Special Report

D&O liability insurance

INTRODUCTION

DIRECTORS' AND OFFICERS' LIABILITY INSURANCE IS very much a buyers' market. Over the past seven years, European companies have benefited from increasingly advantageous prices and terms as a result of continuing high insurance capacity.

Yet it is unrealistic to assume that the market will be able to sustain the double whammy of reduced premiums and high business acquisition costs indefinitely. While the credit crunch and economic recession may not have produced the volume of claims expected, other factors are emerging that will increase losses.

Regulators and criminal prosecutors are becoming less forgiving of bad corporate behaviour. Directors and their insurers are having to dig deep to fund the legal expenses of investigations and defending allegations. So-called 'first-party' claims are growing, with companies seeking compensation from directors for perceived mismanagement and for fines levied by regulators or criminal courts. Bankruptcies are leading to a flurry of claims.

These trends have been seen across Europe, particularly in Germany, where the new VorstAG regulation is creating problems.

As recently as 25 years ago, few European companies bought D&O cover; it was a US phenomenon. Now it is not so much a question of whether to buy, but how much. The increasing global reach of companies has brought a growing need for worldwide D&O policies. But global cover does not work for all jurisdictions, so there will always be a place for locally arranged covers.

Few commentators see signs of the D&O market hardening in the short term. But history shows it doesn't take many large losses or an industry-wide shock, such as the recent Japanese earthquake, to trigger a sharp swing in insurance cycles. History also shows that the really big losses are not predictable. If they were, they would never have been allowed to reach that magnitude.

Prudent risk managers will enjoy the buyers' market. But they will alert senior managers to the fact that it won't last forever. SR

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VIEW OVER EUROPE

Directors' cut

Insurance rates for directors' and officers' liability have dropped once again, but claims for bankruptcies, regulatory investigations and criminal proceeding are on the rise

EUROPEAN COMPANIES ARE generally experiencing lower directors' and officers' (D&O) liability insurance rates for the seventh consecutive year. The only exceptions may be businesses that have radically changed their operations or whose risk has increased significantly.

Chartis vice president, financial lines Europe, Géraud Verhille says: "Over-capacity is pushing prices down, with insurers carrying more risk for less premium. Rate reductions are offsetting income from new clients, so the premium pool is stable. In addition, insurers' business acquisition costs are high and growing."

Airmic's 2010 *D&O Liability Insurance Benchmarking Report* shows that, at the last renewal, 14% of UK firms had a premium reduction of 10%-20%; 32% had 5%-10% and 13% a reduction of less than 5%. Only 11% had increases, with the rest staying the same. The downward pattern is being repeated this year for European companies, though reductions are in single figures. Executive director at Willis's FINEX division David Purdy says: "Our renewals and negotiations are finding premiums continuing to fall, although not as dramatically as last year."

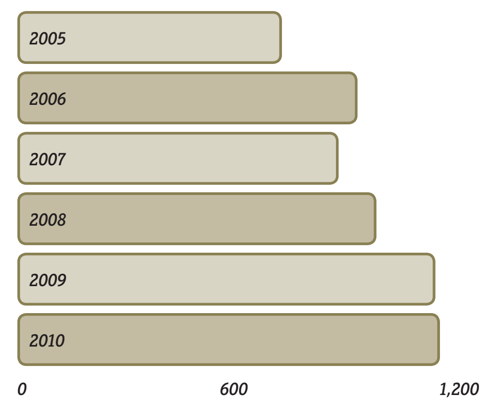
Airmic technical director Paul Hopkin also attributes the drop to a benign claims landscape. "There hasn't been the level of claims expected three or four years ago. With the global financial crisis, it was difficult for shareholders to say individual directors were negligent because all companies' shares went down in value."

While continued softening of the market appears unsustainable, Aon head of European D&O Enrico Nanni says: "There are no signs of the market hardening until there's a reduction in capacity."

The view is that this is a buyer's market: with lower cost has come broader coverage, says Purdy. "In the past six months we've seen carriers tuning wording to clients' advantage."

'Over-capacity in D&O liability cover is pushing prices down, with insurers carrying more risk for less premium' **Géraud Verhille** Chartis

Securities lawsuits



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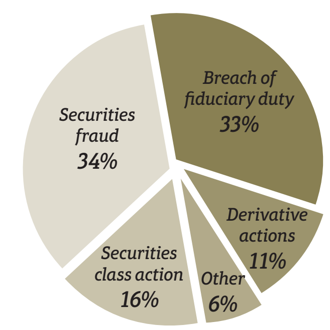

Verhille says: "We are observing the development of older claims as well as more recent bankruptcy and derivative claims on the back of the financial crisis, alongside a general surge in regulatory or criminal proceedings, and investigations and company claims. We have observed a shift in loss profile from low-frequency and high-severity claims, often linked to the USA, to home-grown higher frequency, medium-severity claims out of Europe. This, coupled with decreasing rates and increasing acquisition costs, will translate into an unsustainable outcome for the industry."

With most losses affecting primary policies, dynamics in the excess markets will be different. "These are likely to be hit by securities claims, especially in the USA," Verhille says. "Here, while the number of securities claims in the financial sector has reduced, there's been a steady stream from other sectors, with a shift of allegations from accounting irregularities to operational mismanagement. In addition, bankruptcy proceedings and company claims, typically characterised with severity, will also up the cost for the excess markets. But they may take longer than the primaries to experience the pain and react." And once the market contracts, the swing could be brutal.

What other unpleasant surprises may be on the horizon? Claims in areas such as legal expenses for individuals in regulatory and criminal proceedings are growing, as is the number of proceedings, particularly in the USA, UK, Italy, Spain and France. Unless prices for such cover are adjusted, it may be withdrawn or limited, warns Verhille.

Purdy agrees there is cause for concern over the reach of regulators, particularly for bribery charges under the US Foreign Corrupt Practices Act and UK Bribery Act.

More companies are seeking to recover losses from their directors – for example, for hedging transactions that have gone wrong, or to reimburse fines levied by regulators or criminal courts. With the core function of a D&O policy seen as protecting individuals and settling third-party claims, insurers are watching this closely, says Verhille.

Hopkin says non-executive directors feel particularly vulnerable. Verhille suggests they should focus on the solvency of the companies whose boards they sit on. "The proportion of bankruptcies of subsidiaries and participations far outweighs that of parent companies," he says.

Nanni believes financial institutions should worry about exposure to sovereign debt in countries such as Greece, Portugal and Spain. The Spanish authorities require some banks to raise minimum levels of core capital, forcing them to go to capital markets to raise money, which might also raise these banks' exposure to claims, he says. **SR**

D&O in Europe

01: Lower premiums and broader cover continue.
02: Claims are growing with respect to bankruptcies, regulatory investigations, criminal proceedings and company recoveries from directors.
03: Anti-bribery legislation will increase losses.
04: Non-executive directors perceive high vulnerability.
05: Specific national requirements are increasing exposures.

GERMANY

Those who can, D&O

The recently introduced VorstAG legislation in Germany is putting company directors at greater risk, for which there are two possible insurance solutions

THE GERMAN D&O LIABILITY insurance market shares the characteristics of the rest of Europe, with competition generated by over-capacity continuing to push down premiums and broaden covers. Like other countries, there are no signs of the market hardening in the short-term. However, risk managers are not ruling out a change.

"Everyone has been expecting the big bang to follow after the financial crisis and some prominent corruption incidents," says Bertellsman AG senior vice-president for corporate risk management and insurance Jurand Honisch. "We feel that this may be the quiet before the storm."

Certainly, claims against German directors and officers seem to be rising. "There has been a surge in bankruptcy notifications from the 2008-2010 period," says vice president, financial lines Europe, Chartis, Géraud Verhille. "Limited credit availability keeps this area at greater risk than normal. There's a correlation between the economic downturn and the surge in company claims. But there is also a consistent volume of company claims trying to establish director or officer liability on the back of an underlying breach of fiduciary duty, linked to operational and managerial issues causing financial loss to the company."

Claims made by companies against their directors on the back of hedging transactions gone wrong, or more recently for reimbursing corporate fines and penalties, have become an additional very expensive contributor to market losses, he adds. Such claims initially involve lengthy defence, with insurability and actual individual liability determined case by case. In addition, the German financial sector is experiencing a big rise in claims after the financial crisis, some of which have gained much attention in the national media.

Verhille warns that if the notifications in volume and substance go beyond what other jurisdictions would observe in terms of derivative actions or other third-party claims, the market may need to reassess the format, pricing and/or scope of company claims cover. He says ever greater understanding and use of the D&O policy may generate growing claims activity. In addition, bankruptcy proceedings permeating into claims and criminal proceedings are likely to be a growing trend.

Honisch considers one of the biggest risks for German directors is being held responsible for poor company results. "We are heading towards a US comparable situation where shareholders are the biggest enemies of the executives," he says.

A recent development for German directors was the introduction of VorstAG – Gesetz zur Angemessenheit der Vorstandsvergütung [Law on the Appropriateness of Managerial Remuneration] – from 1 July 2010. One of its provisions is a compulsory deductible for board members of public limited companies that have a valid D&O claim of 10% of the value of the claim, up to one-and-a-half times a director's fixed salary.

As a member of the board of German risk management association DVS, Honisch has discussed with insurers how to deal with VorstAG. He describes two main solutions: "The first is a complete standalone cover for each board member, the second embeds the deductible requirement within the company's existing D&O policy. Standalone policies have the advantage that any claims paid do not erode the primary layer of the company's cover, so don't produce capacity problems. But they do cost more than embedded coverage."

Honisch says discussions with insurers indicate that the split of take-up of the two models is around 50:50. Generally, bigger companies buy the standalone option while smaller ones opt for the cheaper cover.

And there seems to be a question mark as to whether either or both solutions comply with the punitive intent of the law. Honisch says: "We'll have to wait for the first claim, when the legal system may reveal whether one system is better than another." **SR**

CORRUPTION CASES

SIEMENS
Following a record €1bn settlement of corruption and bribery charges in Germany and the USA, together with an estimated €1bn in legal fees, in 2008 Siemens pursued seven former managers, including former chief executive Klaus Kleinfeld, for compensation. It alleged that they failed to stop the bribery, allowing it to continue for two years.

The German press reported that Siemens was claiming between €1m and €6m from its former executives. At the end of 2009, Siemens announced that it had reached compensation agreements with Kleinfeld and five other managers.

MAN GROUP
In December 2009, Man Group agreed to pay €150.6m in settlement of bribery charges.

In February 2011, Klaus Stahlmann resigned as chief executive of Man's Diesel & Turbo division. He is the subject of a continuing investigation into bribery and other alleged claims.

REGIONAL COVER

Buying local

Multinationals need to walk the thin line between consistent, company-wide insurance and protection form country-specific risks

International exposure

01: Assess the trade-off between global and local cover.
02: Determine purchasing strategy.
03: Choose a realistic limit.
04: Review territories and national requirements.
05: Top up the primary limit with excess cover as required.

A NUMBER OF FACTORS AFFECT a company's decision whether to opt for a single group master D&O policy, a global D&O programme or to insure individual operations nationally. Chartis vice president, financial lines Europe, Géraud Verhille says all solutions offer their own benefits and drawbacks.

"Global policies are written in a fairly universal way, which means they provide consistent cover that doesn't discriminate between executives in the group; the cover provided by individual local policies could be quite different to one another," he says.

Independent local policies or those found within a programme allow for local payment, which may not be possible with a global policy underwritten by an insurer that is not admitted in the country concerned. Further, local policies can cover specific national exposures that might not be readily available or even be uninsurable in the country where the global policy is issued. The reverse is true as well. The global policy might pick up exposures not readily available or insurable in some jurisdictions.

Another consideration is that capacity is shared in a global programme, whereas independent local policies only share capacity between local directors.

With just a limited number of multinational insurers possessing the practical network capabilities for global coverage, there's likely to be more competition for single global policy solutions than for global programmes. But economies of scale generally make global programmes more attractive than paying lots of individual premiums for local policies. Also, says Verhille, firms should consider whether they actually need a specific policy in countries where the group's exposure is limited.

In practice, many large European multinationals already have global D&O policies. Risk managers thinking of taking the plunge into a programme or multiple policy logic have much to consider. Adequate solutions for insureds will range from the simple to the more complex: given the time needed for due diligence, finding the right provider and implementing such solutions, it is important risk managers engage their broker and insurers early on.

What to consider

Multinational companies should identify their purchasing policy to decide what cover they need, says JLT head of D&O liability Mike Lea. Do they simply want to protect the directors (so-called side A cover) or include protection for the company's balance sheet where it indemnifies executives (side B)? Is the balance sheet robust enough to take an uninsured hit?

After that comes the question of how much. Working out the limit needed is likely to require benchmarking. Lea says: "This generally involves limit comparison and exposure analysis. The risk manager will probably talk to a broker to see what limits similar companies buy and how his company's exposure differs from its peers."

The company's cover needs come next. "Multinational companies need to identify the countries where they face D&O exposure and national idiosyncrasies," Lea says. "There are different regulations, even in Europe. For example, German directors of public companies face personal liability under Vorst AG (see previous page).

"Finland, the Netherlands and Sweden have issues around companies' indemnification of directors," he adds. Swedish firms need shareholders' approval.

In some countries, premiums for standalone policies for directors are treated as benefits in kind, so the directors have to pay tax on them. There may be provisions on issuing policies in local language. France has specific rules on retroactive cover, which effectively mean that companies acquiring a French subsidiary are liable for its actions before the date of acquisition.

Those are just some of the differences in Europe alone. But worldwide, the variations proliferate, reflecting different countries' regulations and codes of conduct.

> *In some countries, premiums for standalone policies are treated as benefits in kind, so the directors concerned have to pay tax on them*

Making your choice

Following all this essential background work is the crucial decision of what type of cover to go for. Usually, it isn't a simple choice between one global policy or a number of local covers, but a compromise with a master global policy supporting local arrangements in countries where the global policy may not be effective. The wide-reaching nature of the global policy means it is important to choose a carrier with expertise in handling claims worldwide.

"Where countries require locally placed insurance, the risk manager will need to work with an insurer that has the capability to issue these, or brokers represented in these countries that can buy locally," says Lea. " If the local policy cannot be tied to the global policy, there may be duplication of cover." And, of course, buying local cover means paying local premium income tax.

Difference in conditions and difference in limits provisions in a global master policy can protect directors in jurisdictions where the locally admitted insurance falls short, although indemnification needs careful handling to avoid falling foul of national regulations. On the plus side, D&O claims are fairly rare against operations in such jurisdictions.

The final step in arranging a primary global D&O policy, says Lea, is considering how to place any excess cover, reflecting the total capacity required by the business.

As Airmic's *D&O Liability Insurance Benchmarking Report 2010* sums up: "While it is essential to have a global D&O insurance policy that provides high limits and broad protection, it's equally important to have local D&O policies to protect foreign executives in jurisdictions where the global policy may not be effective." SR