

The Evolving Liability Environment

This Alert revisits, with some additional material, the recent Executive Risks contribution to the Willis Marketplace Realities 2007 publication, whose first edition was published November 1.

With 10 mega claim settlements in the first six months of this year totaling roughly \$3.5 billion, both the frequency and severity of such settlements were ahead of 2005's record pace. (Mega claims are those Directors & Officers (D&O) claims where the cash portion of a settlement or court award exceeds \$100 million.) In 2005, there were 17 mega settlements, which followed 13 in 2004. In a counter trend, the frequency of new security class action filings dropped during the first half of this year, along with the size of the related stock-drops. Although the two trends tend to somewhat offset each other, the positive trending for D&O claim portfolios has not reversed cash outflows for D&O carriers.

Corporate directors and their insurers received some good news in the courts. In a closely watched case, the Delaware Supreme Court ruled five-to-zero to uphold the lower Chancery Court's decision in the almost decade-long suit against the directors on Walt Disney's compensation committee. Following that, Milberg Weiss, a well-known law firm that represents securities plaintiffs, and two of its partners were indicted by a grand jury alleging that the law firm paid clients millions of dollars to serve as plaintiffs in up to 150 class action and derivative lawsuits. While the impact of this indictment appears limited (other than to force a change in legal representation in a number of ongoing D&O cases), corporate executives who felt victimized by this law firm are no doubt relieved.

Recent Headlines

More than 100 companies have disclosed that they are the subject of regulatory, criminal or internal probes into whether or not they improperly inflated executives' pay when dating their stock options.

Experts believe the number of companies on this list is likely to grow. These cases may well produce a relatively high frequency of claims and yet result in a fairly low severity, perhaps along the lines of the IPO laddering claims which ultimately resulted in 300+ cases paying an average of \$4 million. With new rules on disclosure of executive compensation currently under consideration, watch for some immediate spillover into probes of corporate auditors. It seems safe to say that the focus on executive compensation is likely to remain strong for all concerned.

The first six months of this year also saw the government's successful criminal prosecution of Enron's most senior executives. With much of the Enron-related litigation concluding, global attention shifted to the extradition from the UK of the "NatWest 3." Three bankers are alleged to have participated in questionable asset sales in which they and some Enron executives personally benefited. Political controversy surrounds this case regarding what some are labeling over-zealous prosecution. With global coordination in D&O enforcement and litigation, extradition may well be something that executives face going forward.

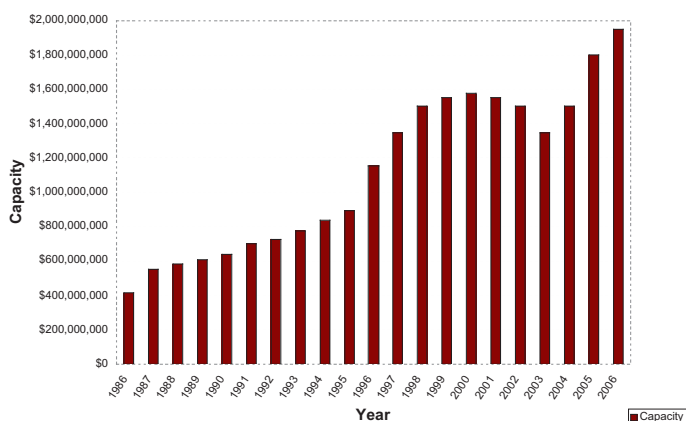
As of mid-July, the Sarbanes-Oxley Act (SOX) became applicable to foreign firms that file with the SEC or are listed on US stock exchanges. This will test their ability to address the complexities of SOX's §404 and its requirement that the company, its CEO, CFO and outside auditors attest to the robustness of the company's financial reporting. Considering that many of these firms may still be dealing with last year's assumption of new international accounting standards, this may be a challenging period for the numbers people – and those responsible for the numbers – at these companies.

Directors & Officers Liability

Limits and Capacity

Total global D&O capacity remains stable in spite of some carrier turnover. Among the departures were a long-term, specialty insurer and an excess carrier. The loss of their capital was mitigated by the increased appetite for D&O risk in both the US and international markets. As a result, global D&O capacity is greater than ever – well in excess of \$1.8 billion before considering the additional limits that may be available on an A-Side basis (for non-indemnifiable claims).

Market Dynamics – Global D&O Capacity



With one major carrier rejoining the marketplace for primary placements on larger, public-company D&O risks and with continued competition for privately held and not-for-profit organization risks, there may actually be more suitors for the primary (initial base) layer of coverage – setting the tone for the rest of the program. A word of caution: there still remains a marked difference between *stated capacity available* and the actual *deployment of limits*. Carriers are increasingly signaling their desire to deploy significant limits on preferred A-side D&O programs as opposed to the more traditional, more expansive A+B+C coverage for public companies.

Pricing

Upward premium adjustments are anticipated for companies facing claims activity and/or financial challenges, but market indicators on new and renewal business suggest that premiums are competitive for worry-free accounts. With risk differentiation and market timing in mind, we believe that premiums for companies with large market capitalizations are generally remaining flat or decreasing by five to 10 percent. Where there are risk adjustments, premiums are increasing by at least ten percent and possibly much more. As always, risk differentiation is critical.

Pricing Index

Risk Components	Large Market Cap	Mid to Small Cap
Solid Fundamentals	Stable to 10% reduction	10-15% reduction
Risk Challenges	~10% increase	Stable to 10% increase

Due to the abundance of available capacity, and as more carriers target mid- to small-market cap companies and private firms, premiums in these classes will continue to reflect greater reductions, potentially in the range of 10 to 15 percent.

Terms & Conditions

For all companies, the focus on hot button issues will continue for the remainder of the year and well into 2007:

- **Non-rescindable coverage**, originally available solely for A-Side coverage, which may now be extended to include the rest of the D&O contract with non-rescindable B and C insuring agreements on some accounts (still a challenge for Fortune 500 companies)
- **Thresholds for the personal conduct exclusions:** illegal profiting, intentional illegal conduct – which may dovetail with the firm's indemnification provisions
- **Narrowing the imputation of knowledge provision** and the definition of *Application*
- **Tailoring global programs** to fully balance the need for local policies
- **Modified claims reporting notices** to eliminate the over-assertion of late-notice claims denials
- Potential coverage clarification with newly introduced **D&O extradition endorsements**

Employment Practices Liability

The EPL Litigation Environment

For Employment Practices Liability (EPL), the signature events thus far in 2006 relate to severity. At least two class action settlements are being finalized in the \$50-to-\$100 million+ range and several single-plaintiff actions exceeded expected settlement figures (and their policies' retentions / deductibles).

We expect that larger, multinational companies will now experience greater underwriting scrutiny as carriers review their limits management and seek to adjust retentions.

Limits and Capacity

In 2005, a major offshore market pulled its maximum capacity back from \$100 million; for large companies in late 2006, there may well be further restrictions of limits and pricing corrections. The good news is that while there are few carriers willing and able to lead EPL programs for global Fortune 1000 companies, there is typically abundant capacity in the excess marketplace to fill out a program even at fairly low attachment points. Furthermore, unlike D&O and Fiduciary Liability, the Bermuda markets are pursuing this class and size of business.

Given the robust cast of carriers seeking to write private, small to medium-sized companies, the capacity in the domestic and international markets for these companies is not only competitive but abundant. Please note that EPL for private and not-for-profit organizations is typically written on a combined basis with D&O, so these companies can continue to expect a warm welcome in the marketplace.

Pricing

Two contrasting trends dominate the EPL marketplace today. For the privately held, small to medium-sized company sector, we find an abundance of capacity, with a long list of qualified markets and competitive premium levels. Clients fitting these risk categories will have plentiful choices, and tailoring the terms to the risk may be their greatest challenge.

For large, publicly traded firms with significant employee counts and international operations, we find that the selection of primary carriers is limited and that discounted pricing is more a phenomenon of the past. Still, other than those being adjusted by the primary Bermuda markets, claims-free companies demonstrating sound employment policies can expect premium levels to remain stable.

EPL Terms & Conditions

Many of the basic coverage issues identified in a D&O contract have potential EPL implications. As severability remains a focus on D&O, we are often requesting non-rescindable coverage on EPL renewals.

Other anticipated coverage trends are the clarification of retentions for non-indemnifiable loss, refined notice of claims triggers and client-specific bordereau reporting, along with possible expense coverage for mentoring and sensitivity programs (still strictly a Bermuda market enhancement at this time).

Though not an industry staple yet, a very select number of carriers are now offering Fair Labor Standards Act (FLSA) coverage on a sub-limited basis to clients that meet their risk

qualifications. Even if the sublimit applies to defense costs only, it may be a valuable extension for companies in the private and/or small to medium-sized category.

Some carriers are also offering something akin to a lawsuits-only EPL contract, accomplished by deleting coverage for Equal Employment Opportunity Commission (EEOC) complaints from the definition of claim. This option has pros and cons for insureds and should be selected only after a careful review of a company's corporate philosophy and reporting requirements. It is not a solution for all and could be a serious impediment to coverage for some.

Fiduciary Liability

Tagalong and Cash Balance Cases

In Fiduciary litigation, the spotlight is on Employment Retirement Income Safety Act (ERISA) tagalong and cash balance cases.

"ERISA tagalong" is the popular title given to cases brought under ERISA, usually in tandem with a D&O stock-drop securities case, and typically on behalf of 401(k) participants who held the employers' securities in their pension accounts. Unlike the often well-tilled fields of securities litigation, there isn't a truly fertile base of ERISA procedural cases to act as precedent in the tagalong cases. This is beginning to yield trial and appellate level decisions that appear, to at least one side in the controversy, to be ripe for (further) appeal. In the short run, the result is twofold: first, there may be little certainty or reliance that either party can place in the initial outcome of their case; second, the plaintiffs' bar is beginning to correct what some perceive as defects or vagueness in their earlier pleadings. In the mid-term, Fiduciary carriers are paying for the defense of the initial suit and the subsequent appeal out of the diminishing limits of coverage. Remember: unlike the results of much cash balance litigation, the Fiduciary Liability carrier may also be liable for a resulting settlement or court award in these cases.

We recently saw the reversal of a lower court win for the plaintiffs in IBM's cash balance litigation, and we are now poised for its potential appeal to the US Supreme Court. Without a doubt, this decision gave heart to other corporate defendants. However, it is unlikely that their insurers felt a similar degree of satisfaction. While defense expenses come out of the available limit of coverage, most Fiduciary Liability policies are written on a duty-to-defend basis. This means that the insurers may be obligated to continue to pay out coverage for the defense of claims even if they may ultimately have no obligation to pay for a resulting court award or settlement. This is largely true in the area of cash balance litigation where the plaintiffs are seeking to reverse benefits decisions (benefits due under a plan are generally not covered

under a Fiduciary Liability policy). This means that the immediate impact of the victory for the insureds and the successful appeal by the insurers may be an increase in litigation expenses for the carriers. Regardless of the outcome of the IBM appeal, we expect to see this case go to the US Supreme Court.

The Pension Protection Act of 2006 (PPA), which was signed into law August 17, may have more impact on corporate benefits plans than any event since ERISA itself was passed in 1974. We note three specifics addressed by the PPA. First, the act clarifies that cash balance plans are not a *per se* violation of ERISA's discrimination rules. Second, it sets out new funding standards for defined benefit plans while providing some industry-related funding relief (for example: the airline and auto industries). Third (and perhaps most significant), the PPA focuses on the ground rules for defined contribution plans in the areas of automatic enrollment and investment advice.

When the PPA is considered in light of the new pension disclosure rules announced by the Financial Accounting Board, it may well be that the earliest results of the Act will be to accelerate the merger, termination and/or freezing of traditional (defined benefit) pension plans. While none of these transactions in themselves directly result in ERISA fiduciary claims, carriers tell us that they are closely associated with increased claims activity.

Limits and Capacity

The Fiduciary marketplace is unusual in that rising demand (and rising prices, as discussed below) is not necessarily prompting increased supply. One reason is that a number of underwriters don't believe that they fully understand Fiduciary exposures, especially regarding ERISA liabilities. Even as rates continue upward on many larger, global risks, some carriers appear reluctant to enter the marketplace or to offer capacity on lower layers in a Fiduciary program.

Another factor is the limits management programs of many carriers, who limit themselves to an aggregate amount of coverage they are willing to offer on larger risks. If their available \$25 - \$35 million has already been utilized on D&O, then this market may simply not be available to us on the ERISA Fiduciary program. Efficient coordination of the available markets among the Executive Risks lines of coverage (especially D&O, Fiduciary Liability, and Employment Practices to a more limited extent) is therefore critical for larger placements.

Pricing

As suggested above, pricing on larger accounts, especially those with significant mergers and acquisitions activity and/or large helpings of employer securities in their retirement plans, continues to rise. While still measurable and more economical than D&O (on a price per million basis), these accounts can expect continued rate increases in the 10 to 15 percent range.

Global companies may face higher increases, as more stringent financial reporting standards may have required them in 2005 to disclose total international pension assets and exposures for the first time. As pension assets are the basis for pricing Fiduciary Liability, utilization of a global pension calculation rather than merely US assets, may result in further upward pressure on pricing.

Risk differentiation continues to be key. Improved limits, pricing and terms are still available where the company has:

- No history of ERISA litigation
- No employer securities in any of its pension plans, including 401(k) plans
- No intention of converting any of its plans into cash balance plans
- No significant M&A activity
- No frozen or severely underfunded benefit plans
- No plans to (drastically) reduce retiree benefits

ERISA Fiduciary Terms & Conditions

The terms and conditions that come up for discussion with underwriters generally fall into one of two categories. The first includes those that have migrated from other Executive Risks lines of coverage (most notably D&O). These include a priority of payments provision, non-rescindable coverage, and others. The second consists of those terms and conditions necessary to tailor the coverage to a particular risk and includes items such as the basis for the insuring agreement and claims notification requirements.

A notable addition to Fiduciary terms and conditions is an extension offered by at least one major carrier for plans that have undertaken a fiduciary compliance audit. At its most basic, a simple audit can result in a free coverage extension (and help prepare a company for an enforcement audit). A more thorough, operational audit can yield more meaningful coverage enhancements in exchange for additional premiums. This trend may prove to be of considerable benefit to plans and their fiduciaries.

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