SEEING THE D&O FOREST RATHER THAN THE TREES:

Claims Issues in Reinsuring Directors & Officers' Exposures World-wide

by Pina Albo

I have been asked to share with you our experiences in reinsuring D&O liability on a world-wide basis. In particular, I would like to outline our thoughts on how recent developments have had or will have an effect on claims in the D&O area. To this end, I will focus my discussion on four main developments:

* Legislative
* Economic/Commercial
* Cultural
* Coverage.

Legislative Developments

We have witnessed a growing legislative trend aimed at more clearly defining the duties and ensuring accountability of directors and officers world-wide. The 1990's will certainly be remembered as the decade of corporate governance, not only in Europe, but also in other parts of the world.

As you are already well aware of the developments in the UK, I will not dwell on these here. Suffice it to say that a series of legal amendments and the Cadbury and Greenbury Reports have highlighted D&O liability in the UK (and done wonders for the sale of D&O insurance).

In continental Europe, the notion of corporate governance was introduced in various stages. Spanish legislators were arguably one of the first to embrace the concept. The 1989 legal reform of the Companies Act, which focused on the necessary diligence of D&O's and the consequences for failure to observe same, made the risks inherent in being at the top evident in this country. The more recent Olivencia Report, which made a number of recommendations aimed at promoting transparency, independence and efficiency of company management, has simply served to drive the point home[1].

France started discussing corporate governance, referred to in that country as "le corporate governance", in the mid-90's. Like its Spanish equivalent, the French Vienot Report of July 1995 also made a series of recommendations for good corporate governance. Since then, a number of well organised and even better versed

1 Some of the recommendations made in the Olivencia Report include:

* a board should have a reasonable number of independent directors
* a board should comprise a minimum of 5 and a maximum of 15 directors
* a board should create both a Remuneration Review and Audit Committee
* a board should draw up a list of director's duties.

minority shareholder groups have launched several actions forcing top brass in that country to take this movement seriously.

The German and Italian governments have just recently become more active in the area of corporate governance. In 1998, both enacted laws aimed at making management more accountable and their actions more transparent.

In Germany this came in the form of KonTraG[2], a law applying to publicly traded companies. In addition to placing more responsibility on members of German Supervisory Boards to oversee actions of German Managing Boards, the law also decreases the quorum necessary to bring a derivative shareholder action against D&O's from 10 to 5% in certain cases, and requires the implementation of certain risk management measures.

In Italy, the Dragghi Report on Corporate Governance resulted in legal amendments to the laws governing publicly traded companies. The amendments, which came into effect on July 1, 1998, also focus on transparency and shareholder protection. To this end, the law reduces the quorum necessary to bring derivative shareholder actions against D&O's of Italian companies from 20 to 10%.

Moving outside Europe, similar trends can also be observed. In Israel, for example, developments included legal amendments highlighting management accountability, and the introduction of class actions lawsuits against D&O's by many pieces of legislation. Other recent legal developments in this country which are sure to increase the number of claims against management are the 1998 law on the Prevention of Sexual Harassment and the new Companies Law enacted in April 1999. While the latter does not enter into force until February 1, 2000, given that it affords more rights and powers to minority shareholders and creditors, the repercussions for D&O liability and insurance are already now being seriously debated. One amendment introduced by this law which has drawn particular attention is the apparent ease with which courts will be able to pierce the corporate veil and hold shareholders, D&O's and the internal auditor responsible for the company's obligations.

Asian legislators have also jumped on the corporate governance bandwagon. In 1993, for example, the Japanese government revised the country's commercial code facilitating derivative action suits against management by severely reducing the monetary requirement for bringing such a claim. (Prior to this change, court costs were prohibitive.) This pushed the number of derivative actions in Japan from 31 in 1993 to 270 as at January 1, 1997[3].

2 The law regarding the control and transparency of companies.

3 The Increasing Exposure of Directors and Officers in Asia, Presentation of Mrs. Aruno Salvi, General Manager/Principal Officer of Reliance National Asia Pte. Ltd at the 2nd Asian Conference on D&O Liability Insurance, September 1997.

The Korean Government became active after a massive (uninsured) lawsuit against the D&O's of Korea First Bank. As a result of this case, legislation now requires all listed companies to have at least 1 independent board member. It also allows investors holding just 0.01% of a company's shares (before 0.5%) to sue directors.

The legal measures taken by legislators in Europe, Asia and other parts of the world are consistent in their move towards greater D&O accountability. While these have done wonders for the sale of D&O insurance, they have also been responsible for an increase in the number of D&O claims.

Commercial/Economic Developments

A series of commercial or economic realities have also made the position of director or officer more exposed.

One of the key buzzwords here is "globalisation". Merging with or acquiring another company is currently a very popular way of becoming a global player. M&A activity is now at an all time high and with investment houses setting up shop all over the world, the trend shows no signs of subsiding.

M&A activity is not, however, without risks for D&O's. According to the 1998 Tillinghast-Towers Perrin D&O Liability Survey, companies with a history of merger and acquisition activity are almost twice as likely to experience a D&O claim than those without. One recent case-in-point is the legal aftermath of the Deutsche Bank take-over of Bankers Trust. The transaction has resulted in a series of large class action lawsuits against the boards of both Deutsche Bank and Bankers Trust in the United States due to statements made by management denying the merger.

Another increasingly popular way of becoming a global player is to attract public investors, especially in one particular market. The US has undoubtedly become the dominant international centre for raising capital. Selling securities on one of the US stock exchanges is, however, a risky venture for D&O's given generous securities laws, a claims conscious society and a very professionalised plaintiff's bar.

Exposure to US investors can also take place overseas and without a US listing, namely from US pension funds. While these funds have been investing in foreign capital markets since the mid-80's, the volume of this investment in now on the increase due to growing opinion that buying abroad (particularly in Europe and Asia) is sound investment strategy. Not only does investing overseas promote portfolio diversification and lessen volatility, but some analysts also say that foreign markets are rife with opportunity. Add to this the fact that 60% of the total world assets are outside the US and investment abroad just makes good financial sense.

With their money, US pension funds also bring with them their culture, that is avid protection of their investment. In fact, recent legislative amendments in the US

require them to do so[4]. This has not only caused disruption to European and Asian business, but also provided public education for the locals.

Cultural Developments

While still not as mature as that of the US, we have also noticed an internationally growing claims culture, particularly in Europe and the Far East. In the UK, the recently introduced "no win no fee" arrangement is expected to foster an already well established and growing claims mentality. Although the arrangement is currently limited to personal injury claims, there is already talk of expansion.

In continental Europe, the trend is the same. In some respects becoming more litigious is easier there as many are armed with legal costs insurance to do the job. Just a few years ago, management mistakes in Europe were kept quiet and dealt with behind closed doors. Now, newspapers jump at the opportunity to point the finger at managers and their mistakes, and recourse is often sought.

In Asia, consistent profits and the tradition of respect for higher authority shielded D&O's from shareholder interference for a number of years. Financial stability is, however, no longer the reality in these countries. Now, when a company goes bankrupt, respect takes a back seat as investors look at the personal assets of directors as a way of getting their money back.

Cultural issues are also at the root of many EPL claims. Simply put, comportment which is considered acceptable or tolerable in one country is actionable in another. The Mitsubishi case is, for example, a clear example of cultures clashing. In the context of expanding globalisation, cultural factors will become an even greater generator of EPL claims under D&O policies.

Coverage Developments

A fourth development affecting claims in the D&O area is the soft market. Free from claims, or at least big claims (outside the US), the industry has lowered premiums while at the same time extending coverage all in what appears to be an attempt to create claims so that prices can increase and coverage narrow.

Some of the coverage extensions we have witnessed in the recent past, which are sure to change the claims environment, are the following:

1. Reinstatements/Costs-in-Addition Coverage

One of the key features of D&O policies world-wide was the fact that they offered aggregate coverage, i.e. one limit for all claims in a given year, inclusive of costs. As a result, insurers were aware of their maximum exposure. This is, unfortunately, no

4 A 1994 directive of the US Department of Labour requires pension funds to vote in shareholder meetings abroad.

longer the case. We have seen an increasing amount of policies offering reinstatements, mostly at very nominal prices.

More disturbingly, we have witnessed the introduction of costs-in-addition coverage in D&O policies. While costs-in-addition coverage was admittedly already available in some countries where required by law (Italy, Israel, Belgium), it is now being offered in countries where the law does not require this (UK). This development will certainly add to claims costs in general.

2. Extended Reporting Periods

Insurers have also become more and more generous in their offering of extended reporting periods. Not too long ago, policies provided a 90 day extended reporting period for free, with an option to purchase up to a one year ERP at a cost of between 50% and 75% of the expiring annual premium. In some countries, insureds can now readily get ERP's of anywhere from 3 (France) to 5 (Italy) years for no or a nominal fee.

German insurers have come up with yet another attractive way to offer extended reporting periods, referred to in that country as the "save-up model". This model involves offering an insured a free three month extended reporting period for each year of coverage it has purchased up to a maximum of 5 years. The problem with this model is that it is given to insureds even if another policy is purchased from a different insurer. This can result in double insurance, which in turn can affect the amount of paid claims. Some insurers therefore include a clause in their policies which terminates this cover in the event that another policy is concluded.

3. EPL Entity Coverage and Punitive Damages

Another standard extension is the EPL entity endorsement. Given the fact that the entity is the primary target in an EPL claim, and that these types of claims are on the rise not only in the US but also elsewhere, D&O claims are turning more and more into a frequency problem. Add to this coverage for punitive damages, which is now readily given even where they are not insurable, and severity is also an issue.

4. Fines, Penalties, Criminal Defence, Bail Bonds

In Europe we are witnessing an increasing trend towards offering coverage for statutory fines and penalties, criminal defence costs and the posting of bail bonds. The Italian government recently enacted Law No. 472 which makes management personally responsible for violating certain tax regulations and imposes fines on same. Criminal defence costs are a big issue in Italy and also in France where D&O liability is largely defined as criminal in nature. Coverage for the establishment of bail bonds is the most interesting development in this context. While it appears to be a purely Spanish phenomenon to date, it poses a big exposure to insurers in that country. One of the reasons for this is that the imposition of bonds is very prevalent in Spain. Another is that courts are very generous with this tool. In recent financial

scandals, judges have required bonds of up to GBP 428 mio[5]. While some policies only cover the administrative costs of establishing the bond, it is also possible (but not advisable) to provide coverage for the amount of the bond itself.

5. Deleting Exclusions

While extensions grow, the exclusion list shrinks. One former standard exclusion which is only seen on rare occasions today is the exclusion for **failure to buy or maintain insurance protection.** The importance of this exclusion recently came to light in Germany as a result of the fire which shut down the Dusseldorf airport. The problem was that the airport did not carry business interruption insurance, and the finger was pointed at management for failure to secure same. In connection with this case, the industry discovered that very few airports actually carry business interruption insurance in Germany so exposure is certainly there.

The dilution or deletion of the once sacred **pollution** exclusion is also cause for concern, particularly in continental European countries. In Germany, for example, some pollution-related losses which would be considered property damage in other countries and therefore excluded, may be considered pure financial losses and therefore covered.

Two related exclusions which have been subject to dilution and deletion recently are the **insured vs. insured** and **company vs. insured** exclusions. This development is particularly disturbing because these exclusions prevented potential collusion or abuse of coverage. While the erosion of the insured vs. insured exclusion appears to have originated in common law countries, that of the company vs. insured exclusion has its roots in civil law countries, primarily Germany.

With respect to the former, erosion started by introducing carve outs, and therefore positive coverage, for the following claims by one insured against another: EPL claims, claims for contribution, claims by former D&O's, and shareholder claims including insureds. In the meantime, the insured vs. insured exclusion has disappeared almost altogether in the UK.

The German initiated erosion of the company vs. insured exclusion basically involved leaving it out of the policy altogether. Still, there was some justification for this in that country (and arguably in other civil law jurisdictions). In Germany, it was historically almost impossible for a shareholder to bring a claim against management whether directly or derivatively, as management is primarily responsible only to the company itself. The recent legislative amendments mentioned above make derivative actions easier but, given German corporate

5 D&O in Spain, Presentation of Pablo Wesolowski, Managing Partner Davies Arnold Cooper Abogados, Madrid at the Munich Re European D&O Seminar, June, 1999

structures, this is true more in theory than in practice. Since most claims against D&O's in Germany must be initiated by the supervisory board (an insured body) in the name of the company, the industry decided to leave the exclusion out of the policy arguing that to do otherwise would be to offer empty coverage. Unfortunately, it did not take long for this extension to reach other countries where the legal justification for it is not apparent.

Today, more and more insurers in the UK and other parts of Europe have dropped the company vs. insured as well as the insured vs. insured exclusions. Some insurers have, however, attempted to contain the danger by adding new exclusionary language for collusive claims. This will likely be of little assistance as insurers must prove the collusion. Fortunately, to date, the deletion of these exclusions has not applied in respect of US claims.

Conclusion

The demand for D&O insurance world-wide has increased dramatically over the past 5 years. Increased sales have not, however, translated into a corresponding rise in profits. In fact, the opposite appears to be the case as premiums fall and more and more D&O claims are advanced every day. Ironically, or actually logically, the same developments which are responsible for generating sales - legislative, economic, cultural and coverage - are also the very reason for the increase in losses. The only one of these factors fully in the hands of insurers which can be used to contain negative results are the policy conditions and, of course, underwriting. As bottom lines shrink, more and more insurers will be forced to revisit these issues.

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