Professional Indemnity Insurance after Enron

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Two years ago, in Cancun, I gave a short presentation about 'New risks and new cover in professional indemnity insurance'. I could not, however, report about new types of risk or new forms of insurance coverage, but rather about higher premiums, shorter policy terms, increased caution of insurers in risk assessment, individual exclusions of cover and – particularly relevant for lawyers – reluctance of insurers to offer third-party mandate cover.

Basically, I am writing about the same topics today. The insurance market in Switzerland is still the contrary of what one would call a soft market. Many insurers have had poor loss ratios, and this has led to a change in market behaviour. Enron and the Sarbanes-Oxley Act have not caused, but certainly intensified, this development.

Let me quote from the Annual Report 2002/2003 of the Swiss Insurance Association: 'At the beginning of the third millennium the Swiss insurance industry has been thoroughly shaken, if not cut to the quick. If 2001 was a bad year, 2002 was positively bleak. The continued backward slide of the world's stock markets had a drastic impact on the performance and balance sheets of insurance companies'.[1] In particular, with regard to liability insurance, I quote again: 'A slight increase in premiums and a drop in the incidence of loss were to be noted in general liability insurance, However, the loss ratios rose sharply. The trend during the last five years is alarming. There is a need for action with regard to new technologies, in medical care, and in many companies. If these trends continue, substantial premium increases will follow'.[2]

And *premium increases* have followed. It is probably fair to say that after a wave of mergers in the 1990s, many companies have an increased vulnerability due to more complex structures and increased dependencies. On the other hand, mergers of insurers have led to a decrease in competition. However, due to a decrease of the capital assets caused by the weak stock exchange and due to weak loss ratios, the insurers' own funds have been substantially reduced. Thus their financial strength and risk capacity have been weakened.

As a result, premiums were and still are on the rise. In the field of liability insurance, even favourable loss records cannot prevent premium increases, because insurers now consider some risks as catastrophe risks and assess entire industrial fields separately. There are examples of insurance contract renewal offers with premium increases of up to 400 per cent, sometimes even combined with impaired insurance conditions. On the other hand, it appears that such premium increases can be reduced to a certain extent by shopping around, despite the decrease of competition.[3] Furthermore – but this mainly refers to D&O policies – insured companies may receive a premium discount if they abide by the so-called Swiss Code of Best Practice for Corporate Governance,[4] which was published in July 2002 by the Swiss Business Federation, 'economiesuisse', the largest umbrella organisation covering the Swiss economy and representing, *inter alia*, 100 trade and industry associations and 20 cantonal chambers of commerce. The 'Swiss Code' is primarily intended as a recommendation for Swiss listed joint-stock companies, but also provides appropriate guidelines for non-listed companies.[5] While we did not have new legislation as a consequence of 'Enron' and other scandals, the Swiss Code is certainly such a reaction.

As far as *policy terms* are concerned, it should be noted that today hardly any multi-year insurance contracts are being concluded, but instead, we normally have agreements with a term of one year, so that they can be renegotiated after a year.

The *risk assessment* is carried out by asking the insured certain questions by means of a written questionnaire, and the insured must provide truthful and complete answers to these questions. This is nothing special but probably more or less the same in many jurisdictions. The legal consequences of non-disclosure of a material fact are probably more distinctive. Under Swiss insurance law, the legal consequence of a non-disclosure is not only that the insurer can deny coverage but the complete avoidance of the policy. The insurer can rescind the insurance contract, even if there is no causal connection between the non-disclosure and the damage. Rescission of the contract implies that the insured has had no cover from the beginning of the contract, and has to refund any monies previously paid out in relation to prior claims, while the insurer may retain the premium for the ongoing and for any prior insurance terms.

While in the past, it was more often the case that no great value was attached to the answering of the questions asked in the proposal form, the tendency today is clearly that underwriters take this more seriously. This refers particularly to questions on the

loss record of the insured and to the question of whether the insured is aware of any circumstances that could lead to a claim being made. Today, the insurers very carefully consider the answers to these questions before entering into a contract. But the proposal form is also reviewed in the event of a claim, and if it turns out that a question had not been correctly answered, insurers do not hesitate in rescinding a policy. I have myself done this a number of times on behalf of insurers in the last few years.

The next point for discussion is *individual exclusions of cover.* While Swiss insurers did not really change their standard policy wordings, a more precise and cautious risk assessment (as just mentioned) has led to individual exclusions of cover becoming more common.

Today, insurers practise risk selection, which means that they refuse to conclude new contracts or even that they terminate existing contracts with regard to cover that they consider to be 'heavy risks'. For example, some insurers do not offer third-party mandate cover for start-up companies but require that a company must prove a minimum duration of successful business activity first.[6] Many insurers – to give another example – offer worldwide cover, with the exception of the United States and Canada. Whenever insurance cover for these countries (in the case of a subsidiary, for example) is needed, it will be examined separately on a case-to-case basis.

As far as *third-party mandate cover* is concerned, which primarily relates to the extension of PI insurance for lawyers and accountants to cover D&O liability risks, it should be noted that related court actions have become more common in recent years and insurers have become accordingly more cautious. This trend is set to continue. It is more difficult to obtain D&O cover, particularly for companies that operate in the financial services sector (banks, investment fund companies). The situation is even harder in the case of appointments as the president of the board, and in cases where there is no delegation of management responsibilities to a full-time managing director.

Did 'Enron' and the Sarbanes-Oxley Act change this situation?

The answer is: not really. But it turned out after the Enron scandal and the demise of Arthur Andersen that almost all of the former 'Big Five' in the auditing business already had to settle claims related to their insufficient revision. However, in order to protect the auditors against a flood of claims, the Swiss legislator has foreseen – up to now – strict conditions to the causal connection between the damage and any auditor's lack of care. Furthermore, auditors usually argue that they cannot be a relevant source of information to shareholders or investors, because they address the board of directors and that, therefore, auditors should not be held liable towards any third party. However, more recent decisions of the Swiss Federal Supreme Court appear to establish a more severe liability of auditors also with regard to third-party damages.[7] In a leading case of 1997, the Federal Supreme Court acknowledged the right of an investor to claim damages from the auditor of a company because the auditor had not raised objections regarding a necessary adjustment of value that had not been made and, consequently, had confirmed a net value of the company that was too high. The investor claimed that he had paid too much for the shares of the company.[8]

'Enron' and the Sarbanes-Oxley Act have not changed but have intensified this trend and, no doubt, have contributed to the appreciation that conflicts of interest should be avoided, by a clear separation of auditing and consulting activities.

I should refer in this connection to a very recent revision of the Swiss Penal Code, which will introduce a criminal responsibility of companies for lack of proper internal organisation. Fines up to CHF 5 million will apply. When this rule enters into force – probably in 1995 – an increasing number of criminal actions, aiming to support civil claims, will probably be raised against companies. It remains to be seen whether the insurance industry will react to this but this again might be of more relevance for D&O than for PI policies. Winterthur Insurance Company, for example, provides coverage for costs related to criminal acts of insured directors or officers; this may change once this new article of the Penal Code is in force.

As far as the Sarbanes-Oxley Act is concerned, there is, of course, a direct impact on companies that are technically subject to the Act, in particular on Swiss companies with a listing in the United States and on auditing companies, performing services in the United States. But there are also repercussions of the Sarbanes-Oxley rules, namely as far as the provisions for auditing companies are concerned, even when these are not directly applicable. In particular, the principle that auditors should not perform advisory services for the benefit of a company that they audit (with the possible exception of tax consultancy) is increasingly accepted although not – or should I say not yet? – required by Swiss law. Furthermore, certain auditing companies have already adopted the Sarbanes-Oxley rule of lead partner's rotation after five years, even though the applicable Swiss rules (the so-called Swiss Code of Best Practice for Corporate Governance that I have already mentioned) provide for rotation only after seven years. There are also propositions to create a Swiss version of the Public Company Accounting Oversight Board provided for in the Sarbanes-Oxley Act.[9]

As far as the Swiss insurance market is concerned, I refer to the observations that I have already made. 'Enron' and the Sarbanes-Oxley Act have not caused but have undoubtedly contributed to enhancing the policy of insurers of the last few years, which can be summarised as increasing caution on the side of

insurers and the tendency to avoid completely any major risks.

Notes

1 Annual Report SVV/SIA 2002/03, p 7.
2 Annual Report SVV/SIA 2002/03, p 40.
3 Schweizer Versicherung 12/2002, p 31.
4 Schweizer Versicherung 6/2002, p 66.
5 Swiss Code of Best Practice for Corporate Governance, p 4.
6 Schweizer Versicherung 6/2002, p 66.
7 Schweizer Versicherung 4/2002, p 73.
8 Non-published judgment 4C.13/1997; cf. Honold, Zur Dritthaftung der Revisionsstelle, Der Schweizer Treuhänder 10/1998, p 1069 ff.
9 Felix R Ehrat, 'Sarbanes-Oxley – a View from Outside' (April 2003) *International Business Lawyer* 76; www.treuhand-kammer.ch: 'Was bedeutet der Sarbanes-Oxley Act of 2002 für Schweizer Unternehmen?', p 11; Schweizer Versicherung 4/2002, p 73.