2005 Directors and Officers Liability Snapshot And Insurance Market Forecast

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Legislation, regulatory activity, litigation and corporate governance requirements continue to impact the exposure of directors and officers to liability. Recent decisions and pending claims are defining (and redefining) the circumstances under which directors and officers are sued. While the number of claims (primarily securities class and derivative actions) may be somewhat consistent over time, the scope of the allegations of wrongdoing, the magnitude of the purported damages, and the liability impact of actual court decisions continue to make headlines. Legislation (and compliance with these statutes and the implementing rules and regulations) may be expressly intended to provide clarity for the executives, but seem more successful in providing fodder for claims. While the number of claims brought has been consistent, the activity of regulators from all fronts has increased dramatically. In the face of all this potential for liability, many directors and officers are struggling with corporate governance requirements.

This D&O insurance market forecast looks at highlights of 2004 and looks forward, to 2005, with detail regarding prior market behavior, and educated expectations for 2005. Overall, it appears that heavy competition continues in the D&O insurance marketplace in certain market segments, particularly for private companies. However, some carriers have stated that they will not continue to follow the market in downward pricing trends if that means giving up on underwriting the risk. Terms of coverage and structure of D&O programs are also front and center in 2005. This liability snapshot is intended to identify some of the major areas of risk exposure for directors and officers and identify some significant D&O insurance market trends.

Legislation

Legislation and the resulting rule making by the Securities and Exchange Commission (the SEC) and others has created an entire category of potential

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liability, as directors and officers struggle with compliance issues. Section 404 of the Sarbanes-Oxley Act of 2002 (Sarbanes) is on the front burner now for many publicly traded companies. Section 404 requires the creation, implementation and maintenance of identifiable and measurable internal financial controls on financial reporting of sales, assets and liabilities. Compliance with this provision means that management has to develop this internal control system, document the system, implement the procedures, test the process, remediate or fix any system failures (weaknesses), retest, and ultimately prove and certify that the internal controls work. This internal control system must be continually tested and updated, and its sufficiency must be certified in quarterly and annual reports. The outside auditor also has to report on management's assessment of their internal controls. Deadlines for compliance (and certification that the internal controls exist and that there are no material weaknesses – or the identification of material weaknesses) vary depending on company fiscal year ends and company size. While the SEC recently extended certain accelerated filer deadlines, companies have begun to issue warnings or guidance that they will not meet their deadline, or that they will have material weaknesses at the time of their certification. This is a developing issue, as it is unclear whether a private right of action for failure to comply with Section 404 will be upheld, and equally unclear what regulatory enforcement action might result.

Sarbanes also requires chief executive officers and chief financial officers to ferret out fraud and report it. Specifically, CEOs and CFOs are supposed to point out to auditors and to the audit committee any fraud or suspicion of fraud that involves management or other employees with a significant role in the internal controls, whether or not such fraud is deemed to be material. From an insurance perspective, two different issues arise: 1- Does reporting of this fraud equal an admission of liability such that coverage under a D&O policy will be forfeited? 2- Does an accusation by the CEO or the CFO (both Insureds under a D&O policy) against some other officer (also an Insured) trigger the Insured versus Insured exclusion?

Regulatory Activity

Regulatory activity has become aggressive and high profile. In addition to the SEC, the Department of Justice, other Federal agencies, and State Attorneys General, the Corporate Fraud Task Force (CFTF), created by Executive Order two years ago, is keeping a running tally of civil and criminal prosecutions, and the tally is growing exponentially. According to a press release issued by the CFTF, during its first two years CFTF task force members, working in concert with Federal and state justice departments, the Federal Bureau of Investigation,

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the Internal Revenue Service, and the Postal Inspection Service have achieved the following criminal results:

Criminal Prosecution Statistics
• Over 500 corporate fraud convictions or guilty pleas • Over 900 defendants including over 60 corporate CEOs and presidents charged with some type of corporate fraud • Over 400 criminal fraud cases filed • Obtained charges against 31 Enron defendants, including 21 former executives, convictions of 11 Enron defendants including the former CFO and treasurer, and seized over $161 million in assets

* *CFTF Second Year Report to the President, July 20, 2004*

In addition to criminal prosecutions, civil and regulatory actions have also been widespread. The SEC obtained a $2.25 billion penalty, the largest penalty in history, against Worldcom, and settled other significant financial fraud, reporting and disclosure matters. The SEC also brought and settled claims against mutual funds and their executives, financial services providers, and securities brokers for market timing and late trading wrongdoing.

SEC enforcement activity is increasing and the costs to resolve such activity has been skyrocketing. The SEC has posted some impressive enforcement statistics over the last two fiscal years:

SEC Enforcement Statistics	
199	financial fraud and reporting enforcement actions filed in fiscal 2003
350+	enforcement actions in the first 6 months of fiscal 2004
32	companies suspended from trading
36	cases where the SEC has sought to freeze assets of individuals or companies
110	corporate executives and directors that the SEC has sought to bar from again serving on or for publicly traded companies
$1 Billion	penalities and disgorgement amounts related to mutual funds

* *CFTF Second Year Report to the President, July 20, 2004*

The SEC is empowered to seek compensatory damages, fines and penalties, imprisonment, seizure or freezing of assets, disgorgement of ill gotten gains,

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cease and desist orders and barring of future service for publicly traded companies. Many of these elements of damages are not insured under a standard D&O policy, and some may be uninsurable under the law.

Defense costs incurred by directors and officers in defending civil or criminal regulatory action may be covered under a D&O policy, though exact policy language needs to be examined. Unless there is an admission or an establishment of liability, the D&O policy typically would respond. Settlements for monetary damages may also be covered unless such monetary damages are designated as fines or penalties. Coverage is not typically provided under a D&O policy for actual compliance with or the cost of compliance with non-monetary relief. Fines and penalties are generally excluded from the definition of covered loss on the typical D&O policy, and disgorgement or the return of ill gotten gains are also not considered to be covered loss.

In addition to increased aggressiveness by the SEC and other federal and state regulators or agencies in bringing civil and criminal enforcement actions, the SEC continues to be tough on potential targets, and even on third party witnesses that are otherwise NOT parties or targets of action in investigative proceedings. While the SEC has historically conducted informal and formal investigations that were often concluded without action or were resolved “without admitting or denying the allegations”, such results are less likely in the current enforcement environment. The SEC is veering away from settlements without admissions, and is more stringent on what it deems to be satisfactory cooperation. Prompt and complete responses to subpoenas including substantial document production are expected, and companies may also be pressured to waive attorney client and attorney work product privileges. It is important to note that waiver of these privileges in the context of an SEC investigation or proceeding cannot be “un waived” later if there is a following securities suit.

The SEC has also encouraged companies to deny indemnification for both defense costs and costs of settlements or judgments whenever indemnification is not mandatory. This does not bode well for individual directors and officers as most D&O policies contain “presumptive indemnification” language which presumes that the individuals are being indemnified unless such indemnification is legally prohibited. This means that the indemnifiable retention or deductible will have to be satisfied by payment of defense and other costs by the individual directors and officers before any payment obligation under the insurance contract will be triggered.

Resolution of regulatory activity is often followed by securities litigation, particularly if the regulatory proceedings or resolutions were publicized and

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resulted in a money payment. In such an instance, derivative claims are likely to be brought on behalf of the corporation, alleging that any payment by the corporation to settle the regulatory action was a waste of corporate assets that should be repaid by the individual directors and officers. Although defense costs for such a derivative suit might be indemnifiable, any payments that have to be made to resolve such action (by judgment or by settlement) are generally not indemnifiable, so the only protection that the individual directors and officers have is D&O insurance. In particular, the D&O policy usually provides non-indemnifiable loss coverage, also known as Side A coverage, without a retention or deductible.

Litigation

Litigation, and specifically the number and type of claims, has been and continues to be the primary indicator of directors and officers liability. Court interpretation and implementation of legislation, rules and regulations, has a direct impact on the potential for liability of directors and officers. Aiding and abetting claims, and obstruction of justice claims are on the rise as is the number of "mega" settlements, reflected by the chart below.

Company	***Settlement ($mm)***
Cendent Corporation	$3,527 (incl. Prides case)
Lucent Technologies	$517
Bank of America	$490
Waste Management II	$457
Global Crossing Ltd.	$325
Rite Aid	$319.5
Oxford Health Plans, Inc.	$300
DaimlerChrysler	$300
3Com	$259
Waste Management I	$220
MicroStrategy	$192
Dollar General	$162
DPL	$145.5
Informix	$142
Sunbeam	$141
Mattel	$122
Conseco	$120
Ikon	$111
Prison Realty	$105

**Stanford Securities Class Action Clearinghouse 2004; www.10b5.com*

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The frequency and severity of securities class and derivative actions has been the thermometer by which D&O exposure to liability has been measured. The average cost of settlements has risen. The 2003 Pricewaterhouse Coopers Securities Litigation Survey, for example, found that the average securities class action settlement was $23.2 million.

In addition to the number of securities class action claims filed (175 for 2003, and 175 through the first nine months of 2004), the average settlement of such claims and the severity of such claims as demonstrated by the mega settlement chart above, there are other significant elements of the litigation landscape that reflect on directors and officers liability. The increasing participation by institutional investors as lead plaintiffs may make litigation more costly to defend and to resolve. For the institutional investor, or for pension fund managers, deciding to act as lead plaintiff may have legal consequences, making it all the more important to recoup the damages experienced by the funds, and therefore more difficult to agree to settle for as little as 25% to 35% of the damages sustained. Institutional investors are also seeking to have personal financial participation by individual defendants as a method of demonstrating that they appropriately squeezed every penny from every stone and therefore fulfilled their own fiduciary duties.

Recent court decisions also appear to be whittling away at certain legislative protections afforded to directors and officers in securities claims. The Private Securities Litigation Reform Act of 1995 (the PSLRA) precluded discovery (document production and response to questions) prior to a decision on a motion to dismiss. This eliminated the ability of plaintiffs to file a generic complaint and then seek discovery to find some wrongdoing to actually support the filing of the suit. A recent decision in the United States District Court for the Southern District of New York (In re LaBranche Securities Litigation, 03 Civ. 8201 Aug 25, 2004) allowed plaintiffs to seek discovery of and to actually get production of documents prior to a decision on a motion to dismiss, when such documents have already been produced in separate government investigations.

Fiduciary Securities Claims

Fiduciary claims that look and smell just like securities class actions are also on the rise. These claims are also triggered by a stock price drop causing the value of the assets in a plan (stock in the company) to correspondingly drop. These tag along suits to securities class and derivative actions do have unique

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characteristics. First, they are subject to ERISA, which is both protective and restrictive. The standard of proof is easier to meet, the heightened conduct standard for fiduciaries places a high hurtle on the individuals seeking ERISA protection, and others that may not be acting as fiduciaries (such as board members) may still be liable for damages. Fiduciary claims subject to ERISA are also not bound by the PSLRA so the discovery preclusion mandated by PSLRA and mentioned above does not apply. This means that plaintiffs counsel in a fiduciary securities suit can seek and obtain discovery even though the companion securities class action plaintiffs cannot.

The defendants in a fiduciary securities claim may vary from those in a typical class action because they will also include plan sponsors, plan administrators, plan trustees, investment advisors, the director of employee benefits or the director of human resources, and as many directors and officers as possible. One liability trend is to hold board members liable for fiduciary losses on a theory that they had a duty to monitor the plan fiduciaries, even when they properly delegated that responsibility to others. While most D&O policies have ERISA exclusions that would eliminate coverage for such claims, some D&O carriers are adding new exclusions for claims arising out of employee stock options or other securities that employees may receive as part of their compensation. Both the ERISA exclusion and the new stock option exclusion are intended to clearly demonstrate that the D&O policy does not cover such claims. Note that fiduciary or pension trust polices should provide this coverage (unless a securities exclusion has been added to the policy) as a drop in value of assets in a plan do not constitute benefits due or implicate other standard exclusionary language.

Corporate Governance as a Continuing Area of Exposure

The governance of organizations, as a result of the litigation, legislation and regulatory activity mentioned above, continues to be challenging as directors and officers work to implement certain requirements, enhance others, and still manage their businesses. Corporate governance has been a D&O topic for several years, as numerous pieces of legislation starting with the Private Securities Litigation Reform Act in 1995, and court decisions such as Caremark's utilization of the federal sentencing guidelines in the late 1990's, to new audit committee rules, to Regulation FD and Rule 10b5-1 regarding insider trading and Sarbanes, have shaped corporate activity.

Corporate governance is also a focus of D&O underwriting and D&O risk evaluation. Most publicly traded companies, and many large private companies

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as well, post information regarding their governance activities, just like their product listing and office locations, on web sites. This typically includes an identification of board members including their independence, listing of officers, code of ethics policy, insider trading policy, and board committees with charters and membership, among other things. Certain external organizations use this publicly available information to "rate" the corporate governance activities of publicly traded companies based on their own concepts of "good" corporate governance. Although D&O underwriters may review such ratings, they do not rely on such ratings to any measurable degree in their own underwriting of D&O risk. It is also important to note that underwriters do not give premium credits for good governance ratings, as good corporate governance is expected to exist. While there appears to be limited value in these corporate governance ratings, it is worthwhile for a company to obtain and review summary information regarding its rating as the criteria used to rate has typically been obtained from publicly available sources, and may therefore be inaccurate. A review of these ratings or scorecards can also be useful for a company to do its own self audit – by seeing the various criteria, there may be something listed that is not currently under consideration but that might be useful to consider.

With continuing (and increasing?) exposure to liability from legislation, regulatory activity and litigation, directors and officers continue to look first to their companies for protection, and second, to D&O insurance. Board members may be interested in purchasing the broadest coverage to provide protection both to the individual directors and officers, and to the company itself (as a way to protect the corporate balance sheet). Individuals are interested in the degree of personal protection provided by D&O policies, particularly when the company cannot protect them so insurance is their only protection. Individuals are also asking for more information about specialty products that may be available for certain added protection.

Summary of 2005 D&O Market Expectations

The 2004 Year in the D&O marketplace overall has been more favorable to Insureds than was 2003. Insureds across many industries obtained rate decreases and better terms and conditions as a whole. Decreases have been seen on both the primary coverage layer as well as well as excess policy layers. For 2005, we believe that while some Insureds will continue to see modest reductions many will have flat premium pricing proposals with a greater focus on broadening policy terms and conditions and continuing to evaluate various policy structure options available.

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Looking Back: 2004 D&O Market Highlights
• 2004 was generally a year of premium decreases, with notable exceptions in some financial services segments and some healthcare areas. • Large publicly traded companies saw average rate reductions of 5% to 15% • Small to middle market public and private company Insureds saw more aggressive reductions in the 10% to 30% range. • Insureds that had smaller rate increases in 2003 generally saw lower reductions in 2004, some renewing with flat pricing. • Excess carriers added to downward pricing trends in 2004 by adjusting their excess pricing modifiers from 2003's level of 90% – 95% to more realistic levels of 75% - 85%, in some cases lower. • More Insurers competed for primary layer positions as their excess rates and positions were placed under pricing pressure. • Some Insurers began offering multi-year fixed premium annual installment programs, although primarily for private company customers. • As some very large providers of D&O insurance purchased less reinsurance, reinsurers were driven to find newer Insurers to make up for the premium loss, thus adding additional downward pressure on the market. • Continued growth in Side A insurance programs being purchased. Many companies used some or all of the premium saved by 2004 rate reductions to shore up limit levels purchased.

Shape of the 2005 D&O Market

While we believe that 2005 will be a period of greater rate stability in the market, we anticipate there will continue to be a very competitive environment for the better risks. There are signs of a shift in attitude among many of the key Underwriters of D&O insurance. Insureds should expect fewer rate reductions overall during the coming twelve month period. Settlement values of some high profile cases have been greater than many expected and at least one Insurer has talked of internal directives to maintain rate or walk away. Underwriters are greatly concerned with the shape of the ever changing regulatory landscape by government regulators and state attorneys general. As entire business models come under pressure for change, it presents unique underwriting challenges for D&O Insurers.

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Many companies continue to be unhappy with their D&O programs and therefore the market will continue to be tested during the next twelve months. Some Insurers seem ready and indeed have walked away from some business. At least one Insurer has written to its Insureds indicating a willingness to step away from the D&O marketplace due to the rapid change from a very hard market to one competing on price. We expect that the next few months will determine just how much business Insurers are willing to walk away from in order to try to stabilize pricing. The D&O marketplace appears increasingly fragile to excessive swings in pricing due to an expanding litigious environment, an increasing number of mega-settlements and fragile reinsurance support. As we move into 2005, we are doubtful that the aggressive premium cutting witnessed in 2004 will be sustainable. Longer term D&O Insurers appear to be having difficulty staying in front of the loss trends. Newer market entrants, originally competing without legacy claims, now also appear to be impacted. Time will tell whether these Insurers have reserved for losses aggressively enough. Trends that we see are listed below.

2005 D&O Market Trends

- Heavy competition in selected market segments will continue especially for private company business. Industry segments that continue to be less favored by the market are financial institutions, healthcare and certain technology companies.
- Insurers may be more willing to walk away from renewal and new business opportunities if pricing levels remain under heavy pressure. Already some Insurers have been vocal about not following downward pressures as that adversely impacts their ability to actually underwrite the risk. This could be early signs of a market shift. New entrants to the market in 2005 should benefit from an overall stabilizing market.
- Capacity levels should hold although we see some carriers pulling back and some that are about to enter the market. We see certain Bermuda based and London Insurers opening up underwriting facilities in the U.S. targeted at specific market segments.
- An increasing number of Insurers will compete for primary business as their excess rates have come under downward pressure creating opportunity for some companies to benefit from further rate reductions.
- Insureds will continue to evaluate program structure and total limits purchased for appropriateness.
- Breadth of contract severability, rescission, and fraud language will be key negotiating points.

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- Many Insureds will continue to purchase Side A insurance for the first time and those that already purchase this coverage will look to consider additional towers of Side A coverage.
- Some Insureds will purchase additional coverage solely available for their independent directors.
- Companies will continue to focus on the breadth of Outside Directorship Liability coverage offered to their directors and officers.

2005 Rate Expectations

Our expectations are that most Insureds will see moderate decreases to flat renewal pricing during 2005. Insureds that have gone through two rounds of price decreases are more likely to see flat pricing without a strong round of marketing forcing additional cost savings for better Insureds. Those with higher profiles are likely to see greater pressure for a premium increase without substantial program marketing, even if recently marketed.

Better Than Average Risk	Flat to 10% Decrease
Average Risk Profile	Flat to 5% Decrease
Higher Risk Profile	Flat to 15% Increase
Extreme Risk Profile	Flat to 25% Increase

We believe that approximately 50 companies write D&O, including public, private and/or non-profit companies. Many Insurers have exited or substantially altered their focus over the last few years as short term profits disappeared with ever expanding litigation trends and settlement amounts. D&O is a "feast or famine" business and the time period that D&O carriers get to feast has become increasingly short. From 1995 to mid 2002, pricing levels declined dramatically while average settlement values of securities cases rose and coverage expanded. We have seen that it is difficult for any Insurer to time the right moment to enter and exit the market and companies typically look for long term staying power from their D&O Insurer.

Currently, only four or five primary insurance markets compete in the large public company segment of this business. New capacity that has or is entering the market has tended to focus more on excess business and the private and/or non-profit sectors. While it is expected that the industry as a whole will be profitable

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for 2004, there is widespread concern over the adequacy of reserves as a whole. Establishment of timely and appropriate claim reserves is a critical component of any insurance company. We worry about the ability and fortitude of newer and financially weaker Insurers to appropriately reserve in the volatile D&O line where understanding complex legal matters can be difficult.

Issues effecting rate expectations are many but some that we believe Insurers will focus on during 2005 will be:

- Financial Statement profile
- Board and Audit quality
- Claims history
- Corporate Governance profile
- Industry and company specific regulatory profile
- Ownership Profile
- Sarbanes 404 Compliance (Underwriters have particular concerns that many small to mid-cap companies will not be able to comply)

Excess Pricing

Filling out a large limit program is still a time consuming exercise, but was less so in 2004 and we expect that trend to continue into 2005. Whereas 2003 saw demands from underwriters to know both pricing below and above their layer and individual demands as to terms and conditions, applications and exclusions, 2004 was a year of excess capacity available for most programs. Excess layer pricing fell fairly dramatically in some cases from upwards of 100% of the underlying limit rate to rates of 75% to 85%, and sometimes more depending on the overall size of the program. We expect this trend to continue during 2005. However, for the larger limit programs, it is important to note that excess rates on line, or rates as a percentage of the layer below, does level off at some point to a minimum price per million.

Is Their Competition?

Dramatic price increases have been replaced by moderate price decreases and some increases for selected Insureds based upon individual characteristics and industry. Competition has expanded on both a primary and excess basis albeit some industries still have very few choices for their lead primary Insurer. New capital continues to be added and we anticipate a few new markets in 2005 with targeted capacity primarily for private company business. We saw some

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business combinations affecting the D&O market in 2004 that will carry into 2005. Notably, the combination of St. Paul with Travelers Insurance and Gulf has effectively reduced the marketplace both by number of carriers and by available capacity. The number of Insurers writing combination forms for private company business with multiple lines of business, i.e., D&O, Fiduciary and Crime has expanded. Some Insurers have sharpened their focus on non-profit business. One example would be the recent purchase of the renewal rights from Fireman's Fund of their non-profit book of business by Philadelphia Insurance Company. Markets such as Zurich, ACE, HCC, XL, St.Paul Travelers, Hartford and AIG lent more competition to the large cap primary market segment while a large number of others provided healthy competition in the public mid-market segments.

Market Capacity

We expect market capacity to be relatively stable in 2005 with some new capacity expected to be introduced from London as well as additional access points from off-shore markets setting up operations in the U.S. Well established long term Insurers such as National Union (AIG) and Chubb continue to dominate the market for large primary business.

Sample D&O Capacity Roster		
AIG	Chubb	C.N.A.
Hartford	RLI	Navigators
St Paul Travelers	Monitor Liability	Great American
Genesis	Houston Casualty	Zurich
Crum & Forster	Darwin	XL USA
Old Republic	Arch USA	Axis
ACE	Liberty International	Quanta
Fireman's Fund	AWAC	Philadelphia Insurance
AEGIS	Starr Excess (Bermuda)	Lloyds (London)
CODA (Bermuda)	Max Re	Swiss Re
XL Bermuda	Endurance (Bermuda)	

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The Changing Face of "Side A" Insurance Coverage And Consideration of Other Structure Options

We have noted in this report the increasing tendency to purchase, maintain or expand Side A coverage for directors and officers. As D&O policies continue to be examined from a breath of coverage standpoint, the market has shifted to offer additional contracts to broaden non-indemnifiable coverage provisions under their standard D&O programs. Standard Side A programs protect directors and officers in situations where the company is legally prohibited or financially unable to indemnify. Side A Difference-In-Conditions or DIC contracts, broaden standard Side A excess policies with some interesting additions, however, we caution the reader that no two are alike and many so called DIC policies have been added to the D&O market in the past year. The decision to buy Side A coverage is being driven in large part by the CFO and independent directors questioning how their program has been structured and how it pays a loss in the event of a claim.

Side A features can include:

- Protection limited just to the directors and officers. No sharing of the limit with the corporate entity.
- Coverage that cannot be rescinded by an Insurer for any reason except non-payment of premium. These policies, often with "difference-in-conditions" provide broad protections where a traditional Insurer might attempt to rescind a policy due to the malfeasance of one or a few.
- Protection where the company wrongfully denies indemnification to the directors and officers, leaving a very surprised director or officer stuck with a sizeable corporate deductible.

We expect purchase of these contracts to accelerate in 2005 as more independent directors and audit committees scrutinize coverage that is being purchased.

Although Side A or non-indemnifiable loss coverage, is the most common "alternative" coverage structure that we expect to be considered in 2005, some companies also utilize or are considering other alternatives. These include recognized alternatives such as D&O contracts that do not contain coverage for

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the corporate entity at all. These non-entity contracts can either be silent on any allocation that might be necessary, or can contain pre-agreement on an allocation when both the un-insured corporate entity and Insured individuals are named in a claim. Separate D&O policies reserved solely for independent directors (or even further narrowed to apply solely for audit committee members), are available as are individual or personal D&O contracts that are purchased by an individual director or officer solely for his or her own protection and are portable. Blending together complementary coverages (D&O, EPL and Fiduciary for example) has been done before and can be done again for the certain types of companies. Including multiple exposures under a single product does mean the potential for dilution of limits (and perhaps less coverage for the directors and officers) but can certainly be part of any structure options discussion. In addition to these alternatives, many companies are considering how they might use a captive insurance company to insure some of their D&O exposure (the indemnifiable parts).

Severability and Rescission

High profile cases where insurance carriers have sought rescission of D&O policies make rescission a hot topic. In the face of publicity over rescission actions, directors and officers are worried that their D&O policies may be rescinded or taken away when they need it most. The threat of rescission is actually not a new threat. Rescission of a D&O policy, just like rescission of any contract, depends on the facts and circumstances that caused the contract/policy to be entered into by the parties in the first place. The point of rescission is to put the contracting parties back in the position they were in prior to entering into the contract. The contract then becomes void from the beginning of time (as if it never existed) and money that exchanged hands is exchanged back again.

In the context of D&O insurance, however, the idea that a policy which protects numerous parties, might be voided because of the wrongful conduct or misleading statements of one or two parties, is problematic. Directors and officers should look at severability language as one method of protecting against rescission and examine the degree to which the policy may actually be "non-rescindable" and the question of whether this is the kind of coverage that an Insured wants.

A severability clause in a D&O contract goes to information provided to the Insurer in the underwriting process and would affect coverage in its entirety if it later turned out that false information was knowingly provided to encourage the Insurer to issue the insurance. The idea is that the Insurer was not aware of the

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real risk that it was underwriting, and one or more Insureds were aware of the true picture and hid it from the Insurer. In order to rescind a D&O policy in its entirety, a carrier would generally have to show that the information given during the underwriting process was false, one or more Insureds knew at the time that the information was false, and the information was material to the risk being underwritten.

Some D&O policies have gone further than "severability" to address this issue, by expressly providing that certain portions of the D&O policy are non-rescindable. Usually, this is provided for non-indemnifiable loss (called Side A loss) only. This means that if the company is not legally permitted to indemnify its directors and officers in connection with a claim, then the policy is the only protection that those individuals have. In that instance, the threat of rescission of the policy is a greater threat, so the non-rescindable provision is a greater benefit.

Some Insurers question the real benefit of having a Side A non-rescindable D&O policy by arguing that innocent Insureds don't want to provide non-rescindability to other Insureds that may be wrongdoers. Insurers typically do not seek rescission of the entire policy because of one black hat unless that black hat was the one giving the carrier false and fraudulent information in order to get an insurance quote. Some Insureds may agree. Unfortunately, this begs the question of who is a wrongdoer, when is such wrongdoing determined and by who, and if the policy is rescinded, then how does that protect those innocents?

Other Pertinent Terms and Conditions of Coverage Under the Microscope

We expect that terms and conditions of coverage will continue to be scrutinized, particularly since insurance carriers continue to introduce new forms into the marketplace. Following is a representative sample of terms of coverage that are coming under the microscope:

- The definition of Securities Claim: While entity coverage for securities claims continues to be overwhelmingly purchased for all but the very largest of companies, the actual entity coverage provided by the policies has been narrowed to some degree by the revision to the definition of securities claim. Where this definition used to say "claims arising out of the purchase or sale of securities, or any other claim by a securities holder in their capacity as such", many definitions have been narrowed to require that the claim arise under the securities laws, or to only apply in a

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purchase or sale situation (what about when the claim alleges that the claimant held the securities because of misrepresentations), or to require multiple triggers in order to meet the definition and get entity coverage. Some definitions do not include a stock for stock merger deal as a securities transaction.

- The changing trigger for the personal conduct exclusions continues to evolve. "In fact" language replaced by "final adjudication" replaced by "admission in the form of a writing".

- When a claim is deemed "first made" is relevant since D&O coverage is generally provided on a claims made basis. D&O policies were historically silent about this, but some now expressly indicate when a claim is first made, which could have adverse ramifications for Insureds.

- When notice is required ("as soon as practicable" is now sometimes accompanied by "but within 60 days"). Note that even when the time clock appears to start running from when the risk manager or general counsel first finds out about the claim, this is sometimes followed by "but in any event within a certain number of days".

- Investigative costs coverage continues to be a misunderstood coverage expansion that is being withdrawn by many D&O carriers. While it is unclear whether this expansion was necessary (is it already covered when there is no exclusion?) it is also unclear why this is being withdrawn.

- There is an increasing application of a professional errors and omissions exclusion to a D&O policy. Management carve outs appear to give back coverage for failure to supervise subsidiaries, rather than for failure to supervise individuals providing the professional services.

- Failure to maintain insurance exclusions continue to be required by some carriers and not by others. It is worthwhile to have a discussion about this exclusion to determine whether it is more or less important to Insureds. To the extent that it is primarily an issue of defense costs coverage, then carve backs for such coverage should be sought.

- Employed lawyers extensions continue to be considered, particularly as the number of lawyers working "in house" continues to expand. The value of adding employed lawyers to a D&O policy (further sharing of limits) is another topic worth discussing.

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- Outside directorship liability extensions on D&O policies certainly expose the limits to a claim involving some other unrelated company. Many companies have determined to eliminate this coverage entirely from their D&O programs, and have encouraged their officers to seek assurance from the outside entity regarding indemnification and insurance provided by that entity.

Conclusion

In this liability snapshot and market forecast, we have looked at where it appears that directors and officers will continue to be exposed to liability and have discussed the trending of the D&O insurance market. Overall, we believe that directors and officers are best served by understanding their exposure to risk and understanding the various methods available to them to address and mitigate this risk.

Hilb Rogal & Hobbs is the 7th largest insurance broker in the United States and trades on the New York Stock Exchange under the ticker symbol HRH. The Executive Risk Solutions Practice is a specialty unit within HRH devoted to executive liability issues and corresponding insurance needs. Susanne Murray, Esq. (Susanne.murray@hrh.com) is an Executive Vice President of HRH of New York and the D&O Practice Leader of the Executive Risk Solutions Practice. Fred T. Podolsky (fred.podolsky@hrh.com) is an Executive Vice President of HRH of New York and the Managing Director of the Executive Risk Solutions Practice.

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