

# Guy Carpenter Views

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## Current Conditions in the D&O Liability Insurance and Reinsurance Markets



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**The directors and officers (D&O) liability market has experienced massive changes over the past few years. High-profile bankruptcies, accounting scandals, and greater legal and judicial oversight have led to increased scrutiny and a heightened threat of litigation for a firm's directors and officers.**

*Guy Carpenter Views* speaks with Chip LaLone, D&O Practice leader for Guy Carpenter's Professional Liability Specialty Practice, about the evolution of current market conditions and his thoughts about how this market will develop going forward.

Part One of this two-part interview begins with a general description of the structure and types of coverage provided by D&O insurance and reinsurance. The discussion then turns to key drivers of changing market conditions, the evolving need for coverage, and the current availability and affordability of D&O insurance and reinsurance.

In Part Two, Chip will discuss January 2004 renewals, his expectations for the future of this market, and the role of Guy Carpenter in assisting clients with their D&O coverage needs.

### ■ Part One

#### Description of Primary Insurance Product

**Guy Carpenter Views:** Can you briefly describe what is covered under directors and officers (D&O) liability insurance policies? How is coverage structured and triggered? In what ways have insureds' growing coverage needs changed the way in which insurers write these policies?

**Chip LaLone:** Directors and officers insurance is designed to provide protection to a company's directors and officers—and in some cases the company itself—for liability resulting from negligence, error, or omission in conjunction with the performance of their duties.

Claims are generally filed by shareholders of the corporation who allege that director and officer or company behavior has, for example, lowered stock values, depleted corporate funds, negatively affected corporate standing, or otherwise caused them financial harm. Claims are also filed by other stakeholders such as customers and employees.

Coverage is available in three sections:

- Side A coverage directly reimburses directors and officers for their personal liability arising from negligence, error, or omission in the performance of their duties.
- Side B coverage reimburses the corporation if it was legally required or permitted under state law to indemnify its directors and officers for their personal liability.
- Side C coverage reimburses the company for its own liability, rather than for the liability of its directors and officers.

Historically, D&O insurance policies included only Side A and Side B coverage. However, in the late 1990s, Side C coverage, also known as entity coverage, was offered in response to disputes over how to allocate settlements between the covered directors and officers and the uncovered corporate entity. That this coverage was provided at little or no cost was arguably a consequence of the soft market.

The structure of D&O insurance is changing once again. In fact, with entity coverage disappearing from many policies, Side A only policies are becoming common coverage choices for the larger risks, primarily because of price and availability issues.

Coverage is typically written on an annual basis for a single aggregate limit of liability. In the middle and late 1990s, coverage was offered on a multi-year, single aggregate basis, which contributed substantially to the adverse experience incurred by insurers and reinsurers.

**GCV:** Why has Side-A-only coverage gained popularity during the past few years?

**CL:** For insureds faced with the high rates and reduced terms that characterize the current D&O insurance product, Side-A-only policies have become an attractive option. The principal reasons are that:

- Coverage for the directors and officers is typically much broader than that provided under traditional policies.
- Because the company itself is not indemnified under this policy, coverage is not considered a corporate asset. Therefore, coverage for individual directors and officers would likely not be affected in the event of the company's bankruptcy.
- This structure is generally less expensive than traditional three-sided coverage.

**GCV:** What is a severability provision, and how does it affect the determination of coverage provided under a D&O policy?

**CL:** Severability provisions preserve coverage for innocent insureds when other insureds under the same D&O policy have made a material misrepresentation to the insurer or have committed a wrongful act that would otherwise result in the cancellation of coverage.

In some cases, courts have allowed insurers to rescind coverage for all insureds if one insured provides false information or acts improperly. To prevent that from happening, insureds generally look for policies that contain one of two types of severability provisions:

- Full severability prevents the knowledge of one insured from being attributed to another insured for purposes of the policy application.
- Limited severability assumes that all insureds possess the same knowledge as any signer of the insurance application or as certain executive officers. Thus, coverage for all insureds can be voided if the signers or the relevant executives knew of the false disclosures in the insurance application.

## Reinsurance Product Description

**GCV:** What is covered under D&O reinsurance treaties? How have these treaties traditionally been purchased and structured (e.g., in terms of exclusions, policy limits, retentions, triggers)?

**CL:** Generally, D&O reinsurance covers all losses arising from a cedent's D&O portfolio on a follow-the-form basis. Eighty percent of the reinsurance purchased is proportional, with the remainder currently structured as excess of loss treaties. The maximum limit being offered by virtually all carriers is \$25 million, but in practice carriers have been limiting a large proportion of their book to \$15 million limits and less.

About 75 percent of reinsurance treaties written contain some type of aggregate limit, whether through a loss ratio cap or limited reinstatements. Ceding commissions have come down roughly 5 to 7.5 points from where they were in 2000 and before.

Another important trend in treaty structures has been the dramatic increase in retentions taken by cedents. Whereas four years ago retentions as small as \$2.5 million to \$5 million on a \$25 million or \$50 million facility were not unusual, cedents are now retaining a minimum of \$5 million and as much as \$10 million or more. Ceding companies are attempting to maximize retained premium in a hard D&O market as well as satisfy reinsurers' concerns that they have enough "skin in the game."

## Overview of Current Insurance Market Conditions

**GCV:** Can you briefly describe current conditions in the D&O market? How have exposures increased over the past decade for insurers and reinsurers writing this line of business?

**CL:** Rising rates combined with capacity reductions and stricter terms and conditions have contributed to what is viewed as a highly favorable underwriting environment for D&O insurance and reinsurance since the last hard market in 1985.

Coverage limitations offered or imposed by D&O insurers, such as the deletion of severability, Side-A-only policies, stronger fraud exclusions, and prior acts exclusions, have been significant contributors to projected profitability. However, the end of multi-year policies, resulting in multi-fold premium increases, has been the primary driver of the industry's return to profitability.

Although each D&O insurer measures rate increases differently, it is a widely held view that rates have been adequate and have outpaced loss costs since 2002. Despite recently initiated reductions in excess insurance rates, there is no information available suggesting that industry rates in the near term will become inadequate.

On the claims side, insurers have been aggressively defending insureds as well as denying coverage for those who have acted fraudulently. A positive trend has been the increase in structured settlements, where insurers agree to settle with insureds for a reduced limit of liability or where they receive a large additional premium to compensate them for a possible settlement. This should serve to mitigate the number and size of "mega-settlements" in the near term. However, it is possible that these large settlements may act as a continuing catalyst for discouraging any major reduction of rates from their current levels.

## Claim Frequency and Severity

**GCV:** How have the frequency and severity of D&O losses changed over the past few years?

**CL:** Although the number of high-profile so-called "mega-settlements" has increased over the past few years, and their average settlement cost has been higher than \$20 million, NERA reports that the median settlement of all D&O claims has ranged from \$4 million to \$6 million from 1996 through 2003.

Frequency in the form of securities class action suits filed saw a somewhat artificial spike in 2001 and to a lesser extent 2002 due to the IPO "laddering" and research analyst claims. Excluding these claims, frequency has remained at a relatively stable average of 212 securities suits per year since the passage of the Private Securities Litigation Reform Act (PSLRA) in 1995.

A subset of these 212 securities suits involves those filed against Fortune 500 companies. These Fortune 500 lawsuits, the settlement value of which contributes substantially to the mega-settlements noted above, skyrocketed in 2002 to 61 but fell in 2003 to 25, which more closely mirrors the activity in this segment from 1999 to 2001.

It is these headline cases, the number of large suits in the pipeline, and the IPO "laddering" suits that have contributed to a somewhat misleading view of frequency and severity in the D&O market.

## The Impact of New Capacity

**GCV:** Where is new capacity coming from? Is Bermuda playing a role?

**CL:** New insurance capacity has come into the D&O market in two waves. First, the companies that were set up post-9/11 have started writing D&O in what has been one of many hardening casualty lines. Second, the sustained hard market in D&O specifically has attracted a number of entrants.

New reinsurance capacity entered in 2002 in the form of companies that were started post-9/11 as well as established companies that decided a foray into D&O was timely.

This new reinsurance capacity has effectively replaced the capacity lost when several reinsurers went out of business and the majority of the direct reinsurers pulled out of this line in 2002.

In Part Two of this interview, I'll discuss January 2004 renewals, my thoughts about the future of this market, and the role of Guy Carpenter in assisting clients with their D&O coverage needs.

## ■ Part Two

### January 2004 Reinsurance Renewals

#### Overview of Market Changes

**Guy Carpenter Views:** How would you characterize January 2004 D&O reinsurance renewals? What changes have taken place in this market over the past year?

**Chip LaLone:** The January 2004 D&O reinsurance renewal process was relatively smooth, which is consistent with the fairly stable D&O reinsurance market that has existed since July 1, 2003 treaty renewals.

At the moment, a certain degree of equilibrium between supply and demand seems to exist. An abundance of capacity is available for certain contracts, particularly if the ceding company significantly increased its net line over the last year. Even the "new" D&O facilities are getting the capacity they require, albeit at more restrictive terms.


For the first time since the latter half of the 1990s, D&O reinsurers have the attitude that high-quality reinsurance coverage is "earned." Insurers with proven track records and management/underwriting teams are being granted the best treaty terms and conditions, whereas new carriers—even those with well-regarded management teams—are encountering reinsurers' "prove it to me" attitude. This shift in reinsurers' approach, which became apparent last year, contrasts with that of the soft market of the period from 1996 through 2000. Borrowing from accounting terminology, I use the term "LIBO" (last in best out) to describe the fact that the last (i.e., each successive) reinsurance treaty in the market got the best terms.

As part of their more cautious approach, reinsurers have intensified the amount and level of detail of information that they require to provide the highest-quality capacity at the best economic terms. This is leading to the development of empirical analyses, which will become future standards. Even given where we are today, reinsurers were exponentially better equipped to make underwriting decisions at January 1, 2004 than they were just a short time ago.

**GCV:** What were clients looking for from reinsurers a year ago? What were they looking for at 2004 renewals?

**CL:** A year ago, most programs did not experience turnover of reinsurers. This was because allocation of capacity had been decided a year prior, when markets decreased the number of their commitments, but increased their shares on those remaining. Generally, clients were looking to renew as expiring with minor tweaks.

In 2004, clients were looking first and foremost for the most stable, financially secure capacity available. Credit quality has only increased in importance in the past twelve months, in part, because



of the large amount of ceded premium as well as the heightened scrutiny surrounding this topic. Ceding companies are exploring and will be looking favorably to those reinsurers that can help them gain greater confidence about their future reinsurance recoverables.

## Pricing

**GCV:** How did reinsurance pricing change?

**CL:** Since most treaties are either cessions-rated excess of loss or quota share structures, the 2003 primary market rate increases simply flowed through to reinsurers. Adjustments to reinsurance pricing came in the form of changes to ceding commissions and loss limitations. All things being equal, reinsurance rates did not change even though the underlying market appeared to have flattened.

## Capacity

**GCV:** Was there sufficient capacity available?

**CL:** Yes. We are not aware of any placement that suffered an unrecoverable loss in capacity, and much of the capacity lost in the past few years has been replaced by the new Bermuda companies. Those reinsurers that are in this market are supporting fewer carriers with larger participations.

## Coverage Terms

**GCV:** Did reinsurers impose any limitations on the coverage they offered?

**CL:** Seventy-five percent or more of in-force reinsurance treaties, including those written at January 1, 2004 renewals, include reinstatement restrictions, loss ratio caps, or limitations on loss corridors. Typically, these coverage restrictions are on programs involving start-up entities or leveraged excess of loss layers, or on programs that were in "payback" mode. Unlike 2002 renewals, where there was considerable discussion surrounding exclusions for financial institutions coverages, 2003 renewals were not yet similarly affected by the mutual fund crisis.

## The Role of Guy Carpenter

**GCV:** What is the role of Guy Carpenter in this market? How do you assist your clients in finding adequate and affordable coverage? Where are you finding new capacity?

**CL:** Because of the high degree of volatility and the large limits required in D&O, this line of business is reinsurance dependent and likely will remain so for the foreseeable future. The exceptions to this are AIG and arguably Chubb because of their size.

Our two primary roles are to help our clients analyze and select the most efficient way to transfer the desired amount of the relatively high degree of volatility inherent in D&O and to generate the needed capacity. Other traditional roles that we fulfill are to evaluate the financial stability of potential trading partners and effectively manage the claims, accounting, and contract servicing.

Finding adequate and affordable coverage is a balancing act between finding the structure that transfers the most volatility for the lowest price and placing it with the most well-managed and financially strong reinsurance companies. The latter objective has become an overriding priority.

The analytical side of our services has taken on increased importance in recent years. On every transaction, we are using Guy Carpenter's proprietary model, MetaRisk® to evaluate the benefits and tradeoffs of specific reinsurance structures.

In February 2004, Guy Carpenter & Company, Inc. launched the industry's first model for analyzing and forecasting the frequency and severity of securities class action suits. The new LEAD™ model (Loss & Exposure Analysis for D&O), engineered over a 12-month period in collaboration with Marsh & McLennan Companies subsidiary NERA Economic Consulting, leverages the companies' combined in-depth understanding of the D&O market and NERA's proprietary database of securities class actions to uniformly analyze the loss potential of individual D&O policies and of entire portfolios.

By bringing together such information as stock issuer characteristics, stock trading information, financial statement metrics, and stock ownership breakdown, LEAD™ estimates both the risk of a future securities class action suit and the severity of that suit should it occur. Guy Carpenter's D&O clients will be able to use the output of this model to analyze and manage shifts in frequency and severity within their portfolios, evaluate the risk/reward of different attachment points, and supplement existing D&O reserving methods.

The LEAD™ model represents a significant step forward in analyzing D&O risks. When used together with Guy Carpenter's MetaRisk® model, a proprietary dynamic financial analysis platform, reinsurance buyers can better assess the reinsurance options available to them, calculate the tradeoffs between various strategies, and generally make much more informed reinsurance decisions.

The overwhelming interest that Guy Carpenter clients and other companies writing D&O business have shown in the LEAD™ model underscores the critical need for empirical analyses of D&O exposures.

## The Future

**GCV:** What are your thoughts about the future of this market? Are you optimistic?

**CL:** Although the reinsurance market remains fragile due to fears of flattening or declining prices of the underlying business, actual and perceived adverse loss development, the continuing susceptibility to large securities claims, and events such as the mutual funds scandals that have or will affect most D&O insurers over some of the recent past accident years, our clients remain optimistic about the strong fundamentals in the business and the high degree of profitability in their in-force portfolios.

We also believe that if the sophistication of the D&O reinsurance market continues to improve, the profit potential, which is substantial relative to almost any line of insurance, will grow significantly. There is a direct correlation between economic and capacity decisions made by reinsurers and the health of the underlying market. Better-equipped reinsurers will make better decisions so that profits for both reinsurers and ceding companies can be maximized.



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