Guest Editorial

Lessons Learned from the History of Corporate Liability Insurance in the United States

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The goal of this guest editorial is to place the issues discussed at the Seminar¹—and specifically those concerning the insurance coverage of corporate liability risks—in context. I would like to do this by discussing some of the history of corporate liability insurance in the United States, and comparing the manner in which insurance problems and challenges developed in the past to what is happening today.

Of course, history never exactly repeats itself. But it is also true that almost nothing is ever entirely new. Therefore, what I find is that there are both parallels between the current situation and the past, and differences between the past and the present.

The first part of this editorial looks at the history of corporate insurance in the United States over the past 30 years. This is a history of both insurance against liability for bodily injury and property damage, and of insurance against liability for corporate wrongdoing that results in financial losses. Thus, the two main subjects are Commercial General Liability (CGL) insurance and Directors & Officers (D&O) insurance.

Three factors causing instability in the past

Three factors contributed to the periodic instability in the insurance markets over the last 30 years. Each is related to the other. These factors are pricing uncertainty, judicial risk and exogenous shocks from outside the insurance market that destabilised that market.

Pricing uncertainty

In CGL insurance, pricing uncertainty resulted from the explosion of long-tail environmental and toxic tort liabilities in the latter part of the 20th century. Not only did these new liabilities generate widespread litigation over the scope of coverage available under occurrence-based policies that had been sold in the past, but also, for

¹ The 13th Joint Seminar of the International Association for the Study of Insurance Economics (The Geneva Association) and the European Association of Law and Economics (EALE) that was held in Milan, Italy, at the Department of Law “Angelo Sraffa” of Bocconi University, on 11–12 May 2009.

roughly the 20 years between the late 1970s and the late 1990s, insurers were uncertain whether the explosion would continue, and if so, at what rate.

Yet the mechanisms that insurers attempted to use to combat pricing uncertainty were not completely effective. Commercial purchasers of insurance were not terribly receptive to insurers' efforts to shift from occurrence to claims-made policies. And the absolute pollution exclusion, which was incorporated into occurrence policies around 1986, applies only to some long-tail liabilities, not all of them.

In D&O liability insurance the causes of pricing uncertainty have been different, but uncertainty nonetheless has plagued this market as well. In the United States the principal form of liability covered by D&O liability insurance is liability for public misrepresentation of the company's financial condition, under the U.S. securities laws. But almost no lawsuits alleging liability for violation of the securities laws go to trial. They are almost always settled. Less than ten cases have gone to trial in the last decade, out of approximately 3,000 such suits that were brought during the same period.

To be held liable under the securities laws, a misrepresentation has to rise nearly to the level of fraud or constructive fraud. Yet D&O liability insurance policies expressly exclude coverage of liability for adjudicated fraud. And even if they did not, U.S. courts would almost certainly hold as a matter of public policy that adjudicated fraud cannot be covered. But settlements are covered. Therefore one of the reasons that securities lawsuits are settled is that the directors and officers insured by D&O policies insist on settlement in order to protect their own assets. Another reason that almost all cases are settled is that the sums at issue are so large—often billions of dollars—that it is simply too risky for either side to go to trial in the United States, where a jury of ordinary citizens would decide their fate.

But with almost no cases that go to trial, D&O insurers do not have the broad base of loss experience that might be used to help them set premiums. Settlement amounts provide some basis, but this data is essentially circular. Unlike settlements in other fields, settlements in securities lawsuits do not take place in the shadow of trial outcomes. A securities settlement does not necessarily reflect the expected value of the case if it actually went to trial. Therefore the setting of premiums for D&O insurance, as Tom Baker and Sean Griffiths' work has taught us, is based on the criteria about the quality of corporate governance whose reliability is not proved.²

Increased judicial risk

American courts have sometimes interpreted the terms of commercial insurance policies in ways that surprised insurers and that insurers consider unfaithful to the policy language. The result has been a *de facto* expansion of the scope of coverage. Insurers' responses range from raising premiums for future coverage, to redrafting policy language so as to make it more difficult for the courts to ignore the insurers' intent. For example, in the United States, all D&O policies contain an exclusion of coverage of liability imposed in certain suits by one insured against another—the

² See Baker *et al.* (2007); see also Baker (2009).

“insured vs. insured” exclusion—whose detail and exclusionary features have grown over the years, precisely in order to constrain the courts from circumventing these exclusions.

In addition, judicial risk has produced a more adversary relationship between policy-holders and insurers generally. There is less continuing loyalty and more distrust than there once was. Policy-holders with large losses sometimes institute litigation that has long odds of success, because the potential reward from the investment in litigation can be so substantial.

Exogenous shocks to the market

In the CGL context, the main shocks the insurance market suffered resulted from the enactment of the federal environmental clean-up regime known as CERCLA and sometimes called the Superfund Act, and from the rise of unexpected toxic tort liabilities. These new liabilities destabilised the market and led to the reshaping of scope of CGL coverage. As a consequence, more liabilities than before are now self-insured or run through wholly owned captive insurers with direct access to the reinsurance market.

In the D&O insurance market the principal exogenous shock resulted from the massive fraudulent schemes conducted at Enron, MCI and other companies at the beginning of this century. This led to efforts by insurers to rescind coverage based on alleged misrepresentations made during the application process, and to much more complex policy provisions regarding the severability of coverage as among individual insureds than had previously been contained in D&O policies.

Finally, the entire commercial P&C insurance market, including CGL and D&O insurance, was also affected across the board by the terrorist attacks on 9/11. Claims for losses arising out of these attacks consumed a substantial portion of the surplus capital of the insurance industry and that ushered in a hard market for several years.

The present context

With this history in mind, I would like to turn now to the current situation, particularly in regard to D&O liability insurance and the relatively new insurance products that are sometimes used to facilitate mergers and acquisitions. To what extent can we expect the three factors that have affected corporate insurance markets over the past 30 years to affect the current situation?

The first issue to consider is how much pricing uncertainty to expect in the immediate and intermediate future. Here I would expect considerable variation in uncertainty levels, depending on the sector of the economy involved.

Obviously, insuring risks associated with mergers in the financial sector are likely to pose the most uncertainty. If there is ongoing litigation against a merger target, for example, and this litigation concerns past conduct in the securities markets, then setting a premium for such innovative products as litigation-buyout insurance may depend on the valuation of the derivatives or other securities that figure in this

litigation. Yet it is the difficulty of valuing these securities that is at the core of certain aspects of the current financial crisis itself. Therefore pricing insurance addressing litigation involving these securities may prove to be difficult.

As to D&O insurance itself, the problems may not be as complex, but the pricing uncertainty may be just as great, since we can expect future securities litigation brought by shareholders of companies in the financial sector, alleging misrepresentation by these companies about their financial condition in the period leading up to the steep declines in share prices in the Fall of 2008. On the other hand, in connection with D&O insurance and merger-related insurance within other sectors of the economy, valuation difficulties, and therefore pricing uncertainty, may be less severe.

As to judicial risk, it is difficult to know just how much such additional risk, on top of what already existed, to expect as a result of the current financial climate. The atmosphere in the United States right now is not particularly friendly to the banks and other financial institutions that have received major infusions of cash from the federal government. Consequently, the courts probably will not be inclined to stretch the language of D&O insurance policies to cover liabilities that these institutions incur to their shareholders.

On the other hand, if access to D&O insurance is necessary to prevent a financial institution's insolvency, or for institutions that become insolvent, I can easily picture courts concluding that the insurance industry should be asked to bear a portion of the cost of protecting shareholders, and doing so through expansive interpretation of D&O insurance policy language.

With respect to mergers and acquisitions insurance going forward, however, the same dynamic is not likely. By now, everyone is aware of the risks associated with the uncertain condition of financial institutions, and it seems unlikely that courts will be inclined to stretch the language of litigation buyout or representations and warranties insurance policies in order to protect companies against risks that they have knowingly taken in recessionary economic climate.

The last development that has influenced the corporate insurance markets over the past thirty years, and that may impact markets in the future, involves exogenous shocks that can destabilise the market and eventually produce a different equilibrium. The financial crisis that began in 2008 is obviously an exogenous shock of such magnitude that it dwarfs the shocks that have hit the insurance market in the past. Neither the rise of massive new legal liabilities in the 1980s, nor even 9/11, can compare to the amount of influence the recent financial crisis is likely to have on the corporate insurance market.

For example, D&O insurance and merger-related insurance serve a function analogous to credit. They provide what amounts to leverage, thereby making feasible transactions that would otherwise be precluded. On the one hand, the slowdown in the economy has probably reduced the need for leverage, and therefore also reduced demand for the corporate insurance that provides a form of leverage. On the other hand, at the very time when the credit markets have shrunk, the reduction of insurers' surplus can be expected to make it more difficult to obtain corporate insurance and for the insurance that is available to be more expensive. Exactly what this interaction of supply and demand will produce in time is not entirely clear, but I would be inclined to predict a tighter market and higher prices.

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