

## III Europe's D&O insurance market

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The European D&O market has been shaken up since the onset of the current financial crisis. The high number of insolvencies and indemnifications means board members must ensure they are fully protected against potential claims. Julian Elms, a class underwriter at Catlin Insurance Company (UK) Limited, expects the market to experience a surge in activity. "Financial concern for some of the largest carriers has impacted buying decisions by insured parties. A-side policies are being purchased more regularly by European purchasers. Claims activity has increased since the start of the financial crisis, particularly for financial institutions. In addition, the number of corporate debt defaults is growing, and will have an impact on claims activity," he says. Heightened activity means both insurers and their clients should be more thorough when drafting insurance agreements.

Experts agree both the frequency and severity of D&O insurance claims are rising and the market is experiencing major changes. Awareness has grown since the economic downturn and company leaders are demanding greater insurance protection. This is a result of shareholders, dismayed by declines in market capitalisation values, taking legal action. Looking at the Swedish market in particular, Susanna Norelid, a partner at Advokatfirman NorelidHolm, says despite claims against board members being low in the past, the D&O market has recently become more active. "Claims regarding insider trading are becoming increasingly common. However we have not yet seen that many – at least official – major claims. Claims from employees, creditors and shareholders are also increasing but the same applies here, which means that the claims have up until now rarely lead to any reimbursements from the insurer. Many claims are also settled between the parties without the involvement of the insurer. So far, the costs for Swedish/Nordic insurers often only amount to investigation and attorney costs." Although the region is now more attentive towards claims, in both making and receiving them, the number of actual claims being processed through insurance channels remains low. But industry experts suggest having insurance is still a priority given the uncertainty surrounding financial institutions.

This uncertainty has led to greater numbers of individuals making claims against bankers and brokers. Shareholders dismayed by losses on shares, are placing the blame on company decision makers. A similar scenario occurred in late 2000 when IT stocks crashed. But experts point out that many cases do not result in actual reimbursements since board members cannot be held accountable for poor market conditions. A greater workload for those administering the claims is often the only outcome.

Also, indemnifications are more common in certain countries like the Netherlands and Belgium but do not have the same implications as the US. Francesco Dal Piaz, regional manager of Southern & Eastern Europe at HCC Global Financial Products, a subsidiary of HCC Insurance Holdings Inc., says the likelihood of corporate indemnification varies across Europe, "and is generally more difficult under a civil code regime. Although there seems to be a trend that indemnification is more and more accepted, it is by large untested and hence a very grey area in many European jurisdictions." If case volumes continue to grow and

payouts become more frequent, insurance providers could raise premiums in order to offset greater risks they are taking on.

Presently, the most concerning source of D&O claims against Europeans is the US. Reports by NERA and Cornerstone suggest a noticeable increase in SEC filings in cases where non-US firms are defendants. The expense of countering such cases is high, especially when there are settlement costs. In addition, regarding Europe, experts believe the economic downturn will bring with it inaugural cases, where opposing parties, often new and old management teams, are both insured.

The frequency of claims has brought greater risks for insurers, pushing them to increase their insurance premiums. The financial crisis will see more European D&O claims put forward by competitors as well as shareholders. But experts still insist higher case numbers will not necessarily translate into more reimbursements, as previous claim booms have shown. But Ms Norelid thinks the collapse of AIG last year has raised market awareness in both the US and Europe. "The market became much more aware of the risks they face if the insurance company providing their D&O insurance faces bankruptcy, she says. "This has brought on demands from brokers and policy holders on insertion of a so called Security Default Cancellation Clause. Such a clause is designed so that if the insurers' credit ratings fall under an agreed bottom credit rating the policy, the holder is free to transfer the insurance to another insurance company." This freedom will allow more certainty when making business decisions, knowing that cover can be switched to a more secure provider.

In addition, the European D&O market is expected to place more emphasis on the continuity and flexibility of its insurance coverage. Circumstance provisions, non-aggregation clauses, and insurability of fines and penalties will all become policy features to counter the impact of the financial meltdown. "Insurer solvency concerns, pricing and terms are beginning to reflect the losses that are expected due to the financial crisis," thinks Mr Elms. "There is a definite lag between claims materialising, eroded profitability and price increases. We are now clearly in a market with increasing rates." Although financial institutions are experiencing higher rates, other industries, even traditionally high-risk pharmaceuticals and biotechnology, have negotiated rates cuts. This is partly due to companies agreeing lower prices by opting for larger deductibles.

### Impact of changes in laws

Companies and their directors must also take into account alterations to the laws governing D&O insurance. The most significant change, adopted by some European countries, is the introduction of the class action system. Already prominent in the US, the process will allow shareholders unable to launch law suits individually to take action together. Also, changes to bankruptcy proceedings by some jurisdictions will make directors and officers more liable to face charges. "Furthermore, Foreign Corrupt Practices Act enforcement activities against European companies may also alter the D&O insurance market," says Mr Dal Piaz. "More legal and regulatory developments will follow due to the failure to properly evaluate risk within financial institutions, their con- ▶▶

trollers, and the consequent need for State intervention to mitigate the aftermath of this perfect financial storm.”

Within Sweden, some changes to laws have given rise to uncertainties regarding the responsibilities of directors and officers. For example, laws on insider information have been upgraded, preventing a company from acting on private information to secure higher value on a stock or financial instrument. Although the move is intended to clamp down on boardroom corruption, the nature of the ruling has created uncertainty. “According to a recent judgement from the Swedish Supreme Court, it is permitted to buy a financial instrument on insider information as long as the information lacks details and only consist of a recommendation such as ‘buy’ or ‘sell’. Since the situation regarding insider offences is uncertain, this naturally affects the D&O insurance market,” points out Ms Norelid. This is likely to push up the price of coverage given the added uncertainty insurers must now factor in.

The performance of directors before the onset of insolvency will come under greater scrutiny of. Legal advisors will look to determine whether poor management, resulting in damaged operations, caused the company’s problems. In this instance, D&O insurance payouts can effectively be used to ‘reimburse’ creditors and stakeholders if a link between insufficient assets and mismanagement can be legally proved. Recent events in Sweden have increased the likelihood of policy changes arising from insolvency cases. Investment bank Carnegie was last year taken under state control after taking exceptional risks by lending large amounts to one client. “Exposing operations to such great risks in the way done by Carnegie is a breach of Swedish legislation. Also neglecting to notify such operations to Finansinspektionen (the Financial Supervisory Authority) has been held to be an act not in compliance with Swedish law,” says Ms Norelid. “Individual claims against the directors and officers of Carnegie have not yet surfaced but it is likely that we in will soon see claims against the responsible directors and officers in Carnegie.” It is likely Sweden’s D&O market will take into the account the outcome of claims against Carnegie when considering how to draft fresh policies.

When assessing Europe overall, Mr Elms agrees insolvency is one of the major D&O exposures across all jurisdictions. “During insolvency, often the legal screen of the entity is dissolved, directors and officers, as natural persons, are held personally liable for significant portions of any liabilities of the bankruptcy estate. With growing numbers of corporate debt defaults due to the current economic environment, the loss in expectations and their severity will have an impact on the insurers’ profitability, and therefore on their pricing behaviour,” he explains. It is therefore likely that insurers will increase their prices to counter the large sums

they are contracted to pay out due to more insolvencies. The price hike has forced companies to search the market, evaluating offers from other insurers in the hope of finding the same level of cover for less.

Cases such as Carnegie in Sweden and the indemnifications that follow are avoidable if firms quantify risk better and adopt higher corporate governance levels. The recent economic downturn has highlighted the lack of risk quantification. “Also, firms should match risk need, in terms of limits of liability purchased, with an adequate wording that guarantees the broader terms and conditions, supported by insurance companies that are able to meet the long tail liability issues – thus making the long term financial strength of the carrier the first point on the agenda,” suggests Mr Dal Piaz. In addition, he says when firms quantify risk, insurance brokers should provide assistance in helping clients understand their vulnerabilities. Ms Norelid adds that insurance should be purchased on valid, statistical data which reflects a company’s needs. “One should also keep in mind that each insurance policy is a highly negotiated financial instrument and that detailed fine print often entails regulations which can lead to losses for the policy holder. All too often, D&O insurance purchasers become so focused on pricing that they fail to scrutinise the actual contract terms of the insurance.” Experts agree that acquiring insurance should not be taken lightly and cost should be one of several considerations. In testing circumstances, insurance cover can be rendered inadequate by litigating parties because it does not protect against all D&O activities.

But the wave of claims expected in the near future will help insurers identify ways of improving existing products. Experts say that D&O products are constantly evolving, with insurers offering variations on conventional cover to suit client’s specific needs. Mr Dal Piaz, speculating on future products, says, “I wouldn’t be surprised to see some insurers introduce D&O coverage for liquidators, when appointed, that would properly insure their liabilities in their specific role as liquidator. It is a niche that could be developed considering the bankruptcies, and hence increased demand for liquidators, hosted by this financial environment.” Increased competition in some insurance markets has already resulted in a greater variety of products on offer.

D&O insurers appear to have a prominent role to play in the near future. Volatile markets around the world have left firms and their directors scrambling to ensure coverage against potential litigation. Since insurers will be more restrictive on reimbursements in certain cases, directors and officers may seek to spread their cover across several providers, partly to avoid a scenario where a sole provider defaults and is unable to pay out. ■



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