

As Prices Rise on Executive Liability Coverage, Strategy and Negotiations Enter Tough Terrain

BY DE'ANDRE SALTER AND KAREN KUTGER

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Thanks to continuing turmoil in the economy, general counsels and risk managers should prepare for a sharply different landscape in the areas of directors & officers liability, professional liability (E&O), and employment practices coverage.

From all indications, pricing for all types of executive liability insurance will continue to rise, with insurers pulling back on limits and capacity, and being far more particular about whom they are willing to insure. Companies are already discovering that securing and negotiating coverage in this market calls for new strategies and sometimes, alternative approaches.

A Financial Firestorm

Oddly enough, just a few months ago, premiums for D&O (Directors & Officers), E&O (Errors & Omissions) and EPLI (Employment Practices & Liability Insurance) coverage were at their lowest levels in many years. Insurers were scrambling for market share by dropping prices and sweetening terms, creating an ideal buyer's market. Most companies had little trouble finding low-cost coverage with generous terms - even though there was an ominous uptick in shareholder and employer lawsuits. Carriers were willing to cover companies that were facing bankruptcy and other troubles.

But good times started to sour once the subprime crisis snowballed through the financial sector. As the failures and defaults rippled across mortgage companies, banks and securities houses, insurers were suddenly faced with a surge in shareholder and investor lawsuits, which they were obligated to defend under D&O and E&O policies. Some estimates put the total at some \$9 billion in potential liabilities, stemming from the subprime problem alone.

Naturally, insurers quickly called a moratorium on insuring any company in the financial or credit sector - or immediately cranked up premiums and tightened terms. Right now, financial firms have difficulty securing even bare bones coverage at very high rates and limited terms.

For a while, companies outside the financial sector with attractive risk profiles continued to enjoy low prices, abundant capacity and broad terms. That all changed in the fall of 2008, when troubles at blue-chip companies like General Motors and General Electric sent Wall Street tumbling. From there, further disasters like the alleged Madoff fraud scandal made things even worse.

Insurers quickly found themselves at the center of a perfect storm, a 360-degree onslaught on profits. On the one hand, insurance companies were on the hook for an ever-growing docket of lawsuits. Shareholders who lost money in the Wall Street decline began to file suits left and right, suing companies that put money into Madoff funds, companies that bought subprime paper, and pension funds that lost huge chunks of value. Employees who lost their jobs in layoffs started to file employment practices lawsuits. (And with the recent passage of the Lilly Ledbetter Fair Pay Act, those are likely to increase as well.)

At the same time, insurance companies themselves were stung by huge losses in investment income, in everything from Wall Street to real estate. Those premium dollars they had invested were quickly losing value - at a time when claims were starting to skyrocket.

In fact, a Feb. 9, 2009, report from A.M. Best estimated that underwriting losses and dwindling investment returns would drive down the net income of property/casualty insurers by nearly 80 percent.

The bottom line, of course, is that insurance companies are starting to raise D&O, E&O, and EPLI prices sharply, reducing their own appetites for coverage, and paying a

lot more attention to risk management practices, financials and operations. Companies in every line of business will be affected in 2009.

The effect on risk management strategies will likely be considerable. For one, securing new coverage or renewals in such a climate will not be as simple as it was last year, not even for non-financial companies.

In addition, risk managers and general counsels must be especially diligent in examining terms and conditions, evaluating the financial stability of carriers and negotiating with underwriters. Here are some suggestions for navigating this new market.

Strategy Meeting

One hundred and twenty days before renewal, general counsel and risk managers should review the overall executive liability strategy to determine precisely what protection and coverage are required. (A specialist broker can help here.) Expect that carriers will want to raise premiums, offer more restrictive terms, or simply decline renewal.

Starting early allows time to contact additional markets and solicit proposals and offers from multiple carriers. Negotiations and discussions are likely to take more time than previously. The risk manager, insurance agent and general counsel should attend a strategy meeting and together determine the best course of action for the D&O renewal. Here are some important areas to touch on during this strategy meeting:

- The insurance agent should determine the incumbent D&O insurance carrier's intentions. This includes gauging the interest of participants, potential program structure, limit profile and pricing. It may help to work with a consultant or wholesale broker who can provide additional technical expertise, product and claims knowledge, market leverage and market surveillance.

- The general counsels should spell out the legal concerns that must be addressed by the D&O insurance contract. This will help the agent guide syndication and decide which underwriters may not have an appetite to provide such coverage. In some cases, it may be necessary to custom-design conditions or policy forms to address these legal concerns.
- The risk manager should provide direction on capacity, assumption of risk, pricing and market security.

During this time period, all three constituents should also proactively review the cancellation and non-renewal provisions of the D&O policy and be aware of the state amendatory rules regarding such. A renewal with different terms and conditions may in actuality be considered a non-renewal and may trigger the policy's cancellation and non-renewal provisions.

To protect their positions and to abide by state laws, insurers will issue a Conditional Notice of Non-Renewal Letter approximately 90 days before expiration of all admitted policies. This letter provides notification of the carrier's intent to non-renew, while also advising that they may offer terms but need more information before committing to such. If the policy is written on a non-admitted basis, the insurer is not subject to state amendatory rules and will not send such a Conditional Notice. In a soft insurance market, this Conditional Notice is generally ignored by policyholders. However, in today's market for financial institutions, when a Conditional Notice of Non-Renewal Letter arrives, it must be read very carefully.

Last, this strategy meeting should produce well-defined requirements and timeframes for the company that will serve as a base for negotiating and evaluating coverage for the impending D&O renewal.

Meetings With Underwriters

The more the underwriters see you as an individual company - rather than a faceless class and SIC code - the better. We recommend holding separate meetings for

incumbent insurance carrier(s) and potential new carriers, since the strategy and message for the two will vary.

The primary goal of these renewal meetings is to improve the terms and pricing with the incumbent carriers for the sake of continuity (assuming they offer market terms) and/or gain interest from new carriers. Be aware that there may be less capacity available from the incumbent carriers due to their reinsurance treaty restrictions or changes in underwriting guidelines. Carefully differentiating the management team, operations, financial performance and risk management practices is essential.

In light of today's environment, it's important to specifically address areas of concern that the underwriters may have, such as: 1) exposure to the credit crisis; 2) risk of bankruptcy; 3) regulatory and compliance issues; 4) potential litigation as a result of investment policies, financial performance, and management changes; 5) capital base; 6) ownership structure; 7) corporate governance procedures; 8) layoffs.

Evaluate the Carriers

Equally as important is spending as much time evaluating the carrier as it spends evaluating the company in these meetings.

- What is the carrier's reputation for claims handling? Is it known for tendencies to pinch pennies and nitpick? Or does it respond in good faith? Ask about claims processes. Do they have specialist teams or predetermined counsel to respond to claims and lawsuits?
- Is the carrier stable and sound financially? Discuss any recent Rating Agency decisions or changes. Sadly, even some perennially venerable names in the business may be in danger of becoming insolvent in the near future. Smaller carriers may be even more vulnerable.
- Is the carrier a subsidiary of a large insurance holding company? Is the holding company stable and sound financially? What happens to the insurance that was purchased if the parent holding company goes bankrupt? Insurance companies are

specifically excluded from the Bankruptcy Code. Instead, insurance companies are regulated by state laws that are designed to protect the interests of policyholders. Only the relevant insurance commissioners have the authority to place the insurance subsidiaries into receivership proceedings, which cannot be preempted by the federal bankruptcy law. However, there is no guarantee that an insurance subsidiary will not face economic difficulties resulting from the adverse publicity of a parent company's failure.

A week or two after these underwriter meetings, the carriers should provide D&O proposals that compare to the specific concerns and requirements that were outlined earlier. Keep in mind that D&O contracts can vary significantly, so it is important to read each contract carefully to make sure it's providing what you think it's providing.

Counsels should review all forms and endorsement wordings as well. Renewal policies may include more restrictive terms and exclusions than pre-existing coverage. In light of this economic environment, specifically review policies for duty to defend provisions, fraud and criminal act exclusions, regulatory exclusions and rescission of coverage provisions. Understand the intent of the policy. If amendments to these proposals are needed, now is the time to discuss this with the agent and begin negotiations with the underwriters.

Alternative Strategies

Upon completion of the meetings, the company should be armed with carrier reactions and indications to the company's renewal. Depending upon those, the company should begin developing alternative syndication strategies and be prepared for all possible responses from the company's incumbent D&O carriers. Alternative considerations may include:

- Spreading the risk. With some large writers of D&O teetering on the brink, it may be prudent to spread coverage over a few carriers, rather than entrust your liability to a single source.

- Going with new underwriters or carriers. Many financial institution clients are rightfully wary about signing with new entrants for their D&O program. But, in this market, it may pay to opt for new carriers at least for the short term, until a more stable market presents itself. Securing this capacity may help leverage the terms and pricing from more mature insurance markets. The optimal solution may actually involve the participation of two or more additional carriers.
- Taking on more risk to lower premium. If you are willing or able to assume a higher retention of risk in your D&O insurance program, you may be more likely to find additional insurance capacity.
- Increasing the limit of liability: In this environment of financial tumult and increasing litigation, how much coverage is enough? Consider your asset size and revenues, potential damages and defense costs, and peer purchasing data. However, ultimately, how much insurance you should buy depends on your comfort level with the potential for claims against your company.
- Building additional limits of liability with Side A Excess Difference in Conditions (DIC) coverage. Side A-only policies protect only individual officers and directors. (There is no Side B corporate reimbursement component and no Side C entity coverage feature in these policies.) The Side A excess DIC policy is designed to sit above - or in excess of - a corporation's primary D&O coverage. As an excess coverage, it would respond if the limits of the primary insurance were ever exhausted by defense costs or a settlement.

As a Difference in Conditions policy, it can also drop down and become primary coverage in certain situations, such as when the underlying policy denies coverage for some reason. Usually these policies are non-rescindable, and they can only be canceled for non-payment of premium.

- Run-off coverage and prior acts at inception on a new policy. This will allow you to package all old liabilities in an extended aggregate and start a new policy fresh for less premium.

The Bottom Line

By all indications, lawsuits are not going away, settlements and judgments are growing larger, and the legal risks to directors and officers are more complex than ever. An intelligent D&O liability insurance strategy, skillfully implemented, can dramatically reduce the financial damage of a lawsuit. However, managing D&O issues should not be limited to renewing the insurance contract. It is always smart to foster an ongoing relationship with the carrier and your broker or agent. Meet with them regularly to discuss your business, especially any factors that affect D&O and E&O exposures, and to discuss their financial stability and ratings.

Counsel and executives who build a relationship with their insurance carriers will put their companies in a better position to deal with the insurance challenges that will be on the horizon for the foreseeable future. The bottom line is whether you are a financial institution or in the commercial sector, you need to start working on your D&O renewal today.

De'Andre Salter is CEO and founder of Professional Risk Solutions, and **Karen Kutger** is vice president. They are based in Somerset, N.J.