



This is Advisen's Commercial Lines Expert Witness (CLEW) Report for D&O. CLEW presents the insights of insurance experts into recent market developments and the forces shaping the commercial lines marketplace. Each thought-leader contributing to CLEW was nominated by the market. CLEW can be downloaded from Advisen as well from Advisen's Front Page News (<http://fpn.advisen.com>). Watch for the next CLEW Report on the property insurance market.

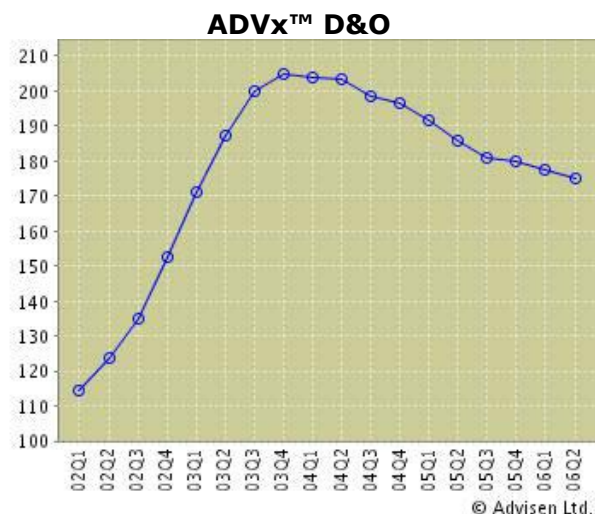
INTRODUCTION

Enron, WorldCom, et al not only shook the world with their allegations of flagrant corporate malfeasance; they suddenly thrust the world of directors and officers liability insurance (D&O) into an unaccustomed spotlight. The previously arcane world of corporate governance and the potential liability of a company's directors and officers, seemingly overnight, became a prime topic of water cooler chatter and fodder for talk show opening monologues.

While blockbuster securities class action suits against Fortune 500 companies have grabbed newspaper headlines, and dented D&O insurer bottom lines, they represent only one segment of the complex and dynamic D&O market. Directors and officers of organizations ranging from the tiniest non-profit entity to the most massive global corporation are exposed to an ever-growing list of actionable grievances by stakeholders and their protectors – regulators and law enforcement agencies. And while the US has long been the hothouse of D&O litigation – thanks to activist regulators and law enforcement agencies, and a plaintiff-friendly legal system – directors and officers of companies throughout the world now are finding themselves in the crosshairs of angry shareholders and their attorneys.

Directors and officers feel increasingly at risk, and worry whether their D&O coverage is adequate for their exposures. D&O

underwriters struggle to bring order to a world where the rules of the game are never quite settled, and where the economic forces operating on the insurance industry often are at odds with sound underwriting judgment. Underwriters do their best to maintain discipline – to charge adequate rates and to keep coverage terms stable – but it has been an uphill battle over the past several years as competition keeps rate levels on a downhill course. Advisen's premium change index for D&O (ADVx™ D&O) shows that, after rising sharply during the 2001-2003 period, average quarterly D&O renewal premiums have been inching steadily downward.



To help bring clarity to the murky turbulence of the D&O market, Advisen invited fourteen leading D&O experts - brokers, underwriters and lawyers from the US, Bermuda and the U.K. - to share their insights on issues ranging from pricing trends to recent court

decisions affecting the liability of directors and officers. Their comments offer commercial insurance professionals an uncommonly vivid and instructional look inside the D&O market, and at the forces shaping it now and in the future.



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CONTRIBUTOR Q&A

Question What is your view of the rate adequacy and current D&O pricing trends for (a) large public companies, (b) small and medium-size public companies, (c) private companies, and (d) non-profit entities. Did any segment of the market become noticeably more competitive?

Mark Simons

Current pricing trends for large public companies have been flat to small decreases. Rate adequacy on ABC programs is very inadequate and rate adequacy on A-Side programs has been adequate.

We would define small and medium-size public companies as Fortune 500-to-1,000 companies with market capitalization of \$1B to \$5B. Current pricing trends have been flat to small decreases. Rate adequacy on ABC programs is very inadequate and rate adequacy on A-Side programs has been acceptable.

LouAnn Layton

Pricing trends continue downward for most clients. The only clients that are not receiving the rate benefits are in the Financial Institution and Pharmaceutical spaces and clients with litigation.

Roddy Graham

Generally speaking we are seeing a small reduction in rate for large public companies that are renewing with little or no material change. Where there has been a material change, for example a sizable acquisition, we are witnessing price increases but due to competition, not to the levels that we have seen in the past, or an amount that underwriters feel is appropriate for the additional exposure involved.

Again, dependent on the nature of the company involved, we are seeing a small reduction in premiums for small and medium-size public companies. In this area, the main downwards pressure is on excess layers and the increased limit factors charged. This is one area, on a selective basis, where we have seen London be very competitive particularly for first excess layers.

The market for private companies continues to be very competitive with small reductions being offered. London does not see a large amount of private business on a direct basis but is a player where large limits are required, or risks are more complex (for example, where different lines of cover are offered on a blended basis).

London sees very little non-profit business on a direct basis, therefore it is difficult to judge the market. However we are not seeing any non-profit submissions where the entity is struggling, or is unable, to obtain acceptable terms, thereby suggesting that there is plenty of aggressive US domestic market for this class.

Bruce Hayes

In terms of pricing trends for large public companies, pricing is stable but as an industry we should still be concerned over whether pricing accurately reflects risk. To continue to offer stability, the market needs to address these gaps and price specific to risk. In the small to mid sized segment, pricing has become noticeably more competitive. A similar trend is evident for private and nonprofit companies, except in the Healthcare segment, where there is continued firming.

Fred Podolsky

As a general matter large public companies are seeing rates trending very slightly downwards in the range of 2.5 to 7.5%. There are a fair number that are seeing flat pricing at renewal but with competition can usually achieve some nominal reductions. Publicly traded companies with difficult financials or significant claims are seeing 5 to 15% increases. Greater upward pricing pressure on larger Financial Institutions segment accounts.

Small and medium public companies are seeing stronger rate reductions as a general matter more in the 10 to 15% range while some have witnessed even larger reductions from some of the newer competitors.

The private company marketplace is trending more dramatically downwards with most private companies achieving reductions of at least 10% with some seeing reductions of as much as 20 to 30%. This appears to be the most competitive segment of the marketplace.

Non-profit entities as a general matter are seeing rate reduction in the range of 5%.

While most of the D&O insurers are publicly saying that the marketplace is stable and flat, that would not be our view as can be seen from the above. In particular the small to middle market public and private company marketplace has become particularly aggressive both from a pricing and terms perspective.

Chris Duca

D&O market pricing in the aggregate is trending to the 1997 benchmark level, which is worrisome. The relevance of 1997 is in that year the D&O industry marked the end of stable and healthy pricing levels as many insurance carriers miscalculated that the passage of the Private Securities Litigation Reform Act of 1995 (PSLRA) had lowered D&O exposure.

Stock volatility and securities class action filings are directly correlated. The S&P 500 Volatility Index is currently at a three year high. Yet D&O pricing for large-capitalization companies is at a three year low. With this in mind, my view is that current excess D&O market pricing based upon experience and exposure for large-capitalization public companies is inadequate. The D&O pricing index of small- to mid-capitalization companies is marginally profitable on a risk-adjusted basis. However, the uneven distribution of securities class action claims particularly in the small- to mid-capitalization D&O sector will separate the winners and losers in the D&O arena.

D&O rates should be higher in the second half of 2006 than current levels. The primary reason is increased exposure, reflecting among other things the increase in stock market volatility and uncertainty. For example, the stock option scandal is expected to be a catalyst for an increase in securities class action filings and potentially a record number of derivative securities suit filings. The need for an increase in the contagion load factor in actuarial models is apparent. An increase in derivative securities litigation should impact all relevant segments of the D&O market including Side A only with DIC policy pricing. The secondary factor for increasing D&O rates, particularly excess D&O rates, will be experience rating. The significant inventory of securities class action lawsuits is expected to settle in the near term providing greater clarity and certainty of the magnitude of the severity of D&O claims. This recognition of severity experience is highly likely to be recognized not only by the legacy D&O carriers paying the losses, but also by the entire D&O market. D&O underwriters need to adhere to time tested, data-driven pricing models that accurately reflect risk in order to sustain a healthy and stable D&O insurance market over the long term.

David Allen

The market is highly competitive on all segments. It seems likely that the marketplace is competing any reasonable profit out of the line. The exposure to this line of business to systemic risk is significant. The market is destroying the risk load for the "fat tail."

Excess layers on large public companies are inadequately priced for the severity exposure. Luck appears to be the underwriting strategy for this class as the good news for 2006 may be that frequency is down on large accounts.

Bill McLaughlin

As a reinsurer, most of our knowledge about rates and current pricing trends is delivered to us by our ceding companies. My view, however, is that rates are not adequate for large publicly traded companies. The settlements keep getting larger and new types of claims keep emerging – e.g.

backdating and spring loading of options. Obviously, there is a lot of competition in the other areas of D&O liability.

Nick Conca

In the wake of the Enron, Worldcom, and AOL/Time Warner settlements, D&O underwriters are operating with extreme caution when evaluating and pricing large D&O risks. This is because of the perception that large companies have been targeted by the plaintiffs' bar and, perhaps more importantly, by activist institutional investors. The market trend is that D&O underwriters (with one or two exceptions) generally are being less aggressive in quoting large companies.

Underwriters continue to vigorously pursue small and medium-size public companies, as those companies are perceived to fly below the plaintiffs' bar's radar. As such, competition for medium size and private companies has continued to grow. Markets have identified the medium sized public companies as historically less likely to be tagged with a securities class action and, when they do get sued, have a greater likelihood of a smaller settlement or being dismissed from the action on motion.

Softening market conditions also exist for private companies, particularly those with some scale (e.g., revenues above \$100 million). Although D&O risks certainly exist for private companies, the major exposure for underwriters is employment practices, which underwriters generally manage through retention levels. Underwriters are accommodating reasonable requests for premium reductions as well as changes to terms and conditions.

Phil Norton

Rate adequacy remains a volatile issue for most D&O insurance carriers. The reason for concern mixed with optimism is conflicting trends such as (1) claim frequency has stabilized and now appears to be declining

(however, some underwriters believe claim severity is increasing), (2) financial restatements doubled in 2005 to record highs, and are believed to be key contributors to perhaps increasing future claim costs, and (3) case dismissals, while up to about 16% or 17% from a low of around 10%, are pivotal to estimates for future claim costs – especially with so many claims still open. Given a scenario of reduced claim frequency at a stable average claim cost with an increase in cases dismissed or summary judgment, current rates should be adequate in most sectors.

Pricing trends are also in a state of flux. The large publicly-traded marketplace has firmed, with most renewals being priced near expiring. This change to last year's substantial decreases began in January and has remained constant for these larger accounts. Primary and excess are typically being quoted at expiring or for a single digit decrease in some unusual circumstances. Also, excess pricing is much firmer than a year ago, when high excess pricing often went down as much as 20% on accounts where the primary was essentially flat.

Small and medium-size public companies are much more competitive than their larger counterparts, with 10% premium decreases somewhat commonplace, though with some indications that the second half of 2006 may not be quite as buyer-friendly. Not-for-profit underwriters are quoting the majority of their business flat or close to expiring. However, with competition and on the more desirable (and sometimes larger) risks, some nonprofit renewals have gone for decreases as extreme as 20% to 25%.

Industry-wise, we are seeing less impact than a year ago when Healthcare and some Financial Institutions business were out of favor. Attractive rates are being given to retailers with a strong track record, manufacturers, technology firms and bio-tech companies.

Question	Are D&O policy terms and coverage conditions trending broader, narrower, or remaining the same?
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Chris Duca

D&O policy terms overall are remaining the same with an emphasis on clarity in the hope of maximizing the probability of achieving the insurance buyers' objectives. If the insurance buyer's objective is to protect the non-culpable outside directors, we are seeing that clarity of coverage for individuals. The increase in demand for Side-A only with DIC policies as part of D&O program structure is one example. Another is the express initial public offering (IPO) and secondary offering coverage for Sections 11 and 12 of the Securities Act of 1933. A third is the inclusion of severability provisions of the D&O policy application and exclusions. In all three cases, to varying degrees based upon the specific facts of the claim and policy terms and conditions, there is no coverage for the culpable directors and officers.

Bob Cox

Terms and conditions obviously vary by customer need and size, but we see a couple of trends in terms of customer expectations. Larger, more sophisticated customers in particular are paying more attention to coverage than ever before. That's also evidenced by greater involvement from outside lawyers and advisors. In addition, outside directors have become more interested in buying D&O and in how the insurance applies to them. While D&O was conceived primarily to protect outside directors, over time, the contract was geared more and more to insiders and to the

company itself. The increased interest among outside directors sheds light on a fundamental question: for whom is a D&O policy really intended? Today, D&O insurance is an asset that is essentially "competed for" – by the corporate entity, the officers, and the independent directors. At a minimum, D&O buyers should consider the manner and priority in which their D&O insurance would be expected to respond, then, ensure that their policy contemplates those expectations and priorities.

Joe Monteleone

From my perspective as counsel to many underwriters and drafter of policy forms and endorsements, terms and conditions are definitely trending broader. Severability has been granted more broadly since the Cutter & Buck decision came down in 2004 and was affirmed in 2005. Insurers are having more difficulty in obtaining adequate "drop down" protection when underlying insurers cut deals with insureds in the face of coverage disputes. In particular, the language is not allowing the excess to achieve greater discounts than the underlying in light of the lesser rate they received.

David Allen

The number of new product announcements as a barometer of terms and conditions suggests we are heading toward broader policy coverage.

Fred Podolsky

Policy terms and conditions are definitely trending to the broader side. Though there is considerable push back from underwriters, many of the more important terms and conditions can be broadened including severability, A-Side non-rescindability (some insurers will offer B&C-Side non-rescindability as well), additional carve-outs to the insured vs insured exclusions such as those for whistleblowers under Sarbanes, creditors committees and debtors in possession from a bankruptcy perspective.

Other issues being addressed:

a) Underwriters are more willing to offer final adjudication language rather than "In Fact" language in the conduct exclusions though it needs to be negotiated as to whether this applies in a court of law or an ADR proceeding and whether it applies in the underlying claim or in a separate proceeding.

b) Some insurers are particularly interested in seeing changes made to subrogation language.

LouAnn Layton

I think each client is able to negotiate several enhancements to their contract. Some of the enhancements are window dressing but others are extremely beneficial.

Phil Norton

D&O policy terms and coverage conditions are definitely trending broader. Improvements are focused around the issues of severability, conduct exclusions, key definitions, M&A activity, non-rescindability and several Side-A carvebacks. Carriers are willing to listen.

Bruce Hayes

There seems to be a market trend toward broader policy terms. While this might be appropriate for some risks, it is important that customers understand the significance and implications of policy enhancements (e.g., losing control of policy proceeds) as they apply to their potential claims activity.

Dan Bailey

D&O policy terms continue to trend towards broader coverage. As a broader segment of the brokerage community now requests more coverage enhancements, it appears that some requests are being made without full appreciation of the reasons for and consequences of the requested change, thus creating the potential for unintended coverage consequences. For example, in the last several months, many brokers are now asking excess D&O insurers to issue a so-called "shaving limits" endorsement, which generally states that liability attaches to the excess D&O policy if either the underlying insurers or the Insureds pay the amount of the underlying limit. However, there appears to be significant confusion by many brokers and Insureds regarding the purported benefits of such an endorsement and the effects of various alternative versions of that type of endorsement.

An important new version of the Side-A policy was introduced this quarter, which combines the benefits of a standard Side-A policy with an Independent Director Liability ("IDL") policy. This new version creates a separate limit of liability only for independent directors if the initial Side-A limit of liability is exhausted.

Roddy Graham

Generally we are seeing policies renewing as expiry. In certain circumstances there is some policy broadening, but nothing that will probably end up being meaningful in the majority of claims situations.

A typical policy enhancement is an amendment to the Assured versus Assured exclusion to allow cover for whistleblower suits. We also see a continuing focus on the quality of severability/non-recission language in policies, as well as the adequacy and breadth of separate Side-A/DIC towers.

Nick Conca

Key areas that are frequently addressed are the triggering mechanism under D&O policies (i.e., the definition of "claim"), severability of the application and conduct exclusions, as well as wordings for warranties. Other

provisions that are subject to amiable negotiation have been provisions such as order of payments; insured v insured carve-outs; limits tie-in between fiduciary policies

and D&O programs; investigative cost coverage and sub-limits; and alternative dispute resolution.

<h1 style="margin: 0;">ADVISEN POLICY FORM COMPARISONS</h1>	<ul style="list-style-type: none"> • OVER 1,000 POLICIES Learn More... • HUNDREDS OF CARRIERS • ALL MAJOR LINES <p style="text-align: right; margin: 0;"><i>...and it's INTERACTIVE!</i></p>
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Question	How is the stock option backdating scandal impacting D&O underwriting?
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Jim Skarzynski

Given the recent investigations and rising number of civil lawsuits, the topic of backdating stock options, and potential related future losses, is currently one of the most talked about issues in D&O underwriting circles. Insurers are appropriately concerned about the issue. Since March 2006, over sixty companies have become targets of investigations by the SEC and/or Department of Justice, a significant number of shareholder and derivative class action lawsuits have been filed, and the number of lawsuits is expected to rise as the investigations continue.

Throughout June 2006, a number of articles were published specifically addressing the backdating issue, and offering speculation on the effect of the recent lawsuits and investigations on the D&O marketplace. While I note that no significant increase in premiums has been reported, insurers are understandably taking steps to temper the expected surge in backdating claims. In fact, we have observed that, when assessing a prospective new insured, or evaluating a renewal with a current insured, insurers are now seeking information on whether or not a particular company has received an inquiry from the SEC or is otherwise involved in the current investigations or civil lawsuits. In addition, Insurers are specifically inquiring about a prospective insured's past and present practices with regard to backdating and the timing of the options. If a company

has offered backdating stock options to its executives and/or employees, insurers may seek to exclude any potential future liability through a policy's prior/pending date or a specifically worded exclusion.

While it is likely that the number of lawsuits will continue to grow as the investigations continue, it is too early to predict how significant the settlements arising out of these lawsuits will be. Certain facets of the current backdating lawsuits have shades of the recent mutual fund scandal. I note that initially, the mutual fund scandal created widespread concern across the D&O marketplace, and many predicted significant financial losses. However, ultimately, the losses were not nearly as severe as initially speculated. Additionally, one factor that may lessen the potential severity of the financial impact of backdating is the requirement imposed by Sarbanes-Oxley in August 2002 that stock option grants must be reported within two business days. Many analysts have noted that backdating damages should be significantly curbed to the extent companies complied with this regulation.

Dan Bailey

The primary underwriting impact to date arising out of the stock option backdating allegations is the use by many underwriters of a new questionnaire which solicits underwriting information relevant to stock option practices. To date, the backdating

"scandal" has not resulted in any noticeable increase in premiums, because it is far from clear what effect these allegations will have on D&O insurers. Although dozens of companies have been identified as having stock option backdating problems, only a few securities class action lawsuits have been filed so far relating to these allegations. In most instances the disclosure of the allegations did not result in a meaningful drop in the company's stock price, thus precluding a securities class action lawsuit. In contrast, shareholder derivative lawsuits have been filed against the directors and officers of many of the identified companies, but it is questionable whether most of those derivative lawsuits will have significant settlement value for several reasons. First, the derivative lawsuits will be subject to many of the standard defenses raised in other types of derivative lawsuits, including in particular the pre-suit demand/demand futility defense. Second, the amount of recoverable damages suffered by the company as a result of the stock option backdating is questionable in many instances. Third, significant coverage defenses will likely exist at least with respect to coverage for the Insured Persons who received and agree to disgorge any ill-gotten gain as a result of the backdating practice or any Insured Persons who knew about the backdating practice when the Insureds signed an Application Warranty. For many companies, the alleged wrongdoing occurred up to 10 years ago, so coverage defenses based upon relatively old applications may arise.

Bob Cox

This is a brand-new issue for insurers. As underwriters digest this issue, they have simultaneously implemented heightened underwriting procedures to better evaluate these exposures. No particular approach has taken a dominant role in the marketplace. However, as a carrier that concentrates on knowing its customers through one-on-one meetings, we will address this development just like any other emerging issue and evaluate it on a case-by-case basis.

Bill McLaughlin

This is on the mind of every D&O underwriter. As these allegations are relatively new, underwriters are taking a very cautious approach to underwriting public D&O accounts. As we do not know how these claims/lawsuits will ultimately play out, we need to ask appropriate questions as our policies/treaties renew. I personally believe that a good deal of money will be spent defending and rectifying this issue. How much remains to be seen.

Joe Monteleone

Underwriters have reacted much as they did during 1999 with the then looming Y2K problem. They are devising supplemental questionnaires and/or requesting conference calls between the insured and all markets to discuss the risk's potential backdating exposures. As in Y2K, insureds are resisting giving helpful information, or at least not responding with anything that could be deemed to be a representation or warranty as part of the application process.

LouAnn Layton

Still a very mixed bag. We have some underwriters requiring detailed information with warranties and other being satisfied by answers to some general questions in an underwriting meeting. I have not seen any exclusions or underwriters non-renewing because of this exposure.

Bruce Hayes

The stock option backdating scandal has impacted the underwriting process in a number of ways including the necessity for underwriters to revisit rates and pricing reductions. In order to gain additional insights into the corporate culture, another probing and meaningful layer of questions has been incorporated into the underwriting process, helping to drive the appropriate price and coverage options.

Chris Duca

Questions regarding executive compensation and board oversight have always been asked and/or reviewed by D&O underwriters as part of the underwriting process. The D&O

application, supplemental questionnaires, company's proxy statements and SEC filings that disclose the specific awarding of stock options, executive compensation, and the compensation committee oversight continue to be relied upon in the D&O underwriting process. There is a higher level of detail, transparency and comprehensive plain English disclosure of executive compensation being required by investors, regulators and D&O underwriters.

Nick Conca

A company's procedure with regard to the granting of stock options has become a standard avenue of inquiry for D&O underwriters in assessing a company's risk profile. Underwriters, apparently under strict mandate from their senior management, have been asking probing questions of their current and prospective insureds regardless of industry group and irrespective of even the most favorable corporate governance ratings. Whether in face-to-face meetings or by marking quotations contingent upon managements' reply, the results of any internal review conducted by the audit committee or outside party, the impact of the implementation of Sarbanes-Oxley, the approval of option grants and the selection of grant dates, and the existence of any SEC investigation will all draw scrutiny.

Perhaps most decisive in terms of worsening a company's risk profile will be any indication that the company intends to restate previously filed financial statements or that it is more likely than not to announce such a restatement. Beyond this intensification of the underwriting process, carriers may seek to impose exclusionary language or to demand completion of a questionnaire as an addendum to its standard application.

Mark Simons

At this stage there has been no impact, other than querying clients as to whether this has been an issue for them.

Phil Norton

Thus far, the impact has been limited. While none of our accounts has been affected, underwriters are clearly testing the waters

with the concept of questionnaires or exclusionary endorsements. Most clients are addressing the issue at underwriting meetings, however. Concerns about trying to guarantee that all historical actions are free from backdating are obvious. Indeed, in at least one recent situation, an underwriter requested a warranty-style response covering our client's entire history of option grants. Such underwriter was not given the written warranty and then was replaced upon renewal.

Interestingly enough, most of the cases being brought thus far seek disgorgement by the individual involved (already excluded) and breach of duty on the board's part for approving the backdated options. We feel that these breach of duty claims may not be too serious outside of defense costs as the Delaware court has already held that executive compensation falls within the business judgment rule (see the Disney decision regarding alleged excessive compensation to Ovitz). Although other state courts may differ, creating some liability from backdating options, we feel the greatest risk may be stock market reactions to such news. Some companies have admitted to backdating and found their stock pricing falling hard on such news. A securities violation lawsuit is easy to surmise in these cases as long as stock price drop is significant.

Fred Podolsky

All underwriters seem to be asking whether their insureds awarded or issued stock options with a strike price at the time the trading window for the company's shares was closed. Additionally, underwriters have also now begun to ask about "spring loading." Essentially they are now also concerned with determining whether an insured issues stock options just ahead of some positive news. Underwriters are asking if insureds are aware of any grants that occurred during periods where technically there should have been a blackout period initiated and there was not.

Obviously how these questions are viewed and responded to can create concerns over the giving of a warranty where one would not ordinarily be required, and whether there is a need to potentially circumstance an insurer

with information about potentially questionable option practices to preserve any coverage that may exist for these practices.

While insurance underwriters have threatened to add exclusionary language regarding stock options to D&O and Fiduciary policies we have not seen any that have been actually added to date.

Roddy Graham

It is a bit early to see a real trend. Underwriters are requesting questions on stock option procedures but we have yet to

see an account where, eventually, the answers have been deemed unsatisfactory.

There is a concern that there will be a knee jerk reaction from insurers and all clients that have some form of an issue will be treated in the same manner, whereas we would expect each case to be addressed on its individual merit. Whilst some of the issues do appear to be serious, it is too early to judge the effect it will have on insurers but should the suits that have been already been filed "go the distance," then the consequences may be a tightening or non liberalization of terms and increased premiums.

Question	What recent legal decisions or regulatory actions most impacted the D&O marketplace, and what legal decisions or regulatory actions are you watching for future impact?
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Phil Norton (with Donna Ferrara, Esq., Gallagher SVP)

The biggest change has been the requirement that corporations file documents electronically and, thus, the availability of that information on the Internet. The easy availability of information has changed how corporations act and will continue to do so. For example, in 2002, the SEC changed the accounting rules for stock options, but it was not until 2005, when an academician compiled the data that anyone – including the SEC – actually realized what corporations had been doing. For example, some companies backdated their options for executives not just to find an attractive strike price, but to circumvent new rules regarding the expensing of options.

Another change that has led to real differences is increased regulation of non-US companies. Non-US companies have been subjected to regulation for some time, but enforcement – and therefore compliance – has been lax. Non-US companies seem to be getting even more attention from the SEC - and therefore from the plaintiffs' bar as well.

Increased pressure from non-SEC governmental entities is also a major change. Since the inception of the federal securities laws, enforcement of corporate regulations has fallen mostly to the SEC. The SEC generally used the US Attorney's office to bring criminal suits. Now, the Justice Department and state law enforcement have weighed in on their own. A side effect of this new activism is increased cooperation among state and federal (and even some local) enforcement efforts. These tools have been in place all along, but haven't been used.

The SEC is again considering rules on executive compensation, but we doubt that any real change will happen there. The courts continue to make narrow decisions on pleading standards, such as in the Dura case, that likely make no significant difference, but are touted in the press as if they really do.

Finally, stock trading blackout periods seem to be very effective based on some recent cases. Insider trading is often seen by juries as an indication that management knows more than is disclosed to the public. A strict

trading schedule blunts that allegation quite effectively.

Dan Bailey

Several developments in the last few months create both good news and potentially troubling news with respect to Side-A exposures. First, the Delaware Supreme Court's decision in the Disney case affirms the broad protection afforded by the Business Judgment Rule under Delaware law. Among other things, the Court ruled that absent a conflict of interest directors and officers typically are not liable absent an actual intent to do harm, intentional dereliction of duty or a conscious disregard for one's responsibilities. The decision recognizes the high legal burden a plaintiff must satisfy in order to prove liability in many shareholder derivative lawsuits, which are the most common source of losses under a Side-A policy.

Second, the US District Court for the Southern District of New York ruled that the government's attempt to prohibit companies from indemnifying directors and officers who are targets of criminal charges was unconstitutional. The decision, which was a stinging rebuke of the government's attempt through the so-called Thompson Memorandum to gain an upper hand in its criminal pursuit of directors and officers, confirms the fundamental importance of a company's indemnification obligation, noting that a D&O's right to indemnification is "as much a part of the bargain between employer and employee as salary or wages." The decision gives greater comfort to both insureds and insurers that a company's commitment to indemnify its directors and officers will be enforced, thereby reducing the risk of Side-A policies being manipulated.

Third, a somewhat surprising number of recent court decisions have dismissed shareholder derivative lawsuits because the plaintiffs failed to make a pre-suit demand on the board of directors to bring the lawsuit directly by the company. Although this pre-suit demand defense has been used as a basis to dismiss derivative lawsuits for decades, these most recent court decisions appear to evidence a more broadly endorsed

willingness by courts to dismiss derivative lawsuits on this procedural basis.

As a potentially troubling development, a few derivative lawsuits settled in recent months for unprecedented amounts when compared with historical derivative settlements. For example, the Oracle derivative litigation settled for \$100 million, plus a \$22 million plaintiff attorney fee award, and the HealthSouth derivative litigation settled for \$100 million. These settlement amounts, although arguably aberrational and attributable to the unique circumstances in those cases, are nearly twice the amount of the previous record settlement for derivative suits. Obviously, if the magnitude of settlements in derivative lawsuits significantly increases on a more widespread basis, underwriters of Side-A policies will likely need to adjust their underwriting decisions and pricing.

Chris Duca

The cover story of the June 26, 2006 issue of Barron's is titled "Is Your CEO Lying?" with the sub-title: "In the post-Enron era, big investors are more skeptical than ever about companies' creditability - Unmasking corporate lies." The investor sentiment is that corporations need to provide more transparency not less. The current political environment provides regulators, policy makers and judges with the mandate of protecting investor and employee rights.

Two cases of concern include a pending securities class action lawsuit and an employment-related matter. On April 24, 2006, a fairness hearing was held regarding the February 15, 2005 preliminary and tentative settlement of In re: IPO Securities Litigation involving the issuers. The US District Court Judge Shira Scheindlin in New York expressed skepticism of the tentative settlement terms, which brings uncertainty to the final terms of the settlement of the pending IPO Allocation securities class action lawsuits involving the issuers' liability. In the second case, Burlington Northern & Santa Fe Railway Co. v. White, the US Supreme Court in a unanimous ruling adopted the Seventh Circuit's lower threshold standard and broadened the scope for a plaintiff to allege

an employer's violation of Section 704 of Title VII of the Civil Rights Act of 1964's anti-retaliation provision. The higher threshold standard set out by the Sixth Circuit Court of Appeals required a plaintiff to show an actual material adverse change in employment. The scope for violations of the anti-retaliation provision of Title VII was broadened to include aspects of employment and workplace environment. The previous scope was limited to hiring, firing, promoting and compensating an employee. This landmark employment decision is expected to make it easier for employees who allege discrimination or claim whistleblower status to successfully pursue a claim for retaliation. The ruling will likely increase the number of employment-related claims and anti-retaliation claims coupled with higher settlement demands from employees alleging violations of Title VII.

Roddy Graham

It would appear that both the Dura Pharmaceutical and Disney rulings are having a positive effect on claims activity, but with no examples of this on our book of business such effect is purely anecdotal at present.

One side-effect of SOX, is the number of companies (both US and International) we are seeing choose to IPO on the London Alternative Investment Market ("AIM") and other foreign exchanges, rather than on NASDAQ. We have seen a significant increase in new enquiries for AIM IPO's and cynics might suggest that NASDAQ purchasing 25% of the London Stock Exchange (which owns the AIM market) is one way for it to recoup lost business.

The London D&O market is monitoring closely the coverage implications that might follow the case of the "NatWest Three." Three former NatWest bankers charged over an £11 million fraud will be extradited to the US on 13th July. They will face trial in the US on charges related to the collapse of the energy giant, Enron. The extradition has been criticized as it was sanctioned under a controversial fast-track procedure. The treaty means Britons can be extradited to the US without evidence first being produced that they have a case to answer. The "NatWest Three" could be held in a US jail for two years

awaiting trial; they have cited that this is wrong because Britain is where they live and where the alleged offences took place. They face custody when they arrive unless they can raise \$1 million bail.

Bruce Hayes

Recent legal decisions affecting the D&O marketplace include rulings that plaintiffs in securities class actions are required to establish a causal connection between alleged wrongdoing and subsequent shareholder losses (*Dura Pharmaceuticals v. Inc. v. Broudo*). This ruling was applied to eliminate all shareholders who sold their stock prior to the first corrective disclosure from a proposed class because they could not, by definition, demonstrate a loss causally related to the defendants' alleged misrepresentations. Additional regulatory actions that have most impacted the D&O marketplace have occurred in the context of the IPO laddering cases, the mutual fund "market timing" and "late trading" scandal, the insurance broker contingent commission and bid-rigging cases, the finite reinsurance matters, and the stock option re-pricing matters.

LouAnn Layton

The Lucent case on indemnification got people interested in revisiting their by-laws. The Disney case was good for the business judgment rule in Delaware Court. The Dura decision made a great deal of press and victory laps for the defense side, but we have not seen any tangible positive results as yet. Rescission cases such as Homestore and Cutter and Buck triggered the importance of the severability clause. The Dabit case involving the Supreme Court decision under the Uniform Standards Act of 1998 may in the long run have the most positive effect on D&O litigation. It will be interesting to see the final decision by the SEC on compensation disclosure rules. The new protocols may have impact on D&O litigation.

Bill McLaughlin

Recent legal decisions, such as Dura and the Disney derivative suit, have been viewed positively by the market. But, the industry needs to be steadfast in its underwriting as new developments, either commercial or legal

in nature, always seem to crop up. One thing that we have always watched is the so-called "law of unintended consequences." We often read about some new development that we believe is beneficial to the D&O marketplace. Later on, we realize that unintended consequences have come about. An example of this is Sarbanes-Oxley. Initially, SOX was viewed as solving many existing problems and preventing others from appearing. Clearly, a good deal of corporate malfeasance has been prevented, but numerous critics of SOX also believe that the law has made it much too costly to operate as a publicly traded company. This might help to explain the huge amount of activity in the private equity arena.

Nick Conca

Generally speaking, areas that we are watching include:

- a) The increased activity by the SEC in enforcement actions (nearly 45% in 2005), given the SEC's apparent pursuit of individual D&O based upon their individual conduct;
- b) The increased focus on outside directors and alleged breaches of duty to the company;
- c) The alleged heightened standard of duty of loyalty depending on the directors' background;
- d) The "cutting loose" of certain D&Os to benefit entities in regulatory actions;
- e) ERISA tag along suits filed in connection with traditional securities class actions;
- f) Increased derivative litigation activity and jurisdictional indemnification implications;
- g) Opt-outs from securities class actions to potentially benefit a plaintiff law firm's individual client;
- h) The impact of the Supreme Court's decision in Dura Pharmaceutical on securities class action dismissal rates, as well as its impact on settlement negotiations; and
- i) The recent Supreme Court decision regarding retaliatory conduct, and SOX whistleblower actions.

Mark Simons

- a) Regulators response to stock option backdating and the outcome of the current investigations.
- b) Basel II Accord amendments, which are due out in 2008.
- c) Certain industries have been impacted by litigation (not necessarily direct D&O litigation) that has resulted in significant D&O price increases.
- d) There have been several large billion-dollar D&O settlements but these have not impacted D&O pricing.

Bob Cox

There are a couple of recent decisions that are intriguing from an underwriting standpoint: (a) Dura Pharmaceuticals, which gets at the importance of establishing a clear link between damages and loss causation, and (b) The Disney case, which affirmed the business judgment rule in a major compensation suit. As for future impact of rulings such as these, it's too soon to tell.

Joe Monteleone

The two most significant decisions, in my opinion, have been Dura Pharmaceuticals and Cutter & Buck. The final verdict as to the impact of the latter is still out, but I believe loss causation issues have put the brakes on some potentially runaway settlements. Plaintiffs tend to overly minimize its impact, while defendants often see it as a type of silver bullet defense. We still need some more practical settlement experiences and case law texture from the lower courts to assess the true impact.

Fred Podolsky

- a) Worldcom - outside directors agreed to pay \$25MM, or 20% of their combined net worth from their own pockets.
- b) Enron - directors agreed to pay \$13Mm from their own pockets.
- c) Disney - dismissal of the derivative lawsuit against the directors and officers of Disney Corporation by the Delaware Chancery Court.

Question	What role did captives, trust funds, etc. play in dealing with increased D&O and related exposures?
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LouAnn Layton

Nontraditional structures had little appeal in 2005 and 2006.

Nick Conca

Captives typically do not play a significant role in large commercial D&O programs. While common in Healthcare and Accounting to address "hard to place" D&O and professional liability exposures, the vast majority of the SCA activity does not implicate captive or trust fund vehicles.

Dan Bailey

We have seen no movement towards the use of captives or other similar alternatives to traditional D&O insurance. There is good reason for companies not to use such alternatives. Consistent with existing legal authority, these alternatives may be viewed as a guise for indemnification from the parent or sponsoring company, in which case the alternative vehicle may not be legally permitted to protect directors and officers against certain types of non-indemnifiable loss. Because protection for non-indemnifiable

loss is of paramount importance to directors and officers, the risk of not having that protection is compelling justification for avoiding these alternative vehicles as a substitute for traditional D&O insurance.

Phil Norton

Captives, trust funds and the like have had very little impact in recent times on the D&O marketplace and how clients finance their D&O risk. In the mid-80s, this was very different as group captives and policyholder-controlled companies at that time (ACE, X.L., CODA, BICL, OIL, Aegis, SCUUL/UE, Sargasso and many others) played a very significant role in dealing with D&O and related exposures. Today, policyholder-owned companies and group captives writing D&O are almost unheard of. There is much talk in this arena, but limited action - primarily an occasional corporate risk manager putting his "Side-B" and "entity" D&O risks into an established captive, yet still purchasing "Side-A" D&O coverage from the traditional marketplace.

Question	How has Sarbanes-Oxley impacted the frequency of securities class action filings and the size of settlements?
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Bruce Hayes

While Sarbanes-Oxley has improved corporate governance and the level of accountability throughout an organization, as of yet it has not impacted settlement size or claims frequency. Frequency and severity are still trending at the same levels. We will need to monitor the activity over a period of time –

and through different stock market cycles – to gauge the real impact from a settlement size and frequency perspective. There are other trends, however, that are directly related to Sarbanes-Oxley. These include an increase in stock exchange competition, with some companies now listing or issuing an IPO on foreign exchanges or deciding to go private to avoid the added regulatory compliance costs.

Dan Bailey

The Sarbanes-Oxley Act of 2002 ("SOX") continues to have no discernable impact on the frequency or severity of securities class action lawsuits. There is, though, a noticeable increase in the number of current or former employees (including current or former officers) who serve as confidential witnesses for plaintiffs in securities class action lawsuits, thereby providing to plaintiffs useful evidence which assists the plaintiffs in surviving the Motion to Dismiss. Part of the reason for more officers and other employees serving as confidential sources for plaintiffs may be the whistleblower protection afforded pursuant to Section 806 of SOX. From a D&O insurance coverage standpoint, these confidential witnesses/whistleblowers can create a coverage issue under certain versions of the insured v. insured exclusion. As a result, in recent months more brokers have been requesting an amendment to the insured v. insured exclusion which carves out of the exclusion any assistance or participation by a whistleblower who is protected under Section 806 of SOX or any similar whistleblower protection statute.

Nick Conca

Statistical data would suggest that there has been no increase in securities class action activity due to Sox; however, it has been relatively recent since the passage of SOX and the requirements imposed thereunder.

With respect to the size of settlements, while the average and top 10 settlements have trended upward, we do not believe that SOX has directly led to such an increase. The size of settlements is typically driven by market capitalization loss, the active participation of institutional investors, the existence of 3rd party defendants such as accountants and investment bankers, a restatement and deep pockets. Many of those factors may be viewed more as a function of the individual factors of a case, the passage of the PSLRA and the bursting of a perceived inflated stock market, rather than the passing and implementation of SOX.

LouAnn Layton

I do not believe we can point to any concrete linkage between SOX and the frequency or severity of securities claims.

Chris Duca

The most significant impact of Sarbanes-Oxley on D&O insurance is Section 302 - Corporate Responsibility for Financial Reports. The written certifications by the CEO and CFO of the financial statements filed with the US Securities and Exchange Commission (SEC), like all SEC filings, are relied upon by D&O underwriters and form part of the D&O application. This provision not only provides assurances to D&O underwriters of the integrity of the financial statements, but also peace of mind to non-culpable officers and directors that their D&O policy limits will not be eroded needlessly by culpable executives' defense expenses or damages. It is too early to tell whether Sarbanes-Oxley has impacted the frequency of securities class action filings and the size of settlements. I believe that SEC Commissioner Roel C. Campos had it right when on May 9, 2006 he commented about the effect of Sarbanes- Oxley on director liability. Commissioner Campos stated, "...it (Sarbanes-Oxley) created a sense of greater liability for directors and certainly for management. ... With respect to directors, however, there has really been no direct imposition either by statute or case law of additional liability. " He added, "Still, the environment feels more dangerous, and directors certainly are concerned about being dragged into lawsuits and spending their valuable time and resources to defend themselves, even if they are ultimately found not to be culpable."

Bob Cox

It's too soon to measure the impact of Sarbanes-Oxley on either the frequency or severity of future claims, though it's safe to say that allegations about inadequate internal controls are far more common today that they were pre-SOX.

Roddy Graham

It would appear that Sarbanes-Oxley is having a material effect in reducing claims

frequency. The discipline that the Act puts on companies seems to have the desired effect and the number of claims is significantly down on the same period last year. It would also appear that an announcement of a breach of a material weakness in the internal controls of a company does not automatically lead to a suit being filed, which is good news and may be tied into the Dura ruling.

It is too early to ascertain the effect on settlements as most of the post SOX claims are still to be resolved.

Joe Monteleone

In my opinion, SOX has had no impact on the size of settlements and likely will not have any such effect in the future. If anything, average settlement values continue to increase as the last of the corporate meltdowns of 2001-2002 play out and other settlements involving huge market cap losses take place. Relatively smaller market cap losses in a more stable market environment will lead to smaller settlements regardless of SOX.

Frequency of securities class actions dropped in 2005 compared with 2004, but a close examination of all years since 2001 shows no sustained, discernible downward trend in frequency. In fact, an educated guess at this juncture in 2006 suggests that the backdating scandals will lead to 2006 becoming a year of increased frequency compared with 2005. SOX may well have a beneficial effect on frequency in the long run and, in fact, the options backdating claims overwhelmingly involve pre-SOX activity. Yet, it may be still a little too soon to draw a firm conclusion as to any correlation between SOX and class action frequency.

Phil Norton

Directly, not at all. There is no private cause of action under Sarbanes-Oxley. However, the requirement of fast, electronic, public filings is likely to combine with requirements in Sarbanes-Oxley to indirectly make a difference sometime in the future. Because information can be compiled and interpreted faster and with greater precision today, the impact of specific corporate misdeeds is now more measurable and thus can be seen more dramatically.

We do not believe Sarbanes-Oxley will by itself impact claims frequency at all – in fact there has been a small decrease in class action filings recently. However, we believe that it may (and will continue to) increase D&O claims severity somewhat, as it is now much harder to hide or mischaracterize corporate activity – and knowing the rules and still breaking them often leads to greater claim values.

Mark Simons

It's too early to tell.

David Allen

Until executive compensation and Wall Street's focus on making the numbers quarter by quarter change there will be numerous chances for plaintiffs bar to make allegations of securities fraud.

Bill McLaughlin

I believe that the jury is still out on the frequency of securities class action lawsuits, but the recent developments seem to be encouraging. We will have to see if this becomes a trend. Average settlements are definitely increasing. Is this due to SOX or bad corporate governance? Time will tell.

Comments Welcome

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