POISED to SHIFT

Softer conditions are expected to continue in the management liability sector for the short term, but established underwriters have clearly stated that they will not continue to follow the downward pricing pressures, let alone expand the coverage to meet the new competition in the marketplace.

By Adam Briklyn

Photo: John Hryniuk

Management liability insurance in Canada is commonly understood to include directors and officers (D&O), employment practices (EPL) and fiduciary liability (F/L) insurance. These specialty lines are estimated to be worth between $600 million and $800 million in written premiums. While the majority of the premium is written domestically, a sizeable amount is written with insurance markets outside of the country.

While the market segment is modest in relation to property insurance in Canada, its importance cannot be overlooked. In the backdrop of ever-increasing legislation, aggressive regulators and increasing securities litigation, both in the United States and in Canada, the personal protection afforded by these lines of insurance attracts the attention of inquiring directors, officers and trustees.

Terms and conditions in Canada within the D&O marketplace began to soften in the second quarter of 2004 and have continued to soften. The rate increases experienced in 2002 and 2003 stabilized in 2004, and by the fourth quarter of 2004 clients that participated in broad re-marketing exercises were witnessing rate decreases of up to 20 per cent off their 2003 rated programs.

The decreases were a direct result of increased competition in certain market segments from underwriters outside of Canada that recognized that the Canadian marketplace was lagging the already soft U.S. market. Canadian large-cap companies and companies listed on U.S. exchanges that were heavily rated in 2002 and subsequently in 2003, as well as financially stable and having excellent loss ratios, witnessed the largest decreases by the end of 2004. Small-cap companies, private companies and not-for-profit organizations typically enjoyed a flat premium renewal or a marginal rate decrease by the end of 2004.

Conditions by year-end began to improve as many of the deductible increases implemented in 2003 were no longer a priority for underwriters in 2004. In addition, with a more meaningful loss-sharing mechanism in place, underwriters began to broaden their coverage positions. In the third quarter of 2004, coverage restrictions began to improve, and in certain situations restrictive language was removed. For example, pre-determined allocation for defense costs and securities claims percentages began to increase from 60 per cent to 70 per cent and on occasion up to rates of 80 per cent, while the failure to maintain insurance exclusion was commonly removed.

While softening conditions within this market segment are expected to continue for the short term, it is clear that this market segment is poised to shift. Established underwriters have clearly stated that they will not continue to follow the downward pricing pressures, let alone expand the coverage to meet the new competition in the marketplace. The established D&O underwriters with a claims legacy do not believe that the new entrants will have the financial fortitude to survive once their claims roster begins to fill.

INCREASING LEGISLATION

D&O underwriters continue to watch for potential exposures under the Sarbanes-Oxley Act of 2002, and in 2005 underwriters will be paying close attention to Section 404, Management Assessment of Internal

Controls. Section 404 requires that senior management of publicly traded companies in the United States certify that internal controls exist on their financial reporting of sales, assets and liabilities and that these control procedures have been audited. An outside audit and report on management's assessment of its internal controls will be a requirement for compliance, and deadlines for certification will vary and depend on a company's size and year-end as a public company. In terms of D&O coverage, underwriters are focused on confirming that their existing and prospective policyholders are compliant, as securities litigation may result from a company's failure to meet the guidelines as established.

In Ontario, legislation in 2005 will also be watched closely as the much awaited Bill 198, (Keeping the Promise for a Strong Economy Act) may come into force. Its purpose is to encourage better corporate governance by expanding the responsibilities and accountability of corporations and their directors and officers. Bill 198 has taken its direction from the Sarbanes-Oxley Act of 2002. It is believed that Canadian companies and their directors and officers will face the same increasing scope of liability and proliferation of lawsuits with which their American counterparts have had to contend. As well, it remains to be seen how the Ontario Securities Commission and the Ontario courts will interpret and apply the provisions of draft Bill 198.

New national guidelines on Capital Accumulation Plans (CAPS) such as defined-contribution pension plans, group-registered retirement-savings plans and deferred profit-sharing plans will take effect on Dec. 31, 2005. Canada's Joint Forum on Financial Market Regulators, which comprises regulators from Canada's securities, pension and insurance industries, has created guidelines that establish best practices for CAPS. The guidelines are voluntary, but are expected to set the standard for appropriate administration of CAPS. The guidelines will require employers to clearly define the purpose of their CAPS, decide if they have the knowledge and skill within their organizations to manage these plans and — should the plans be moved to a third-party provider — establish and monitor criteria for plan administration.

The guidelines also address investment diversity and liquidity of investments and call on employers to provide their employees with decision-making investment tools. It is anticipated that underwriters will reward organizations committed to the achievement of these best practices as they predict that organizations with poor pension governance will face increased liability from disgruntled employees suing their employer because their investments performed poorly.

SECURITIES LITIGATION

According to the Towers Perrin Tillinghast 2004 Directors and Officers Liability Survey Report, shareholders were the largest claimants in the majority (57 per cent) of claims against directors and officers of public companies. U.S. public companies in the D&O Liability Survey reported that 30 per cent of all claims were class actions, while 16 per cent were derivative actions, and the remaining 11 per cent were direct action claims.

The frequency and severity of these claims has been the yardstick by which exposure has been measured. NERA Economic Consulting found in its February 2005 "Recent Trends in Shareholder Class Action Litigation" report that in 2004 the average mean securities class-action settlement was valued at $27 million, up from $20 million in 2003. The report also states that securities cases with allegations of accounting irregularities such as premature revenue recognition, delayed expense recognition and income smoothing result in settlements that are higher by approximately 20 per cent.

The following table sets out a sample of recent securities litigation settlements in which accounting irregularities were alleged by the plaintiffs:

Cendant Corporation	$3.527 Billion
McKesson Corporation	$960 Million
Waste Management Inc. II	$457 Million
Global Crossing	$325 Million
ENRON	$168 Million
Computer Associates	$144 Million

Source: www.securities.stanford.edu

Pension funds and institutional investors are now leading more actions than ever before, and it appears that they are playing a significant role in increasing the settlement values of the cases in which they are involved. As lead plaintiffs, they have a real stake in the outcome of a claim, and, while they often seek the highest recoveries possible, they also push for corporate governance change and occasionally seek personal financial participation by the individual defendants.

On Jan. 6, 2005, *The New York Times* reported that 10 former outside directors of WorldCom, the telecommunications company that faced the largest bankruptcy in history at $180 billion, agreed to pay $18 million to settle a class-action lawsuit by the lead plaintiff, the New York State Common Retirement Fund. Days later, 18 former directors of failed energy giant Enron agreed to pay $13 million of their own money to settle the class-action lawsuit by the lead plaintiff, the California State Teachers Association.

In both cases, the lead plaintiffs offered higher contingency fees if their attorneys secured personal payments from individual directors and, in the WorldCom case, the plaintiff refused to settle the case unless the former outside directors personally paid damages. On Feb. 3, 2005, *The New York Times* also reported the WorldCom settlement fell apart as the judge presiding in the case ruled that one aspect of the settlement was illegal since it would have limited the outside directors' potential liability and exposed the investment banks that remained as defendants in the case to larger damages.

In a statement by the lead plaintiff, "the settlement is being terminated solely because of the potential impact on the amount other defendants might pay if the suit is successful, to be clear, the judge did not rule against the personal payment" (*Wall Street Journal*, Feb. 3, 2005).

THE SIDE "A" SOLUTION

In today's litigious environment, directors and officers of corporations need to give serious consideration to the purchase of a Side "A" D&O insurance policy. This insurance provides broad asset protection for the directors and officers solely should a non-indemnifiable claim be made against them. A non-indemnifiable claim involves circumstances whereby the corporation is either financially unable to indemnify or is not permitted by law to extend indemnification.

If a company goes into bankruptcy, the company is generally unable to fund its commitment to indemnify its directors and officers. If the D&O program contained securities coverage, either through an entity or pre-determined allocation grant, the D&O policy might not be able to respond as the courts may deem the policy an asset of the bankrupt estate and direct the proceeds to settle creditor obligations before affording protection to the directors and officers. This scenario can be avoided with the purchase of Side "A" D&O coverage, whether it is in a side-by-side program or with an excess policy exclusively dedicated to non-indemnifiable claims.

Broad provisions typically offered in the Side "A" Excess or Difference in Conditions Insurance Policy include less restrictive exclusions for personal profit or advantage,

dishonesty, bodily injury and when one insured person brings a lawsuit against another insured person. The policy is typically non-rescindable.

TAG-ALONG FIDUCIARY LITIGATION

Fiduciary claims arising from the management of pension plans against directors, officers and trustees are now being filed as companion litigation to large securities class action lawsuits. Tag-along fiduciary claims, as they are commonly referred to, target companies whose retirement plans own company stock.

The plaintiffs, the company's retirement plan participants, use the same factual allegations in the securities class action lawsuit; the defendants misrepresented or failed to disclose certain material facts about the company's financial condition, with plan assets in the company stock either acquired or maintained at an artificially high price. When the misleading disclosures are corrected and the stock price drops, causing the value of the assets in the plan to correspondingly drop, the plan beneficiaries seek compensation for the decline in the price of their stock from the artificially inflated price.

The defendants in these lawsuits typically include, directors and officers, the plan trustees, sponsors and administrators, investment advisors and human resource staff.

The following table sets out a sample of recent tag-along fiduciary settlements:

ENRON	$85 million
Global Crossing	$79 million
Lucent	$69 million
WorldCom	$51 million
Dynegy	$30.8 million

Source: www.bigclassaction.com

FIDUCIARY LIABILITY

One of the driving forces behind the purchase of fiduciary liability insurance is that most D&O insurance policies exclude pension- and benefit-plan-related claims under the contract. For years fiduciary liability insurance was a line of coverage that did not garner any boardroom attention. Today, this low-key approach to the coverage has changed and become important for plan trustees.

Coverage is becoming restrictive as underwriters in this market segment are considering excluding security claims due to recently experienced tag-along fiduciary claims. As an alternative, underwriters are considering limiting their capacity between the fiduciary and the D&O policies through tie-in of limits endorsements for common claims between the D&O and the fiduciary liability policies for U.S. plan exposures.

In Canada, the recent trends in class-action lawsuits against plan trustees have been centered on pension-plan surplus ownership, plan asset reversions, plan wind-ups, plan management and the failure to fund employee pension and benefit plans.

In the context of increasing litigation against trustees and with emerging legislation, it should come as no surprise that rating in this product line was flat and in many cases increased by up to 25 per cent in 2004. This specialty product line is also poised to shift as the number of fiduciary liability underwriters in the marketplace is limited.

Policy terms remain a moving target as underwriters are implementing restrictive conditions in their portfolios. Absolute contribution holidays, asset reversions, failure to fund and failure to maintain insurance exclusions were all restrictive conditions that many underwriters attempted to implement in 2004. Increases in retention amounts for single- and multi-plaintiff, including class-action plaintiffs, were common negotiation objectives in 2004 as well. While capacity has stabilized, the marketplace in Canada is small, and, therefore, a strategic integration of this specialty line of insurance with the D&O placement is critical in the overall management of the liability.

EPL

The growth of the employment practices liability insurance marketplace in the U.S. in response to Title VII of the Civil Rights Act of 1964 began to accelerate when the legislation was amended in 1991. The Act prohibits discrimination in employment on the basis of race, colour, religion, sex or national origin. The law covers recruiting, hiring, compensation, job-assignment training, termination and other terms and conditions of employment.

Title VII is enforced by the Equal Employment Opportunity Commission (EEOC) and through the assertion of private causes of action by disaffected employees, disgruntled ex-employees, or disappointed job seekers. Existing employment-practices coverage solutions within the comprehensive general liability, directors and officers and umbrella liability policies are limited in scope, leading to the development of the modern day mono-line EPL insurance solution.

The amendments to the Civil Rights Act in 1991 — specifically the allowance for jury trials and for plaintiffs to seek compensatory and punitive damages — significantly increased the liability for organizations in the management of their own employees. While the frequency of employment claims as recorded by the EEOC has averaged 80,000 charges filed annually since 1993, the severity has increased with monetary benefits recorded by the EEOC by discrimination increasing on average from $17.2 million in 1993 to $41.9 million in 2003.

The following table sets out a sample of recent large settlements attributed to employment discrimination:

Metropolitan Life	$90 million
Boeing Company	$72.5 million
New York City	$26.8 million
University of California	$18 million
Home Depot	$5.5 million

Source: www.bigclassaction.com

In Canada, severity associated with employment claims is often the result of employment termination as opposed to discrimination or harassment. An employer may only dismiss an employee without notice or compensation in lieu of notice when just cause exists for the dismissal. If an employer terminates an employee in the absence of these conditions, then the employee may sue the employer for a wrongful dismissal.

This setting has limited the growth of the coverage in Canada since many companies feel that they can afford the cost of employment litigation. Canadian companies with operations and employees in the U.S. recognize the need for the coverage and correspondingly purchase the insurance. The resulting effect on these companies is that they experienced similar market conditions as companies operating south of the border.

The rating environment in 2004 was flat with increases of up to 25 per cent for organizations with employment losses or companies in high-risk industries, such as retail, financial institutions and food and beverage. Split retentions were implemented with regularity for single versus multi- or class-action exposures and for Canadian versus U.S. exposures. While capacity remained stable, strategic implementation of the coverage with the directors and officers liability insurance placement became critical as merely a handful of underwriters provide the coverage in Canada.

OUTLOOK

While the current direction in the marketplace will continue for the interim, it will become important to address proactively the shift towards a hardening in this market sector that is expected to occur. In an effort to address this movement, it is critical for

companies to work closely with their insurance advisors to mitigate the effects of the shift, especially given the fact that a small number of Canadian companies have contributed to the litigation that has occurred in the U.S., which in effect has altered the Canadian marketplace.

Strategic pre-renewal planning sessions should take place with your insurance advisor and key decision makers within the company. The focus should be on establishing and managing expectations throughout the renewal process with an emphasis on developing a marketing strategy that will differentiate risk quality. Meetings with incumbent and prospective underwriters should take place with an emphasis on highlighting operational, financial and governance-based positives while being prepared to deal with any perceived negative matters. Program priorities should be communicated and ideally the program of choice should get executed in the formation of a successful renewal.

The information contained in this article provides only a general overview of subjects covered. It is not intended to be taken as advice regarding any individual situation and should not be relied upon as such. Insureds should consult their insurance and legal advisers regarding specific coverage issues.

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