BEST'S REVIEW

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Navigating Rough Seas

Directors and officers writers find tough economic times give rise to litigation in this rapidly growing market.

by Peter R. Taffae

It has been 15 years since the insurance industry experienced a hard market. At that time, it came quickly, it was decisive, and it swept over the industry like a tsunami. It took about 24 months for the waves to return to sea level.

Some believe the directors and officers market is not as soft as it once was—that premiums were lower in 1984. But those that think premiums are the only measure neglect to consider contract wording, high litigation costs and judicial decisions. These three variables, in addition to premiums, are what make the D&O market the softest ever.

Depending on the insureds' claims experience and industry, premiums have started to reach white-cap levels. Underwriters are beginning the risk-selection process by taking passes. The lack of their profitability over the last few years is forcing underwriters to take a serious look at the coverage, price and selection of their insureds.

It is important to understand what has occurred since 1985 to fully comprehend where the D&O market came from and where it is going.

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Not only have D&O premiums declined over the past 15 years, but the coverage has metamorphosed. The D&O policy of 1985 had a "Takeover/ Greenmail" exclusion, Absolute Pollution exclusion, Payments/Commissions exclusion (also known as the Lockheed exclusion), Failure to Maintain and/or Purchase Insurance exclusion, Insured vs. Insured exclusion and Presumptive Indemnification wording. All of these but the Insured vs. Insured exclusion and Presumptive Indemnification wording have disappeared from today's policies—even when mergers and acquisitions transactions abound, new forms of pollution have been acknowledged and certain types of insurance have either become unavailable or more costly.

One easily could argue that the Presumptive Clause and Insured vs. Insured exclusion were always the intent of D&O underwriters and that clarification became necessary only because of a few innovative interpretations by certain insureds and their counsel. The D&O policy was originally, and continues to be, designed to protect the insureds' corporate directors and officers from third parties. The Insured vs. Insured exclusion (also known as The Bank of America exclusion) was necessary after it was discovered that without the wording, the policy would pay when the parent corporation sued the officers of a

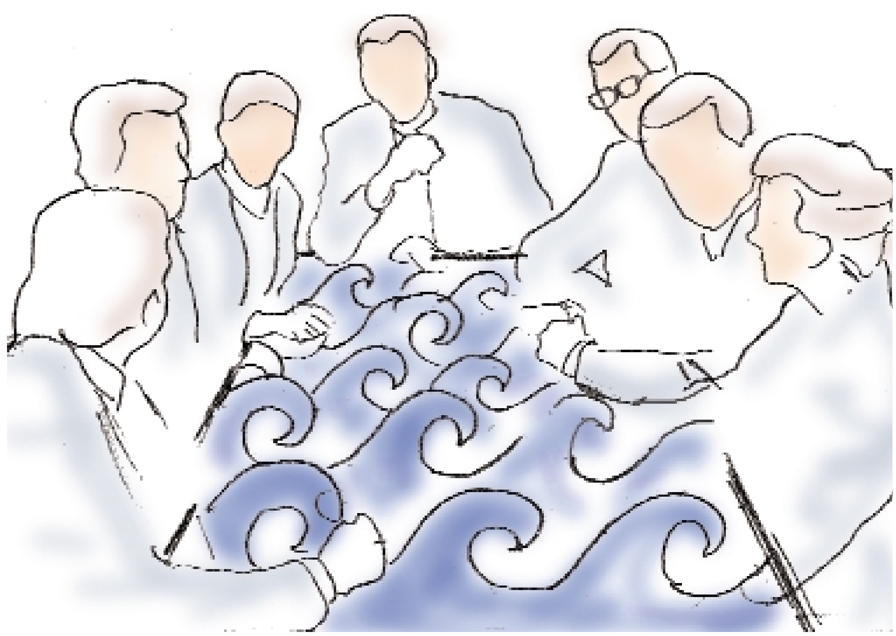


Illustration by Adam Garlinger

subsidiary for its poor business decisions.

Another creative interpretation of the D&O policy arose in 1985 when insureds were forced to substantially increase the "Corporate Reimbursement" retention. A major drug company based in Philadelphia accepted a $5 million Corporate Reimbursement retention to minimize the D&O premium increase. Shortly after the renewal, litigation was filed against the company's directors and officers. The indemnification wording of that D&O policy was so liberal the drug company just refused to indemnify, so the claim moved to the nonindemnified (i.e., individual side) of the policy. The insured saved $5 million just by saying "no." This was never the intent of the policy and demonstrates how important and sophisticated the contractual wording is both from the insured and the insurer perspectives.

Discovery periods have increased from a standard 90 days to one year or more. In addition, in the last five or so years, underwriters have made the discovery bilateral. Historically, discovery was available only to the insured when the insurance company either nonrenewed or canceled a policy.

Allocation of Liability

Many believe the single-most important judicial decision affecting D&O insurance since *Smith vs. Van Gorkon* in Delaware in 1985 was the *Nordstrom vs. Chubb* decision by the 9th Circuit Court in 1995.

For more than 30 years, the issue of allocation plagued the insurance industry. Too often, insureds had to litigate against their D&O carriers to reach an agreeable insurance settlement. The dilemma in D&O insurance settlements was always the allocation of liability among the defendants, usually the directors, officers and corporation. This is especially true in securities claims. Steps were taken to minimize the allocation controversies by assigning separate defense counsel to the directors, officers and the corporation. This helped with expenses. But nevertheless, when the litigation between D&O and the corporation was settled with the plaintiffs, the allocation of liability coverage issue raised its ugly head.

Shortly after the *Nordstrom* decision, Chubb, American International Group and others introduced "allocation endorsements," which changed the course of D&O insurance.

The first endorsement started out with a 70%/30% allocation, with an additional or discount premium offered, depending on the allocation percentage. Within six to 12 months, D&O underwriters were offering 100% predetermined securities allocation at very little or no additional premium.

The effect of this substantial and long-overdue contractual enhancement was monumental. According to most D&O underwriters, entity coverage for securities claims increased loss cost by 50% to 60%. That was no problem, as long as premiums increased by a similar percentage. But underwriters received no additional premium for the increased exposure and, in most cases, due to market conditions, received less. It also eliminated the financial incentive the insured might have to litigate the plaintiffs' allegations.

Although the clarification has greatly increased the working relationship during the claims-settlement process between insured and insurer, the actual paid D&O claim substantially increased.

Another phenomenon that occurred was the advent of multiyear, or "stretched aggregate," policies. Underwriters began deeply discounting premiums in exchange for extending the

Major Federal Class-Action Awards And Settlements

Outcomes of court cases brought by shareholders.
($ Millions)

1980s		1990s	
Rexene Corp.	$145	Cendant Corp.	$2,804
Frank B. Hall	48	Waste Management	220
Walt Disney	45	Phillip Morris	118
Ames Department Stores	41	Ikon Office	110
MGM/UA Communications	35	Chambers Development	95
LA Gear	29	Wedtech Corp.	77
Van Gorkom	24	IDB Communications	75
Revlon	20	Charisma	75

Source: Information compiled by e-perils.com from various sources, including Arter & Hadden LLP.

Hard Market Similarities

1980s	1990s
Then-record number of IPOs	New record number of IPOs
High-yield bonds	Dot-com stock
Large increase of D&O litigation	Largest increase of D&O litigation
High D&O settlements	Higher D&O settlements
Then-record M&A activity	New record M&A activity
Corporate raiders	Dot-com raiders

Available Capacity of Leading Directors and Officers Writers

($ Millions)

Company	1984	1986	2000
Aegis/DOLI	$20	$2	$35
American States	2	N/A[1]	0
Associated	25	5	0
CNA	25	15	50
Crum & Forster	25	3	15
Evanston	25	3	5
Federal/Chubb	25	15	50
F&D	5	2	25
Forum Insurance	10	N/A[1]	0
First State	25	1	50
Harbor	25	5	0
Home	20	0	0
INA	20	5	0
Lexington	10	5	10
Liberty Mutual	25	10	50
Lloyd's	25	10	25
Midland	5	N/A[2]	0
Mt. Hawley	5	1	25
National Union	50	20	50/100[4]
Old Republic	5	4	15
Royal	10	1	10
Scarborough	10	1	0
St. Paul	15	5	50
Tudor	5	3[3]	0
Wausau	10	1	0

Source: Tillinghast-Towers Perrin
[1]Exited Market [2]Rehabilitation [3]1987 [4]NYSE companies only

aggregate limit offering coverage over two or three years. Unfortunately, there was no actuarial value associated with the premium discount. The likelihood of receiving multiple claims on a single policy over a two- or three-year period (the alleged basis for the discount) was minuscule. Thus, the D&O premium base deteriorates further, with no corresponding decrease in exposure.

Legislation Backfires

Most likely, the legislation that had the most impact on the D&O market in the last 15 years was the 1995 Private Securities Litigation Reform Act, which to date has had a negative effect on the overall D&O insurance market.

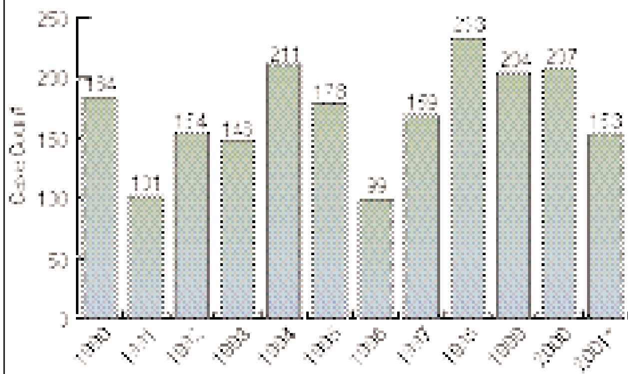
Initially designed to protect its most avid supporters—the technology industry—the legislation has resulted in more claims being filed than ever. The intent was to overtly address the frequency and severity of securities class-action litigation that many companies (especially those in the technology sector) were being subjected to by professional plaintiff firms.

While Congress' intent in passing this legislation was to limit these suits, it actually just shifted some of the rules and the playing field. According to the most recent National Economic Research Association research, securities class-action litigation filed since 1995 has increased. Our study, based on publicly disclosed information, shows a 92% increase in the number of securities class-action cases brought on an annual basis between 1996 and 2000. In addition, in the first 10 months of 2001, our study shows a 74% increase in cases, compared with all of 2000. Now, instead of most of the litigation being filed in federal courts, the state courts are experiencing substantial increases. Because the state courts have a general lack of experience with securities litigation, the plaintiff attorneys have taken advantage of this opportunity. Being forced to switch from federal to state venues has resulted in greater plaintiff successes.

The most significant settlement was the $2.83 billion of Cendant Corp. and its directors and officers in January 1999. The significance of this case, other than a new ceiling being established with such a large settlement, is the fact that the lead plaintiffs were three of the country's largest public pension funds.

Shareholder Class-Action Lawsuits

The number of federal shareholder class-action lawsuits peaked in 1998, three years after the passage of the Securities Litigation Uniform Standards Act.



*Through June 2001
Source: Woodruff-Sawyer & Co.

Cendant was formed by a merger of CUC International Inc. and HFS Inc. in December 1997. Four months later, the newly formed entity announced that it had discovered accounting irregularities at CUC and would restate its earnings. More than 50 shareholder suits were filed after the resulting stock drop, according to a report published in *Securities Litigation and Regulation Reporter.*

Lead plaintiffs in the suit were the California Public Employees Retirement System, the New York State Common Retirement Fund and the New York City Pension Funds. Together, they lost $89 million from their purchases of Cendant securities during the class period, according to the published report.

Passage of the Private Securities Litigation Reform Act greatly increased institutional investors' role in securities litigation. Since 1995, institutional investors have been filing lawsuits against directors and officers with greater frequency. Institutional investors, due to the size of their holdings, most often sustain the greatest losses. Institutions often can present a much stronger claim under Section 18 of the Securities Act of 1934 than traditional plaintiffs present under Section 10(b). In the past five years, this new plaintiff has changed the playing field.

According to published reports, the settlement amounts have steadily increased over the years. In 1984, the average settlement was in the $8 million to $9 million range. Today, excluding the Cendant settlement, the estimates are close to $15 million.

The securities reform act represents another of the liberalizing events in the D&O market without underwriters having a reactionary measure (price or contract) since 1985.

Stormy Seas Ahead

The Internet has had an adverse impact on the D&O industry. In addition to the reduction in the number of dot-com companies and the liabilities arising out of bankruptcies, the efficiencies of the Internet have had an impact. Because of the global nature of the Internet, people all over the world learn of class-action filings in a quick and efficient manner. It is easier and quicker for classes to grow. Attorneys now have helpful insider information e-mailed to them through their Web sites. Corporate message boards and chat rooms can be monitored for anonymous information that potentially leads to directors and officers litigation.

Similarities between the events leading up to the hard market of the 1980s and the current business environment abound.

The D&O market has more than doubled in the last 10-plus years, due largely to the massive increase in the number of companies purchasing this coverage. With an average of more than 400 initial public offerings a year for the last 10 years, there are more than 4,000 new public companies in the United States alone. This large number does not include private companies started or spun off or nonprofit organizations that most likely are purchasing D&O insurance, too. According to a Conning & Co. study in December 2000, the D&O market was just over $2.5 billion in 1987 (post-hard market). Recently, a major D&O underwriter suggested that the 2000 D&O market is about $2.5 billion in written premium. If this is true, the price per insured has monumentally decreased, because of the large increase in corporations buying D&O. We believe the market to be between $3 billion and $4 billion, which is still low considering the pool of insureds. It is important to recognize that IPOs have a great deal of risk involved. This past year's demise of the dot-com initial public offerings clearly demonstrates the catastrophic exposure connected with this form of raising capital. Add the plaintiffs' ability to have hindsight, due to the statute of limitations on securities fraud, and the stakes get higher.

Near Future Looks Dim

Historically, D&O litigation increases during hard economic times. People are less likely to bring securities litigation when stocks are going up. Amid the potentially worst recession since World War II, the near future is not encouraging for those underwriting public D&O insurance.

But brokers and insureds can minimize the repercussions by taking the following steps:

- Choose underwriters with long records of accomplishment for conscientious underwriting—profitability, longevity and commitment.
- The structure of the program will greatly determine its success. Build a program that is proactive with built-in contingencies.
- Choose D&O brokers who have learned from the past and can provide the lessons learned to the insureds' benefit. BR