

Looking *for* TROUBLE

With litigation rising, insurers advise companies to shore up their liability defenses.

by Bonnie Brewer Cavanaugh

INVESTORS' NIGHTMARE: Financier Bernard Madoff leaves U.S. District Court in Manhattan after a bail hearing in New York Jan. 5. Madoff allegedly lost as much as \$50 billion of investor money under fraudulent pretenses. Some experts believe Madoff's actions could enhance a trend of increases in D&O renewal prices for financial institutions.

This could be a busy year for litigation, especially for financial services and insurance folks, as investors look to recoup their securities-fraud losses by tapping into the directors and officers or errors and omissions coverages of the firms they hold accountable for their economic ruin.

The most high-profile among

such firms today is Bernard L. Madoff Investment Securities. In December, New York investment adviser Madoff was charged by the U.S. Securities and Exchange Commission with one count of securities fraud. Madoff allegedly lost as much as \$50 billion of investor money under fraudulent pretenses.

The Madoff scheme could cost insurers between \$760 million and

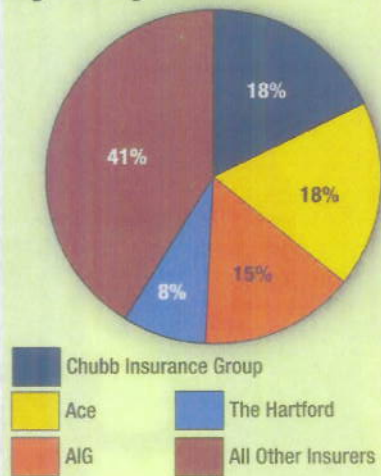
► **What's Up:** The financial crisis could cause D&O and E&O claims to spike, even as D&O prices fall.

► **What's Happening:** The economic squeeze is causing many insureds to cut back or drop coverage, when they should be increasing coverages.

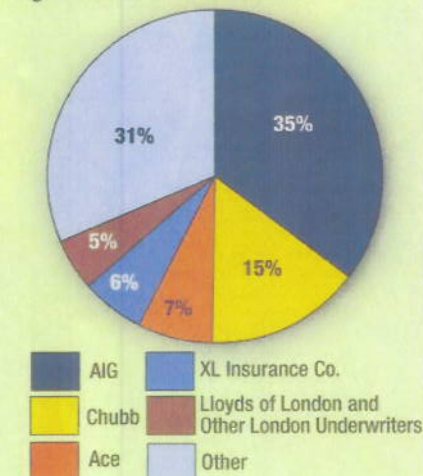
► **What's in Store:** Insurers are advising clients to buy or bolster management liability and similar products, and developing special financial services units to address the market squeeze.

Directors & Officers Insurance

Primary Market Share By Policy Count



Primary Market Share By Premium Volume



Source: Towers Perrin Directors and Officers Liability 2007 Survey of Insurance Purchasing and Claim Trends

\$3.8 billion in reimbursements and defense costs, with the total likely around \$1.8 billion, according to analysis from Aon Benfield. Aon, prior to its merger with Benfield, was the world's leading insurance broker based on brokerage revenue of \$6.1 billion, according to *Best's Review's* 2008 ranking of global brokers.

Some experts believe Madoff's actions could enhance a trend of increases in D&O renewal prices for financial institutions, even as overall D&O rates continue to fall. The Quarterly D&O Pricing Index from Aon Risk Services shows that from the third quarter of 2007 to the same

period in 2008, coverage renewal rates for financials jumped 19.7%, while overall rates declined by 11.3%.

Yet, the big question seems to be: How much impact could the Madoff situation have on D&O going forward?

Insurers already have begun to offer new financial protection products. For instance, in October, Bermuda-based specialty underwriter Argo Group launched a new London unit, Argo Financial Products, dedicated to D&O, securities insurance, employment practices liability, pension trustee liability, crime and bond, and professional indemnity to financial institutions.

A company spokeswoman said Argo is not yet ready to discuss its financial strategies, but in a statement, the company said the new unit would focus on non-U.S.-domiciled insureds and will offer limits of up to \$20 million. Argo Financial Products will underwrite through new subsidiary Heritage, formerly Heritage Underwriting Agency Ltd.

Even before the bad financial news hit Wall Street in September and Madoff's alleged scheme was revealed late last year, Towers Perrin reported an increase in coverage enhancements in its 2007 *Directors and Officers Liability Survey of Insurance Purchasing and Claim Trends*. According to the survey's 2,927 respondents, 18% decreased D&O policy limits, compared with just 4% in 2006. The average limit purchased was \$9.86 million, compared with \$11.55 million in 2006.

The Towers Perrin survey also showed a growing interest in independent directors liability policies—30% of private companies and 21% of public companies said they are considering this coverage. Increased purchases should result as independent directors get more familiar with this coverage, the report stated. IDL interest was strongest in companies stating assets up to \$400 million.

And Advisen Ltd., an industry analytics firm, revised its original February 2008 forecast of \$3.6 billion in D&O-insured losses due to the credit crisis. Advisen now estimates

An Attorney's Point of View

Nancy Sher Cohen, a partner in the Los Angeles office of law firm Proskauer Rose LLP, said she's been receiving phone calls "by the dozens" from directors and officers anxious to see how well they're covered...or not.

She's advising them to beef up their D&O coverage with E&O, plus comprehensive general liability, which can cover advertising injury for claims of misrepresentation by a lender. She also suggests fidelity and crime policies, which can provide broad coverage extensions and endorsements of mortgage securitization, mortgage pooling and other financial instruments.



Nancy Sher Cohen

"Don't assume you have D&O and leave it at that," Cohen said. "You need to be thinking about all these kinds of coverages and your risk manager needs to make sure you have them all in place."

Other policies expected to gain in popularity this year are employee class action, bankruptcy, contracts, and labor and employment, she said.

Executives also should be talking to their corporate counsel to see if there's any potential for coverage, which under the law, is enough to trigger responsibility for the insurance company to pay defense costs, she said.

That's making some insurance companies nervous.



The number of lawsuits filed against public companies rose 27% in 2008 compared with 2007. Many of those lawsuits are related to subprime and credit issues.

—*Maria Treglia,*
Program Brokerage Corp.

insured losses totaling \$5.9 billion for the years 2007 through 2009, with the largest amount incurred in 2008, according to the company's special report, *The Subprime Mortgage Meltdown, the Global Credit Crisis and the D&O Market*.

The revised forecast reflects an increase in securities class action suits; securities fraud suits brought by regulators and law enforcement agencies; losses under Side A policies from bankruptcies; shareholder derivative suits; and defense costs associated with dismissed suits, the report stated.

Madoff in Context

However, when compared to the subprime/credit crisis losses, the Madoff factor should not be a major event for the U.S. D&O market, said Dave Bradford, Advisen executive vice president.

"Of the 90 Madoff-related cases we've identified so far, at least a quarter of them are non-U.S.," Bradford said. "Many of the U.S. cases are more likely to trigger coverage under E&O policies than D&O policies, assuming the firms bought insurance."

Besides, large financial firms often buy Side A-only D&O policies, "which typically won't respond unless the company is insolvent," he said. Madoff-related D&O claims will be borne mostly by the same insurers that have been "clobbered" by the subprime/credit crisis claims, he said. Since just 10 companies write some 80% of all financial institution D&O premium, many of these same companies write most of the financial institution E&O premium, Bradford added.

"We forecast that subprime/credit crisis D&O losses will reach \$5.9 billion, but even with those massive losses, D&O rates, other than for financial institutions, continue to fall," Bradford

said. "In the fourth quarter, the average non-FI D&O premium fell 4.5%."

The number of lawsuits filed against public companies rose 27% in 2008 compared with 2007, said Maria Treglia, first vice president of Program Brokerage Corp., a wholesale arm of HUB International Group. Hub International Ltd. is the world's 10th-largest broker, based on 2007 brokerage revenue of \$664.1 million, according to *Best's Review's* ranking of global brokers. Many of those lawsuits are related to subprime and credit issues, Treglia said. Her statistics come from the Stanford Law School Securities Class Action Clearing House.

PBC expects the financial market turmoil to hit many industries this year. "We don't see an end in sight. We think things will probably get worse before they get better," Treglia said. "For insurance costs or terms and conditions, they're definitely scaling back coverages."

Dropping Insurance

PBC is concerned that its insureds may go out of business or cut back on insurance to manage costs. "That's what everybody is doing. But in our lines of insurance, what we're telling our customers is to buy more insurance," she said.

Financial institutions should review and revise their insurance policies as needed to make sure they have adequate coverage, Treglia said. Employment practices liability insurance is essential for any company considering layoffs, she said.

"That's absolutely going to be impacted. We're already seeing it," Treglia said.

Property/casualty lines are still seeing rate reductions in these products and customers are cutting back on limits or premiums, so profitability

in these lines is down. "Where they are doing well is on [D&O and E&O] lines, but the claims are also coming in," she said.

Nonprofit organizations are not immune from the economic turmoil and soon could be filing claims against their directors, said Harold Hirshman, a partner in the Chicago office of law firm Sonnenschein Nath & Rosenthal LLP. For example, Madoff allegedly bilked some \$110 million from Yeshiva University, even though he was one of its trustees.

"The Madoff thing and the stories about it point out that this issue isn't limited to the Citicorps of the world," Hirshman said. Some nonprofits, like Yeshiva, waived diversification obligations and entered into what's called an "interested transaction" with their investor—one that's between an entity and a director or officer that is "inherently suspect," he said.

Claims from nonprofits would need to be brought by the state attorneys general, and will vary from state to state. Allegations could include gross negligence or willful and wanton misconduct, Hirshman said. The office of New York State Attorney General Andrew Cuomo already is investigating Madoff, he said.

It's a somewhat delicate situation. Many nonprofit directors and officers volunteer their time and don't personally profit from their relationship with the organization, Hirshman said.

"There are certainly a lot of questions that exist with some of these transactions with charitable organizations," he said. "It's like quicksand out there."

—*Senior Associate Editor Alyn Ackermann contributed to this story.*

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