

The New Reality of Risk™

A REPORT FOR CLIENTS AND COLLEAGUES OF MARSH ON TIMELY RISK-RELATED TOPICS



Protecting Your Company's Assets

What's On Executives' Minds? Nathan Sambul

If you are a principal of a company or one of its senior managers, you have to be thinking: How do I protect my organization in light of the events of the past few months? Is my firm doing enough to protect its operations and its employees?

When we talk about protecting a firm's assets, we are referring to more than just its physical locations. We know that executives are also concerned about their company's reputation and viability if a major error or omission should occur. And let's not overlook the fact that with so many employees enrolled in benefit programs such as 401(k) plans, executives want to know more about fiduciary liability protection.

We gathered five experts for our April teleconference and asked for their views on these and other issues. The panel included:

- Jill Dalton – property practice leader for North America.
- Don Schmidt – a risk consultant from our Boston office and a leading expert on emergency management.
- Cathy Cummins – practice leader for fiduciary liability insurance.
- Harry Conaway – from our sister company, Mercer Human Resources Consulting, who oversees their Washington Resource Group.
- Jack Flug – head of Marsh's FINPRO practice in New York.

SPEAKERS



Nathan J. Sambul
Managing Director

Nathan J. Sambul is Chief Marketing Officer for Marsh Inc., responsible for the Business Intelligence Unit, Quantitative Research, the Data Management Group, Advertising, and other marketing-related areas. Prior to joining Marsh, he was a Managing Director at Guy Carpenter & Company. He has authored books and articles on finance and communications.

Mr. Sambul holds a B.A. from Queens College, and an M.A. from the University of Michigan.



Jill Dalton
Managing Director

Jill Dalton is a Managing Director and North American property practice leader for Marsh in New York City.

Previously, she was the manager of the Global Services Group in Marsh's Boston operations. She has more than 17 years of experience with the firm.

Ms. Dalton holds a B.A. in Economics and Spanish from Boston College. She has an M.B.A. in Management from Fordham University.

The comments in this report do not represent coverage interpretations by underwriters and are not meant to discourage any organization or individual from filing claims. The underwriters, not Marsh, will determine if coverage is available. Specific questions should be addressed to your Marsh representative.

Marsh is committed to delivering information about risk-related issues that you need to grow and protect your organization. If you have any questions or comments about these topics or any other risk issues, please send them to us at questions@marsh.com.

Terrorism Coverage

Jill Dalton

Nathan Sambul: Immediately following 9/11 many property insurers began adding terrorism exclusions to their policies. They anticipated losing reinsurance protection for losses due to terrorism.

But since the Insurance Departments of New York, Florida, Georgia, California and Texas have not approved any terrorism exclusions that have been submitted, how is it that an insured can have or can expect a terrorism exclusion on a property renewal policy?

Jill Dalton: Insurance laws do vary by state, but in New York certain insurers are subject to rate and form filing while others are exempt from this regulation. Those insurers that are exempt from rate and form filing are those that are surplus-lines insurers and those insurers that write within what's called the "Free Trade Zone." There are several criteria for being in the Free Trade Zone, some of which are:

- the policies are layered,
- the premium is in excess of \$100,000,
- the deductible is in excess of \$50,000, and
- the risk is considered "exotic" or "difficult to place."

There are many insureds that meet these criteria. They may be faced with terrorism exclusions. For those insureds with minimal property exposures, several insurers are not excluding terrorism. This has not been an issue for them.

NS: What options are available to a company if terrorism exclusion is unacceptable?

JD: There is a market for stand-alone terrorism insurance that

“Terrorism exclusions on most property policies are very broad and coverage under the stand-alone terrorism policies is very specific.”

has developed since 9/11. It started in London with a Lloyd’s facility that has historically written political risk coverage in countries with very volatile environments. There are three other insurers that will provide stand-alone coverage. They are AIG, Berkshire Hathaway, and Axis. Axis is the newly formed Bermuda-based insurer formed by Marsh & McLennan Capital.

The good news about this insurance market is that pricing is beginning to come down since the first of the year. Also, a few additional insurers may be offering terrorism coverage. The bad news is that these insurers are carefully monitoring their aggregate exposure by zone. In some areas, such as midtown Manhattan, their aggregates are being reached and they may start to decline business.

NS: If an insured were considering pursuing stand-alone terrorism coverage, what would you advise?

JD: Here are a few pointers for stand-alone terrorism coverage:

- Pricing and availability are dependent on the profile of the risk.
- Available limits are up to \$500 million, but typical limits actually placed are between \$50 million and \$200 million. In the past, there were no caps on coverage for terrorism.
- Rates are between .05 percent and 5 percent applied against the limit. These rates vary greatly depending on the risk.
- Coverage may be cancelable. If there is another terrorist event, the insurers might cancel policies with only 30-days notice.
- Lastly – and this is very important – there might be some gaps in coverage between the terrorism and property policies. Terrorism exclusions on most property policies are very broad and the coverage under the stand-alone terrorism policies is very specific. For example, a terrorism exclusion under a property policy might exclude civil commotion or riots. This type of loss was traditionally covered under a property policy. The definition of terrorism under most stand-alone policies will not extend to this type of loss. There may be a potential gap in coverage.

NS: What do you see down the road?

JD: Unfortunately, unless new carriers for stand-alone terrorism coverage eagerly come into the market, it’s not likely that there will be a complete solution in the short term.



Donald L. Schmidt
Senior Vice President & Managing
Consultant

Mr. Schmidt joined Marsh Risk Consulting in 1986 and serves as a consultant in risk analysis and hazard control. He is also Operations Manager for Marsh's Boston office.

Prior to joining Marsh Risk Consulting in 1986, Mr. Schmidt worked for a major HPR insurance carrier, a multi-national aluminum producer, and a federal fire prevention agency. For seven years, he was a fire fighter.

Mr. Schmidt is a graduate of the University of Maryland with a B.S. degree in Fire Science. He has also attained the Associate in Risk Management designation from the Insurance Institute of America.

In Washington, the General Accounting Office (GAO) issued a report citing the negative impact of the lack of affordable coverage for terrorism on the economy. Alan Greenspan also issued a statement urging Congress to pass some legislation. The problem is this has become a partisan issue between Republicans and Democrats. They are arguing over the tort reform aspects of the bill. Many senators are not convinced that this is a serious enough problem to warrant passage of a bill. In the absence of another attack, we are not optimistic that anything meaningful will be passed.

The fact that capacity is available is hindering the activity in Washington. The inactivity is spurring some insurers to consider a more open-minded approach. We're optimistic that with the two forces (that is, the private market and the public sector) working at cross-purposes, there will be a positive solution for our customers.

Emergency Management

Don Schmidt

Nathan Sambul: Don Schmidt has just co-authored a book entitled **Business At Risk: How to Assess, Mitigate, and Respond to Terrorist Threats**, which covers everything from risk assessment to emergency response techniques to subrogation and recovery options (published by National Underwriter Company, www.nuco.com).

Don, are businesses doing enough to protect themselves and their employees?

Don Schmidt: There is no question that post-9/11, virtually all businesses assessed their capabilities to respond to terrorism. A lot of attention focused on evacuation and business recovery.

Today, however, most businesses have moved onto other pressing issues. Executives are not asking the tough questions about preparedness. The threat of terrorism has now waned, but businesses still need to be prepared.

NS: What needs to be done?

DS: Businesses need to mitigate their exposures. They need to enhance communications and preparedness. They need to ensure effective command and control. And they need to determine protective actions commensurate with the type of threat.

NS: Don, you can't go into an office building anymore without signing in. Is that the level we're talking about?

DS: Visitor and package screening is not enough. Take a look

“Every business should create their own threat levels that define their preparedness.”

at critical building systems, such as means of egress, occupant notification, emergency power supplies, and air-handling systems.

Don't overlook the arrangement of building air-handling systems. Intakes and fanned rooms should be protected against potential terrorists. The location and operation of all controls should be properly documented in emergency plans.

NS: You mentioned communications before. What advice can you give?

DS: Recently, the federal government proposed a Homeland Security Advisory System with five threat levels: low, guarded, elevated, high, and severe.

Every business should create their own threat levels that define their preparedness. If they can, they should match the Office of Homeland Security's level, which is now at "elevated." This means that we are at a "significant risk of terrorist attack." Plans should be up-to-date, and staff should be briefed regularly. Drills should be conducted as needed. Public warning systems should be constantly monitored.

Communication with building occupants, the emergency response team, and public emergency services is key. During the confusion of a major event, it's very difficult to determine what is happening and what needs to be done. Occupants must be notified to evacuate and where to assemble.

NS: What are the pitfalls you've seen in various emergency plans?

DS: I've seen a lot of plans where the incident commander has responsibility for carrying out the plan, but has no real authority to act. It's an awkward situation at best, and a bad situation during an emergency. The emergency response, crisis management, and business recovery teams must be well organized and there should be a unified command to ensure prompt decision making and effective coordination of all activities and resources. Also, don't forget to address chain of command in case leaders are not available.

An emergency operations center – an EOC – provides the facilities, information, and supplies to support the command and control of an emergency. However, few companies have primary and fewer have secondary EOCs. Every company needs to have a primary EOC on-site in a protected space and a secondary EOC not subject to the same event. Don't forget to arrange for transportation and access to the EOC. Make sure everybody knows where to go.



Cathy Cummins
Senior Vice President

Cathy Cummins is a Senior Vice President in the FINPRO New York Advisory Services Group. She specializes in Directors and Officers Liability Insurance, Fiduciary Liability Insurance, Employment Practices Liability Insurance, and related products such as Errors and Omissions. In addition, Ms. Cummins is the practice leader for Fiduciary Liability insurance.

Prior to rejoining Marsh in May 2001, she worked for an insurance broker as a Senior Consultant. She began her career with Schiff Terhune in 1975. She joined Marsh in 1985.

Ms. Cummins graduated from the University of Miami with a B.B.A. degree in Finance.

NS: I think many companies are not thinking about a secondary EOC. What words of advice can you give us?

DS: Be complete in your thinking and get good advice. Let me give you an example. Many buildings have evacuation plans, but that's clearly not enough. If there is an airborne hazard outside, then it may be best to protect occupants inside the building – shelter-in-place. I doubt most buildings have these plans (the exception being those buildings in proximity to major chemical plants). Shelter-in-place requires prompt shutdown of building air-handling systems – again, something not always addressed in emergency plans.

Fiduciary Liability

Cathy Cummins

Nathan Sambul: Cathy, as head of our fiduciary liability practice, I would imagine that prior to the Enron situation, fiduciary liability insurance was a sleepy product.

Cathy Cummins: To a certain extent, that's right. Losses were mostly thought of as insignificant. The limits purchased were generally not catastrophic and the premiums were low. This has all changed with the well-publicized advent of fiduciary claims involving 401(k) plans.

Over the past several months, underwriters have been paying close attention to shareholder class action lawsuits involving employee benefit plans. The lawsuits are referred to as “follow-on” claims as they tend to follow directors and officers liability claims, though they only focus on breach of fiduciary duty.

NS: How are these claims positioned?

CC: The claims are brought by plan participants who also happen to be shareholders due to their stock ownership in an ESOP, 401(k) plan, or other similar plan. While shareholders may make claims against directors and officers, they may also bring a separate and distinct ERISA breach of fiduciary duty claim against the plan fiduciaries. The class of plaintiffs is often a subset of the securities class action. To date, the ERISA claims have involved allegations that the sponsor misled plan participants about the appropriateness of investing in company stock, particularly at a time when the stock was artificially high.

NS: The decade of the 1990's was an incredible bull market, where employees didn't always focus in detail on their benefit plans. Is the market decline the primary reason why plan participants are now paying close attention?

“Going forward, underwriters are going to require detailed information on clients’ plans, particularly 401(k) plans.”

CC: That and some well-publicized bankruptcies were certainly wake-up calls. But let’s not overlook the fact that plaintiff firms are beginning to recognize that damages recoverable from an ERISA-approved plan may result in a significant settlement or award. Also, non-SEC based law firms are recognizing the opportunity to capitalize on another firm’s filing of a securities class action by filing a “follow-on” ERISA claim.

The key to this litigation is whether the fiduciaries breached their duties under ERISA by investing in company stock that was declining. Did the plan sponsors act prudently in the selection and retention of a particular investment option? Did the plan prevent employees from making investment changes while the company’s stock was plummeting?

NS: [You deal with the insurance markets on a regular basis. What are you seeing?](#)

CC: Underwriters are concerned that going forward, where appropriate, an ERISA 401(k) breach of fiduciary claim will be filed simultaneous with or in tandem with a 10b-5 securities fraud claim. Recognizing the surge in securities fraud claims activity, a correlating surge in 401(k) based claims would seem inevitable.

NS: [What are insurance market conditions like and what do you see in the immediate future?](#)

CC: Insurers are sharply increasing rates. I’ve seen rates move up 70 to 100 percent or more. We’re not seeing multi-year policies. In addition, retentions for companies with significant amounts of employer securities in their plans are also increasing.

Going forward, underwriters are going to require detailed information on clients’ plans, particularly 401(k) plans. Underwriters are going to want to know:

- How often can plan participants change their investment mix?
- Is there a matching contribution in employer stock? If there is, are there any restrictions prohibiting the sale of company stock?
- What percentage of plan assets is comprised of company stock?
- Was there a change in administrator or record keeper since the last renewal? If so, how long was the blackout period?

As these claims are still in their infancy, and without any settlements or judgments to speak of, it’s hard to say how they



Harry Conaway
Mercer Human Resource Consulting

Harry Conaway oversees Mercer's Washington Resource Group and Information Research Center in the United States.

Prior to joining Mercer in 1989, Mr. Conaway was Associate Tax Legislative Counsel in the Office of Tax Policy of the U.S. Treasury Department.

Mr. Conaway holds a B.A. from Trinity College, an M.A. from the University of Pennsylvania, and a J.D. from George Washington University.

will evolve. Insurers, the plaintiff bar, and fiduciaries will be closely monitoring their development, as well as monitoring legislative changes to determine whether ERISA shareholder actions will rival securities fraud litigation in frequency and severity.

A View from Washington D.C.

Harry Conaway

Nathan Sambul: In Washington D.C., our sister company, Mercer Human Resource Consulting, has an extensive Resource and Research group, with attorneys, legal professionals, and information specialists that analyze and report on topical issues. Harry Conaway, who is responsible for the operation and who is an attorney himself, has been monitoring developments in Congress and at various federal agencies.

Harry, there are two House Committees and one Senate Committee that have approved pension reform proposals. What do you think Congress will enact?

Harry Conaway: We expect the House to approve a bill in mid-April. The Senate schedule is less clear, as Senate Finance must still weigh-in. And on the regulatory front, the SEC has proposed several enhanced disclosure rules that it doesn't believe require congressional approval.

NS: We all know that what gets proposed and what gets signed into law can often be quite different. What are your best prognostications?

HC: You never know what ultimately will go to the President for his signature, but there are seven items that are seriously being discussed and debated. These include:

1. More disclosure of benefits and investment information to participants.
2. Incentives to encourage employers to provide employees with investment advice. The proposals would protect ERISA fiduciaries from liability for participant-directed investments based on "qualified" independent investment advice and would allow firms that offer investment options under a plan to also provide investment advice.

NS: Do you think employees will be allowed to make pre-tax contributions to purchase retirement planning services?

HC: It is certainly being considered. President Bush and others are supportive of it. I think there is concern, though, with any pre-tax treatment because of the budget deficits that are projected.

“The Kennedy bill, as it’s known – is one of the most contentious proposals currently on the table.”

NS: You said seven items. You covered two. What are the rest?

3. This involves participant-directed company stock investments. This proposal – the Kennedy Bill, as it's known – is one of the most contentious proposals currently on the table. It would bar participants from directing investments of their own account balances into company stock if any employer contributions (such as matching contributions) are automatically invested in company stock. There would be an exemption if the participants were covered under a defined benefit plan meeting certain benefit minimums.
4. This item deals with accelerated diversification rights. The leading proposal would require that participants be able to diversify 401(k) elective deferrals immediately upon contribution and other employer contributions (including matching contributions) after the participant has three years of service or after the contributions have been in the plan for three years. Stand-alone Employee Stock Ownership Plans would be exempt.
5. This item covers blackout periods. This is controversial, especially in the Enron case. Proposals would require at least 30-days advance notice. They would also put an outside limit on the length of blackout periods (30-45 days).

NS: Is there a limit today?

HC: No. There are fiduciary issues about unreasonably long blackout periods, but there's not a clear line drawn in the sand.

Let me move on to the sixth and seventh issues.

6. Executive stock transactions. Companies would have to make faster disclosures to employees of transactions by insider owners, directors, and officers. Also, insider owners, directors, and officers would be prohibited from trading company stock during blackout periods in qualified plans.
7. Finally, expand ERISA liabilities and remedies. Proposals would expand remedies for fiduciary breaches to include consequential and punitive damages and would make non-fiduciary officers and directors (and auditors) liable as fiduciaries if they knowingly participate in or conceal a breach. Also, one proposal would require fiduciary insurance for plans with 100+ participants.

NS: If Congress gets stalled on this, what can the federal agencies do?



Jack Flug
Managing Director

Jack Flug serves as a department head in the FINPRO New York Advisory Services Unit.

Mr. Flug joined Marsh in 1995 after spending nearly ten years in various senior capacities in both claims and underwriting at National Union Fire Insurance Company, a subsidiary of American International Group. He began his career in insurance at AIG in 1985.

Mr. Flug holds a B.A. degree in Sociology from Queens College and a J.D. degree from Touro College School of Law.

HC: The SEC, in particular, is considering proposals that do not require legislative action. The SEC proposals focus on enhanced disclosure. Some of the proposals would:

- Accelerate reporting by companies of insider stock transactions. Current reporting guidelines mandate ten days after the month of transaction. Frankly, ten days after the month is too slow.
- Accelerate filing of quarterly and annual corporate reports.
- Expand 8-K disclosures, such as changes in rating agency decisions or transactions in company stock with executive officers and directors. These would be filed within two business days after their occurrence.
- Require that quarterly, annual, and other SEC reports be posted on corporate Web sites when filed with SEC.
- Require disclosure of critical accounting policies in annual reports.

The momentum for pension reform legislation and SEC disclosure reform is strong. Expect action this summer.

Errors and Omissions Coverage

Jack Flug

Nathan Sambul: Jack, from your perspective as head of our financial and professional services practice here in New York, how has the Enron shakeout affected the errors and omissions (E&O) marketplace?

Jack Flug: E&O, or professional liability risk, affects many different sectors, such as financial institutions, technology and media firms, and, of course, professional services firms. Each sector is facing its own E&O issues. Let me concentrate on the professional services arena from a post-Enron point of view.

As with any bankruptcy, professional service firm providers can often be dragged in by trustees in their quest to satisfy creditors. In the wake of Enron, lawyers and accountants will be required to provide additional information about the specific types of transactions they perform for clients and how they deal with client situations they may deem to be inappropriate.

Another impact of Enron will be a new awareness that even significant insurance limits may not be enough for protection against professional liability. It is possible to “bet the firm” through certain activities. Conflict issues and potential new regulations will only complicate this area.

NS: Let's break down this large sector into small units. What are you seeing with respect to law firms?

JF: Rates were up 20 to 40 percent in the past year, with worst cases getting 50 percent increases and best cases at 10 percent. While rates are increasing across the board, intellectual property and securities-related law practices are getting more difficult to place. In addition, there is upward pressure on insurance retentions.

As is the nature of long-tail liability business, claims development continues to deteriorate from past losses. At the same time, when the economy slides downhill and bankruptcy claims rise, claims against attorneys tend to increase. In general, losses are becoming more severe and defense costs are increasing. Finally, multidisciplinary practices – law firms branching out into other areas of non-legal professional advice – is an emerging source of underwriter concern.

NS: Are you seeing the same type of increases for consulting firms?

JF: Rate increases for consulting firms have been averaging 35 to 50 percent. Having said that, consultants with significant technology integration operations have experienced much more significant premium increases and adjustments in their retentions. Losses arising out of government contracts, outsourcing, client bankruptcies, and/or client management changes are contributing to underwriters' concerns.

In addition, as the economic outlook for companies is bearish and consultants look for ways to maintain their business, there is an increased underwriting concern that consultants will not be able to hold to their practice of limiting their liability through wordings in their engagement contracts. Furthermore, the larger information technology consultants often face significant increases in retention in addition to premium increases, and manuscript wordings may be examined and restricted.

NS: And what are you seeing for architect and engineer (A&E) firms?

JF: On average, rates for A&E firms rose 20 to 35 percent in the second half of 2001, and have held steady since then. The worst cases experienced 60 percent price hikes year over year.

Loss experience is worse for larger A&E firms that have taken on design/build work, as opposed to smaller firms sticking to traditional, pure design work. In the shift to design/build work, firms are picking up liability from contractor negligence and exposures related to delays. Hardest hit are A&E firms with clients building power plants, bridges, tunnels, stadiums, and residential projects.

“Some property insurers are backing away from providing property insurance in states with standard fire insurance regulations, while others are hoping that the imposition of an agreement between the insurance company and the client will protect them.”

Questions & Answers

NS (to Jill Dalton): We've been hearing about issues with losses arising from “fire-following” an act of terrorism. Can you explain what those issues are and how they might affect a property insurance program?”

JD: This is a complicated issue. Certain states' insurance laws do not allow limitation of what's called a standard fire policy. That means that even with the terrorism exclusion on a property policy, insurers might be held liable for the losses that result from fire-following a terrorist act. Yet, these insurers likely do not have any reinsurance protection for these losses since state regulations don't apply to the reinsurers.

Some property insurers are backing away from providing property insurance in states with standard fire insurance regulations, while others are hoping that the imposition of an agreement between the insurance company and the client will protect them. Unfortunately, this is an issue that will be decided in the courts in the event of another loss if the insurance market does return to providing terrorism coverage or if the federal government doesn't act soon.

NS (to Don Schmidt): Don, how do insurers view companies that have well-documented and well-trained emergency response teams in place?

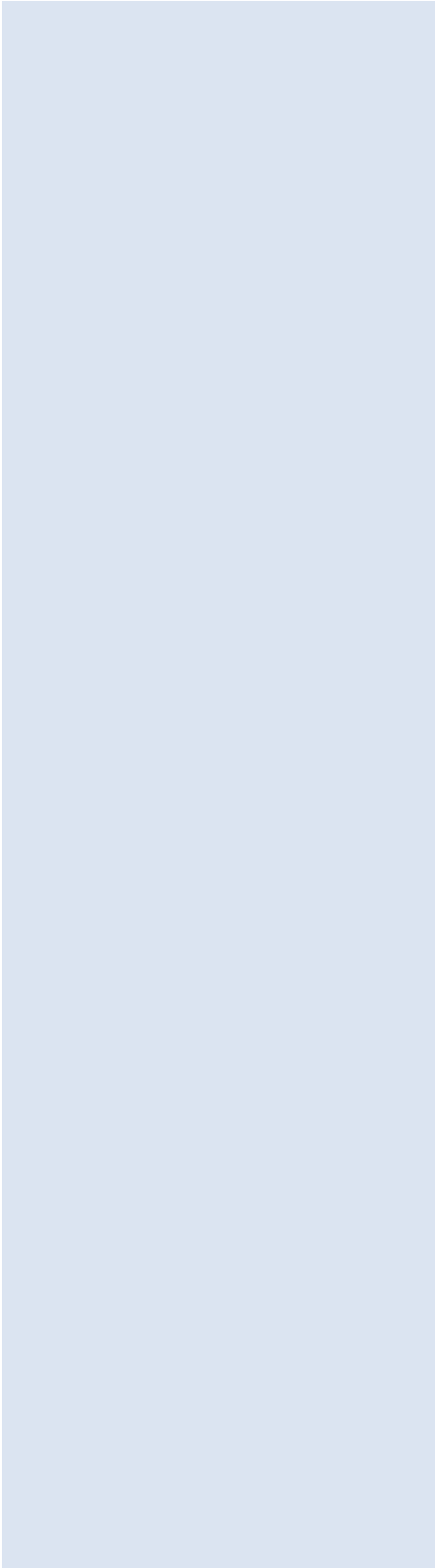
DS: It is back to basics for underwriters. They have the expectation that their insureds will have good emergency management and business recovery plans in place. They're asking tougher questions in evaluating these programs and they're making recommendations for improvements when they identify deficiencies. Companies that don't have proper plans in place can suffer consequences in the form of higher premiums, higher deductibles, or less coverage when renewing their policy.

NS (to Cathy Cummins): Cathy, how are insurers responding to the increased fiduciary liability claims activity?

CC: They've started increasing rates on this product. Underwriters are looking closely at risks that may have higher exposure to 401(k) plans that includes the sponsor's stock.

NS (to Jack Flug): Jack, what about project-specific professional liability policies that previously enjoyed long extended reporting periods? I think we've had policies that have gone ten years or so. Has there been a change in the time frame?

JF: Yes, there has been. Because of changes in the reinsurance marketplace, underwriters are somewhat less willing to write these long-term programs. The changes in the extended



reporting periods are now geared toward the five-year period, and in many instances you'll see them only offer three years right now.

While we have attempted to review key topics impacting terrorism coverage, emergency management, fiduciary liability, legislative and regulatory issues, and errors and omissions coverage, we recognize you may have additional questions or concerns. Please contact your Marsh representative or send an e-mail to questions@marsh.com. For additional information on risk-related issues, log on to our website, www.marsh.com.

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