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The Betterley Report

SIDE A D&O LIABILITY INSURANCE MARKET SURVEY 2009

Good Loss Experience Brings More Competitors, but Recent Losses May Reverse This Trend

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Editor's Note: Directors and Officers interested in their coverage for lawsuits alleging mismanagement of their organizations are continuing to be concerned about the actual protection in their D&O policies. With uncollectible coverages claims reported in the press, board members are asking whether, or not, their protection is as reliable as they thought.

The D&O market has responded to this concern with a variety of products that provide separate and/or broader coverage for board members, collectively—but perhaps not accurately—described as Side A coverages. In this issue of The Betterley Report*, we report on these new products, their distinguishing characteristics, how they can be useful, and which carriers offer them.*

In this review, we not only identify the carriers and the differences in their offerings, but also evaluate the state of the market—how healthy the line is, and how fast it is growing. This is difficult for a new product, but with the substantial publicity and growth of Side A products, it is necessary.

In our last Report on Side A policies, published in 2007, we reviewed products from fourteen carriers. For 2009, we have deleted Darwin, which was purchased by Allied World, and replaced it with the two AWAC policies (one from their Bermuda company, the other from their U.S. company). C.V. Starr's product is also included, now on their own paper (Lloyd's). Lloyd's syndicates also offer similar products, but they are not reviewed here.

You will note that this is our first Report that includes Chartis as a source of insurance; Chartis is the new name for AIG.

While each insurance carrier was contacted in order to obtain this information, we have tested their responses against our own experience and knowledge. Where they conflict, we have reviewed the inconsistencies with the carriers. However, the evaluation and conclusions are our own.

In most cases, we examined actual policy forms and endorsements provided by the carrier. Rather than reproduce their exact policy wording (which can be voluminous), in many cases we have paraphrased their wording, in the interest of space and simplicity. Of course, the insurance policies govern the coverage provided, and the carriers are not responsible for our interpretation of their policies or survey responses.

In the use of this material, the reader should understand that the information applies to the standard products of the carriers, and that special arrangements of coverage, cost, and other variables may be available on a negotiated basis. Professional counsel should be sought before any action or decision is made in the use of this information.

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INTRODUCTION

Corporate counsel, risk managers and their advisors have become concerned in recent years that the coverage they arrange to protect their directors and officers against loss from lawsuits alleging a variety of mismanagement may not be as reliable as originally thought. Actions by several courts and insurance companies have served to call into question whether the D&O coverage will actually pay in certain situations. As board members and their advisors realized that their D&O coverage may not be able to pay, they have expressed concern about the coverage—and risk managers have responded.

A recent settlement of an alleged backdating of stock options may have a profound effect on the Side A market; on August 28, 2009, the D&O insurers of Broadcom Corp. agreed to a $118 million settlement of the case. What is unusual about the case is the level of participation by the excess Side A carriers, $40 million (as reported by Business Insurance on September 14, 2009). Typically Side A carriers attach at high enough limits so they are not likely to participate in such claims, as the primary D&O coverage is sufficient. Side A is usually involved only if there is a bankruptcy of the insured or an inability to indemnify the director or officer.

We are not sure of the implications of this settlement; will Side A insurers consider it an aberration, or will it cause a rethinking of their pricing? We suspect the latter.

One concern is that, in certain circumstances, a D&O policy may be blocked from paying for defense costs and damages if the corporation or organization is an insured under the policy, and is bankrupt. This concern arose when, in the case of a bankrupt corporation, a bankruptcy judge decided that the policy was an asset of the corporation, and that directors and officers covered by the policy would have to wait in line for their claims payments as though they were creditors. This exposed them to the risk of collecting only a portion of their claim, and also to a delay in payment of the claim. Since the corporation was entitled to coverage under the policy, it reasoned, all insureds would have to wait for payment until the bankruptcy plan of reorganization was concluded. This included a stay of payments to the directors and officers insured under the policy.

Even if the corporation is not an insured, there is still a similar risk. A bankruptcy court may be able to withhold payments owed by the corporation to the individuals under the corporation's bylaws indemnification provisions.

Other concerns have also arisen, as D&O policies have been rescinded by insurers—or attempts have been made to rescind them—arguing that they were misled into issuing the policies. If management misleads the carrier, for example, by issuing erroneous financial statements, argued the carrier, then no coverage for resulting claims should be provided.

This had the unfortunate effect of denying coverage for board members for one of their chief exposures—financial mismanagement of the organization.

D&O insurance was originally designed to cover the direct responsibilities of individual directors and officers for management liability. Coverage was provided directly to the individual (so-called Side A of the D&O policy, since the coverage was typically labeled as such). Coverage was also provided to the corporation, but only to the extent that the corporation or institution owed the individual indemnification under its bylaws. This coverage is known as Side B coverage. As the indemnification agreements in most bylaws were expanded, more insurance claims by the corporation resulted.

Coverage for the individuals, whether Side A or Side B, accomplished its goal of protecting the directors and officers against the risk of serving on a board. The organization for which they were responsible was not insured for any role it played in the alleged mismanagement of the company.

This meant that many claims included a component that was not insured—the corporation. Thus, forcing the insurer to decided how much of the claim was to be paid to the individual director or officer, and how much was not insured (because the corporation was also a defendant); said another way, the insurer had to allocate which portion of the claim was attributable to the individuals, and which to the corporation. The result was many a squabble, as risk managers and legal counsel disagreed on the carrier's allocation; not enough payment attributable to the individuals, too much payment excluded because it was attributed to the corporation. These problems would not have occurred if the corporation was an insured, but since D&O insurance did not cover the corporation, the uncovered portion of the claim became prominent.

Concurrently, other forces in the market were acting to broaden D&O coverage. The fierce market share battles of the 1990s led new carriers (and some existing carriers) to broaden their policies to include coverages not traditionally part of a D&O policy. Thus, Side C coverage was born.

Side C coverage is that portion of a D&O policy which protects the corporation or institution. The portion of the policy which led to the allocation fights became a part of the insurance. Now, not only was the individual insured; so was the organization for which he or she was responsible—leading to the concerns of board members that, in the event of a bankruptcy, they may not have coverage after all.

Other factors raised concerns about coverage—several of the financial success stories of the booming 1990s turned out to be built on sand, with overly optimistic (if not outright misleading) financial statements and sales forecasts. D&O carriers were inundated with claims arising out of lawsuits alleging that their insureds did not properly oversee their organizations, and indeed committed fraud in the policy application. Carriers acted predictably, attempting to reverse the policies involved by rescinding them.

While this may have been a fair action for the carriers to take, it caused individual board members not involved in the problem, to question whether, or not, their protection was as good as described—and to go looking for reassurance. They sought coverages that applied directly to them, with features that protected against rescission and bankruptcy stays.

Carriers have developed new approaches to this coverage need. They fall into three broad categories:

- Side A only—this is simply a policy that eliminates (or did not originally include) Sides B and/or C. Usually purchased in parallel with the organization's regular D&O policy, so it only covers when the original policy cannot or does not pay. Generally it is not broader than the original policy.

- Side A Enhanced—this policy provides coverage similar to Side A, with additional coverage features (see *Product Features* section later in this Report).

- D&O DIC—similar to Side A Enhanced, but wraps around an existing Side A coverage.

While in 2006 we saw the introduction of a new ACE Bermuda (CODA) form and the entry of Monitor into this product arena, in 2007 we saw a flurry of new product forms, led by AIG Executive Liability (now Chartis) and RLI, as well as new forms from CNA, The Hartford, and XL. Liberty had added coverage via a new endorsement, and we have included Scottsdale to this product line.

In 2008/09, there has been another flurry of new (or enhanced) forms, as carriers became more comfortable with the line, and as competition increased the pressure. ACE (both Bermuda and U.S.), Arch, AWAC, Chartis, C.V. Starr, The Hartford, Liberty, and Monitor all brought significant enhancements to their products.

We welcome this continuing innovation in forms that benefits the insureds.

STATE OF THE MARKET

This type of coverage is still relatively new; we understand from the carriers that large, publicly-traded companies are buying a substantial number of policies; one leading carrier reports that 'well over 50 percent of the Fortune 1,000 companies are buying some form of DIC Side A policy. This makes sense to us—board members have a significant say in their coverage. And, rightfully so, as they should not have to worry about the coverage they thought they had, and if it will pay as they originally thought. A properly covered director is more likely to make the hard decisions, knowing they are protected.

Side A is mostly a large, publicly-traded company market, so far. Not-for-profits and private companies are not yet pursuing Side A coverages in volume. We suspect that this will remain so, with the exception of large not-for-profits, which may well decide (or have their trustees decide for them) that Side A coverage is a risk they want to be sure is adequately covered. The soft commercial lines insurance market is also encouraging the addition of this coverage (and/or higher limits of D&O) as insurance budgets are under less price pressure. We suspect that lower rates are also making the purchase of coverage more widespread.

We believe that the total premium written for Side A-type coverages continues to be in the range of $700 to $900 million for business written in the U.S., with perhaps another 50 percent written outside the U.S. We expect that the actual premium is at the higher end of this range, after adjusting for additional insureds but lower rates. Unfortunately, this is still a difficult line of coverage on which to get premium information.

STATE OF THE MARKET – RATES

Side A D&O insurance rates are stable, with the exception of large publicly-held and financial institutions. For these more risky insureds, rising rates can be expected.

For desirable accounts, carriers are going to defend their customer base even if it means similar rate reductions, but we don't think that these will go on forever. It may be that, as a new product line, rates were high to begin with, and the natural evolution of new products leading to lower cost premiums is going to be at work here. The countering forces of the tightening D&O market and the impact of the Broadcom settlement argue for higher rates in the near future.

TARGET MARKETS

Side A has, for the most part, been a product of interest for the publicly-traded company market, especially larger companies. There seems to be only slight interest from private companies and not-for-profits, although carriers are generally willing to write Side A products for them. Having said that, we are seeing that interest grow, as privately-held and larger not-for-profit organizations get inquiries about coverage from their Board members.

The reason, of course, is that directors and officers of larger companies are the most likely targets of lawsuits, and have the most influence on the purchase of D&O coverage.

We note in our *Target Market* table the details as reported to us. The leading carriers tend to not have firm restrictions on the class of accounts they will consider, other than size. Some restrictions apply for certain products.

In our 2007 Report, carriers were more specific about the types of prospective insureds that they would consider; in 2009, most are interested in all prospects.

The reality is that the smaller carriers are unlikely to want—or appeal to—the largest insureds; those that need big limits, sophisticated underwriting and claims handling, and have the ability to survive turbulent markets should they come.

PRODUCT TYPE AND FEATURES

As noted in our introduction, there are three basic product types offered by all carriers:

- Side A only
- Side A Enhanced
- D&O DIC

All carriers will allow coverage to be limited to specific individual directors and officers. We think that offering this special coverage to selected board members (such as outside directors) makes a lot of sense, and think it should be more widely considered.

SIDE A ONLY PRODUCTS

One benefit of a Side A product is the non-cancellation feature, which protects the individual insured against the risk that the carrier will cancel the policy in the event of financial restatements. Of course, failure to pay premiums may be a cause for cancellation, but otherwise, an insured should not take the risk of the carrier deciding it no longer liked an account or line of business

Another key feature is protection against the policy being rescinded, which can normally happen when the carrier believes that the risk is greater than that portrayed by the applicant.

Enhanced Side A and DIC Products

Several key features apply to the Enhanced and DIC products, including:

- noncancellation and nonrescission,
- coverage for claims in underlying policies that have been rescinded,
- at least as broad as wording,
- wrongful refusal to indemnify,
- financial inability to indemnify, and
- excess over underlying EPLI.

Limits and Deductibles

Insureds can arrange limits of up to about $200 million by purchasing primary and excess layers; individual carrier capacity varies, with Ace-Bermuda (CODA) offering up to $75 million. Chartis and XL offer up to $50 million, and other carriers generally offer limits up to $25 million. Exceptions include C.V. Starr and Scottsdale ($15 million), and Monitor with $10 million. Minimum limits are generally $1 million, although it is hard to picture an insured settling for such a low limit.

Deductibles tend to be nil, since board members are accustomed to a no-deductible coverage.

Typical Limits

We asked about the limits insureds are buying, and found a wide range, perhaps reflecting the newness of the product and broad range of insureds. There is perhaps no consensus on the part of insureds and their advisors, as to limits.

The largest insureds, with annual sales exceeding $10 billion, certainly buy the highest limits, ranging from $10 million to as much as $200 million (although this may be an outlier, reported by only two carriers).

Insureds with annual sales in the $1 to $10 billion range buy $5 to $25 million, with exceptions to $75 million reported.

Smaller insureds are also reported to be buying $5 to $50 million limits.

One note—D&O coverage often consists of multiple policies with stacking limits; some of the reporting carriers are likely reporting the limits that they are issuing, not the total limits the insured is buying. We will try to obtain more accurate information in future Reports.

Policy Type and Definition of Insured

All policies reviewed are written on an indemnification basis; none use a Duty-to-Defend form.

Coverage for an insured while serving on an outside board at the request of the entity (for example, serving on the board of a business association) is generally available either in the basic policy or by endorsement. Many will consider for-profit boards, so perhaps negotiation would be successful.

Claims Reporting and Extended Reporting Period

An important distinction between policy forms is when a claim has to be reported. Most carriers require the Named Insured to report "as soon as practicable," which seems reasonable. In practice, unless the insured has delayed reporting so long (and irresponsibly) as to compromise the defense of the claim, there is little practical difference between carriers.

Extended Reporting Period (ERP) protection is an under-appreciated feature of Side A policies, one that will take on a growing importance if carriers lose interest in the market.

Whether the ERP is one way or two way (bilateral) is important to know. One way means the ERP is available only if the carrier cancels or refuses to renew. Two way means the ERP can be purchased even if the insured cancels or does not renew.

All carriers offer an ERP, but length and cost differ. Consider the ERP carefully when choosing coverage; if the ERP is not to your liking, perhaps a longer option can be negotiated.

Selection of Counsel and Consent to Settle

Who selects counsel, the carrier or the insured, is particularly important for D&O policies, and especially for Side A coverages. All carriers reviewed allow the insured to select counsel.

For most liability policies, carriers are reluctant to allow insureds much control over settlement, understandably, since D&O suits often involve a good deal of emotion. Both directors and officers are often willing to continue their fight in court long after it makes economic sense to settle. Of course carriers are reluctant to fund such battles.

Side A policies are generally written on an indemnity basis, rather than duty-to-defend, and so the insured is not required to settle a suit that they do not wish to settle. Happily, these policies generally do not include a hammer clause.

Advancement of Defense Costs

As indemnity-based policies, Side A coverages require an insured to pay for defense costs and settlements, then seek payment by the insurer. All carriers will advance defense costs as they are incurred, which reduces the insured's cash flow drain.

Prior Acts Coverage

All of the policies reviewed include Prior Acts coverage in their standard form. Insureds should carefully review the restrictions, such as pending and prior litigation, and retroactive dates. Pending or prior litigation exclusions quite reasonably are included in all of the reviewed policies.

Territory

All of the reviewed policies include worldwide (suit brought anywhere) coverage, which is important. Aggrieved parties can be located anywhere, so coverage should extend anywhere as well.

Exclusions

Policy exclusions are similar for the various policies, but we recommend insureds and their advisors pay particular attention to anti-takeover, securities claims brought by bankruptcy trustees, short swing profit, libel/slander/defamation, pollution, and professional liability and securities exclusions, as well as those relating to punitive damages and intentional acts.

Risk Management Services

Risk management services are few when it comes to D&O, but we do note that ACE-Bermuda sponsors a D&O newsletter and various forums and conferences on corporate governance and Chubb offers a useful series of loss prevention handbooks. Risk Management services are not really all that appealing for the big insured that typically buys Side A protection, so there has been little investment in them.

Summary

Side A D&O coverages, in their several manifestations, are still not growing beyond the larger, publicly-held company market, though there is some interest coming from privately-held and not-for-profit organizations. We continue to predict that they will become common in the larger institutional market as well. Market growth in smaller organizations, and private companies in general, may happen, but we remain less confident in forecasting significant market penetration.

The concerns of board members that their traditional D&O policies may not pay are real, and although it may be that the risk of an uncovered loss is less than currently feared, it is important that board members have the confidence in their coverage that allows them to execute their duties effectively.

This is an interesting product; it seems to address the fears of directors as much as the actual risk. We don't object to that—reassuring a Board that its members are protected is healthy, not only for the insurance companies offering the protection, but also for the organizations that buy it for them.

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