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BRC

THE BETTERLEY REPORT

PRIVATE COMPANY MANAGEMENT LIABILITY INSURANCE MARKET SURVEY—2015:

Rate Environment a Bit Choppy as Insurer Loss Experience Varies

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Highlights of this Issue

- *Rates a Bit Up (or Down)Depending on Insurer Experience*
- *Lines That Can Be Included Continue To Expand*
- *Cyber Coverages and Unauthorized Electronic Fund Transfer Coverages Are Especially Popular (and Needed)*

Next Issue
October
Side A D&O Liability Insurance Market Survey 2015

Editor's Note: *In this issue of* The Betterley Report*, we present our annual review and evaluation of the important private company management liability market. This product combines several lines of coverage for so-called business practices risks into a single policy.*

We have focused this Market Survey *on the private company market; similar products are available for not-for-profit organizations with similar terms and conditions. Public companies of course are the dominant buyers of directors and officers (D&O) from a premium, claims, and influence standpoint, but since their pricing and coverage forms are quite different, we decided to limit the* Survey *to the private company product.*

In this review, as always, we not only identify the insurers and the differences in their offerings; we also evaluate the state of the market—how healthy the line is and how fast it is growing. Rates are moving in a narrow range as insurers seek to optimize profit opportunities. This despite continuing problems for insureds in California and higher-than-expected levels of entity D&O claims arising out of the Great Recession.

Insurers continue to be creative in offering additional coverage lines on the basic management liability insurance (MLI) forms. In particular, cyber-risk and privacy coverages are becoming more available on MLI policies, as have errors and omissions, media liability, and crisis response protections. Insureds and their advisers are seeking additional types of protection, and the MLI product is proving to be a good way to provide it.

Wage and hour coverage continues to be a hot topic for any policy relating to employment practices liability (EPL), so our "Lines of Coverage" tables provide detailed information about this controversial coverage.

Please see our "Lines of Coverage Available" discussion and tables for further information.

We have selected 27 insurers for this year's Survey (up from 25 in 2014), having added Aspen, Franchise Perils, and Hanover. Philadelphia was deleted because we were unable to obtain updated information. Finally, the Fireman's Fund product was rebranded to Allianz.

As always, while each insurer was contacted in order to obtain this information, we have tested their responses against our own experience and knowledge. Where they conflict, we have reviewed the inconsistencies with the insurers. However, the evaluation and conclusions are our own.

List of Tables

Rather than reproduce the insurers' exact policy wording (which of course can be voluminous), we in many cases have paraphrased their wording in the interest of space and simplicity. Of course, the insurance policies govern the coverage provided, and the insurers are not responsible for our summary of their policies or survey responses.

In the use of this information, the reader should understand that the information applies to the standard products of the insurers and that special arrangements of coverage, cost, and other variables may be available on a negotiated basis.

For updated information on this and other Betterley Report *coverage of specialty insurance products, please see our blog,* The Betterley Report on Specialty Insurance Products, *which can be found at:* **www.betterley.com/blog**.

Introduction

The insurance coverage that we call private company management liability combined products is a combination of various lines, all of which are generally related to the insured's business practices. The core coverages are liability forms, but some additional lines (such as crime or kidnap and ransom) are available from some insurers.

Although combined policies have been around for some time, special forms for private companies began to become prominent when Executive Risk (now part of Chubb) brought out its first policy in 1995.

The management liability combined product is generally appropriate for privately held companies. Publicly traded companies are a very different risk, especially for D&O, and, therefore (and not surprisingly), typically not eligible for this product line.

Not all insurers offer the same lines of coverage. Most include the following core liability coverages:

- Directors and officers, both individual and entity
- Employment practices
- Third-party discrimination and harassment
- Fiduciary

Some insurers also offer one or more of the following:

- Side A D&O
- Wage and hour defense
- Wage and hour indemnity (rarely)
- Kidnap and ransom
- Crime
- Intellectual property liability (rarely)
- Cyberrisk liability
- Identity theft post-breach response
- Miscellaneous professional liability
- Employed legal counsel
- General partner liability

Insurers in this Survey

The full report includes a list of 27 markets for this coverage, along with underwriter contact information, and gives you a detailed analysis of distinctive features of each carrier's offerings. Learn more about *The Betterley Report*, and subscribe on IRMI.com.

- Private equity liability
- Media liability
- Crisis response
- Pollution defense
- Reputation response
- Workplace violence

An insured is not required to buy each coverage. It can pick and choose according to its needs (and budget). However, insurers generally require that an insured purchase either the D&O or EPL coverage in order to qualify for the combined product.

By combining various exposures into one policy, the insured is less likely to encounter disputes between insurers, the administrative burden for both insured and insurer is lessened, and premium economies can be achieved.

One additional benefit of a combined product is that insureds can choose to combine several lines into a single aggregate limit of liability or even a multiyear aggregate. We do not see many insureds combining multiyear aggregates, since the premium for this coverage has been relatively attractive. As we see rates increase, we expected to see more insureds accepting multiyear aggregates in an effort to control premiums, but the reverse seems to be happening—fewer insurers even offer multiyear aggregate limits, perhaps based on the market's chilly reception to the concept.

A reminder: our surveys focus on the most prominent insurers writing the most business or those that offer some unique product or service. While this omits some insurers, we believe that it makes the information more useful for our readers.

To be certain that we are covering the key insurers, we have reviewed the list with some of the most prominent observers of the management liability market, who have confirmed we did not omit any significant markets.

Some notes on the tables: in the "Exclusions" tables, the entry "no" means that the exclusion is not present in the policy. Of course, if coverage is not present (because it is not included in a definition or insuring agreement), the absence of an exclusion does not necessarily mean coverage exists.

State of the Market

In 2009, we saw the Great Recession as being an effective block to higher rates, which proved to be right (and in fact resulted in a decline in premiums collected from individual commercial insureds as exposure bases shrank). Carryover into 2010 led to yet another year of deferred rate increases, as insurers were willing to sharpen the pencil to acquire or retain insureds. During 2011, though, the tide began to (slowly) turn. 2012 and 2013 saw additional rate increases, but in line with general commercial insurance rates, the increases were moderate.

Private company MLI rates are heavily influenced by the D&O and EPL portions of the premium, and, thus, loss experience in both is affecting the cost of MLI. California has become increasingly troublesome, with some insurers reluctant to renew insureds at current deductibles and rates.

MLI rates are increasingly affected by D&O entity loss experience. Entity claims, considered rare for private companies, have become a concern for some insurers (and curiously, not for others), who are seeing an uptick in severity claims emanating from business activity during the Great Recession. Troubled businesses may have taken some steps during those troubled times that they wouldn't take during more normal times, and these may be responsible for the increasing levels of litigation.

As we talk with people knowledgeable about actual quoting and renewal activity, we are hearing some pretty strong messages about the challenges of getting adequate rates for this product, especially for insureds in difficult states (California). Insurers poaching market share from their competitors is more common, and the incumbent is more likely to defend its share even if it requires giving up rate. Rates are moving in a narrow band, some a bit up, others a bit down, in contrast to last year where we mostly saw mild declines. This trend seems to be mostly a result of individual insurer experience (both claims and sales).

Deductibles seem to be stable, although insurers are still seeking higher in California EPL insurance (EPLI).

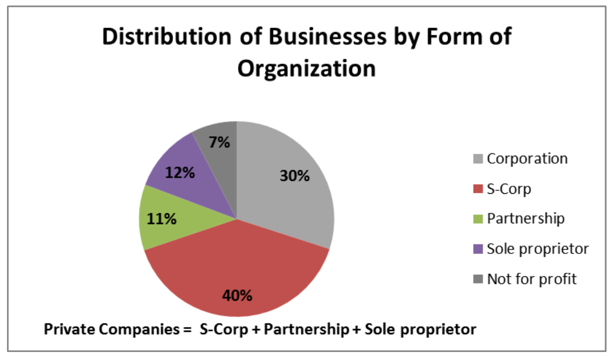
We surveyed our participating insurers about their rate expectations, both for themselves and for the market in general. Responses varied, and we think insurers are realistic about what the market will allow. In states other than California, rate expectations ranged from up to as much as 5 percent and down by a comparable amount. California is seeing a wider range, mostly increases in rates of as much as 15 percent.

The volume of premium being written is remarkably difficult to come by, as many insurers seem to track premiums by each line of coverage they offer in the MLI product. We are sure they know what these total up to (recall that each coverage would be sold separately as well as part of an MLI product) but aren't sharing it with us.

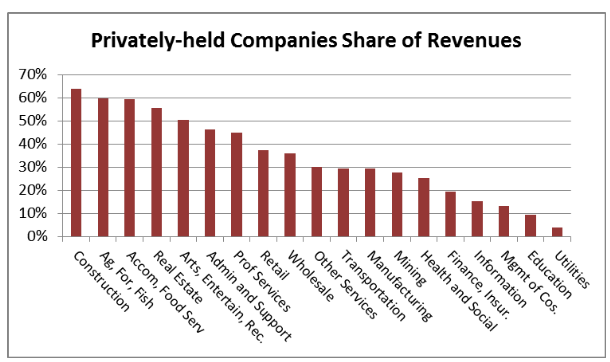
We have seen estimates of US MLI premiums as low as $1.3 billion to as high as $4 billion, with another $1 billion written for insureds based outside the United States. This is similar to our findings in 2014, but we continue to lack strong confidence in estimates of the total premiums being written.

Although the size of the market measured by premiums written is hard to determine, we do know that the potential is much greater. MarketStance, a respected source for market demographic, insurance, and economic information for the commercial property-casualty industry, researched the size of the private company opportunity in the United States.

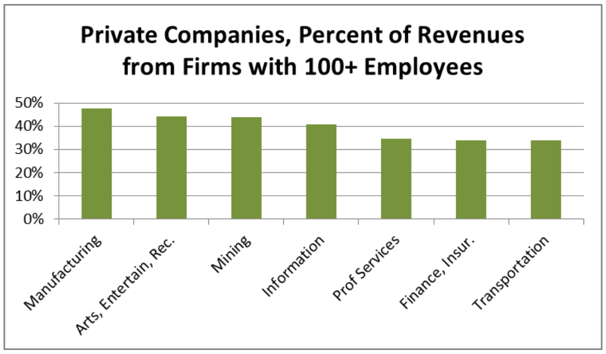
The chart below displays the footprint of privately held companies (red, green, and purple slices) among the universe of American firms. By number, these three forms of privately held firms account for more than 60 percent of all employer companies.



Based on share of revenue arising from privately held firms, the construction industry has the strongest presence of privately held firms, followed by the agriculture, forestry, fishing, and hunting industry. Privately held firms also have large presence in the accommodation and food services industry, real estate sector, and the arts, entertainment, and recreation industry. See the chart below.



Not all privately held firms are small. In fact, larger private enterprises (defined here as firms with 100+ employees), account for more than 40 percent of larger-firm revenues in manufacturing. Privately held firms also account for substantial shares of larger firms' revenues in the arts and entertainment, information, and mining sectors.



For more information about MarketStance, please follow this link: www.marketstance.com.

Claims

We did not solicit information about claims experience because of the large number of coverages in the management liability product line. Anecdotally, we understand that the product is reasonably profitable. EPL portions are not so profitable, but the line in general seems to be. The number of insurers still offering these products certainly indicates that the insurers find them attractive.

Again, much of the claims pressure is on the EPL line, which is not surprising when one considers the claims experience for monoline EPLI products. As the uneven economic prosperity continues to be a factor, increasing claims frequency is still expected.

We expect to see that this claims pressure will, over the long-term, push rates and deductibles higher. We do not foresee a restriction in coverage breadth or availability, except perhaps for wage and hour claims.

Lines of Coverage Available

As we noted in the Introduction, there is a core group of coverages offered by almost all insurers (D&O, EPL, third party, and fiduciary). An insured must buy D&O or EPL, at minimum, to qualify for the product.

Where insurers differ is in the other coverages they offer. In the table "Lines of Coverage Available," the coverages that an insured can choose are shown by insurer. We no longer allow insurers to list coverages that they offer outside of an MLI product; we are solely interested (for this *Report*) in coverages that are offered as a part of their MLI program.

There is a significant difference between insurers in the coverages an insured can choose. Depending on their comfort, perceived expertise, and perception of market interest, insurers offer an array of coverages. Insurers continue to add cyberrisk/privacy, media liability, and/or professional liability options to their management liability products.

Although insurers continue to broaden the types of coverages they offer the middle market, we believe they are missing a golden opportunity by not offering more coverage options.

Adding more coverage options can be a successful product strategy because MLI policies are an easy sell to insureds and their brokers—most insureds need at least a couple of the core coverages (EPL and fiduciary). Adding additional coverages to an existing policy is an easier buy (or sell?) for many insureds, who find it easier to add an option than to buy an entirely new policy.

Many insureds and brokers have told us over the years that they can get internal support for an added coverage option that would have encountered resistance as a new policy purchase. This was especially true during the recent soft market, when premium reductions freed up budget for additional insurance purchases.

Intellectual property (IP) coverage had been an option for a few insurers, but as we found in our April report on monoline IP policies, few insurers are interested in offering this type of coverage. We would like to see IP protection become a standard offering in management liability policies, but it does not appear that this is going to happen. We would note that the D&O coverage section for individual directors and officers may well include protection against suits alleging IP misuse, but that entity coverage for IP is unlikely at best.

Target Markets

Insurers focus this product on smaller and midsized companies, as shown in our "Market Information" table. Many insurers specify their target market as companies with up to a certain number of employees or amount of assets. We find both of these to be guidelines, not absolutes. Certainly, larger private companies can buy management liability policies if they are an attractive risk.

The real barrier for many insurers is companies that expect to go public. The D&O risk for pre–initial public offering (IPO) companies is far greater than for companies that expect to stay private, so many insurers will not write, or restrict coverage for, these insureds.

With insurers that are willing to write companies that are pre-IPO, coverage restrictions, such as Securities and Exchange Commission exclusions, should be watched for.

Limits and Deductibles

Different coverages offer different limits and deductibles, so we refer you to the "Limits and Deductibles" table. Insureds are generally looking for higher limits (above $5 million) for D&O and/or EPL only. They do not typically buy limits above $2 million to $3 million for lines such as fiduciary.

Our table "Limits Options Available and Cost" shows the three that are typically offered:

- **Insurer Offers Separate Annual Aggregate for Each Coverage**—this means the insurer will offer a separate annual aggregate for each line of coverage, so that a blowout loss in, for example, EPL, does not erode the coverage for D&O.
- **Insurer Offers Combined Annual Aggregate for All Coverages**—this means the insurer will offer a single annual aggregate for the entire policy, so that a blowout loss in, for example, EPL, will erode the coverage for D&O. This is dangerous, since risk managers and/or insurance brokers do not find it much fun when informing the directors that their coverage has evaporated because there was a big EPL claim!
- **Insurer Offers Combined Multiyear Aggregate for All Coverages**—this means the insurer will offer a single aggregate for the entire policy, both coverages and term, so that a blowout loss or an accumulation of losses will erode the coverage for, say, D&O. This can also be dangerous, for the same reasons, and the chances of it happening are greater, because claims can accumulate over the multiple-year term of the policy.

There is a premium discount offered for insureds that opt for other than annual per-coverage aggregates. Typical discounts are shown in the table.

To counter the risk of inadequate aggregate limits, most insurers offer reinstatement of limits options (generally subject to negotiation and of course underwriting). Reinstatement options can be a valuable enhancement to a policy and should be considered carefully.

Typical Limits

As an indication of the maturity of this market, we are more often asked about the typical limits purchased by insureds, and less often about which types of employers buy coverage. All but five of the participating insurers provided useful information.

Since limits often equate to the size of the insured, we specified employers ranging from $10 million to $500 million in annual sales. The results are summarized in the attached table "D&O Limit Usually Purchased by Insurer's Insureds." The answers are merely an indication of the limits insureds select and should not be used as an indication of sufficient limits.

To us, it is evidence that many smaller employers still do not buy enough limits, content to have insurance, even if it is inadequate. We hope that cost cutting by insureds won't result in coverage that is even less adequate.

Policy Type and Definition of Insured

When considering the issue of duty-to-defend versus indemnify forms, there is a lot of flexibility in how these policies respond to a claim. A number of the insurers offer the insured the flexibility to decide at the time of the loss whether the claim will be defended by the insurer or by the insured. All policies reviewed can be written on a duty-to-defend form, but a number of insurers offer the insured the option of an indemnity form as well. In earlier years, all insurers except AIG offered this option at the time the policy was purchased; AIG allowed the choice for each claim at the time of the claim, giving the insured the most flexibility. We now see more insurers offering the same flexibility as AIG, to the benefit of the insureds.

The definition of insured varies from policy-to-policy and from coverage-to-coverage. The most significant difference is in the EPL line, where coverage for independent contractors, leased employees, and part-time employees is not automatically included in most policies.

Other coverage observations:

- Leased and contract employees may need coverage; a number of insurers extend coverage to these individuals if they are indemnifiable like employees.
- Newly acquired organizations is one area in which insurers differ, and subsidiaries is another. Generally, we find less distinction between insurers than before.
- Whether or not the entity is covered, and whether or not the policy includes a spousal extension, is important for any comparison of D&O.

So-called Side A issues have become critical for publicly traded companies in the United States, following the well-publicized coverage problems of Enron, WorldCom, and Adelphia directors. Private company directors and officers are probably not as concerned as their publicly traded company counterparts about the risk of corporate bankruptcy limiting their coverage, or rescission of the policy completely eliminating coverage. A few insurers have, or are creating, individual D&O policies in response, but most of the insurers report that they have seen little or no demand for specific individual (Side A) products. Several report they are willing to provide their policy with Side A coverage only for D&O but that there has been very little demand.

All insurers offer coverage for the entity; most include it automatically, while a few insurers make it an option. We find few insureds choosing D&O coverage without including the entity, and most (if not all) proposals include the option.

Spousal extensions include the insured's spouse for coverage and are available from each insurer.

Claims Reporting and Extended Reporting Period

When a claim has to be reported is an important distinction between policy forms. Most insurers require the named insured to report "as soon as practicable," which seems reasonable. In practice, unless the insured has delayed reporting so long (and irresponsibly) as to compromise the defense of the claim, there is little practical difference between insurers.

Having said that, we note that, as with all claims-made policies, the insured needs to be cautious about notice provisions. If they have an indication that they might have a claim, are they required to report it to the insurer? Would it be covered if it became a claim? What if they change insurers and the new insurer denies the claim as having been reported to a previous insurer?

For an insured that is not changing insurers, this may not be important, but many smaller insureds frequently do change and need to be careful about situations where notice of a potential claim ends up precluding coverage.

Extended reporting period (ERP) protection is an underappreciated feature of claims-made policies, one that will take on a growing importance if insurers lose interest in the market.

All insurers offer an ERP, but length and cost differ. A variety of insurers offered at least 1 year, with 3 or more years available. Many insurers now report that the length is negotiable; make sure that this negotiation is completed before the insurer loses interest in your business!

Whether the ERP is one-way or two-way (bilateral) is important to know. One-way means the ERP is available only if the insurer cancels or refuses to renew. Two-way means the ERP can be purchased even if the insured cancels or does not renew, and is available from almost all insurers.

Selection of Counsel

We have been vocal in our criticism of insurers that do not allow the insured a voice in the selection of counsel. We believe that the relationship between counsel and client is a precious one, as trusting as the bond between doctor and patient. While it is very important in EPL, it is even more important to the comfort and security of directors faced with a D&O suit.

At the same time, we agree with the concern of insurers that unqualified legal representation cannot be allowed and that control over fees is necessary in a line like D&O or EPLI. Indeed, one insurer has told us that the primary reason it is reluctant to enter the smaller employer market is its belief that such employers often use improper counsel and take employment actions without legal advice.

We are pleased to report that, while most insurers continue to control the selection of counsel, almost all are very flexible in allowing the insured to select or approve counsel. If the insured requests specific counsel approval at the right time (during proposal negotiations), the insurer is likely to approve the insured's choice.

A few insurers offer the insured a choice of an indemnity policy, which allows the insured full control over selection of counsel. While some dispute our attraction to indemnity policies (since an uncovered allegation may not be defended by an indemnity policy), we still think control over counsel is of enough value to make indemnity policies worth consideration.

Note that the insurers that are primarily interested in larger employers are more likely to give selection of counsel to the insured; insurers that specialize in smaller insureds are less likely to be able to invest the time necessary to approve special counsel requests, since they are charging correspondingly less premium. However, in our experience, insurers are generally willing to allow the use of the insured's choice of counsel, as long as they are clearly qualified. For the insured that asks, even the smaller insurers are willing to allow selection by the insured.

Consent To Settle

Insurers are still reluctant to allow insureds much control over settlement, understandably, since D&O and EPL suits often involve a good deal of emotion. Both employer and employee are often willing to continue their fight in court long after it makes economic sense to settle. Of course, insurers are reluctant to fund such battles.

The so-called hammer clause allows an insurer to limit its claim payment to no more than the amount it could have settled for plus defense costs. This protects the insurer against a "litigate at any cost" insured, while protecting the employer against a "settle it, who cares about the precedent" insurer.

The hammer clause causes both insured and insurer some unhappiness, so "soft" hammer clauses exist, which share the cost above the claim between the insurer and the insured. Originally offered by Royal, it is now a feature of many insurers' products, primarily for EPL.

Most insurers will not force an insured to settle but are free from any additional cost (settlement or defense) obligations. A few policies continue to allow the insurer to settle without the insured's consent, which is very dangerous to the employer. In practice, if the insured has a good reason to continue the defense, insurers will not enforce their hammer clause.

Preset Allocation of Costs

Few insurers are willing to agree in advance that defense costs will be allocated on a fixed, preset basis, which is an agreement that the defense costs of an uncovered allegation (if any) will be *x* percent of the total defense costs of the claim.

Insurers offer various options, including no preset allocation, allocation for defense costs only, defense costs and indemnity (securities claims only), and defense costs and indemnity (all claims).

We feel lukewarm about the benefits of preset allocation, but some find it attractive. For some, it is considered a possible solution to the Side A dilemma, but we do not find the argument convincing.

Exclusions

Policy exclusions vary widely, but we recommend insureds and their advisers pay particular attention to professional liability and securities exclusions, as well as those relating to punitive damages and intentional acts.

Risk Management Services

Our table “Risk Management Services” identifies the types of value-added services offered by insurers.

These services are primarily focused on EPLI and kidnap/ransom, with increased services to help mitigate D&O and cyberrisk, offering the same type of benefit to the insured that, for example, loss control engineering does for property insurance. We have not seen much in the way of new services in the non-EPLI coverage area, and in this market environment, do not expect to see much change.

Innovation in value-added services has slowed, but it is still a primary source of product innovation in the EPLI business, and one in which numerous vendors, including law firms, are competing for business. As with loss control engineering, it presents the opportunity for insurers and insureds to mutually benefit.

Summary

For many middle-market insureds, and even some of the small market, MLI is a core specialty markets product, one that can be bought from a number of insurers. Since the product is built on top of coverage lines already offered by specialty insurers, it can be developed and managed without the large investment required of a totally new product.

On the other hand, insurers that want to offer a broad MLI policy, one that includes a wide variety of optional coverages, must already be writing those lines. An insurer that does not offer a wide array of the underlying lines will be at a distinct disadvantage in the MLI marketplace.

Which reminds us of something that we should emphasize more often—when selecting an MLI product, an insured (and its broker) should consider not only the lines it wants to cover today, but also the lines that might be needed tomorrow. Not all insurers offer a broad array of MLI coverage lines.

MLI is a great product—it efficiently bundles together an array of coverages and makes the management of those coverages relatively simple for the insured to purchase them. And for an insurer, it allows a somewhat simplified product management challenge *and* the opportunity to offset losses in one line with profits in another.

We continue to foresee slow growth in this line as the economy continues its recovery, somewhat offsetting mild rate declines. And we hope that more insureds will see the advantages in buying MLI.

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About the Author

Richard S. Betterley is the president of Betterley Risk Consultants, an independent insurance and alternative risk management consulting firm. BRC, founded in 1932, provides independent advice and counsel on insurable risk, coverage, alternatives to traditional insurance, and related services to corporations, educational institutions, and other organizations throughout the United States. It does not sell insurance or related services.

Mr. Betterley is a frequent speaker, author, and expert witness on specialty insurance products and related services. He is a member of the Professional Liability Underwriting Society and the Institute of Management Consultants. He joined the firm in 1975.

Mr. Betterley created *The Betterley Report* in 1994 to be the objective source of information about specialty insurance products. Now published 6 times annually, *The Betterley Report* is known for its in-depth coverage of management liability, cyberrisk, privacy, and intellectual property and media insurance products.

More recently, Mr. Betterley created *The Betterley Report Blog on Specialty Insurance Products*, which offers readers updates on and insight into insurance products such as those covered in *The Betterley Report*. It provides him with a platform to more frequently and informally comment on product updates and newly announced products, as well as trends in the specialty insurance industry. www.betterley.com/blog