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CAS Reinsurance Bootcamp
Professional Liability

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Line of Business Overview

Defining the Terminology
Professional Liability can mean several things…

- While the term “Professional Liability” can be used to represent the collection of Directors and Officers (D&O), Errors and Omissions (E&O), Employment Practices Liability (EPL), Fiduciary, Fidelity & Crime, and Transactional Liability coverages…

… this collection of coverages, each of which falls outside the scope of standard liability insurance is more commonly referred to as **Financial Lines**

- Typically, Professional Liability, when stated in a more specific context, is referring to a variation of Errors & Omissions (E&O) or Professional Indemnity coverage
- Management Liability is another name for Directors’ and Officers (D&O) insurance
- Mergers & Acquisitions (M&A) is another name for Transactional Liability insurance
- Cyber insurance sometimes included with Professional Liability

What are the major Professional Liability coverages?
Each covers against a different type of exposure

- Directors & Officers (D&O)
  - Liability from Management of Company
- Errors & Omissions (E&O, aka PI, etc.)
  - Liability from professional service provided to customers
- Employment Practices (EPL)
  - Employment issues (hiring, harassment, etc.)
- Fiduciary
  - Administration of benefits (health, life, 401k, etc.)
- Fidelity / Crime
  - Often marketed with liability, but first party cover
- Transactional Risk Liability
  - M&A insurance meant to help deals close smoothly
- Cyber Liability
  - Spinoff of Tech E&O for computer related issues
  - Evolving liability for privacy, viruses, ransomware, breaches, etc.

- Coverages are meant to **complement a larger insurance program**, providing coverage for claims otherwise excluded in other casualty policies
- Companies face risk of financial loss not driven by bodily injury, property damage, etc.

How are Professional Liability policies written and sold?
It depends on the insured

- For small private firms – for simplicity and economy lead many of these coverages to be blended into simpler package form with multiple coverage parts
- For large financial firms – traditionally Fidelity & E&O and sometimes D&O sold together, with blended limits
- For large commercial firms – D&O usually separate from E&O; Fiduciary & EPL are sometimes sold with or tied to D&O

- For reinsurance treaties:
  – D&O and E&O can be covered together or separate
  – EPL and Fiduciary often included, as they are rarely reinsured separately
  – Fidelity can be packaged with professional or surety

Building Large Towers
Protection needed can vary by company size, type & coverage

- With potential claims in excess of $100 Million, Large public companies seek substantial limits – sometimes as much as $500 Million
- Few insurers willing to commit $25 Million or more in capacity – so multi-insurer towers are constructed
- Generally insurers with strongest reputation / rating and willing to offer largest blocks of capacity are primary
- The market price for each successive layer rarely follows any actuarial assessment of loss exposure
- Stacking / Ventilated Limits – when the same insurer covers more than one layer on an insured
- Multiple insurers may share a single layer
  (for example 20% of a 100M layer = 20M p/o 100M)
  This is common for some types of E&O and Fidelity, but rare for Commercial D&O, where insurers tend to take 100% of a horizontal slice of the insurance coverage

Tower
5M xs 135M
5M xs 130M
5M xs 125M
10M xs 115M
15M xs 100M
C 25M xs 75M
B 25M xs 50M
Company A 1st 50M
10M Deductible

General Properties of Professional Liability

- Mostly Claims Made or Claims Made and Reported basis
- Non-standard forms
- Many corporate policies written on aggregate basis – rather than per claim
  - Smaller policies may have both per claim and aggregate limits
- ALAE often reduces the policy limit, though some lines not
- Medium-to-long tail loss development
- Most lines subject to high severity claims
- Often difficult to reserve

Errors and Omissions (E&O)
Covers liability for professional services provided to customers

- Covers wrongful acts from providing professional services
  - Including negligence and misrepresentation
  - Extends to liability beyond specific injury protection provided by GL coverage
- Medical Malpractice is probably the best known
  - But most specialized professions offering services are exposed – even actuaries!
- The key issues involved in underwriting the line:
  - What does the firm do – what are the professional services?
  - What is the standard of care?
  - How is liability adjusted through contracts?
- Typically rated on Revenue (or for some lines # of professionals)
- No standard policy forms

Errors and Omissions (E&O)
Covers liability for professional services provided to customers

- Some insured specialties are typically segregated into programs and written by specialist underwriters or MGA's
  - Medical (incl. Hospitals, Physicians, Nurses …)
  - Lawyers (LPL)
  - Architects & Engineers (A&E, or DPL – Design Professionals)
  - Accountants (APL)
  - Insurance & Real Estate Agents
  - Financial Institutions (FI incl. Banks, Insurance, Asset Managers …)
  - Tech Firms
  - Media Liability sometimes broken out
  - Whatever is left (this can vary by company) is "Miscellaneous" MPL

- Reinsurance treaties often cover multiple programs, but will not necessarily combine all E&O programs the company writes

Directors & Officers (D&O)
Covers management liability to shareholders, competitors, governments, etc.

Policies insure…

…Directors and Officers…

- historically, only D's & O's, but broadened during the soft market of the 90's to include some entity coverage

…for wrongful acts

- defined as any act, error or omission in their capacity as D&O
- usually includes Employment Practices Liability, but excludes "professional services" (E&O)

- Typically rated on Assets or Market Value (for public companies)
- No standard policy forms

Who buys D&O?
Companies that need their D&O's to serve…

- Bought by the Company
  - D&O Coverage is voluntary (not required by law), but almost all large Public firms (and many private firms) buy some
  - Primarily for the benefit of the Directors and Officers

    (It's expensive, but then so are other executive benefits!)
  - Multiple Towers are possible, but generally all the D&O's share coverage and limits

Why buy D&O?
Litigation, Litigation, Litigation!

- Private or Not-for-Profit Companies
  - Mostly Employment Litigation
  - Bondholders (if for profit)
  - More rarely Customers, Competitors or Regulators
  - Entity coverage expanded relative to public companies

- Public Companies
  - Exposed to similar suits as Private
  - Shareholder Litigation
  - Even options speculators can sue for stock fraud
  - Usually some EPL coverage, but often also have separate EPL policy

But **shareholder litigation** often involves much larger payouts (and defense costs) than other causes, so it leads to **most of the payout $ of public D&O**

Shareholder Litigation
What type of Allegations?

Common Allegations include:

- Making unsupportable positive forecasts of future results
- Failing to disclose the likely / imminent failure of a key product
- Improper Accounting (failure to accurately state historical results)
- Self-enrichment by Directors such as Options Backdating
- Merger & Acquisition issues – such as blocking a favorable buyout

While allegations differ in their likelihood to prevail, the circumstances and quality of evidence can lead some claims to be summarily dismissed and others to mandate payment

For example, inappropriate conduct claims are more challenging to win due to the plaintiff's burden of proof

Shareholder Litigation Legal Standard
What plaintiffs need to prove

1. Defendants made material misrepresentations or omissions
2. Defendants acted intentionally or recklessly, not simply in error
3. Misrepresentations pertained to the purchase or sale of securities
4. Plaintiffs relied on the representations (directly or indirectly via share price)
5. Plaintiffs suffered economic loss
6. The fraud caused this economic loss

- Interpretations have changed with laws and court rulings
  - Private Securities Litigation Reform Act (PSLRA) of 1995
    - Meant to limit frivolous securities lawsuits
    - Requires plaintiffs to show reliance on <u>specific</u> misrepresentations
  - *Dura* decision requires showing tying of plaintiffs economic loss to the fraud, not merely that the fraud influenced the price

Know your ABC's
The many sides of D&O (…three)

- A-side
  - Covers D&O when the employer cannot
  - Bankruptcy / Derivative / "DIC" situations (such as rescissions)
  - Historically A-side only policies have had fewer payouts
- B-side
  - In most circumstances, companies must defend and indemnify their current and former D&O's – B-side reimburses for this expense
    (So this essentially protects the company's balance sheet)
- C-side / Entity Coverage
  - Coverage when entity is itself named by its shareholder
  - Intended to avoid allocation issues when settling a joint suit
- While A-side is often covered by itself (if company retains B-side risk), or as a supplement on top of a tower of full coverage D&O (A / B / C), it is rare for a policy to include B-Side without A-Side

Employment Practices Liability (EPL)

Policies insure…

…the Company and its Employees…

…for allegations of wrongful employment practices

- Discrimination (Gender, Race, Age, Disability)
- Wrongful termination
- Sexual Harassment
- Retaliation

- Most claims involve individuals, but larger firms have additional class-action exposure – important for excess EPL on larger risks
- Recent uncertainty exists around # of lawsuits arising and leniency of juries in shifting burden of proof to defendants under the "Me Too" movement

Fiduciary Liability

- Policies insure individuals charged with the responsibility of creating, managing, and administering employee benefit plans
- Liability arises from obligations under the Employee Retirement Income Security Act (ERISA) of 1974 created to assure promised benefits are paid
- Claims typically fall into two categories of coverage:
  - Fiduciary Liability deals with the higher-level decisions about plan structure or company stock – “discretionary” acts involving judgment
  - Employee Benefits Liability or E&O encompasses the lower-level handling and actual administration of the programs by HR department – “non-discretionary” acts of simple negligence

Fidelity / Crime

- Commercial Crime
  - Insurance against fraud, embezzlement, forgery, misrepresentation, robbery or theft – by a company’s own employees or others – for firms other than financial institutions
  - Can also include kidnap, ransom or extortion coverage
  - Fills the exclusions gap in Commercial Property policies (e.g. theft by employees, coverage for stolen cash & securities)
- FI Bond
  - Specific to financial institutions
  - More employees have “access to the money” at these firms – can require more sophistication in underwriting as more complex exposure

Transactional Risk Liability

- Representation and Warranty (R&W) Insurance
  - Typically purchased by the buyer, but available to seller too
  - Covers risk of a target company's seller breaching representations and warranties in the applicable securities purchase agreement
    - E.g. financial statement inaccuracies, customer contracts, product state
  - Lowers the required escrows by seller, facilitating the transaction and preserving relationships with sell-side management
- Tax (Opinion) Liability Insurance
  - Protects the insured against unexpected additional tax requirements
- Increased in popularity in recent years as way to smooth M&A transactions
- Typically multi-year policies

Pricing

Professional Liability Contracts

- Majority of reinsurance treaties tend to be simple structures
  - Quota Share (QS) and Excess of Loss (XOL) per risk
  - Some Variable QS (by limit or attachment) – but few Surplus Shares
  - Some treaties involve aggregate loss sensitive features
    - Aggregate limits or reinstatements
    - Annual Aggregate Deductibles (AAD)
    - Loss Corridor, Swing Rate, or Sliding Scale Commission
- Event / Clash covers are rare, except for Medical
  - Can be difficult to define, and more difficult to price
- Aggregate Stop Loss are presently rare, but growing interest
- Most treaties are currently single year

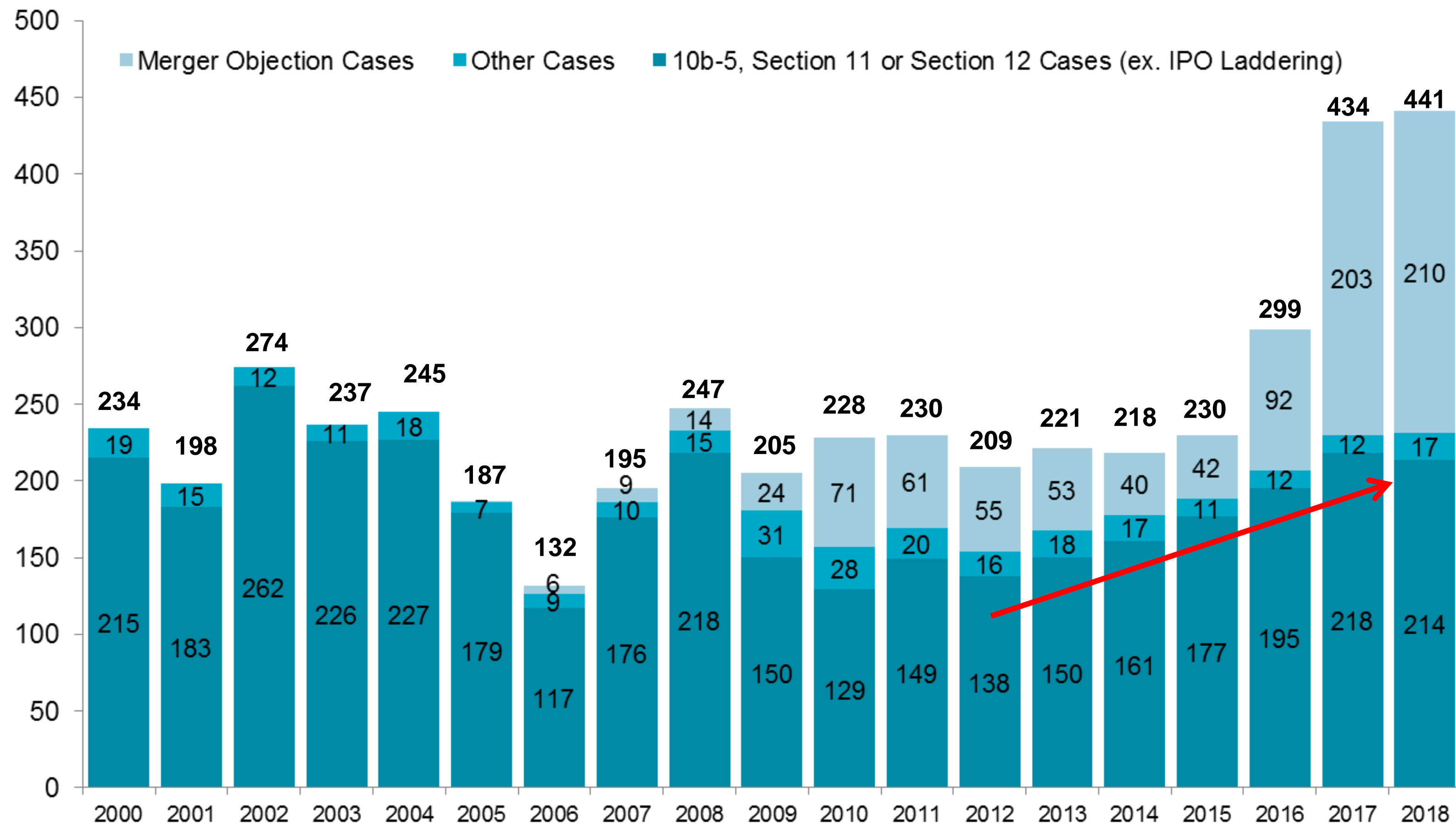
Pricing Issues

- Losses can be severe
- Some lines / layers have few claims – but even when we have many, for most projects the by year results can be driven by few claims
- Large claims can be correlated – either from true clash, general events affecting an entire class of policies, or systemic events across the industry
- Developing to ultimate is difficult – especially for the latest years
- Case law, forms, and underwriting can all be moving targets
- An insurer with $100 Million premium of Public D&O might have 100 policies each with $25M limits.
  Paying less than 3 (limit) claims = profit,
  more than 3 claims = loss,
  and it may take years to know the difference…

Examples of Significant Financial and D&O Events

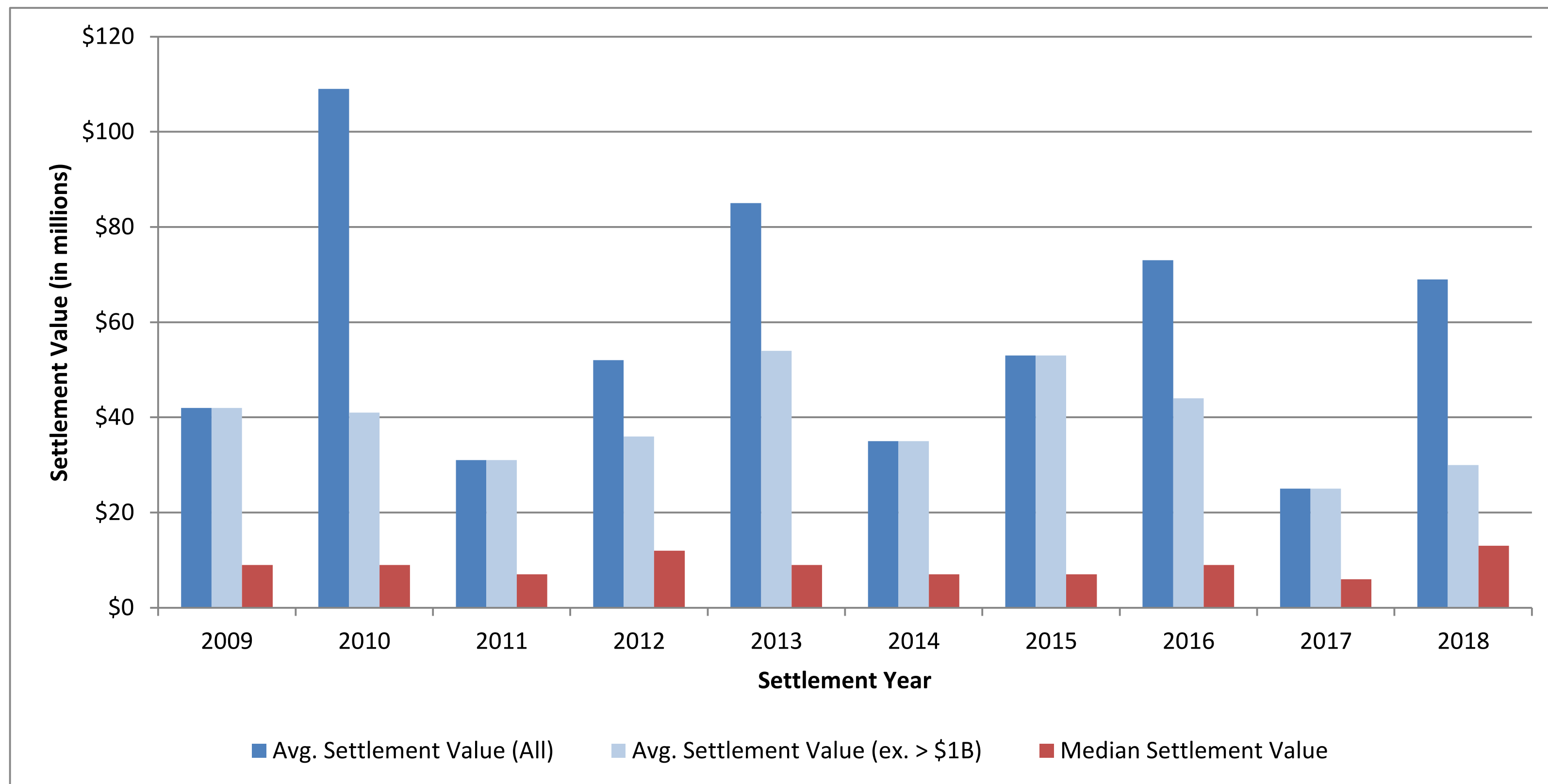
Event / Litigation Wave	Sectors Affected	Allegation	Approximate Cost
Predatory Credit, Lender	Banks, Consumer Finance	Misleading and/or usurious interest	$ 2B
IPO Laddering (2001)	Investment Banks, IPO firms	Unfair IPO allocation & price manipulation	$ 600M
Enron (2002)	Banks (Money Center)	Helped fund Enron with disguised loans	$ 4B
Analyst Claims (2002)	Investment Banks	Fraudulent research to solicit investment banking	$ 1.5B
Mutual Late Trading (2003)	Mutual Funds, Brokerages	Deceptive/preferential treatment to select investors	$ 2B
Options Backdating (2006+)	General D&O	Intentional misreporting executive compensation	$ 2B
Subprime (2007-08)	Inv Banks, Brokers, Banks …	Deceptive practices UW and packaging loans	$ 1.5B
Credit Crisis	Banks (mostly)	Hiding impairment of assets (subprime loans)	$ 6.5B+
Madoff (2008-09)	Asset Managers	Ponzi schemes with diverted funds	
M&A Bump-ups (2009+)	General D&O	Injunctive suits against most major M&A	
Chinese Reverse Mergers (2010)	General D&O	Discrepancies between US and China reporting	

10b-5, Section 11 and 12 class action filings have increased …



- Significant spikes in the # of SCA filings for 2016 through 2018
  - Merger Objection suits drove the large increase in filings, but "Standard" filings (10b-5, Section 11 or Section 12) claims steadily rose from 2012 through 2017. How strong are the suits being filed?
  - Figures above also do not track the growth in IPO suits in state court post-Cyan decision (if no accompanying Federal suit is filed)
- As 10-b5 suits increased, the number of publicly traded companies on NYSE and NASDAQ has remained relatively consistent the past 10 years (average is 5,150 companies with any given year +/- ~4% per year)

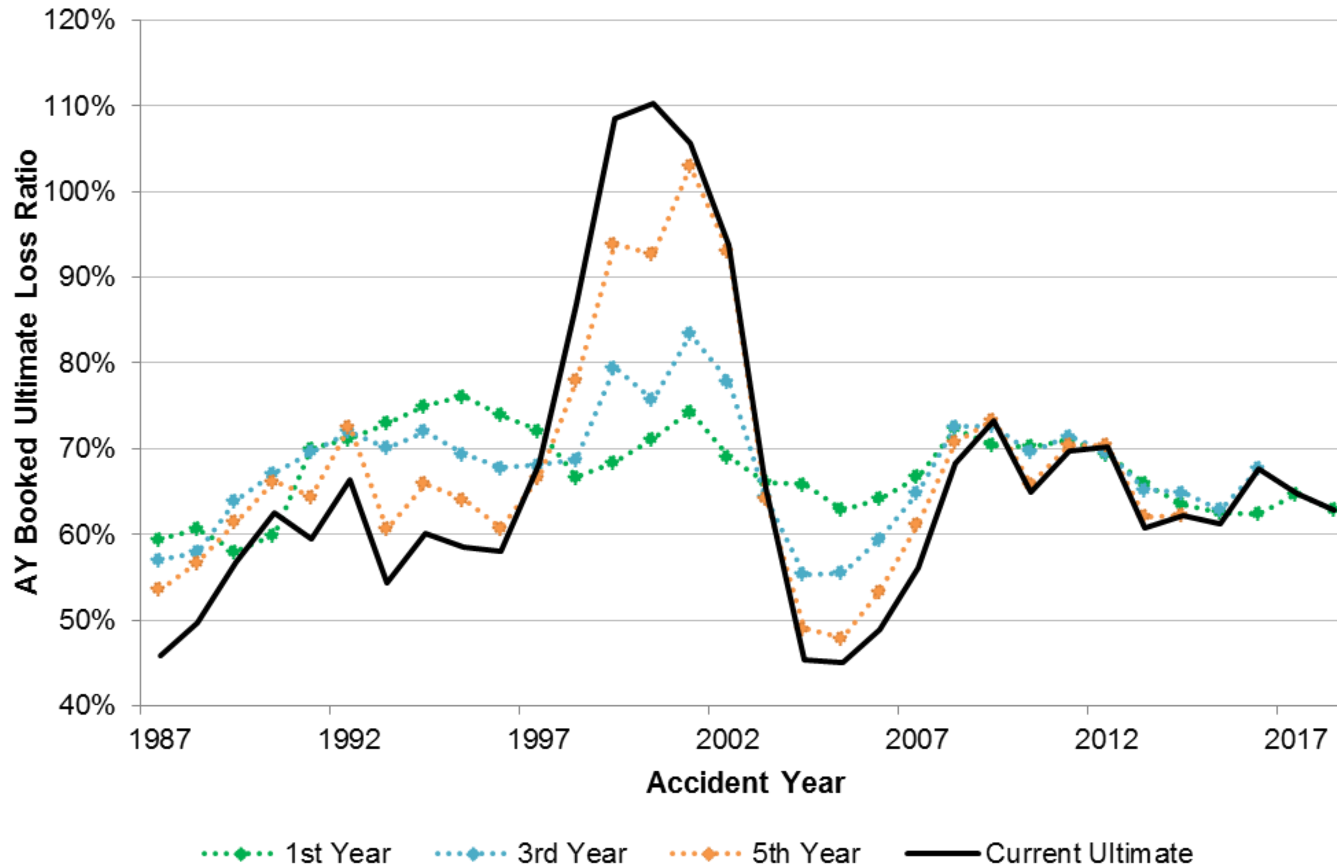
… but average values of class action settlements have been volatile



- Settlement sizes are volatile, and trends can vary by layer of insurance
- Average Settlement Value (All) has been above $40M 5 of the last 7 years; this can be skewed in a given year due to presence of large settlements

Notes:
Average Settlement Values excludes Merger Objection Cases, IPO Laddering Cases and $0 Payments to the Class (**NERA: Recent Trends in Securities Class Action Litigation: Year End 2018)**
Median Settlement Values exclude Settlements > $1B, Merger Objection Cases, IPO Laddering Cases and $0 Payments to the Class (**NERA: Recent Trends in Securities Class Action Litigation: Year End 2018)**

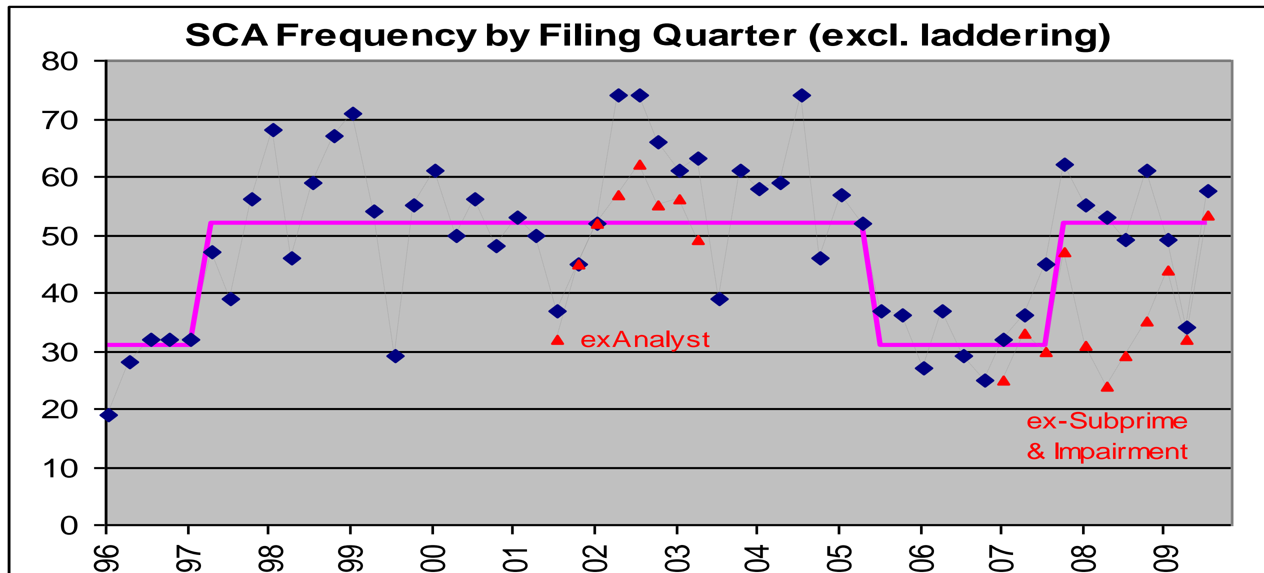
Rate Cycle generally drives Professional Lines Results



Notes
Source: Schedule P – Other Liability – Claims Made for Industry (Predominantly Professional Liability).
Loss ratios displayed are net of reinsurance. Net view selected due to availability of the oldest years.
Gross of reinsurance loss ratios display similar pattern to the above.

- Timing & smoothness suggest that Financial Events are not the dominant factors
- 2002 had much higher claim count & payout than 1999-2000, but policies were written at higher rate levels
- Rates softened from 2003 until 2011 – but loss activity also reduced during the period from 2003-2006
- In the period since 2010, companies have not adjusted reserves from their initial booked values much relative to the extent seen from 1998-2008
- 2011-2018 characterized by rate decreases and a lack of major events

Security Claim Frequency (D&O) – stable … except when it isn't



Source: Stanford Law School

- In early 2005, claim count dropped abruptly from about 50 per quarter to 30
- Subprime contributed many additional cases, but paradigm then shifted to around 40 claims
- The cause of the 2005 drop is still being debated:

US Supreme Court decision *Dura*?

Problems with the plaintiff attorneys?

Sarbanes-Oxley?

Stable stock market?

Major components in reinsurance pricing

- Historical Company-specific and / or Industry Loss Ratios
- Reinsurance Exposure Rating
- Reinsurance Experience Rating
- Rate Change
- Trend
- Expense & Risk Load

Historical Industry Loss Ratios

There are many sources of industry losses and loss information

- Annual Statement (incl. Schedule P) provides some information
  - "Other Liability Claims-Made" = Most Professional Liability falls here
  - Med Mal is its own section
  - Fidelity is grouped with Surety
  - D&O only supplement started in 2011 (by calendar year)
- ISO, Brokers and Third Party vendors have statistics on various segments – but the information may not always be representative of the whole
- Public D&O shareholder claims available at Stanford website
- Some EPL claims available from EEOC and vendors
- The challenge is that few sources let you drill down to estimate the profitability of layers & classes within a larger portfolio

Reinsurance Exposure Rating

- Exposure rating combines portfolio exposure with industry loss information
- Often there is no single standard benchmark Increased Limit Factors (ILF) to allocate expected loss to reinsurance layers, or primary rates
- Primary Insurers will often have their own ILFs that assist them in pricing, calculating rate changes, etc., but these may not be perfectly reflective of the layer risk to the industry and / or their portfolio
  - For XOL on excess policies, most PL ILFs quickly converge to pro rata sharing of policy premium between insurer and reinsurer
- For Public D&O, some primary companies use exposure models for individual risks
  - D&O experience on individual risks is too scarce
  - Industry loss data is more easy to get and combine

Gunpowder and baby powder firms face different E&O & WC risk, but their accounting, governance and investor relations are similar

Reinsurance Experience Rating

- Claims made means the existence of (most) claims will be known quickly, but identifying the significant ones is more difficult…
- …so many companies may hold claims at an initial or signal value until they have sufficient information to reserve or close
  - This "sufficiency" leads to inconsistent development across companies, and even within a company, across lines / years
    - distorting incurred LDFs, especially for excess layers
  - Reserves on emerging systemic events can be "sticky"

- Most PL books undergo substantial mix changes over time
  - E&O segments and D&O industries get added / dropped / reweighted
  - Limits and excess layers can substantially shift
  - Underwriters (and even whole teams) move between companies

Reviewing Experience

In reviewing claims, especially for XOL, make sure you understand:

- ALAE treatment (for lines where not included in limit)
- ECO / XPL – how does treaty respond
- How claims and policy data reflect stacking. If stacking exists…
  - Are the stacked policies ABC on ABC, A on A, or A on ABC
  - Is there ventilation between the policies that should be modeled
- Does attachment include the underlying SIR
- Do we have the 100% and / or company-specific limit
- How will related claims on a policy be aggregated
- Small signal reserves on high attaching policies can cause issues when making assumptions for ground-up claim trend
- Are Additional Case Reserves (ACRs) applicable to the analysis…

Supplemental ACR Estimates

In certain instances, primary companies may provide unofficial projections of individual claim ultimate values that differ from the carried incurred values. This could involve:

- Coverage litigation
- Emerging events
- Timing lag between the data report and current information

If you use this information to revise your ultimate pick, use caution:

- The sum of such ultimate losses still will not fully reflect IBNR
- If LDF's are derived excluding these, developing case + supplement will overstate the true ultimate

Rate Change

- For experience rating, we need rate change to on-level the premium
- Different companies measure rate change differently
  - Premium changes on exact like-to-like renewals
  - Adjusted premium change on most / all renewals
  - Year-over-Year change in actual rate vs (internal) benchmark
- Only the benchmark method can reflect adequacy of new / lost business
- Rate may or may not reflect change in underwriting exposure (such as an increase in revenue or a growing D&O market cap)

Trend

- Loss Trend is difficult for PL lines
- Frequency can shift over time
- Loss Ratio trends are often based on observations of severity trend as this is easier to track, and its existence is more intuitive than frequency trend
  - Short term shifts difficult to measure due to impact of few large claims
  - Some focus on median rather than mean, or cap the largest
- Where many claims hit policy limits, limited severity trend is often significantly lower than the unlimited severity trend
  - However, limited severity trend can exceed unlimited if claims are fairly below policy limits on high attachment points (trend to full limit)
- In some cases, there may be an offsetting exposure trend. This would depend on how frequency trend and rate change are measured

Disclaimer

- The opinions contained in this presentation are the author’s and do not necessarily represent Guy Carpenter or the Casualty Actuarial Society.

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