GUY CARPENTER

2012 Seminar on Reinsurance

CS-2 European Debt Crisis and its Impact on D&O
Part I: The Current D&O Landscape

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MARSH & McLENNAN COMPANIES

What is D&O?
Basic Definition

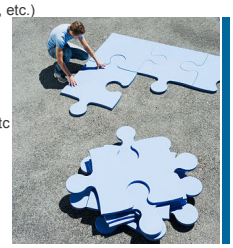
- Directors and Officers policies insure:
  - Directors and Officers
    - historically, only D's & O's, but broadened in soft market of 90's to include some entity coverage
  - For wrongful acts
    - defined as any act, error or omission in their capacity as D&O
    - Usually includes Employment Practices Liability, but excludes "professional services" (E&O)

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
  - Primary for the benefit of the Directors and Officers
    (It's expensive, but then so are other executive benefits!)
  - Coverage is voluntary, but few large companies go without
    Directors will not serve if their personal wealth was accountable
  - Generally all the D&O's share a single tower of coverage and limits

How does D&O fit in with other Professional Liability coverages?
Each covers a different type of wrongful act

- Directors & Officers (D & O)
  - Management of Company
- Errors & Omissions (E & O, aka "MPL", LPL, BPL, etc.)
  - Professional service provided to customers
- Employment Practices (EPL)
  - Employment issues (hiring, harassment, etc)
- Fiduciary
  - Administration of benefits - health, life, 401k, etc
- Fidelity/Crime
  - First-party cover for theft
  - Often marketed with third party D&O/E&O
- Cyber Liability
  - Spinoff of E&O for computer related issues
  - Evolving liability for privacy, viruses, etc
  - Includes first party covers (such as business interruption)



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

- Private Companies
  - Mostly Employment Litigation
  - Bondholders (if for profit)
  - More rarely Customers, Competitors or Regulators
- Public Companies
  - Same as Private
  - Shareholder and Derivative Litigation
  - Even options speculators can sue for stock fraud
  - Usually have separate EPL policy

But shareholder litigation leads to much of the cost of D&O
Coverage for governmental investigations/fines is usually restricted

Shareholder Litigation
How many dollars are at stake?

- Since 1996, there have been hundreds of settlements:
  - More than one hundred exceeded $100 Million.
  - More than ten exceed **$1 Billion** – incl. Enron, Worldcom, Tyco
- Settlements usually come first from D&O coverage, but large settlements can exceed entire insurance towers
- These can involve cash & non-cash company contributions, and can involve contributions by individuals, auditors and other parties
- Recently there have been a number of large derivative settlements
  - Several larger than $100 Million, almost all since 2005

Security Class Action Lawsuits - 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

Sounds simple in theory, but:

What is material?

What qualifies as intent?

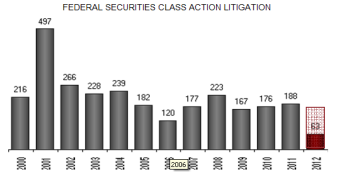
What must plaintiffs present to be allowed to force Discovery?

Interpretations have changed with laws and court rulings…

Evolving Litigation Landscape

- PSLRA - Private Securities Litigation Reform Act of 1995
  - Raised standard of proof for pleading, better consolidation
- Sarbanes-Oxley (2002 legislation)
  - Created new corporate responsibilities, led to more restatements
- Dura (2005 Supreme Court ruling)
  - Plaintiffs had to not only prove fraud, but that this caused loss
- Tellabs (2007 Supreme Court ruling)
  - Allegations of intent to deceive must be more than just plausible
- Morrison (2010 Supreme Court ruling)
  - US security laws do not apply to shares bought outside the US
  - But more suits are now being brought in other countries
- 2010-2011 rise in M&A suits and in Chinese reverse mergers

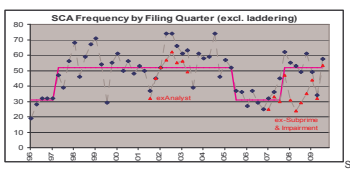
Security Claim Frequency



About 200 security class actions per year.

This amounts to 2-3% of the 6000+ companies traded in the US.

2012 has 63 claims as of late May, annualizing to 161



Claim rate was about 50 claims per quarter

In early 2005 this dropped to about 30.

Subprime contributed many additional cases, but the recent trend is close to 40.

The cause of the 2005 drop is still debated: US Supreme Court decision *Dura*?

Problems with the plaintiff attorneys?

Sarbanes-Oxley?

Stable stock market?

Source: Stanford Law School

Shareholder Litigation
Claims no longer center around Finance

	Filing Year					
Sector	2007	2008	2009	2010	2011	2012YTD
Financial	23%	50%	47%	24%	12%	8%
Services	26%	8%	15%	19%	16%	16%
Technology	20%	13%	8%	13%	26%	22%
Healthcare	15%	10%	14%	21%	13%	24%
All Other	15%	18%	16%	24%	32%	30%

Financial mostly large banks/investment centers in '08 and '09, regional banks in '10.
'11 and '12 are lowest levels since Tech/laddering crisis in 2001!

Services sector includes surge in Real estate operations in '07 and Schools in '10.

Healthcare is typically led by Biotech/Drugs, where stock price depends heavily on R&D.

Technology claims are rising with the recent tide of M&A litigation

Source: Stanford Law School

Shareholder Litigation
What type of Allegations?

	2007	2008	2009	2010	2011	2012
Accounting	24%	23%	19%	22%	29%	11%
Expectation	59%	47%	47%	29%	39%	50%
Conduct (with E&O)	4%	10%	9%	18%	5%	19%
M&A/Improper Listing	10%	10%	9%	27%	22%	17%
Fraud/Self-dealing	3%	10%	16%	5%	5%	3%

"Accounting" alleges material falsehoods in filed information
– often revenue/expense recognition or asset impairment

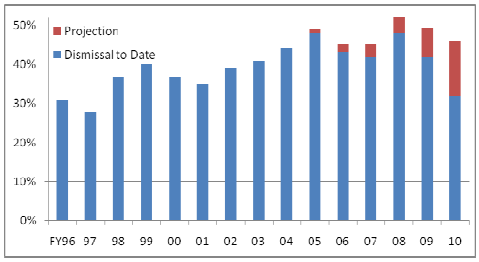
"Expectation" refers to future results/growth/margin
– management made projections that they knew (or should have known) weren't possible

"Conduct" covers loss in share value resulting from E&O/improper actions

2010-2011 saw 42 cases stemming from Chinese firm reverse mergers – mostly accounting.

Source: Guy Carpenter's categorization of allegations of claims from Stanford Law School. Subprime and certain nonD&O claims excluded.

"Crime doesn't pay" – but will Shareholder lawsuits?



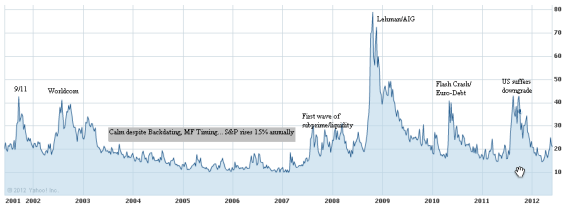
Since 2005 about half of SCA claims result are dismissed without indemnity payment, this is a noticeable increase over the previous decade.

For 2011, while it is still early, there are fewer quick dismissals than 2008-2010.

Source: NERA's security class action database. 2001-02 exclude IPO/laddering and nonD&O analyst claims.

Shareholder Litigation

Investor "Fear Index" reflects caution – but well below Subprime peak



Source: Yahoo! Finance

Market Results?

US D&O Results for 2003-2006 look quite profitable
- Rates contained sharp increases from the 2001-2003 period
- Extremely low frequency in 2005-2006
- Options Backdating (06-07) had minimal effect
- Mutual Fund Timing (03-04) had minimal effect (on D&O)
- Subprime Auction Rate Securities dampened by buyback
- Several favorable court rulings

Subprime results were poor for Financial Institutions
- but much better than originally feared and led to some rate strengthening

More recent results?
- Frequency remains low
- Rates mostly flat – but are far from the hard market highs

Disclaimer

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