax Audit cover will respond to all matters and that clients thoroughly review what their policy defines as a Tax Audit.

The Tax Audit cost coverage provided is generally not as broad as the tax audit coverage provided for under a stand alone Tax Audit Policy. No cover is generally provided for Risk Reviews or for any ultimate findings that may be made to repay outstanding taxes to the ATO. This limited level of cover is reflected in the premium.

The following chart has been adapted from the ATO's Website and is an easy way of visualising the process that they undertake in evaluating a case.[xi]



A tax audit can be a harrowing experience. Fortunately, the vast majority of Australian organisations are law abiding and have nothing to worry about. For those that require assistance, a Management Liability Policy can be an economical way of offsetting some of the potential costs associated with an Audit.

Last Financial Year the ATO Conducted Over 37,000 Audits and Reviews Raising Over $935M in Liabilities[xii]

In a recent article published in the Sydney Morning Herald, the ATO indicated that they would be stepping up their regulation of tax avoidance schemes and indicated that the number of audits they are likely to conduct would increase.[xiii]

Tax commissioner I'm coming after you

ATO declares war

Exclusive
Linton Besser, Kate McClymont

The secret rich list
A tax haven investigation

> "He said his concern was that he did not want at any stage for there to be a connection between himself and the trust. He said that because of his position...he did not want anybody to know that he was connected with this trust."
>
> **Portcullis TrustNet** (Cook Islands)
> **File note on the late John Anderson, the national chairman of corporate finance division of KPMG.**

The Tax Office has declared war on the top end of town accountants and lawyers who have helped Australians avoid tax by setting up secretive offshore companies and trusts.

"I am going to target the facilitators," warned the deputy commissioner of serious non-compliance, Greg Williams.

"I am a pretty simple bloke but I don't wake up in the morning and say, 'You know what, I am going to restructure my business around a secrecy jurisdiction'," Mr Williams said. "Someone is putting those ideas into people's heads."

He said the Tax Office, the federal police and the Australian Crime Commission planned to use the extraordinary powers available under Project Wickenby to focus on the firms.

The comments come after a huge leak of secret offshore data to the International Consortium of Investigative Journalists, and to tax authorities in Britain, the US and Australia.

The data reveals the activities of dozens of accountants, lawyers and financial advisers who have assisted in the establishment of companies in tax havens.

The *Herald* is not suggesting, however, that the firms and individuals identified in the material have acted illegally, or have assisted their clients to avoid tax, as there can be legitimate reasons for the establishment of offshore companies.

On the list are blue-chip companies including Abbott Tout Solicitors, ANZ and Blake Dawson Waldron as well as Sydney lawyers Kevin Munro and Rodney Rosenblum.

Other legal firms that have been active in tax havens such as the British Virgin Islands, the Cayman Islands and the Cook Islands are: Atanaskovic Hartnell, Horwath

Continued Page 4

3.5 Crime Protection

Crime Protection coverage is a first party loss coverage section. That is to say, it protects Insureds in the event that they suffer a loss, as opposed to *third party* cover, which cover Insureds when a third party has suffered a loss because of something that an Insured is alleged to have done, which causes the third party loss. Crime insurance covers Insureds for the misappropriation of their cash or property by a third party. A comprehensive commercial crime cover will include cover for both internal and external fraud, that is, it covers misappropriations committed by both internal or external perpetrators. It will also cover the loss of third party's money or property, which is in the insured's care, custody or control.

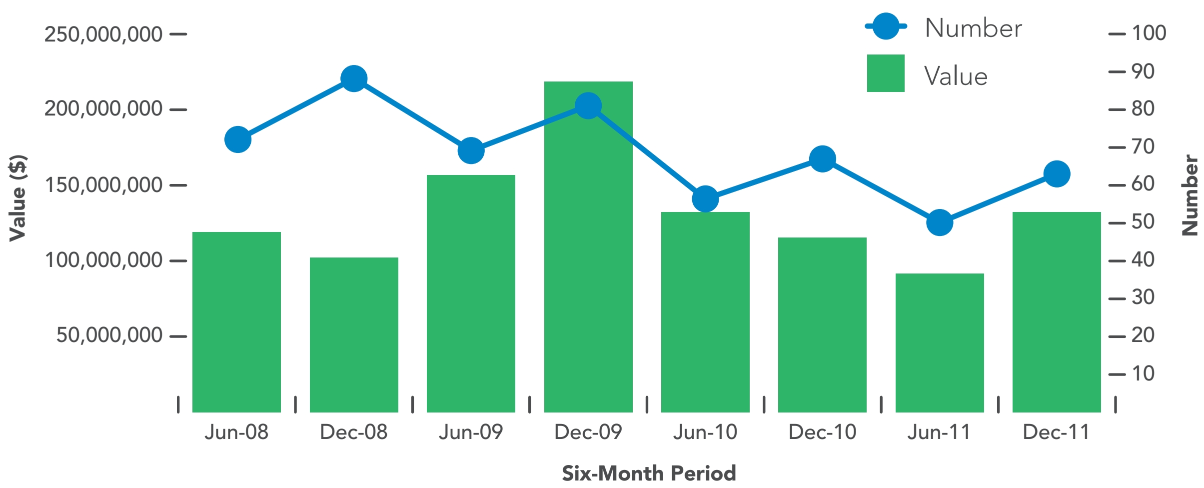
Some market wordings only provide fidelity cover, which provides cover for internal misappropriations only, that is to say, the Policy will only respond to frauds where an employee was the fraudster and not an external party.

A recent report by Warfield & Associates focused on large Australian frauds (over $1 million) committed between 2001 and 2012.[xiv] The report showed that whilst financial institutions were most at risk of fraud, significant frauds occur in a large cross-section of industries and that provided there is money flowing through the business, no organisation or industry is immune. The following table from the report, shows a break down of the industries which have experienced large frauds during the period of the study. [xv]

Industry	Number	Amount	Average
Bank	30	$184,124,601	$6,137,487
Education and Training	2	$29,074,903	$14,537,452
Government	10	$24,519,708	$2,451,971
Legal Firms	2	$4,500,000	$2,250,000
Manufacturing	5	$9,101,652	$1,820,330
Mining	3	$4,395,889	$1.456,296
Not For Profit	4	$7,870,00	$1,967,500
Other Financial Institutions	4	$15,522,801	$ 3,855,700
Recruitment / Employment	2	$6,300,000	$3,150,000
Retail	4	$41,523,353	$10,380,838
Transport	2	$26,989,061	$13,494,531
Wholesale	3	$5,300,00	$1,766,667
Other	15	$33,915,422	$2,261,028
	89	$398,026,143	

Whilst the Warfield & Associates report identifies an alarming number of large frauds, with a total of $398,026,143 misappropriated during the period of the study, the large frauds only account for a percentage of the total value of fraudulently obtained monies in Australia. Smaller frauds are much more frequent and prevalent. KPMG's *Fraud Barometer Report* suggests that Australian businesses face a $1 billion fraud bill in the four years leading up to 2012, which was the period of the study period.[xvi] And that only accounted for known and reported frauds.

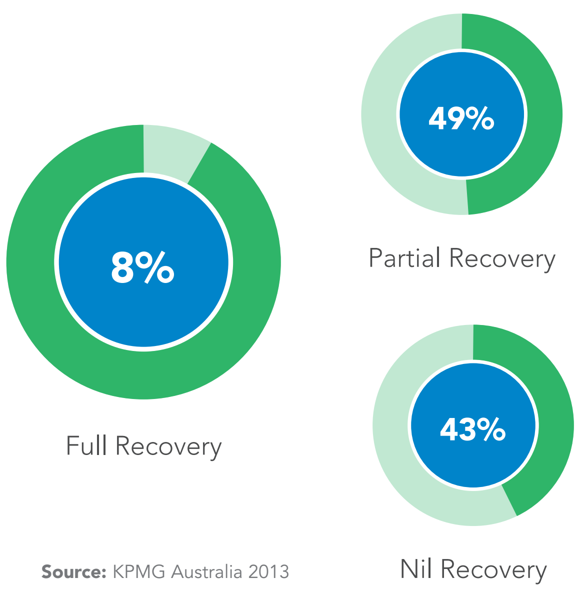
The Value and Frequency of Fraud in Australia



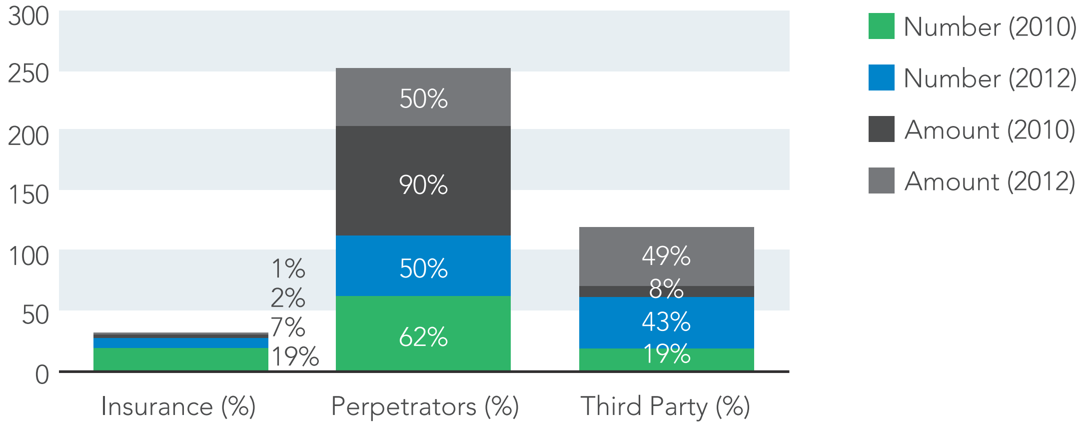
Source: KPMG Australia 2012

The numbers speak for themselves. Year on year, fraud continues to be a major issue for Australian businesses.[xvii] But the real issue with fraud in Australia is the recovery rate. According to a recent KPMG's *Fraud, Bribery & Corruption Survey* only 8% of victims of fraud received a full recovery of the monies misappropriated.[xviii]

Furthermore, the perpetrators, rather than insurers, are actually the most likely source of recovery.[xvii] The same report shows that only a small percentage of the monies recovered came from insurance.



Source: KPMG Australia 2013



Source: KPMG Australia 2013

The recovery rate figures outlined above, show that this exposure is one of the most systemically underinsured exposures in the corporate world. Whilst take up rate of some form of Management Liability insurance have increased over the last decade, purchasing a small crime sub-limit under a Management Liability Policy is rarely satisfactory protection to offset the exposures that organisations face.

CASE STUDY

Clive Peeters

Sonia Causer, aged 39, was a trusted Senior Accountant for Clive Peeters, a white goods retailer. The mother of three embezzled more than $19 million from the retailer by transferring money from payroll accounts over a two-year period. Between July 2007 and July 2009, she made 90 withdrawals, involving 125 payments to eight bank accounts, stealing a total of $19,365,768.

In her capacity as a cheque signatory on the company's bank account and also as one of two employees able to process Electronic Fund Transfers on the company's behalf, she transferred payments from the company's accounts into accounts controlled by her. With these funds she purchased 44 properties and two cars. Her fraud, in part, led to the collapse of the company.

The proceeds of the fraud were almost double the operating profit of $10.3 million that Clive Peeters posted in 2007-08.

Ms Causer received a sentence of 8 years imprisonment for her role in the fraud.[xx]

4.0 The Pros and Cons of Management Liability Insurance

The following table highlights some of the pros and cons of Management Liability Insurance:

The Pros	The Cons
Affordable well rounded coverage for SMEs	One aggregate limit of liability, which is shared between coverage sections
Low deductibles	Basic coverage, low sub-limits, creating potential under insurance for larger Insureds
Numerous coverage sections	Shared limits result in significant horizontal aggregate exposure
Easy to transact - Low documentation	Increased risk of an Error or Omission for Insurance brokers

Packaging up a suite of different products into a shared limit of liability is a cost effective way to transact this class of business, but the trade off is that an organisation only has one limit of liability to share between all of the different exposures. As the size and complexity of organisations increase, the more appropriate a stand alone limit becomes.

5.0 Management Liability vs. Stand Alone Financial Lines Products

The following table highlights some of the key differences between Management Liability Insurance compared to a stand alone suite of insurance products.

Management Liability	Stand Alone
Aggregate Limit	Separate limits quarantining losses to separate towers
Basic coverage	Broad form comprehensive coverage designed for the specific needs of larger Insureds
Choice of easy online transaction	Personal underwriting service delivered by an experienced underwriter who can guide brokers through the purchase decision
Entry Level pricing	Higher price point

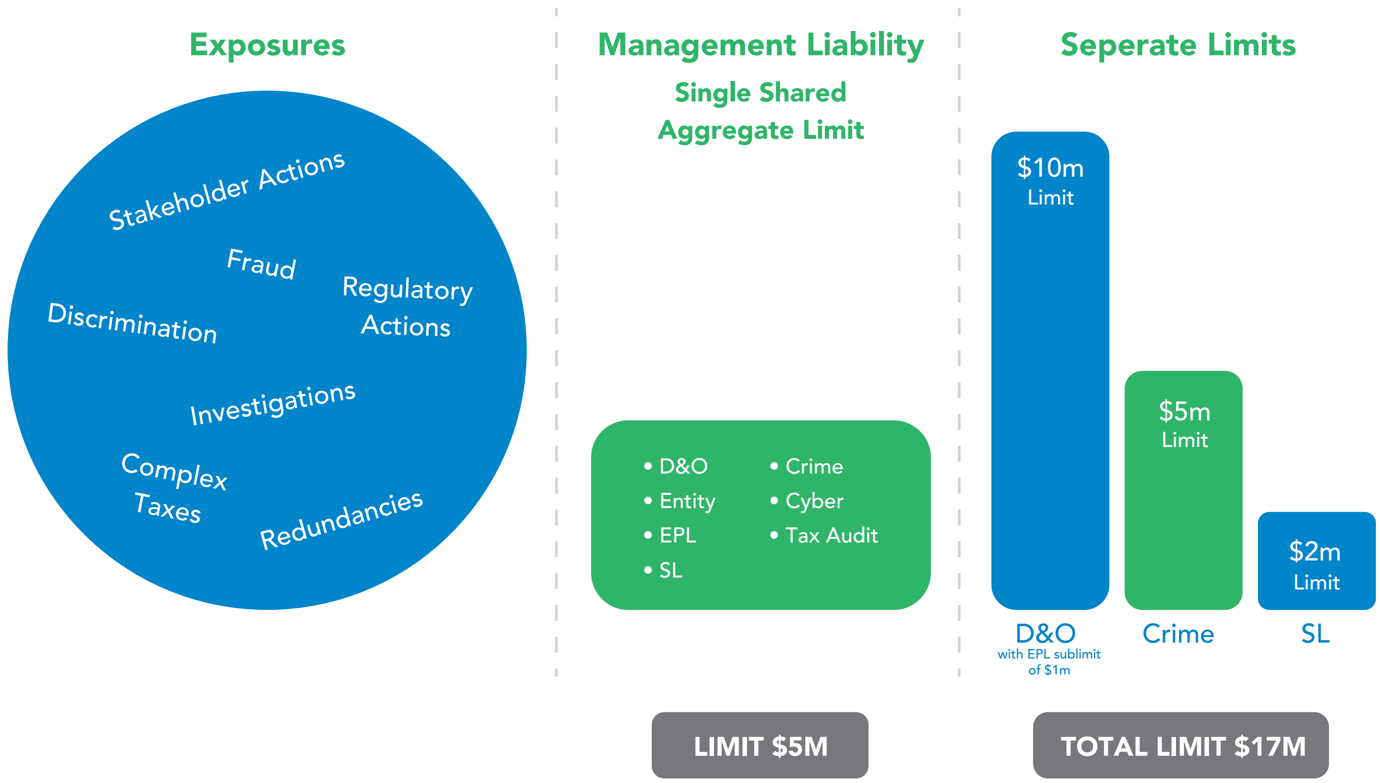
As Management Liability was a product designed for the specific needs of the SME market it had to be easy to transact. The ease of the transaction meant that Management Liability was a product that was well suited to an automated delivery model. This meant a single proposal form and was often transacted online. There were less questions and less documentation required.

Standalone policies on the other hand each required separate proposal forms, needed to be separately underwritten and if an Insured was purchasing 3 or 4 products, they could quite easily have found themselves filling out 30 or 40 pages of forms as well as having to gather financial statements, risk management policies, Human Resources manuals, Employee Handbooks and claims data. Because the nature of the risks being underwritten was greater in dollar value and multiple limits of liability were exposed, underwriters were required to be extra prudent and make sure that they analyse all the data and assessed the risk, before issuing a quotation.

Furthermore, because Management Liability was a product with an aggregate limit designed for SMEs there needed to be a much lower entry point in terms of pricing than stand alone options. Entry level pricing for Management Liability started at around $800, whereas similar cover individually underwritten on a stand alone suite of products, could be anywhere up to a multiple of 6 or more times that of an aggregate Management Liability limit. The pricing point of Management Liability made it an extremely attractive buy for a growing number of SME clients.

The following diagram illustrates how a typical Management Liability Policy compares to a typical stand alone program.

Stand alone products are generally much broader than Management Liability Products. They have more coverage and separate and higher limits of liability. They are designed for more complex business models and Insureds who wish to categorically offset their risks. Because they are broader and provide more cover, they are generally priced accordingly.



6.0 Horizontal Aggregate Exposure: DUAL's Experience

When you have a single product which includes cover for all manner of potential policy triggers, this is what actuaries describe as horizontal aggregate exposure: numerous covers on shared limit.

Over the course of the last decade that DUAL has been providing Management Liability Insurance to SMEs in Australia, the number of claims as a percentage of Policy count has doubled. When we have a look at our 2004 numbers, only 7% of policies experienced a claim. Last year, 14% of Policyholders had claimed on their Management Liability Policy.

But it's not just the number of claims that the market is seeing increase, the value of these claims is also rising as legal fees and cost of representation increase, as litigation funders become more aggressive, opportunistic Plaintiffs try their hand at litigation that may not have been attempted in a bull market when everyone is flush with capital and the legal environment becomes ever increasingly pro-plaintiff. Over the last decade, the average cost of a Management Liability claim has doubled from just under $11,000 to over $22,000, however premiums have not kept up with the increasing loss ratios, driven down by a soft insurance market and ever increasing competition.

There are numerous reasons for the sharp increase in claims frequency and cost. The Global Financial Crisis (GFC), which decimated world financial markets and its knock on effects to the broader economy has certainly played a significant role. But there is no single reason which can explain the increasing claims trend for this class of business. Some of the contributing factors which have lead to the decline of the portfolio include, but are not limited to:

- Repeal of WorkChoices and the introduction of the *Fair Work Act*, increasing the frequency and severity of employment claims;
- The *Privacy Act Amendments*;
- Harmonisation of the *National Workplace Health & Safety Act Regime*;
- Introduction of Anti-bullying amendments to the *Fair Work Act*;
- Increases in the number of ATO audits;
- Increased regulation and red tape for industry;
- A globalised economy exposing companies to multiple legal jurisdictions;
- The end of the resources boom; and
- The ever-present impact on society of gambling and drug addictions, which contribute to the prevalence of fraud.

For many years, Management Liability Insurance contributed to the exponential growth trajectories for many Financial Lines underwriters who benefited from the broadening of their target markets to include SME clients, clients who previously never would have purchased a Financial Lines product. However the products success was also a contributor to its deterioration. Post GFC, the Management Liability product class experienced declining premiums resulting in increasing loss ratios, increasing claims costs and a soft market which further contributed to the product class testing the limits of profitability for underwriters who had entered the market early. The ever present push to grow saw Management Liability offered to an expanded target market, and to many where the cover may not have been the most appropriate available for the client needs.

But why did the loss ratios of the product spike so quickly? Most certainly, the lag effects of a long tail class of business following the Global Financial Crisis down turn had something to do with the turn around, however the elephant in the room was the fact that a class with significant horizontal aggregate exposure was being sold to a market outside that which it was designed to cater for: SMEs.

The deterioration of the profitability of the class has forced many underwriters to rethink their target markets, resulting in several underwriters reducing capacity, increasing deductibles and reducing their appetite.

7.0 Evolution: Where to From Here?

As you can see from above, Management Liability as a product has developed significantly over the last decade, to the position we are in today where it's a must have buy for an increasing number of SMEs operating in an ever more litigious and risky macro-economic environment. Management Liability is an affordable and efficient way for SMEs to access a class of insurance which was once reserved for corporates, however the appeal and success of Management Liability as a product has started to draw some larger corporate entities to purchase the product, which, due to their size and complexity are better candidates for stand alone suites of Financial Lines products, which avoid the pitfalls of horizontal aggregate exposure and Insurance programs can be customised for their bespoke needs. The ease and simplicity of the way in which Management Liability was transacted saw an ever growing market drawn to them.

Its likely that Management Liability will continue to grow and develop to cater for the specific needs of SME clients. There are just so many benefits to Management Liability that it's hard to see that the product class will do anything but continue to grow for SME's.

8.0 Conclusion

Management Liability Insurance is sometimes viewed as the panacea to round out the insurance programs of an organisation. It fits neatly in with PI, ISR and Property to round out the list of general exposures an organisation faces. For some Insureds though, a packaged product isn't actually the answer to all of their problems. Not all organisations fit neatly within the Management Liability box and for some insureds, stand alone products with appropriate indemnity limits where cover can be tailored to meet their specific needs are a more appropriate solution.

The challenge for the Insurance market is to continue to adapt to clients needs and find ways to transact stand alone products with the ease and simplicity, which has seen Management Liability evolve into such a popular product for a growing number of Australian organisations.

Disclaimer

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