

THE HISTORY AND EVOLUTION OF D&O INSURANCE

PRESENTED BY:

*LANCE DALZELL-PIPER, EDGEWOOD PARTNERS INSURANCE CENTER
SEAN BURKE, WHOLESAL TRADING CO-OPERATIVE INSURANCE SERVICES*



October 26, 2011

D&O Insurance- Corporate Facts of Life



The Corporate Facts of Life:

- Individuals serving as Directors or Officers of a public Company face significant legal exposures and personal liability.
- Directors and Officers carry personal liability for the management of the Company. The theory of personal liability is to encourage businesses to observe legal requirements and avoid damage to third parties.

Where do liabilities arise for Directors and Officers?

- Duty of Care and Loyalty to Shareholders
- Securities Acts of 1933 and 1934
- Private Securities Litigation Reform Act (PLSRA) 1995
- Sarbanes Oxley Act (SOX) 2002
- Frank Dodd Act 2010

D&O- The Early Days

Lloyds of London introduces first Directors and Officers Liability Contract in the 1930's:

- Great Depression led to Significant Legal Reforms in US- Securities Act of 1933 and 1934 (Rule 10b-5), Investment Company Act of 1940
- At the time, Corporations were not permitted to indemnify their Directors and Officers
- Personal Finance Protection Insurance is created in response to new regulations.
- Very few purchased the coverage perceiving little risk and the insurance didn't sell.

It wasn't until the 1960's that the Insurance took hold- what changed?

- 1940's and 1950's many state legislatures enacted laws allowing for Corporations to indemnify Directors and Officers
- Company Balance Sheet's now become exposed via indemnification agreements with Directors and Officers
- Insurers revive "Personal Finance Protection" for Directors and Officers and it becomes a viable risk transfer solution. Markets other than Lloyd's of London start offering coverage.
- Data suggests that less than 10% of corporations carried D&O Insurance in 1965, whereas by 1971, 70-80% of major corporations purchased coverage.

D&O Insurance- Policy Construct, 1970's- 1994



The Basic D&O Contract, Personal Insurance and Balance Sheet Protection:

- Side A- Individual Insured coverage for Directors and Officers for loss including Defense Costs. This protects the D&O when indemnification is not available:
 - The Corporation may be legally prohibited from Indemnifying the Director or Officer such as against a Shareholder Derivative Suit
 - The Corporation withholds indemnification
 - The Corporation is not financially solvent and unable to indemnify- bankruptcy, liquidation

- Side B- Corporate Reimbursement for indemnifying Directors and Officers. Typical language of the Insuring Clause mirrors that of the Side A Insuring Clause; however, Side B Coverage is subject to a Self Insured Retention or Deductible whereas Side A has no SIR or Deductible.

D&O Insurance- Policy Construct, 1970's-1994

Protects the Individual

Side A Coverage

- Covers Directors and Officers Liability for non-indemnifiable loss; Direct coverage for Directors and Officers
- Examples of non-indemnifiable claims:
 - Derivative Lawsuits
 - Insolvency
 - Duty of loyalty

No Retention

Protects the Company's Balance Sheet

Side B Coverage

- Covers Reimbursement of Directors and Officers liability for indemnifiable loss by the Entity
- Indirect coverage for Directors and Officers

Retention Applies

D&O Insurance- Policy Construct

Basic Coverage Principals of early D&O contracts included:

- The Policy Form is written on a “Claims Made Basis”. The Claim against the Insured(at this stage that meant ONLY Directors and Officers) has to be made during the policy term.
- D&O utilizes Continuity Dates and Prior Acts Exclusions versus Retro dates differing from Professional Liability (E&O policy) Contract Language.
 - The first notice of litigation, or possible litigation, in the form of a service of suit or administrative agency notification, must occur after the specified prior and pending litigation date.
- Policies did not have strong severability provision for Exclusions or the Application
 - An overriding principal in D&O today is that Bad Actors do not nullify coverage for innocent Insureds
- Policies cover all the Directors & Officers of the Company & its subsidiaries- it is not written on a scheduled named insured basis.
 - Past, present and future directors and officers are covered.
 - Directors are easily identifiable, Officers refer to employees occupying a management or supervisory role.
- Defense costs –Legal Costs means legal and professional fees and expenses reasonably incurred in the defense of actions, suits or proceedings and appeals there from as well as the cost of appeal, attachment and similar bonds. This does not include overhead or benefit expenses associated with salaries, wages and fees.

D&O Insurance- Policy Construct, 1970's -1994

Common Exclusions found in the D&O Form:

- Other Insurance Exclusions:
 - Coverage Excluded that is typically found in other Insurance products:
 - Bodily Injury (General Liability)
 - Property Damage (Property Insurance)
 - Workers Comp Exclusions
 - Employee Benefits Exclusion
 - Pollution Exclusion (coverage carve back for Shareholder Derivative Suits)
- Nuclear Exclusion
- Personal Conduct Exclusions(dishonesty/personal profit), No Final Adjudication Language
- Prior and Pending Litigation Exclusion/Prior Acts Exclusion
- Major Shareholder Suits Exclusion at 15-20%
- Future Securities Offering Exclusion
- Criminal Fines and Penalties.
- Insured v. Insured Exclusion

D&O Insurance- Litigation Developments in the early 80's

Per the Wyatt Survey, the value of Settlements and Defense Costs increased as dramatically which was of major concern to Insurers:

Year	Average Cost of Paid Claims (excluding Legal)	Average Defense Costs
1980	\$877,361	\$318,255
1984	\$1,306,000	\$461,000
1986	\$1,988,200	\$592,000

Adjusting these figures to 1967 Dollars, the increase outpaced inflation considerably- average claim costs went up more than 50% and defense costs increased 35%. By the mid/late-80's, the D&O market had a profitability crisis on it's hands. Compounding problems were the Stock Market crash of 1987, bank and oil company failures and capacity pressures faced in the reinsurance market.

D&O Insurance- Litigation Developments in the Mid 1980's

Carrier response to changing industry economics:

- Many carriers retreat fully from the industry segment- 8 of top 10 D&O Insurers by number of D&O accounts between 1975-1984 leave the market.
- 1985-6 saw only 3 main insurers providing D&O (Lloyds/London, AIG and Chubb)
- 80% of firms reporting to 1986 Wyatt D&O Survey saw premium increases on renewals in excess of 200%
- Deductibles increase dramatically
- With less competition, coverage becomes more restrictive and number of exclusions on policies increase
- Extend Reporting Provisions and Cancellation Clauses change to be more favorable to carriers
- Carriers reduce limits they are offering on renewal with the average policy limit decreasing by 50% in 1986.
- Many policyholder-formed insurance groups are developed to address capacity needs of the market(mainly in the FI and Energy sectors)

D&O Insurance- The Early 1990's Contract

- D&O Contracts are primarily written with two insuring- Side A and B.
 - Side A provides coverage to directly to Directors and Officers.
 - Side B reimburses the corporation for Indemnifying Directors and Officers
 - There is no coverage for the Corporate Entity for their liabilities outside of indemnification of the D&O's

- What happens at the time of settlement? Allocation...
 - Corporate Entities are treated as a Natural Person in the eyes of the Court and carry their own liability
 - D&O policies have allocation provisions limiting contract proceeds to Directors and Officers only and corporate reimbursement indemnifying those D&O's.
 - The 1994 Wyatt D&O Liability Survey reported an average D&O allocation on a securities settlement to be 60% of the Settlement Value paid by the policy. A \$3,000,000 settlement on average would see a D&O program pay \$1,800,000.

D&O Insurance- 1990's Court Decisions and Tort Reform Reshape Industry

Hardening Terms, Conditions and Rates along with improved economic environment attracts significant capacity back into the market in the late 80's and early 90's (ACE and XL formed). As the 90's unfold there are two seminal events that have changed the D&O industry indelibly:

➤ The Nordstrom Decision

- April 14, 1995, the U.S. Court of Appeals for the Ninth Circuit upheld a District Court's 100% allocation to the D&O insurance policy of a settlement in a Federal Securities law claim.
- The Insurer unsuccessfully argued that the corporation was a co-defendant with the D&O's and that a portion of the \$7.5m settlement should be allocated to and paid by the corporate entity, not the D&O policy.

➤ The Private Securities Litigation Reform Act of 1995

- The most impactful Securities Law since the enactment of the Securities Act of 1933 and The Securities Act of 1934
- An attempt at Tort Reform to curtail frivolous securities litigation
- The passing of the Reform Act was an expected victory for D&O Insurers and Corporations

D&O Insurance- 1990's, The Impact of Nordstrom

- The Nordstrom Court ruled:

- While a corporation may have direct liability for securities fraud the insurer failed to show that any such direct liability increased the settlement amount
- A portion of a settlement amount for which both the defendant D&Os and the corporation are liable may be allocated to the corporation only to the extent there is some amount of corporate liability that is both independent of and not duplicated by liability of the D&Os.

In other words, the settlement may be allocated to the corporation only to the extent the corporation alone is liable for a particular claim or to the extent the corporation's liability exceeds that of the D&Os. This allocation methodology is referred to as the "larger settlement rule".

- This judgment had enormous implications and carriers realized they potentially had far larger exposures than they had priced for and would either have to revise coverage terms or increase premiums.
- However, within six months, good news for Insurers was short to follow with the PSLRA becoming effective in December of 1995

D&O Liability- The impact of the PSLRA

The Private Securities Litigation Reform Act of 1995 went into effect on December 22, 1995 passed by Congress as part of the “Contract with America”.

- The goal was to curtail frivolous lawsuits that many corporations argued was tantamount to blackmail as Defense Costs often far outweighed Settlements.
- There were 220 Securities Lawsuits filed in 1994
- This was a 41% increase over 1993 filings and 30% over the average filings of the prior three years

“A Wall Street Journal news article aptly sums up the primary problem with the state of the tort system at the time. The article recounts the story of a Mr. Hutchens , a plaintiff who filed more than 30 shareholder fraud cases and convinced several companies to settle for relatively low amounts. These settlement amounts represented almost pure profit for Mr. Hutchens, because as he never actually owned any stock of the companies that paid him off. Additionally, his overhead was low since, as the Journal notes, “His rent is covered by the government- because his place of business is a 6-by-12 foot cell in federal prison” According to the article, Mr. Hutchens was serving time for attempting to bilk the IRS out of ill-gotten tax refunds”

- PricewaterhouseCoopers, 2002 D&O Insurance White Paper, Page 2

D&O Liability- The impact of the PSLRA

How did the PSLRA effect D&O Litigation?

- Mitigated nuisance claims by requiring that a pleading create a “strong inference” of scienter
 - In alleging scienter under the PSLRA, the plaintiff must, “with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” 15 U.S.C. § 78u-4(b)(2).
 - This allows defendants to obtain dismissal of cases where the plaintiff merely points to a false statement alleging the defendant must have known the statements were false by virtue of their position with the corporation. This requirement is more difficult to prove without the benefit of discovery which the act allowed to be stayed “during the pendency of any motion to dismiss”.
- Was the PSLRA Successful? Initially....
 - Filed Securities claim dropped from 220 in 1994 to 122 in 1996

D&O Liability- The impact of the PSLRA

- The Insurance Industry welcomes the tort reform and starts to soften dramatically:
 - Insurance Capacity increases dramatically. Capital was infused into the industry and more competition was attracted to the D&O market with the promise of better litigation environment going forward.
 - With additional capacity premium rates saw considerable pressure and started falling considerably. Premium rates were reduced by over 50% from 1996 to 2001.
 - Insurers start to offer 3 year single aggregate policy terms at discounted prices just as corporate valuations begin to climb dramatically.
 - Insurers broaden the D&O contract in several key areas...

D&O Insurance- Post PSLRA D&O Insurance Contract

- In 1994, the average D&O settlement saw 60% of the allocation of loss attributed to the D&O Contract with Side A and B provisions. The Nordstrom decision put the industry on notice that future allocation battles may not be successful. Emboldened in part by Tort Reform, the contract evolved:
 - Side A is designed to protect the individual directors and officers of the company when a covered claim brought against them is non-indemnifiable.
 - Side B is triggered if the covered claim brought against an individual officer or director is indemnified by the company. Side B provides reimbursement for the company and indirect coverage for the individual officer or director.
 - Side C provides coverage for claims brought against the company and is limited to coverage for securities claims only.
 - Additionally, other coverage provisions evolve to the benefit of the Insured such as Final Adjudication Language becomes more standard and Severability provisions evolving.

D&O Insurance- Post PSLRA D&O Insurance Contract

Protects the Individual

Side A Coverage

- Covers Directors and Officers Liability for non-indemnifiable loss; Direct coverage for Directors and Officers
- Examples of non-indemnifiable claims:
 - Derivative Lawsuits
 - Insolvency
 - Duty of loyalty

No Retention

Protects the Company's Balance Sheet

Side B Coverage

- Covers Reimbursement of Directors and Officers liability for indemnifiable loss by the Entity
- Indirect coverage for Directors and Officers

Side C Coverage

- Coverage for the Corporate Entity
- Applies to securities claims only

Retention Applies

Both Side B and C are subject to a retention;
but they typically differ in amount

D&O Liability- Post PSLRA Reality

Reduction in Class Action Filings are Short Lived:

- Frequency of Securities Litigation Increases dramatically:
 - 122 Securities Fraud Litigation Cases filed in 1996
 - 167 Securities Fraud Litigation Cases filed in 1997
 - 245 Securities Fraud Litigation Cases filed in 1998
 - 207 Securities Fraud Litigation Cases filed in 1999
 - 201 Securities Fraud Litigation Cases filed in 2000
 - 483 Securities Fraud Litigation Cases filed in 2001 (inclusive of IPO Laddering Cases)

- Severity of claims are Severe:
 - From 1996 to 2001 settlement values increase 150% from \$7m to \$17.2m
 - During this time, with massive capacity infusion to the D&O market, premiums dropped 50%

D&O Liability- Post PSLRA Reality

Factors Contributing to Frequency and Severity issues:

- Restatements by Corporations increase from 116 in 1997 to 270 in 2001.
 - Settlements in 2001 involving accounting errors settled on average of \$23.70m
 - Settlements in 2001 not involving accounting settled on average of \$7.8m
- Accounting Rules do not keep up with new Financial Instruments
 - Accounting becomes more complex and application of current and new rules to financial instruments were not fully understood arising many restatements.
- The SEC took a far more activist approach
- Plaintiffs Bar is far more focused on litigation that pass the requisite scienter set forth in the PSLRA
- Far larger stock valuations equate to far larger losses
- Carriers are no longer sharing risk as they bear 100% of settlement costs. Loss costs, inclusive of Defense Costs, for the D&O industry increased from \$427m in 1996 to \$5.6b in 2001

D&O Insurance- The 2000's

- The early 2000's finds the D&O Industry in a failed economic state.
- A couple major D&O carriers go insolvent (Kemper and Reliance)
- Reinsurance Markets are finding themselves over exposed to the D&O market
 - Many of the newer players to the D&O market reinsure 75-90% of their portfolios
 - Reinsurers support multiple market entrants and have an aggregation issue with losses
 - Many Reinsurers leave the market or reduce capacity
- Carriers increased their exposure to claims 40-50% with the addition of Side C Entity Coverage to their contracts without pricing for the exposure. Further pricing decreased over 50% from what Side A and B only contracts were priced at in the mid-1990's.
- Accounting Scandals and IPO Laddering Cases lead to a new set of Regulations in Sarbanes-Oxley Act in 2002.
- The New Industry Economics are here to stay, how do carriers respond?

D&O Liability- Evolution of Underwriting and pricing of risk.

- Carriers become more focused to underwrite with a high level of due diligence. It is common for underwriters to request meetings with Senior Executives to address key risk factors such as:
 - Financial performance compared to peers and industry
 - Stock performance
 - Quality of balance sheet, liquidity risk management / capital adequacy and debt maturities
 - Cost cutting initiatives
 - Product Development
 - Regulator Compliance- SOX 404, Regulation FD, Insider Trading Policies
- Rates increase significantly from 2002-2004
- Unlike mid-80's, capacity remains strong-market does not see catastrophic increases or coverage restrictions that occurred in mid-80's
- Post 9/11, New Bermuda Insurer's become strong participants in the Industry (AWAC, AXIS, ARCH)
- Capacity is managed more carefully, multi-year policies no longer available.

D&O Liability- 2000's, New Product Development



Higher Settlement Values, Implications of Entity Coverage in the D&O program lead to new product development and opportunities:

- “Side A” Only Excess Insurance becomes a regular part of Insurance programs
- By the late 2000's, “Side A” evolves into a difference in conditions contract (SIDE A DIC) as a market norm
- Independent Director Liability Contracts are introduced

Additional Program Coverage Considerations

Side A DIC

A dedicated Side-A only policy is regularly purchased to sit excess of the primary and/or excess A-B-C D&O policies. It will also drop down to first dollar coverage under specified circumstances, including bankruptcy of the company (called a difference-in-condition provision).

Side-A DIC policies are offered to ensure that if the company goes bankrupt, the coverage will protect the directors and officers and will not be considered a part of the company's bankruptcy estate.

This extra layer of protection provides true "sleep insurance" ensuring that limits won't be eroded by the company and will remain for the benefit of the directors and officers.

Typical Side-A DIC Coverage Enhancements

- Non-rescindable coverage
- Full severability
- No ERISA exclusion
- Narrow bodily injury/property damage exclusion
- Broader definition of a claim
- No presumptive indemnification wording
- Limited insured versus insured exclusion
- No pollution exclusion

D&O Liability- Side A DIC

Traditional Excess:
Coverage typically applies excess and “follow-form” of the primary policy.

(Follow Form Excess of Insuring Clauses A, B & C)

Major Difference:
A-B-C Excess coverage is shared with the corporation and is subject to the same exclusions as the primary layer.

Side-A DIC coverage only applies to Directors and Officers and does not share limits with the corporation.

Major Difference:
Side-A DIC coverage is available to all directors and officers, whereas IDL coverage is available only to independent directors allowing Independent Directors dedicated limits not shared with inside Directors or Officers.

IDL: Coverage mirrors Side-A DIC coverage, but provides separate limits for Independent Directors.

-Helps attract and retain independent directors
-Provides true “sleep” insurance for independent directors

Side-A DIC: Coverage for Directors and Officers for Non-Indemnifiable Losses (under Insuring Clause A); also applies excess of primary A-B-C coverage.

Key Benefits:

- Difference in Conditions coverage terms (i.e. broader coverage terms and various exclusions not included)
- Drop Down Availability when the underlying insurance is not available (i.e. Coverage dispute with primary carrier, or Primary coverage frozen/in dispute because of bankruptcy)

D&O Liability- Market Trends, where are we today?

- Federal Securities Fraud Class Actions (filings or class actions) were up 5% in 2010 v. 2009 (176 v. 168). However, the second half of the year saw activity jump as 104 filings were made compared with 72 in the first half. 145 so far this year-on track for about 180 filings in 2011.
- Filings related to the credit crisis decreased 76.4% from 55 filings in 2009 to 13 filings in 2010. This represented just 7.4% of the overall filings in 2010 compared with 32.7% in 2009.
- Non-credit crisis filings returned to 2005 level with a particular focus on M&A related filings (breach of fiduciary duty) and filings against for-profit colleges (deceptive recruiting and poor student loan repayment rates) as well as a trend of Chinese companies being subject to new filings (32 YTD).
- Median Settlement Values increased 31% to \$11.1m in 2010 v. \$8.5m in 2009.
- The Average Settlement Value was \$37m in 2010 versus \$29m in 2009.

D&O Liability- 2011 Expectations

- Commercial rates appear to be near a low point, although there is still aggressive competition particularly in excess layers
- Incumbent carriers have started to manage the magnitude of premium reductions on renewals
- Companies with material changes in their risk profile should expect to see premium increases commensurate with the change in risk.
 - Examples include companies significantly impacted by adverse credit environment or with liquidity or cash flow problems
 - In addition to higher D&O premiums, these companies may also face more restrictive terms or higher retentions
- Capacity:
 - D&O capacity for A-side only and A,B,C combined is approximately US\$1.5 billion; the maximum capacity likely to be deployed on a risk is \$700 million
 - 2010 saw no less than 5 new entrants into the industry space.

D&O Liability- 2011 Expectations



Where are there heightened exposures?

- Initial Public Offerings
- Subsidiaries with Outside Shareholders
- Joint Ventures
- Capital Raises
- Mergers & Acquisitions
- Major Restructuring
- Opening branches/subsidiaries overseas
- Foreign Listings on US Exchanges
- Research and Development Companies-notably Life Sciences

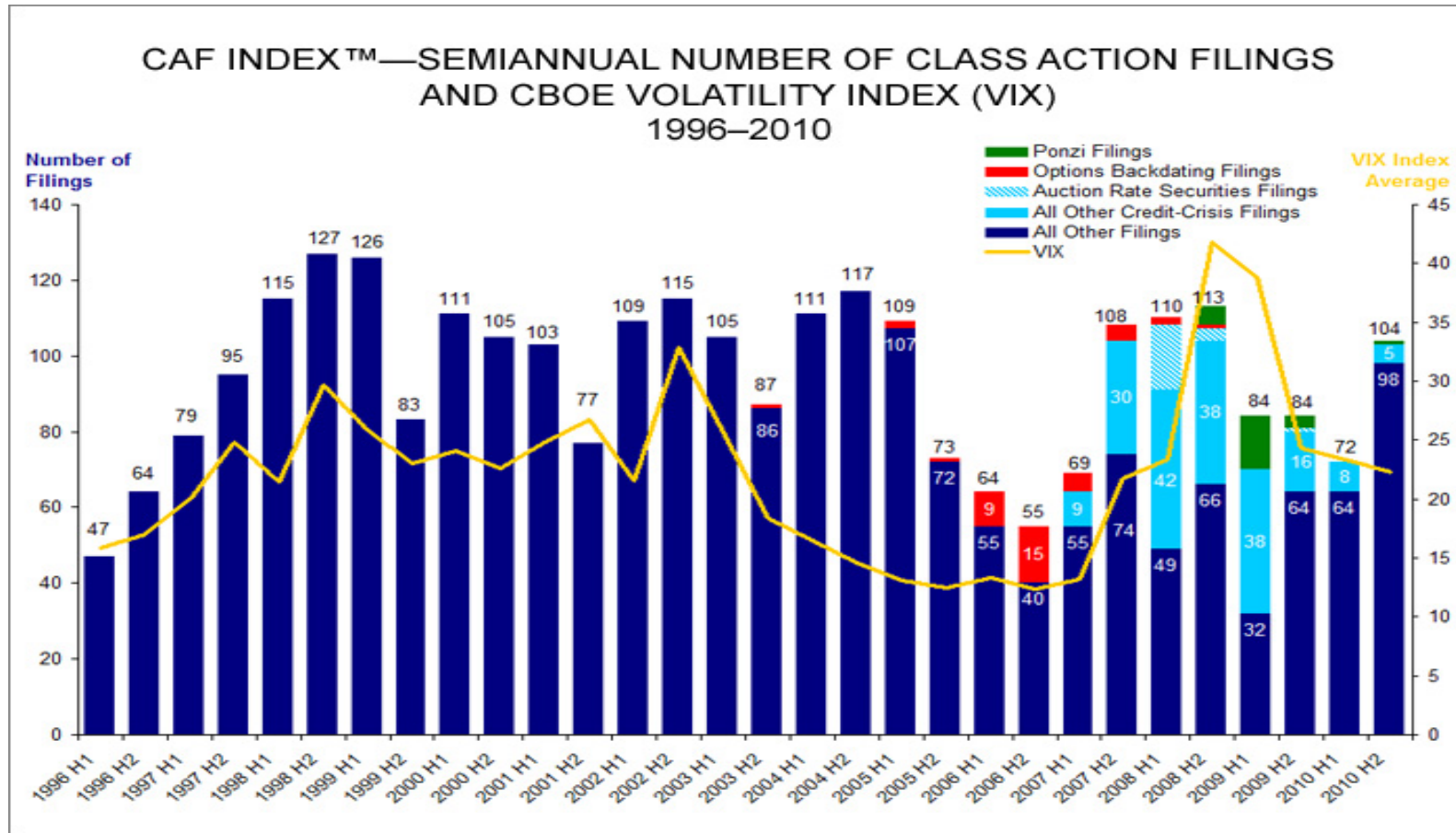
D&O Liability Insurance



Litigation and Benchmarking Statistics

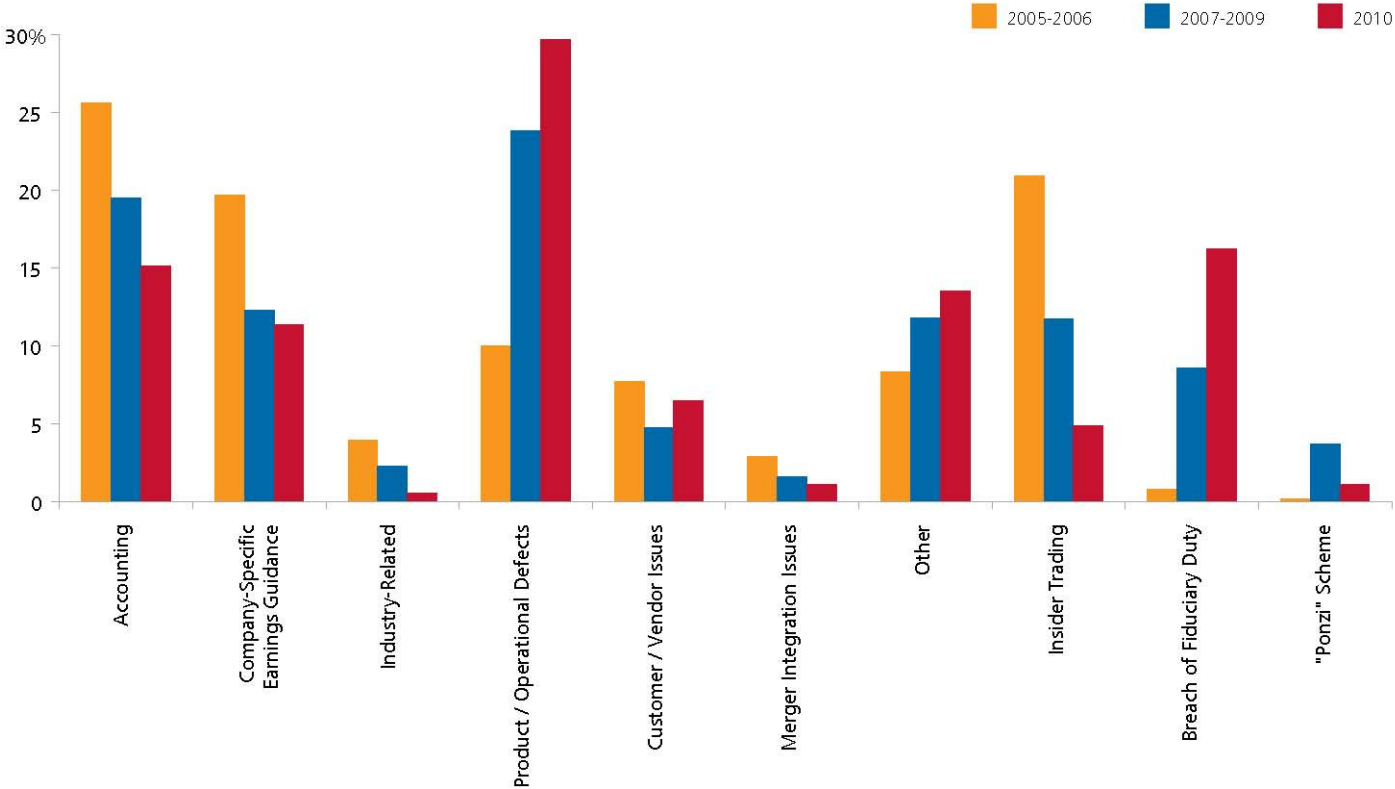
Shareholder Class Action Filings

Securities litigation activity can be correlated to stock market volatility as measured by the Chicago Board of Options Exchange (CBOE) Volatility Index (VIX)



Allegations in Federal Filings

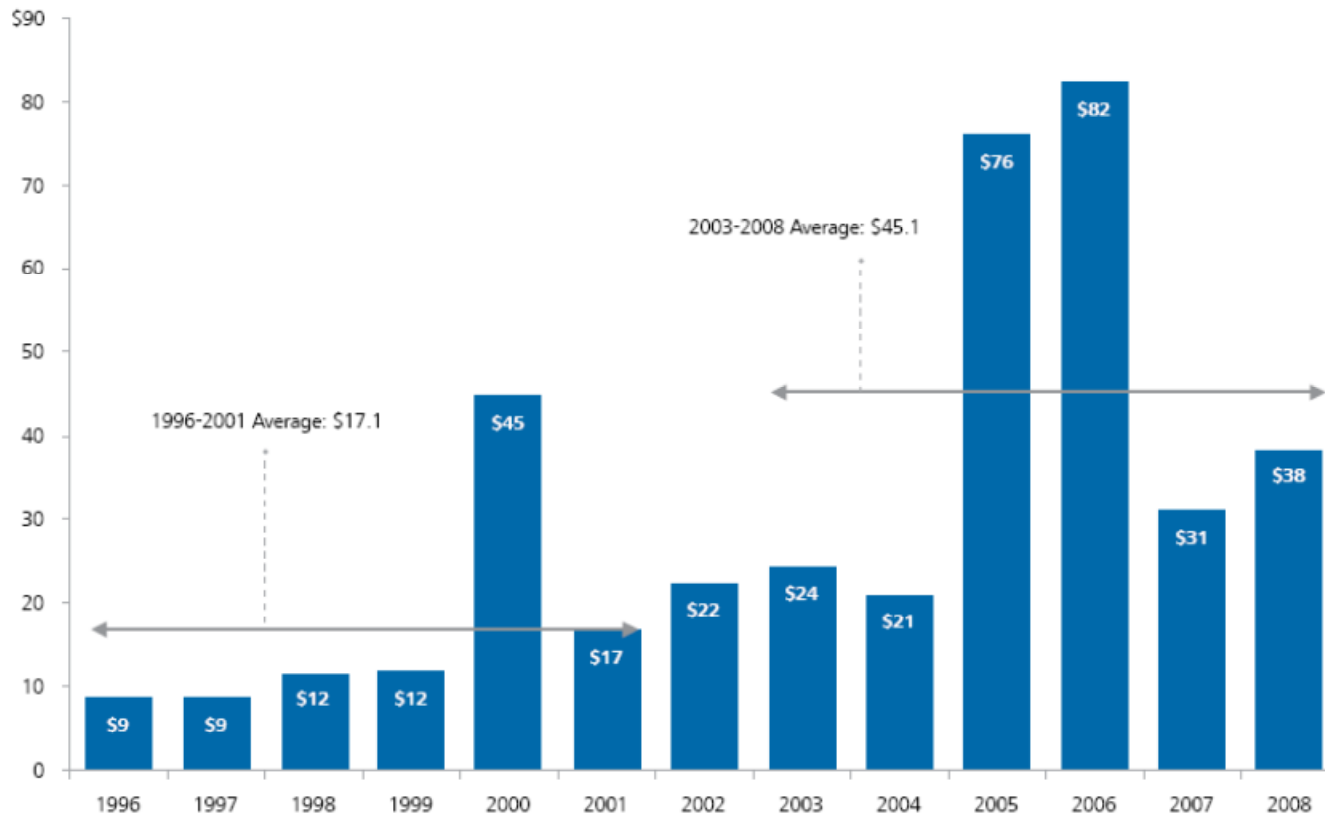
Figure 11. **Allegations in Federal Filings**
January 2005 – November 2010



Source: NERA Economic Consulting, Trends 2010 Year-End Update: Securities Class Action Filings Accelerate in Second Half of 2010; Median Settlement Value at an All-Time High

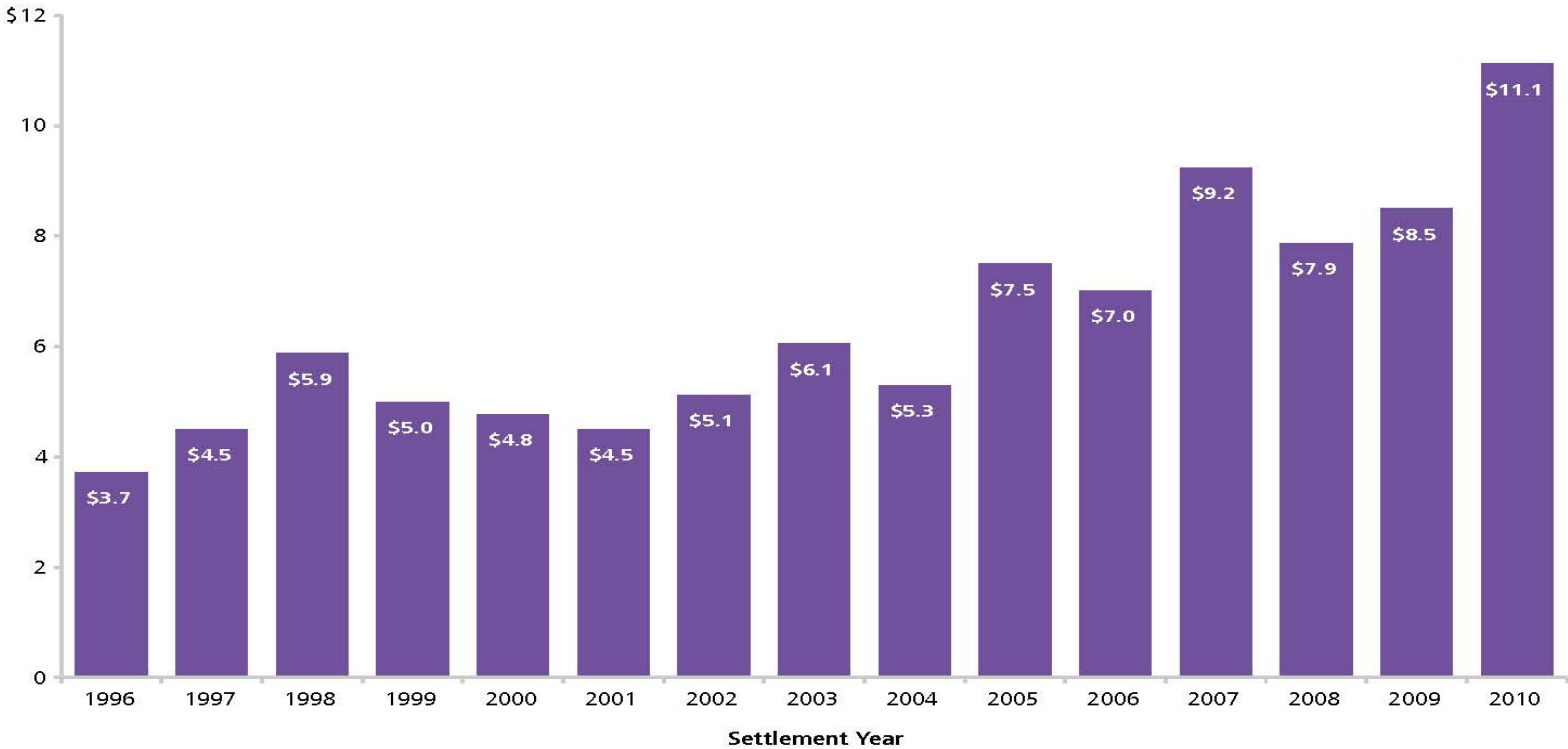
Average Settlement Value

Figure 10. Average Settlement Value (\$MM), All Cases
January 1, 1996 – December 31, 2008



Median Settlement Value

Figure 18. **Median Settlement Value (\$MM)**
January 1996 – December 2010



Notes: Settlements exclude IPO laddering cases.

Source: NERA Economic Consulting, Trends 2010 Year-End Update: Securities Class Action Filings Accelerate in Second Half of 2010; Median Settlement Value at an All-Time High

Top Ten Settlements

Settlements of Post-Reform Act Securities Class Action Lawsuits in Excess of 1 Billion

Rank- Litigation Name	Filing Date	Settlement Amount
1. Enron Corporation	10/22/2001	7185.5 Million
2. WorldCom, Inc.	04/30/2002	6128.26 Million
3. Tyco International, Ltd	02/04/2002	3200 Million
4. Cendant Corporation	04/16/1998	3186.5 Million
5. Nortel Networks Corporation (Nortel I and II)	02/16/2001	2935.9 Million
6. Salomon Smith Barney, Inc.; Citigroup; WorldCom	05/14/2002	2650 Million
7. AOL Time Warner, Inc.	07/18/2002	2500 Million
8. Koninklijke Ahold NV: Royal Ahold Corporation	02/25/2003	1100 Million
9. McKesson HBOC, Inc.	04/28/1999	1032.5 Million
10. AT&T Corporation	10/27/2000	1000 Million

Note: Settlement values may include securities as well as cash. Securities are valued as of the highest value asserted by any party in a court filing. Settlements include proceeds from all sources. Not all settlements have received final court approval. Settlement values in some cases may still increase as additional defendants settle claims.

PEER LIMITS & BENCHMARKING

Total Limits: Tillinghast-Towers Perrin 2008 Directors and Officers Liability Survey

By Market Cap in Millions	Participants Reporting	First Quartile *	Median †	Third Quartile ‡	Average
Under \$10 million	56	\$3.00	\$6.50	\$15.00	\$17.09
\$10 - \$50 million	110	\$6.75	\$10.00	\$15.00	\$16.45
\$50 - \$100 million	68	\$10.00	\$15.00	\$20.00	\$15.75
\$100 - \$400 million	160	\$15.00	\$20.00	\$30.00	\$22.27
\$400 million - \$1 billion	88	\$20.00	\$25.00	\$35.00	\$28.16
\$1 - \$2 billion	58	\$30.00	\$36.50	\$50.00	\$42.51
\$2 - \$5 billion	25	\$39.00	\$50.00	\$62.50	\$53.72
\$5 - \$10 billion	22	\$47.50	\$80.00	\$130.00	\$97.27
Over \$10 billion	16	\$75.00	\$115.00	\$193.75	\$138.44
<i>All Size Groups</i>	603	\$10.00	\$20.00	\$31.00	\$29.92