

# Loaded Liability

The casualty market is diverse and is being driven by many factors, not least of which is regulation. As [Andrew Marcell](#) explains, being aware of the latest and future developments is important for this year's renewals



The casualty reinsurance market appears to be emerging from a relatively volatile period into an environment characterised by relatively stable pricing. The dramatic hardening of rates between 2002 and 2004 was accompanied by coverage restrictions and a renewed emphasis on achieving 'transparency' of information. More rigorous exposure rating techniques enabled ongoing reinsurers to justify continuation in lines of business from which others had withdrawn.

As original rates flatten or decline, reinsurers' internal analysis may adjust loss ratio picks

downward, causing a tightening of terms or a reduction in capacity outlays. The cedant that gets the 'best' terms and conditions may be those that provide reinsurers with the measures to evaluate their portfolio and associated underwriting strategy. Examples of measures include rate and exposure change information, valuation of original policy restrictions and evaluation of the macro economic and regulatory environment.

While new reinsurers are being drawn to international casualty books, we expect that ongoing risk-based capital disciplines will require clarity of exposure analysis. Overall, we anticipate

that reinsurers seeking growth in this market will maintain their actuarial discipline but react positively to well presented and highly prepared renewal presentations. In the upcoming renewal season, it will be crucial to continue marrying the cedant view of its exposure with that of the reinsurers.

## INDUSTRIAL LIABILITY

The year 2000 marked a watershed in the reinsurance of European industrial liabilities. An unprecedented frequency of large product liability claims in the pharmaceutical, chemical and medical products sectors was accompanied by an equally

unprecedented frequency of smaller, but relatively significant, product recall losses, primarily in the automotive/components sector. This wave of claims hit in 2001–2002, at the same time as the post-9/11 collapse of investment returns and stock values, and came with renewed concerns about asbestos liability and other latency claims reserving levels.

The experience of occurrence year 2000 underlined two major exposure factors in the European industrial liability market:

- Heavy US product liability exposure from both exports and manufacturing operations
- Coinsurance of the larger risks, leading to significant, previously underestimated accumulations for reinsurers participating on the reinsurance programmes of the major industrial liability insurers.

From 2002 to 2004, these factors led to a dramatic hardening of pricing and a new emphasis on achieving transparency on the underlying portfolio through detailed

exposure analysis. The increase in reinsurance pricing has partially been driven by the need for pay-back, but primarily by the move to more rigorous exposure rating techniques. A sample of the reinsurance programmes of the largest industrial liability insurers placed by Guy Carpenter shows an increase in the average programme rate on line.

The decrease in the average programme Rate on Line from 2003 to 2004 is probably not due to a decrease in reinsurance rates, but rather to the introduction of annual aggregate deductibles, higher retentions or both. The effective increase in underlying excess-of-loss reinsurance rating for 2004 renewals was approximately 25%.

Insurers have adjusted their original pricing in line with reinsurance rating movements, thereby transferring the cost to corporate insurance buyers.

According to the 2003 Marsh *Limits of Liability Report*, the average rate of excess liability limits in Europe increased 82.2%

in 2003 from €8,730 per million to €15,195 per million. There are wide variations, but four European territories were noteworthy:

Ireland: €28,921 per million

France: €25,451 per million

Sweden: €23,396 per million

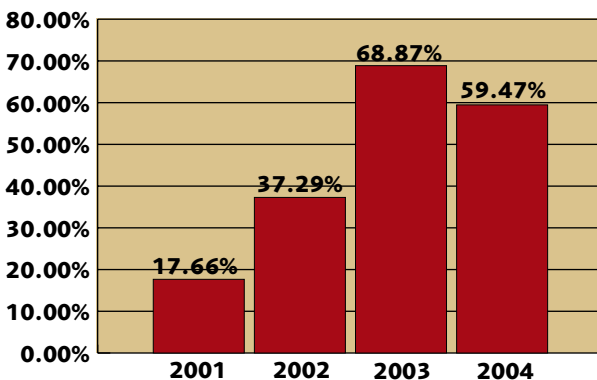
Germany: €21,564 per million

While there may be a difference in pricing linked to the continental European preference to co-insure whole limits as opposed to layering casualty programmes, it is clear that large European liability claims levels are approaching those in the US. The experience of large European manufacturers, driven by their substantial US sales and operations, is equivalent to similar companies in the US.

The chemical and pharmaceutical sector, having been adversely affected by recent claims, saw liability premiums rise in some cases by over 400% from 2002 to 2004. Similarly, companies in hazardous occupations have been obliged to carry higher self-insured retentions. In less hazardous industrial liability classes, self-insured retentions remained relatively lower.

There remains a block of premium held within the primary companies to cover higher-frequency, lower-severity losses which may never reach the attachment point of the excess-of-loss reinsurance programme; and reinsurers should not expect to absorb too much of the premium related to this loss

#### INDUSTRIAL LIABILITY PROGRAMME ROLS





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band. Additional limitations related to coverage have been introduced, for example:

- product recall inner retention and sub-limit
- terrorism exclusion
- total asbestos exclusion
- coverage restrictions for certain products/active ingredients and special declaration and agreement of new products
- electromagnetic field (EMF) exclusion for exposed industries
- broad management liability exclusions
- exclusion of GMOs and other specified development risks and imposition of claims-made coverage for pharmaceutical and chemical business where there are US exposures, and the original limit purchased exceeds €100m
- increasing transition to claims-made coverage on other product liability lines has finally led to an end to the industrial liability market's elasticity of demand.

### **DIRECTORS' & OFFICERS'**

The market in the UK and continental Europe for D&O, Errors & Omissions (E&O) and Financial Institutions (FI) cover experienced a rebirth of underwriting discipline largely driven by exposures to the US regulatory environment with

similar laws being contemplated throughout Europe. Insurers are increasing rates, offering less capacity, increasing retentions, requiring coinsurance, abandoning multi-year policies and adding restrictive wording to all policies. While the market for smaller to middle-sized insureds with no US ADR (American Depository Receipt) exposure appears to be softening in terms of rate increases, the legal environment throughout Europe is opening opportunities for insurers to continue tightening coverage.

After years of low claims frequency and severity, and softening rates in the D&O liability insurance market in continental Europe, the tide may be changing.

The problem for the D&O insurance market at current premium levels is that any one event has the potential to wipe out the market's entire D&O premium income for the countries involved. This is now being actively addressed by D&O insurers who are cutting back limits while achieving rate increases. Maximum lines are being reduced typically from \$50m to \$25m. Primarily, the problems relate to ADR exposures. The core loss ratio for non-US exposed business remains low.

### **FINANCIAL INSTITUTIONS**

The current FI market is defined by events in the US market where the conduct and sales practices of the investment banks and mutual funds during the bull market of the late 1990s has generated myriad actions. Combined with a soft insurance marketplace, results for insurers and reinsurers have proven to be very poor. In the soft insurance cycle of the late 1990s and into 2000, insurers offered multi-year policies, issued aggregate limits, blended professional liability products across large aggregate or even multi-limits and reinstatements (offering substantial pricing discounts for doing so), and broadened coverage. Simultaneously, original insureds were growing rapidly and expanding the services they provided to their customers. As the economy slowed and the stock market bubble burst, many investors lost significant sums of money and may have sought to recover their investments through lawsuits against the companies in which they had invested.

Investment Banking E&O for Wall Street banks has largely been removed. Late trading/market timing

exclusions are now in place for any financial institution that might have this exposure. Unilateral ERPs are in place and fraud/dishonesty exclusions have been moved to 'in fact' wording, wherever possible.

Many reinsurers have exited the FI E&O market as they do not view this class as insurable, particularly the large financial institutions. They will write the class only when it is part of a larger professional liability treaty. Late trading/market timing events brought this issue to the forefront as asset managers were once seen as a very profitable line without systemic losses due to a high degree of regulation. Going forward, capacity may increase if

## ERRORS & OMISSIONS

### UK

E&O remains a viable product in the UK market and is considered a growth product by many insurers. Loss ratios have varied, depending upon the line of business. It is predominantly purchased by professional services firms such as accountants, lawyers, and brokers, all generally risky classes of business. Frequency and frequency of severity have been issues, particularly with IFAs. For those classes that have performed well, capacity has not dwindled, but insurers have fundamentally returned to disciplined underwriting. It remains to be seen how new entrants,

this segment, including Independent, Axa, Wellington and Cox. New entrants include W F Berkley and Catlin. The primary market is still dominated by St Paul, Zurich, Ace, QBE, Norwich Union, Hiscox, and AIG. Together, they write 80% of the primary market.

Significant rate increases were achieved in September 2002 although average rate increases in 2003 were less than 10%. The Solicitors' renewal season has not been completed as we go to print however it is expected that for the October 2004 solicitors' renewals that rates will reduce overall reflecting perceived favourable accident year loss ratios.

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reinsurers see an opportunity to make a profit following the post-mutual fund loss.

As the primary market hardened, reinsurers sought to increase revenue to offset expected claims from investment banking losses. For quota share treaties, reinsurers rode the original policy rate increases and increased the ILF curve markedly. Some sought pro-rata premium for ventilated and excess policies on excess of loss treaties.

particularly in the SME sector, will influence these positive trends.

**Lawyers** – Since the demutualisation of SIF, primary £1m of limit has been provided by the open market Law Society "approved insurers". The minimum coverage requirements remain regulated by the Law Society. A number of insurers did not seek to become "approved insurers" and have withdrawn from

losses from policy years 1997 to 2002, with the potential for ultimate loss ratios upwards of 200% depending on your risk selection/market sector. Historically, good results in this class attracted new capacity from the mid-1990s onwards. This sustained a soft market on terms and conditions such as multi-year policies, discounted pricing, increased limits, availability of reinstatements.

Experienced underwriters have responded to these



historical results and turned this market around. Pricing in 2003 was back to 150% of the levels of 1994 and firms with claims should continue to see large increases in rate. The new underwriting environment has allowed for the implementation of more realistic deductible levels and an end to multi-year deals.

These changes have caused some new entrants and capacity to come back to the market particularly due to the perceived 'shorter tail' of the 'claims-made' product.

**Accountants** – Firms experienced a 25% increase in rates across the market with rates beginning to flatten out in 2004. Most firms, except those that participate in both management consulting and auditing, have adequate capacity. The larger second tier accounting firms remain active in purchasing higher limits where feasible.

**Life Insurance Companies** – Regulatory pressures to cure mis-selling practices made this line

difficult to underwrite. This led to substantial increases in the retentions and up to 50% increases in rates in 2003.

**Insurance Brokers** – As the market has hardened, there has been an increase in claims due to more rigorous claim procedures instituted by the insurance carriers. This line is still difficult to underwrite profitably, particularly for large brokers.

#### Continental Europe

From 2002-2004, E&O premiums increased 20%-30%, particularly for accountants and other professional services firms. Capacity dwindled and terms became tighter in some territories. This has attracted new carriers with increasingly favourable terms. While E&O is written on a claims made basis in most continental European territories, in Germany the trigger for E&O policies remains on an errors committed basis. In France and Belgium, professional

liability has had nearly 20% rate increases.

The cost of stand-alone E&O excess reinsurance treaties has not risen significantly as there has not been an increase in severity losses. Still, the trend is probably upwards. E&O is typically protected within larger general liability or motor treaties. As a result, it is often difficult to break out reinsurance rate increases between the general and professional liability components.

#### CLASH

Court cases, such as Parmalat and Royal Ahold, show that insurers and reinsurers have the potential for a major clash of exposures in a business disaster. Covers that may experience claims may include the D&O policies of the collapsed group itself, as well as the E&O policies of other insureds. The accumulation of losses may extend to the following:

- D&O and E&O of banks, fund management companies and other investment institutions, including life companies and pension funds
- Auditors' E&O
- Accountants' E&O
- Tax advisors' E&O
- Liquidators' E&O
- Lawyers' E&O
- Management consultants' E&O.

It is possible to envision other loss scenarios where a D&O coverage may clash with public and product liability policies and employers' liability policies. The possibilities are broad,

and should not be ignored by insurers and reinsurers in risk-capital-based estimations of worst-case scenarios.

## THE REGULATORY ENVIRONMENT

### UK D&O

Increasing accountability of directors continues to challenge insurers, and has a consequent effect on premiums. Throughout 2003, reports were published about corporate governance, including the Higgs Report (on non-executive directors), the Smith Report (on Audit Committees), and the *Final Report of the Co-ordinating Group on Audit and Accounting Issues*.

On November 1 2003, a new *Combined Code on Corporate Governance* came into force, and in December 2003, the Department of Trade and Industry (DTI) published *Director & Auditor Liability – A Consultative Document*. The new code is based largely on the Higgs and Smith reports, and affects listed companies with financial years beginning from that date. The code requires certain disclosures, although there is no

legal sanction for failing to comply at the moment.

Non-executive directors are required to contribute to the company's strategy, monitor the board performance, financial controls and risk management, and be aware of all issues affecting the company. D&O insurance is required to cover legal action against directors and companies. Details of the cover should be available to prospective non-executive directors.

There is an ongoing DTI consultation on the limitation of directors' liabilities where they have acted in good faith or in the honest belief that their decision was in the company's best interests. Options include amending the current section 310 of the Companies Act 1985 to allow for the indemnification of directors by companies and the advancement of defence costs in certain circumstances, or broadening the relief available to directors under section 727 where directors act reasonably and honestly. The DTI is also considering the adoption of the US model of the Business Judgement Rule.

As of January 2004, the Financial Services Authority (FSA) has prohibited insurance cover for fines it imposes. The FSA is considering whether it should be given power to disqualify directors for serious abuse of the Listing Rules.

The US Sarbanes-Oxley Act of 2002 makes directors of UK companies listed on US stock markets subject to SEC regulation. The EU appears aware of the potential conflict, and suggests that efforts have been made to minimise this through regulator-to-regulator relationships.

At the moment, most D&O policies in the UK market do not include entity coverage, and there is some debate as to whether they should. Some policies covering claims against directors and officers when they were not indemnified by their company have been amended and now state that they are "not indemnifiable" by the company. The D&O insurance market appears to be going back to basics, toward pure cover exclusively for directors and officers and to insure losses not indemnified by the company.

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Debates continue regarding severability and judgment/final adjudication for personal conduct exclusions. They are being widened to exclude from coverage those who have admitted a wrongful act, and to enable a denial of coverage before judgment/final adjudication. It is also common to find numerous endorsements excluding recent financial scandals, for example, splits, pensions, endowments, market abuse, laddering and financial restatements.

Other trends include administrative receivers and liquidators seeking to treat the proceeds of the D&O policy as an asset of the company where claims are submitted from directors of an insolvent company for defence costs.

Jurisdictional conflicts for multi-national companies may increase. For example, the 'Insured v Insured' exclusion is unenforceable on public policy grounds in parts of Europe including Germany, Spain, France and Italy. If multi-national companies continue the current

### European D&O

The European Commission recently announced a series of reforms to tighten corporate governance and accounting standards in line with the 2002 US Sarbanes-Oxley Act. Many EU states are already prepared with their own measures. The UK Companies Bill and the German KonTraG (Corporate Control and Transparency Act), for example, raise the exposure level by raising the expected duty of care directors and supervisory board members need to demonstrate to safeguard the interests of shareholders, creditors and members of the public.

It is difficult for individual shareholders to bring actions against directors and officers of a company on continental Europe. Under Italian law, shareholders are basically limited by a ruling which permits only shareholders with holdings in the company of 5% or more to sue. In the Parmalat case, smaller shareholders must join US class actions since Parmalat was listed on the Nasdaq exchange.

It is likely the EU will address shareholder class actions in future

Germany through the new UMAG (Act for Corporate Integrity and Modernisation of Rights to Contest). The UMAG will enable individual shareholders with stocks worth €100,000 to bring a lawsuit. A government website will enable shareholders to join an on-line forums and communicate with other shareholders to form a class action. Until now, derivative stockholders' actions against management boards have been rare because the law (Section 147 of the AktG) had required shareholders owning at least 5% of the stock to join forces before an action could be brought.

Corporate governance responsibilities are likely to expand in such areas as employment practices and the environment. Companies need to show that they are encouraging equal opportunities and diversity in employment practice, that their business policies are socially responsible and supportive of the local community, and are taking an active role in protecting the environment. Failure to demonstrate appropriate



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trend, this may cause problems for insurers relying on such exclusions in London market-written policies in other jurisdictions.

legislation. Measures to increase shareholders' rights and abilities to take action against directors have already been taken in

management policies in these areas may leave European directors and officers exposed to legal liability in future.

**UK E&O**

Generally speaking, E&O claims remain a popular staple of the courts' diets. There have been no major developments in the law of negligence over the past year, however, the following have been noteworthy:

**Actuaries** – Actuaries had a difficult year in the E&O market. Although the number of high profile cases with adverse decisions in recent years has been limited, the liability insurance market has been wary of actuaries' exposure to claims arising from pension funds. Actuaries commonly advise employers and trustees on the value of pension fund assets and liabilities, offering opinions on the level of benefits and contributions. These funds are substantial, and many individual investors are affected by their values. When the financial markets drop, as they have done in recent years, so too do pension fund assets.

**Solicitors** – Recently, larger City law firms are considering a limit on law firm's liabilities under contract, particularly where late night or high-pressure working environments are concerned. It is unlikely, however, that this will find favour with clients or become common practice in the near future.

A number of recent cases on the 'loss of chance' principle suggest that courts are increasingly prepared to compensate claimants for lost opportunities where, even with the correct advice, those opportunities were unlikely to occur.



**Auditors** – Legislation has been introduced to cap auditors' liability. While larger firms hope to see it pass in the autumn of 2004, there is considerable opposition in industry and political circles. Given this environment, these proposals may never reach Parliament.

Case law on auditors' negligence has been in flux for some time, particularly since *Galoo v Bright Grahame Murray* in 1994 where trading losses of insolvent companies were irrecoverable from negligent auditors. *Galoo*, however, raised more questions than answers, and has led to difficulties for claimants and defendants alike. Insurers of defendant accountants particularly, have found it difficult to reserve for claims.

**Surveyors and Architects** – Perhaps the biggest question for

surveyors will be whether the UK experiences another collapse in the property market. After the last crash in the early 1990s, there were a large number of claims against surveyors for negligent valuations. The economic indicators are somewhat different now, so the true impact remains to be seen. It will take a few years for claims to come through.

Both surveyors and architects could be affected by the introduction of the *Control of Asbestos at Work Regulations 2002*. It creates duties for employers and property managers to investigate and assess asbestos risks in commercial properties. Surveyors and architects have been aware of asbestos risks when working with older properties. However, if clients are faced with substantial penalties for non-

compliance as a result of a failure to advise in this regard, clients may well seek to pass those penalties on to the professional.

### Environmental

#### UK

In 2003, the Environmental Agency reported that criminal sanctions against polluters were slowly on the rise: 2002 figures cite 1,712 prosecutions and 34 fines of more than £20,000 compared to 24 in 2001. The average fine for companies was £8,744 – 36% above the previous year, and at least seven company directors were fined personally.

The courts are taking environmental offences more seriously. The trend appears to be for more companies to be fined larger amounts. There were still relatively few civil liability claims for environmental damage, and one high profile group action on water pollution collapsed when it was struck out at an early stage in the proceedings.

#### Europe

In April 2004, the EU introduced a new Environmental Liability Directive. Designed to put “the

polluter pays principle into practice in a comprehensive manner,” according to EU Environment Commissioner Margot Wallström, the Directive must be transposed into domestic law by April 30 2007. It targets the prevention and remediation of environmental damage, and covers damage to species and natural habitats, waters and land (contamination).

The Directive imposes liability on ‘operators’ of “occupational activities” carried out in the course of an economic activity or business undertaking, whether it is private or public, profit or non-profit. Polluters must take remedial action in the case of actual harm or preventative measures in the case of imminent harm.

The Directive will not apply retrospectively, or to an event which occurred more than thirty years prior to the damage manifesting itself. An operator will not be liable for remedial costs after the earlier of five years from the date the costs were incurred, or five years from the date on which the polluter was identified.

The Directive creates a generalised offence of

environmental pollution governed by a two-tier regime:

- a “strict liability” regime for all three types of environmental damage in relation to the high-risk occupational activities, such as landfill sites incineration plants; and
- a “fault/negligence” based regime in relation to operators of any other occupational activity for damage to protected species and natural habitats resulting from that activity.

While many of the liabilities created by the Directive already exist in English law, the extent of the remedial action required and the threshold at which damage (or imminent threat of damage) is said to occur is much lower under the Directive.

The Directive does not require operators to have evidence of financial security or to take out minimum insurance to cover their responsibilities. It imposes an obligation on domestic authorities to draft regulations and guidance with detailed procedures to allow operators, insurers and other parties to quantify potential costs of related liabilities. It is envisaged that any mandatory financial security will have to be phased in gradually enabling insurers and reinsurers to develop capacity and relevant underwriting expertise and experience. Existing property policies are unlikely to cover these risks, due to standard pollution exclusions. The issue of financial security will be revisited before April 2010.

