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BRC

# The Betterley Report

## SIDE A D&O LIABILITY INSURANCE MARKET SURVEY 2016:

***Steady Rates in a Stable Market***

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**Highlights of This Issue**

- Rates Are Generally Flat
- Public Company Market Is Saturated, but Opportunities Still Exist in Larger Nonpublic Sectors

**Next Issue**

*December 2016*
*EPLI Market Survey 2016*

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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 directors and officers (D&O) liability 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 insurers offer them.*

*In this review, we not only identify the insurers 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. While no longer a new product, with the substantial visibility of Side A products, it is useful.*

*In our last* Report *on Side A policies, published in 2015, we reviewed 27 products. For 2016, we have removed Argo and Aspen, which were unable to respond to our requests for information, and consolidated the Chubb and ACE products, leaving a total of 24.*

*While each insurer 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 insurers. However, the evaluation and conclusions are our own.*

*In some cases, we examined actual policy forms and endorsements provided by the insurer. 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 insurers 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 insurers 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](www.betterley.com/blog).

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## Introduction

Corporate counsel, risk managers, and their advisers have been concerned for 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 D&O coverage will actually pay in certain situations. As board members and their advisers realized that their D&O coverage might 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 insurers and brokers with whom we spoke) 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.

We have been wondering 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, Side A is not commonly carried by large (and certainly not small) not-for-profits.

This is slowly changing, however—a few of our participating insurers continue to report some mild interest on the part of their large not-for-profit healthcare system clients. The severe economic disruptions that many of these systems are experiencing due to the implementation of the Patient Protection and Affordable Care Act could be a factor in this.

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. Also, most large not-for-profits have ample funds and don't concern themselves with bankruptcy, the original concern that drove the purchase of Side A D&O coverage.

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

### Insurers in this Survey

The full report includes a list of 24 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.

only a portion of their claim and 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 insurer, for example, by issuing erroneous financial statements, argued the insurer, then no coverage for resulting claims should be provided.

Rescission had the unfortunate effect of denying coverage for board members for one of their chief exposures—financial mismanagement of the organization. Indeed, this is one of the reasons why prospective insureds might consider buying a Side A policy to supplement their traditional D&O (or trustees and officers) policy.

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 insurer'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 insurers (and some existing insurers) 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 that protects the corporation or institution. The portion of the policy that 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 insurers 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. Insurers acted predictably, attempting to reverse the policies involved by rescinding them.

While this may have been a fair action for the insurers 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.

Insurers have developed new approaches to this coverage need. They fall into the following 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 difference-in-conditions (DIC)—It is similar to Side A enhanced but wraps around an existing Side A coverage.

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

## State of the Market

Despite the efforts of Side A insurers, larger brokerage firms, and *The Betterley Report*, this type of coverage is still not well known by general counsel, brokers, and the board members themselves. Potential insureds seem to be stuck on the "do we have D&O insurance" question and are not getting to the next question—is there other protection we should consider? Side A is still largely a market of the publicly held corporate insureds.

We understand from the insurers 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 whether 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.

Many of these potential insureds undoubtedly buy D&O (or trustees errors and omissions) insurance policies, some of which may include Side A-type enhancements, but how many of them don't buy (and have never heard of) Side A/DIC policies? We believe that the vast majority of them—and their insurance advisers—have never even heard of the product and its value.

As for volume of business written, consistent with our observations in 2015, 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 United States, with an estimated additional 50 percent written outside the United States. 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.

The impact of Berkshire Hathaway's Specialty Insurance operations has yet to be measured, but we suspect its increased emphasis on D&O-type markets will be significant. Large buyers of D&O are its target market, and these are exactly the type of insureds to which Side A appeals. We are pleased that we can include them in this year's *Report*.

## State of the Market—Rates

Side A D&O insurance rates are stable, with the exception of companies that have suffered from D&O claims. For these riskier insureds, rising rates can be expected. But for most insureds, flat or an increase of up to 5 percent can be expected.

Even for desirable accounts, insurers 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.

However, underlying this good experience is trouble in the D&O market, especially with regard to state legal- and regulatory-based claims. As plaintiffs' attorneys find federal-based suits less fruitful, opportunities to base their client's claims on state regulations are becoming a source of covered insurance claims.

Another, and less-predicted, source of covered claims is nonmonetary damages. Such damages are commonly thought to be excluded under D&O policies, but unfortunately not all courts agree. These awards, when included in a claim as covered, can be expensive—and probably not anticipated by the insurer when developing its rates.

If these trends continue, we expect that they will force D&O rates higher and that they may drag Side A rates along with them.

## 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 insurers are generally willing to write Side A products for them. Having said that, we are seeing that interest grows 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 insurers tend not to have firm restrictions on the class of accounts they will consider, other than size. Some restrictions apply for certain products.

In our 2007 *Report*, insurers 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 insurers are unlikely to want—or appeal to—the largest insureds, those that need big limits, sophisticated underwriting, and sophisticated 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 insurers:

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

All insurers 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 should be more widely considered.

## Side A-Only Products

One benefit of a Side A product is the noncancellation feature, which protects the individual insured against the risk that the insurer 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 insurer, deciding it no longer likes an account or line of business.

Another key feature is protection against the policy being rescinded, which can normally happen when the insurer 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:

- 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
- Excess over underlying employment practices liability insurance

## 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 no consensus on the part of insureds and their advisers 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 insurer).

Insureds with annual sales in the $1 billion to $10 billion range buy $10 million to $50 million, with several exceptions to $100 million reported.

Smaller insureds are also reported to be buying $10 million to $50 million limits.

One note—D&O coverage often consists of multiple policies with stacking limits; some of the reporting insurers are likely reporting the limits that they are issuing, not the total limits the insured is buying. We continue to try to obtain more accurate information, but it is a challenge.

## Claims Reporting and Extended Reporting Period

An important distinction between policy forms is when a claim has to be reported. Most insurers 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 insurers.

Extended reporting period (ERP) protection is an underappreciated feature of Side A policies; one that will take on a growing importance if insurers 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 insurer cancels or refuses to renew. Two way means the ERP can be purchased even if the insured cancels or does not renew.

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

For most liability policies, insurers 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, insurers 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 it does 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 and then seek payment by the insurer. All insurers 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 advisers pay particular attention to antitakeover, 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.

## Risk Management Services

Risk management services are few when it comes to D&O. AIG offers complimentary anti-corruption/anti-bribery consultations with various experts, Chubb offers its helpful series of loss-prevention handbooks, and Travelers its web-based loss-control program, Risk Management PLUS+ Online®. 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.

## About the Author

Richard S. Betterley 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 United States. It does not sell insurance or related services.

Mr. Betterley 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.

Mr. Betterley created *The Betterley Report* in 1994 to be the objective source of information about specialty insurance products. Now published six 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, Mr. Betterley 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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