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THE BETTERLEY REPORT

SIDE A D&O LIABILITY INSURANCE MARKET SURVEY 2012:

A Few New Forms, but Otherwise Stable

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Highlights of This Issue

- *Carriers Report Market Saturated For Large For-Profit Insureds*
- *Where Are The Large Not-For-Profit Insureds?*
- *Rates Edging Up, But Not Dramatically*

Next Issue

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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 claims reported in the press, board members are asking whether 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 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 2011, we reviewed twenty-five products; for 2012, we are broadening our coverage to twenty-six. Aspen is the carrier new to this Report, while Torus was removed because we could not obtain updated information. The Hartford returned after a one year absence.

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.

For updated information on this and other Betterley Report coverage of specialty insurance products, please see our blog, The Betterley Report on Specialty Insurance Products, which can be found at: www.betterley.com/blog.

List of Tables

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.

Our read on this market (confirmed by many of the carriers and brokers that we spoke with) is that most of the public company potential insureds are already buying the coverage. Some of the broadening of traditional D&O policies has reduced (but far from eliminated) the need for a separate Side A policy, but it still continues as a policy routinely included in a large public company insured's portfolio.

What we are wondering is when the large not-for-profit market will start buying Side A; the Boards of these insureds tend to be quite interested in 'full protection' against any personal risk, and we would expect them to be interested in Side A. Yet, we are told that Side A is not commonly carried by large (and certainly not small) not-for-profits.

Why is this? We suspect lack of awareness of the risk that a D&O policy might not be able to perform as the Board expects.

One reason Side A D&O is attractive 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 by-laws indemnification provisions.

Other concerns have also arisen, as D&O policies have been rescinded by insurers – or attempts

Carriers in This Survey

The full report includes a list of 26 markets for this coverage, along with underwriter contact information, and gives you a detailed analysis of distinctive features of each carrier's offerings. Learn more about *The Betterley Report*, and subscribe on IRMI.com.

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. In practice, this forced the insurer to decide 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.

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; many call the market 'saturated'. 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 eventually 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 had allowed the addition of this coverage (and/or higher limits of D&O) as insurance budgets were under less price pressure. We suspect that lower rates were also making the purchase of coverage more widespread. As the long soft market ends, new sales of Side A will decline unless new markets open up.

We believe that the total premium written for Side A-type coverages continues to be in the range of $700 million to perhaps as much as $1 billion for business written in the U.S., with an estimated additional 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 companies and financial institutions. For these more risky insureds, rising rates can be expected.

Even for desirable accounts, carriers are going to try to edge up their rates a bit, but we don't detect a lot of urgency. Side A products are enjoying excellent loss ratios, making rate increases less critical.

Target Markets

Side A has, for the most part, been a product of interest for the publicly-traded company market, especially larger companies. 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.

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.

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; since 2009, most indicate that they 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 misrepresented by the applicant.

Enhanced Side A and DIC Products

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

- non-cancellation and non-rescission,
- 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.

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 $600 million (although this may be an outlier, reported by only one carrier).

Insureds with annual sales in the $1 to $10 billion range buy $10 to $30 million, with several exceptions to $100 million reported.

Smaller insureds are also reported to be buying $10 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.

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, libel/slander/defamation, pollution, and professional liability and securities exclusions, as well as those relating to punitive damages and intentional acts.

Note that we have removed the "Short Swing (169(b)) Profits exclusion from our table. Although all carriers answer this as 'No' (meaning the exclusion is not present in their standard policy form), the exclusion for Illegal Personal profits would presumably remove any coverage.

Risk Management Services

Risk Management services are few when it comes to D&O. We do note that ACE-Bermuda/CODA 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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About The Author

Richard S. Betterley, CMC, is the President of Betterley Risk Consultants, an independent insurance and alternative Risk Management consulting firm. BRC, founded in 1932, provides independent advice and counsel on insurable risk, coverage, alternatives to traditional insurance, and related services to corporations, educational institutions, and other organizations throughout the U.S. It does not sell insurance or related services.

Rick is a frequent speaker, author, and expert witness on specialty insurance products and related services. He is a member of the Professional Liability Underwriting Society and the Institute of Management Consultants. He joined the firm in 1975.

Rick created The Betterley Report in 1994 to be the objective source of information about specialty insurance products. Now published 6 times annually, The Betterley Report is known for its in-depth coverage of Management Liability, Cyber Risk, Privacy, and Intellectual Property and Media insurance products.

More recently, Rick created The Betterley Report Blog on Specialty Insurance Products, which offers readers updates on and insight into insurance products such as those covered in The Betterley Report. It provides him with a platform to more frequently and informally comment on product updates and newly announced products, as well as trends in the specialty insurance industry. www.betterley.com/blog

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