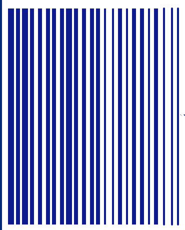

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Underwriters of D & O and Professional Liability Insurance

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"The lesson that appears to have been learned is that there is no downside risk to misleading investors. You artificially inflate the stock, you sell your stock at inflated prices, shareholders sue, you are indemnified, so either the company or the Directors & Officers liability insurance pays the tab for the final lawsuit settlement."

Securities Class Action Alert, December 2001, Page 52.

While the above qotation may be an overly pessimistic comment, there is no doubt that the collective D&O market is facing massive aggregate losses. Attempting to regain some control in the claims process, insurers are looking to partner with buyers in their own loss control and loss mitigation. One option is coinsurance.

Some History

Prior to the Nordstrom, Inc. v. Chubb & Son, Inc. decision in 1995, there existed a measure of "constructive" coinsurance through the allocation of a part of any settlement to the uninsured corporation, thereby reducing the contribution of the insurance companies.

But by concluding [among other things] that any liability that might attach to the uninsured corporation was concurrent with the covered acts of the Directors & Officers, Nordstrom effectively closed allocation as a source of possible relief available to the D&O carriers.

The subsequent inclusion by the D&O market of entity coverage for securities claims meant that the stage was set for 100% of loss settlements for covered acts to be borne squarely by insurers. That, along with a glut of insurance capacity in the late 1990s, successively reducing premiums and a surge in the number of securities class action lawsuits, is how we arrived at the current parlous state. Now, seven years after the Nordstrom decision, coinsurance is making something of a comeback.

Two Types of Coinsurance

Coinsurance sounds simple enough: the insured sharing losses proportionately with its insurers, but there are actually two main types of coinsurance being employed by insurers today. Brokers, buyers and fellow carriers should be very clear which one is being used in any given program.

1. Limit Reducing or Limit Sharing Coinsurance
In this form, the carrier requires that the insured participate on every loss, on a stated percentage basis, until the policy limit is exhausted. For example, a 20% coinsurance provision on a $5,000,000 policy means that the insurer will ultimately pay no more than 80% of the policy [$4,000,000] with the insured responsible for the other 20% [$1,000,000].

2. Loss Reducing, or Full Limit Coinsurance
In this version [using the same amounts as in 1], the insurer is responsible for the full $5,000,000 policy limit, and requires the insured to pay 20% of every loss until the $5,000,000 limit is exhausted. A $5,000,000 loss that would have exhausted the full policy limit in 1) will in this case erode only $4,000,000. The insured is liable for the other $1,000,000 [20%]. It will take losses totaling $6,250,000 for the insurer's $5,000,000 policy limit to be exhausted.

In either example of coinsurance, premium relief is given. As to how much, on this point the market is evolving; while

a coinsurance option is now being offered almost routinely, current discounts have generally not been enough to draw buyers away from a fully insured program.

Another Option

If the goal is to focus buyers on loss mitigation and tie their fortunes to those of the carriers, another possibility is to use significant self-assumed retentions. Retentions have always been part of D&O liability insurance, particularly for Coverage B, but typically at levels that provide no real incentive to question a settlement. Raising them significantly is an underwriting tool currently being used, but as with coinsurance, the premium savings need to be sufficiently attractive.

Summary

That times are challenging for the D&O market will be no surprise to readers of this newsletter. The interests of insureds need to be more closely aligned with those of their insurers. Unreasonable and speculative demands from plaintiffs' attorneys should be countered by greater resistance from buyers, driven in part by an increased financial involvement in the outcome. While many factors contributing to the current crisis are beyond the control of underwriters, coinsurance and retention provisions are ways in which they can exert some influence. Properly used, coinsurance and increased retentions can provide buyers with significant cost savings in return for their greater involvement with the claims process, which will benefit everyone. ✍

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