

# The Willis Index

Willis

## FINEX Directors' and Officers' Newsletter

The Directors' and Officers' Liability Insurance and Risk Management Quarterly

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### Market Conditions and the Results of the Market Survey

The Willis Index conducts a quarterly survey of the Lloyd's and London company market. We invite responses from over 90% of D&O insurers and ask them to comment on premium rates and coverage terms for the preceding three months and over the next three months. The results are aggregated anonymously in this report.

#### The market continues to soften

As our research in the last Willis Index demonstrated, the volatility of rate reductions has continued to abate, with respondents to our winter survey cautiously predicting small but significant savings for insurance buyers. The relatively benign claims environment continues to provide justification for further reductions, and none of our respondents has indicated that a hardening of rates is likely at any time in the near future.

#### Primary Premium Rates

Looking back over the last three months, 54% of respondents said that on average rates had remained unchanged on renewals which is in line with the 58% who made their predictions covering the same period in the last Index. Of the remainder, 38% said they had experienced average reductions of up to 10%, while

8% said they had experienced greater reductions of between 10% and 20%.

For the next three months ahead, the number of respondents predicting flat rates went up to 69%, while the remaining 31% felt that reductions of up to 10% would still be the norm for this period.

#### Excess Premium Rates

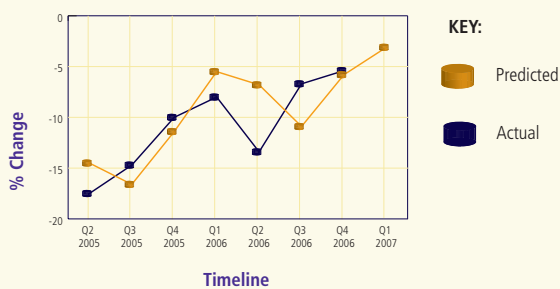
Over the last three months of 2006, the experience of the market tracked closely against the predictions of the previous quarter, with 15% of respondents reporting reductions of up to 10%-20%, and 39% of respondents reporting reductions of up to 10%. The remaining 46% reported flat renewals on average of excess layers.

For the next three months our respondents predicted that larger reductions of 10-20% would mostly disappear, with the answers being split between flat renewals (54%) and reductions of up to 10% (46%).

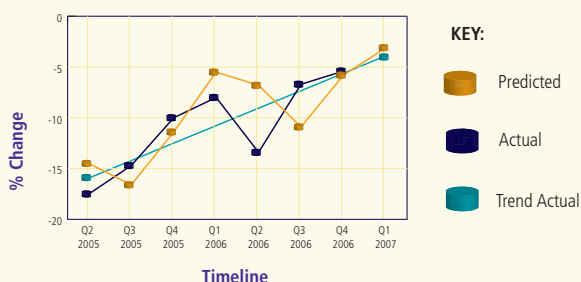
On the charts we have averaged the results of all of our surveys from the summer of 2005 to the present day and have illustrated how our survey predictions have tracked against the actual reported experience of the market over the same period. The

data shows clearly that the overall trend for this period is for smaller premium reductions quarter by quarter, however encouragingly, the overall trend of reducing premiums looks set to continue well into 2007.

Primary Rates - Predicted vs Actual Rate Change



Primary Rates - Predicted vs Actual Rate Change



The Willis Index is a quarterly publication reporting on the relevant issues affecting the insurance industry and the impact they have upon our clients. The main feature is a market survey, providing insurer responses on key indicators such as premium, excesses and cover.

Our quarterly analysis will provide buyers with an accurate picture of the conditions in the insurance market and its future outlook.

Regular features will include updates on the market conditions through the market survey, case studies, technical analysis of coverage specifics and special features highlighting significant changes in regulation, insurance market news and forthcoming events and seminars.

Willis voted "European Commercial Broker of the Year 2006" by StrategicRISK magazine for the second consecutive year.

Willis voted "Best and Most Innovative Insurance Broker of the Year" by Reactions magazine for the second consecutive year.

Willis voted "National Broker of the Year 2006" by Insurance Times for the second consecutive year.

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# Interview with Ed Smerdon, Partner at Reynolds Porter Chamberlain



**Ed Smerdon**  
**Reynolds Porter Chamberlain**

Ed and his team operate as part of a dedicated London Market practice based at the heart of London's insurance market. Ed joined RPC as a partner in 2001 and specialises in London insurance market business. His client base includes Lloyd's and London market insurance companies. He acts for London market insurers and reinsurers, specialising in claims involving directors, banks and other financial professionals. He also drafts and advises on D&O insurance products and is a leading authority on directors' insurance and indemnification issues. Ed lectures and has been published extensively in the areas of Directors' & Officers' liability, insurance and corporate governance.

He is a contributor to the Spring 2004 book "Practical Governance", published by Sweet & Maxwell.

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**Willis:** Looking back over 2006 what would you say have been the key characteristics of the market?

**ES:** The 2006 market has been very soft with high levels of competition which has resulted in the D&O product being relatively inexpensive and broader in scope than ever before.

**Willis:** So when you are advising clients are you recommending that they purchase higher limits to take advantage of the lower cost of purchasing insurance ?

**ES:** It is certainly true that insurance buyers can buy higher limits than previously for the same amount they were paying in preceding years. While the limit purchased is a matter for the individual company there is a logical argument for buyers to increase the cover they afford to their directors if this can be done within the limitations of their existing budget.

**Willis:** Have the changes in company indemnification law created more interest in this issue as well as how the policy operates?

**ES:** Absolutely. The Companies (Audit, Investigation and Community Enterprise) Act 2004 caused many companies to review the scope of their indemnification provisions within their Articles and this in turn led to a heightened focus on the way in which D&O policies are drafted to provide both reimbursement of indemnified losses, as well as protection for directors for situations which fall outside of such provisions or where indemnification fails for whatever reason. The latest draft models of association for public companies, released in anticipation of the Companies Act 2006, contain specific reference to the provision of D&O insurance.

**Willis:** The market recently has seen a greater interest in Side A policies which provide cover for claims which are not indemnified by the company. What is your take on this?

**ES:** While the law has changed to permit indemnification in a much broader range of situations than previously, it is true that directors are much more aware of the potential failure points of indemnification and are therefore taking a keener interest in complimentary products such as Side A and Side A Difference In Conditions (DIC) products. These products have some significant benefits including drop-down cover where underlying

insurance is unable to pay due to insolvency, fewer exclusions in respect of Insured versus Insured claims and pollution, as well as being non-rescindable for financial misrepresentation.

**Willis:** Apart from Side A products, there have been a number of wording developments in the market in the last year — which of these do you think are the most important developments?

**ES:** Perhaps the most interesting area of cover has been the development of additional limits specifically for the benefit of non-executive directors in some insurers' wordings. This first appeared in response to concerns from non-executive directors about their potential liabilities following from the Higgs Report and subsequent amendments to the Combined Code and should give some comfort to non-executive directors that they will be protected, even where a policy limit has been eroded by claims against the executive directors. While only a small number of primary insurers are currently offering this cover, the number appears to be growing.

Cover for extradition proceedings has also been high on the agenda this year with several high profile cases involving directors of UK companies. While most wordings currently provide cover for "arm's length" claims brought by the company, including derivative claims ensuring that there is cover for the costs of prosecuting an appeal brought by way of a new proceeding against the government, after a order for extradition has been signed by the Home Secretary.

**Willis:** In the context of the Companies Act 2006, which gives a statutory footing to derivative claims brought in the name of the company, do you believe changes will need to be made to policy forms?

**ES:** As stated, most wordings currently provide cover for claims brought by the company for "arm's length" claims, including derivative claims, so there shouldn't be a great need for changes to policies. One recent development has been the deletion of the standard "Insured versus Insured" exclusion outside of the USA in favour of "claims control" language by which insurers retain the right to take over and control the defence of such claims rather than leaving the directors to do so.

**Willis:** Do you think this approach will work in practice?

**ES:** It is a welcome step in the right direction given that the exclusion is unattractive, particularly here in the UK, where claims by the company are in theory the main threat. The control provision should in my view only be exercised in claims where there is a clear suggestion that the directors and company are co-ordinating their approach to the D&O policy which could amount to an abuse. In all other cases the insurer need not alter its existing approach of allowing the directors to defend themselves. Therefore, from a practical point of view, it is unlikely to be used often. If it is used, there will need to be careful consideration of potential conflicts of interest between insured directors, and between the insurers and the directors, with appropriate information barriers set up.

**Willis:** Do you think there will be a significant increase in derivative claims resulting from the changes in the law?

**ES:** The timetable for the Companies Act 2006 to come into force is still uncertain but it seems unlikely the derivative action provisions will come into force until 2008. It remains to be seen whether pension funds or shareholder activists will take advantage of the law to bring claims against directors. In one recent high profile case BP is facing a derivative action brought by US shareholders in the US, which appears to have been influenced by the pending statutory changes in the United Kingdom in relation to derivative claims. Beyond that, there will probably be some early cases brought to test the new machinery, which will need the sanction of the courts to proceed, and I expect the higher courts will be called upon to interpret the new criteria for allowing such cases through and establish some ground rules for future cases.

The combination of the new derivative action and the restrictions in the indemnification machinery for claims brought by the company (as derivative claims are considered to be) mean that it is even more obvious that D&O insurance for this eventuality should be bought (and that Insured v Insured exclusions for UK claims are removed or significantly diluted).

**Willis:** The soft market has also seen some easing of policy requirements in relation to

disclosure and mid-term reporting. What are the most important areas in your view?

**ES:** The issue of disclosure has seen some important improvements for insurance buyers. The D&O policy is regarded as composite in nature, meaning that each director has a separate and distinct duty of disclosure of facts and matters within his or her knowledge — this has the important effect that one director will not be presumed to have the same knowledge as another director and so a misrepresentation or non-disclosure by one will not necessarily place the cover in jeopardy for others. Some insurers have gone a stage further and expressly waived their rights to avoid the policy except where a misrepresentation or non-disclosure to insurers was committed dishonestly (they have done this by using so called "innocent non-disclosure clauses") this clearly has benefits for insureds who may inadvertently supply incorrect information.

In addition to this, insurers have raised the threshold below which newly acquired subsidiaries can be automatically covered under the policy — and in some cases have removed this threshold altogether for acquisitions which do not have exposures in the USA. This has an impact upon the amount of disclosure required during the policy period.

**Willis:** Are there any other legislative changes on the horizon which you feel will be important to company directors?

**ES:** The Companies Act 2006 seeks to codify the nature of directors' duties and the applicable standard of care. This has been anticipated for some time. The standard of care is not controversial as it is the same standard that has been applied by the courts in most recent cases, based on section 214 of the Insolvency Act 1986. The nature of directors' duties is now codified and includes a general duty to promote the best interests of the company. How this will be applied (particularly in derivative claims) could be the subject of early case law once the provisions come into force.

The Fraud Act 2006 codifies the law of fraud, creating new offences of deliberate misrepresentation and deliberate non-disclosure. Directors will be subject to these laws in their every day business dealings and, it is suggested in the notes to the Act, also in their disclosures to insurers.



# Meet the Team



**Julian Martin**

We are pleased to announce the arrival of Julian Martin as Practice Leader for the FINEX D&O team. Julian Martin joined Willis in January 2007 as a member of the FINEX UK/North America executive and will chair a newly created Global D&O Practice in London. As a D&O specialist, Julian's expertise lies within US SEC exposure; corporate governance issues; identifying coverage requirements to offer the broadest protection for the individual D&O and/or the company's balance sheet; claims handling and placements in all the international marketplaces.

Julian has also successfully designed and placed

complex blended programmes for clients who require D&O, EPL, Trustee Liability, Crime, E&O and Internet exposures in one policy. Prior to joining Willis, Julian was a founding Partner of JLT's Financial & Professional Liability practice in 2001; and prior to JLT he was a Managing Director at Marsh FINPRO running their Global D&O practice in London. Julian is a major new hire in Willis' strategy to become broker of choice in the arena of Directors and Officers liability.

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## PLUS Annual D&O Symposium

PLUS held the annual D&O Symposium in New York on 31st January/1st February 2007. The event, held to address the significant issues affecting the legal and insurance marketplace for D&O liability insurance, was attended by 1400 underwriters, lawyers, brokers and clients. There was considerable comment about two recurring themes: the reduced frequency of securities fraud litigation and the stock option backdating scandal. In 2006 class action securities fraud filings dropped to a record low of 110, representing the smallest number of filings in a year since 1995 and a 38% drop over 2005. The reduction in filings could be due to a number of factors:

- a robust stock market with low volatility;
- a strict regulatory regime;
- Sarbanes-Oxley means corporations and executives are more cautious (with the risk of going to jail a huge deterrent), and the increased enforcement activity of the SEC and Department of Justice;
- the indictment of Milberg Weiss, the plaintiff law firm who filed the majority of the cases;
- improved oversight from investment banks and auditors following the megas-ettlements after the high profile corporate collapses of Enron and Worldcom.

There was comment that the cases filed would be likely to have serious merit and therefore be more difficult to dismiss, which could lead to increased severity of, and/or quicker, settlements. In 2006 executive stock option grant practices came under scrutiny, especially with respect to backdating stock option grants in order to take advantage of lower stock prices at the time of the grant. The SEC is investigating

a number of companies for such practices. So far, the stock option backdating scandal has led to approximately 120 derivative actions being filed and 22 securities class action suits. There was a lot of debate about how many claims there could be arising out of this issue with some suggesting there could be a tripling in the number of cases. Interestingly, the claims arising from the stock option issues should be considered non-recurring, so if the 110 total of securities class actions for 2006 is reduced by the 22 filed for the stock option scandals the underlying reduced trend is even more significant with a 50% drop in filings. Will this level of reduced filings be repeated for 2007? So far the indications are promising and this will definitely be to the advantage of clients when renewing their D&O programmes.

Willis is one of the world's leading risk management and insurance intermediaries. We have over 15,000 professionals in over 300 offices around the world.

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