Directors & Officers (D&O) liability policy primer and claim modeling potential

Casualty Loss Reserve Seminar

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Presenters

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Purpose of D&O insurance

▶ Protect the personal assets of directors and officers in the event of a claim

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Who are the officers of a company?

► Past, present and future duly elected or appointed director, officer, trustee or governor of a corporation, management committee member of a joint venture and member of the management board of a limited liability company (or equivalent position);

► Past, present and future person in a duly elected or appointed position in an entity organized and operated in a foreign jurisdiction that is equivalent to an executive position listed in Definition (j)(1); or

► Past, present and future General Counsel and Risk Manager (or equivalent position) of the Named Entity.

Responsibilities of directors and officers

► Duty of care
  ► What a prudent person would do in a similar circumstance
► Duty of loyalty
  ► Act in good faith for the companies best interest

State statute example – Delaware

► A corporation shall have power to indemnify any person who was or is a party, or is threatened to be made a party, to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative.

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Corporate by-laws

► Corporate by-laws
  ► Outline the firm's indemnification obligations to the directors and officers
  ► Are based on the statute of the state of incorporation
  ► Set the stage for how directors and officers liability policies will respond in the event of a claim

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Where do claims come from?

Policy coverage parts

Side A	Side B	Side C
► Side A provides the individual directors and officers with coverage in the event the company cannot, or will not, indemnify them.	► Side B reimburses the company for its indemnification obligation to its directors and officers.	► Side C provides the entity itself with coverage in the event it is named in the suit (some insurance policies may narrow this to securities-type claims only).

Slide 1 — How limits and retentions are structured

- D&O policy structure
  - Deductible levels
  - Limit options
  - Tower
    - Side A, B and C
    - Side A DIC
- Sharing limits
  - E&O
  - Crime
  - EPLI

Separate limits	Shared limits
$35M	$35M
$10M x $25M Side A	$10M x $25M Side A — $36,000
$10M x $15M D&O	$10M x $15M D&O only — $36,000
$15M	
$15M D&O — EPLI	$15M D&O — Shared EPLI

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Slide 2 — Consistency in the tower structure

- Does the excess form follow the terms of the primary?

- Does the excess form provide drop-down coverage in the event of underlying erosion?

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Slide 3 — Typical coverage exclusions

Fines and penalties

Punitive or exemplary damages

Tax liability

Dishonesty

Personal profit

Remuneration without stockholder consent

Coverage typically insured by other policies
- Bodily injury and property damage
- Employment practices liability

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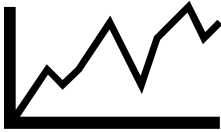Quality In Everything We Do

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Impact of legal trends, laws and regulation

► Policy coverage grants and exclusions change frequently as the market evolves
  ► Examples include
    ► Market timing
    ► Subprime exclusion
    ► Failure to maintain insurance

Definition of claim

► Understanding the variety of definitions surrounding claims
► Coverage can be triggered by
  ► Criminal proceedings
  ► Written demands for monetary and non-monetary relief
  ► Administrative investigations
  ► Arbitration proceedings

Example from Chartis D&O first policy specimen

"Claim" means:
1. a written demand for monetary, non-monetary or injunctive relief;
2. a civil, criminal, administrative, regulatory or arbitration proceeding for monetary, non-monetary or injunctive relief which is commenced by: (i) service of a complaint or similar pleading; (ii) return of an indictment, information or similar document (in the case of a criminal proceeding); or (iii) receipt or filing of a notice of charges; or
3. an **Investigation Claim**. means a civil, criminal, administrative or regulatory investigation of an **Insured Person by the SEC or a similar state or foreign government authority, but only** after service of a subpoena upon such **Insured Person and subject to the Investigation Claim Sublimit of Liability stated in Item 3(a) of the Declarations.**

Policy excerpt from IRMI.com
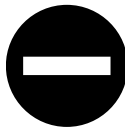

Definition of wrongful act

► "Wrongful act" means any error, misstatement, misleading statement, act, omission, neglect or breach of duty committed, attempted or allegedly committed or attempted, by an insured person, individually or otherwise, in his insured capacity, or any matter claimed against him solely by reason of his serving in such insured capacity.

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Definition of loss

▶ "Loss" means damages, settlements and costs, charges and expenses incurred by any of the directors and officers, but shall not include:

| 1. Punitive or exemplary damages, or that portion of any multiplied damage award which exceeds the amount multiplied | 2. Taxes, criminal or civil fines or penalties imposed by law | 3. Matters deemed uninsurable under the law pursuant to which this policy shall be construed |

Claim examples

Philip Morris
▶ Anti-trust violation

Wachovia
▶ Securities class action

Xerox
▶ Securities class action

Mattel
▶ Securities class action

Mega-claim examples

Countrywide Financial Corporation
▶ Subprime

Bernard Madoff Investment Securities
▶ Ponzi scheme

JP Morgan Securities
▶ Bid rigging

Broadcom Corp.
▶ Options backdating

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Defense cost and settlement allocation

► Aspects potentially excluded from the claim settlement
  ► Professional services – failure to supervisor
  ► Insured capacity
  ► Entity coverage
► Defense costs
  ► May or may not be subject to allocation
► Similar to the definition of claim, there is no standard definition of allocation
  ► Use of best efforts
  ► Relative legal and financial exposures to the parties
  ► Use of arbitration if failure to agree

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Characteristics of D&O losses

► Lower frequency/higher severity than commercial general liabilities claims
► Large events, such as subprime and stock backdating, behave more like catastrophe losses
► Case reserving philosophy varies greatly between companies
► Trigger of claims contains much uncertainties
► Expenses often can exhaust limits provided
► Settlements of cases far outweigh payment of suits

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D&O loss projections

► Traditional methods, such as loss development, BF, ELR and frequency/severity, may be appropriate

► Need to understand company's claims-handling process
  ► Reported claims
  ► Initial reserves setting
  ► Monitoring
  ► Reserves changes
  ► Settlement philosophy
  ► By coverage type

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D&O loss projections

► Differential "normal" losses from "systemic" losses
  ► Normal or attritional losses – random typical losses
  ► Systemic – event(s) driven that affect many corporations or mega-losses
  ► Will want to consider examining these losses separately
  ► Expected loss ratio should have these two components separate

Page 22   Directors & Officers (D&O) liability policy primer and claim modeling potential

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Attritional losses

► Analogous to "non-cat." losses in other PC lines

► No formal definition like catastrophe code (cat. Code)

► Need to be consistent in defining attritional vs. systemic

► Determine expected loss ratio and loss development pattern

► Projections can be easily handled by traditional actuarial methods

Page 23   Directors & Officers (D&O) liability policy primer and claim modeling potential

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Systemic losses

► Examples
  ► Subprime crisis
  ► Madoff claims
  ► Bid rigging
  ► Options backdating
► Analogous to catastrophe (cat.) losses in other PC lines
► Lack of similarity between events
► Need a systemic load for the expect loss ratio
► Projections of the IBNR need for actual events are not easy

Page 24   Directors & Officers (D&O) liability policy primer and claim modeling potential

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Systemic losses

- ► Need to anticipate and identify these claims
- ► Ability to track and understand the book of business is important
- ► Constant communication with claims department is crucial
- ► Need to track legal development and settlement pattern, if any
- ► "Bottom-up" and "top-down" approaches
  - ► Individual claims evaluation
  - ► Macro level evaluation

Page 25   Directors & Officers (D&O) liability policy primer and claim modeling potential

Bottom-up evaluation

- ► Track by exposures and submission of claims
- ► Assign probabilities by types of claims/exposures
- ► Need to consider coverage type
  - ► Side A may have a lower probability if entity is not bankrupt
- ► Need to consider retention (or trigger) level
  - ► The higher the retention, the lower the probability
- ► Need to consider the status of claims
  - ► Existence of case reserves
  - ► Place-holder reserves
  - ► Watch-list
- ► Determine size of the claims
  - ► Limits provided
  - ► Layers exposed
- ► Pure incurred but not reported provision

Page 26   Directors & Officers (D&O) liability policy primer and claim modeling potential

Top-down approach

- ► Macro modeling approach
- ► Based a set of key assumptions
- ► Derive a set of model parameters
- ► Project losses in aggregate based on exposures
  - ► Does not predict how individual loss will fare
- ► Can separate out claims and reserves
- ► Most useful in early stage of systemic event
  - ► Lack of individual claims details

Page 27   Directors & Officers (D&O) liability policy primer and claim modeling potential

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Key assumptions and parameters considerations

► Expected value of D&O losses is a function of the drop in market capitalization
► Distribution of claim – e.g., lognormal
► Claims dismissal rate
► Severity assumptions
► Side A vs. Non-Side A consideration

The next wave

► What will it be?

► Are the companies prepared?