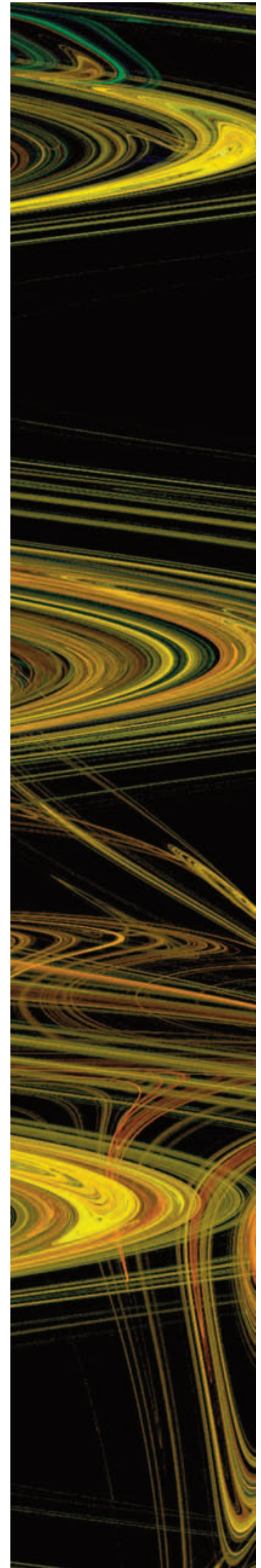
# DIRECTORS & OFFICERS

## HARD TIMES

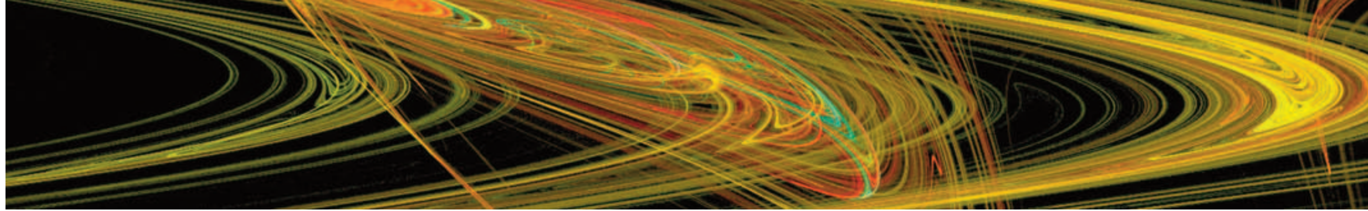


**When we predicted last fall that the Directors & Officers (D&O) market would flatten and perhaps harden in 2009, we said it was a question of when, not if. Now we can be a bit more specific about the timing: the market will turn for you when the economic downturn hits your company. For executives in the financial, real estate and auto sectors, this reality hit in mid-2008. In Q2 2009, industry classification is less important than individual results. If the numbers are down, the D&O costs will go up. For others, even mid-sized, nimble organizations with solid financials, privately held companies and nonprofit organizations, the market has stabilized or flattened. While there will be opportunities to improve pricing and terms for some, these will be the exceptions.**

Some companies are flourishing in the current economic environment and there is active, if not aggressive, competition for these accounts. For organizations somewhat sheltered from the storm, a warm reception is often waiting when they have the opportunity to tell their story to D&O underwriters. Again, however, these are the exceptions.

This will not be welcome news to those feeling the brunt of the economic downturn. In the case of one financially challenged client, the firm's long-time D&O carrier told us that there was "not enough money in the world" to persuade them to renew the struggling firm's D&O coverage. In the past, we may have suggested simply looking at other markets, but such strategies are proving difficult in the current environment.

In addition to raising premiums, carriers may respond to challenging renewals by attempting to reduce the limits on certain risks. This can create a continuity problem, especially in the excess layers. Renewals today are anything but simple.



## TERMS AND CONDITIONS

The market is undergoing substantial and perhaps rapid change, but for attractive risks, some carriers are receptive to adding new terms and conditions creatively, particularly in A-Side coverage. Flexibility in terms offers opportunities to buyers, but the added choices force insureds to think hard about what terms mean the most to them, especially if they are changing carriers. Buyers must be sure they know what is important to their company and their executives. The discussion should look closely at those terms that materially impact how efficiently a policy responds in the event of a claim or changes to the policyholder's business.

In many renewals these days, negotiations focus not only on the buyer's desires but the seller's condition. The terms currently receiving the most intense scrutiny relate to carrier credit ratings and drop-down provisions that address a carrier's financial ability to pay claims.

## TAKE A WALK ON THE A-SIDE

A-Side D&O coverage comes into play when corporate indemnification is unavailable – whether for legal or contractual reasons or because the corporate entity is insolvent. The current economic environment has made A-Side coverage ever more important as the risk of corporate insolvency makes it more likely that the coverage may be triggered. This rising likelihood makes the A-Side choice both more attractive and potentially more expensive.

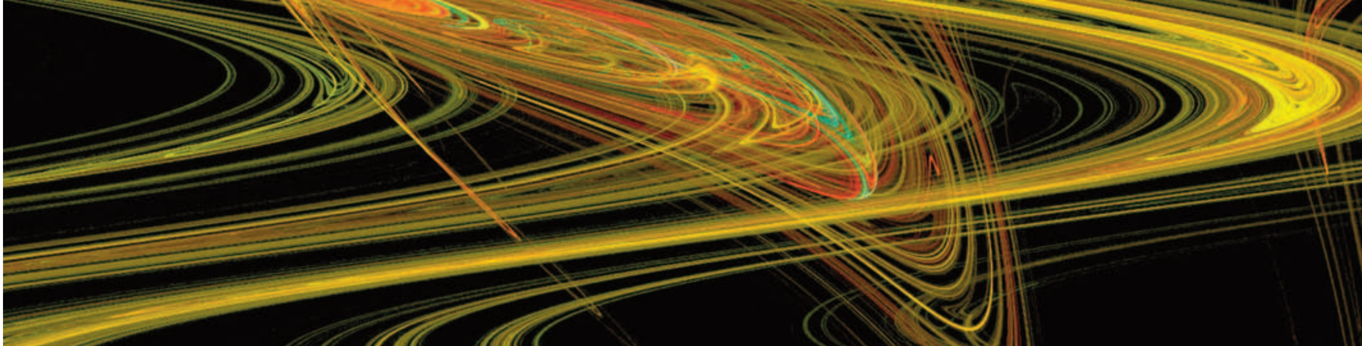
Until recently, A-Side policy terms were broadening, with most carriers having introduced new policy forms over the past 18 months. Most recently, however, we have seen some underwriters enforce pricing increases and coverage pull-backs when they have financial concerns about the insureds – or the insurance companies providing them with underlying coverage. Buyers, meanwhile, are naturally focused on where and when the excess carriers will drop down. The very toughest risks should beware of the removal of some or all of the drop-down features in their programs.

As we work on A-Side claim payments with clients, we are seeing growing evidence of a marketplace trend we have long expected. Some markets are truly committed to A-Side coverage and some are more interested in using it to bolster premium income in soft market conditions. The market is dividing into two distinct categories: carriers that are building a proven record of A-Side commitment and those that are not.

## THE CLAIM STORY

One outcome of the financial crisis is a growing emphasis on regulatory enforcement, which can add layers of complexity in the case of D&O claims, which in turn increases costs. Where once we might have seen a single federal class action, we may now need to add reinvigorated regulatory actions, state derivative actions, opt-out plaintiffs and ERISA tag-along litigation. If the regulatory and enforcement environment evolves in the direction that at the moment seems inevitable, it may, as one pundit stated, "make Sarbanes Oxley look like a walk in the park."[1]

The recession is also taking its toll by bringing upward pressure on the value of settlements. The average settlement value dropped considerably in 2008.[2] We now expect settlement values to skyrocket in 2009, largely in connection with falling share prices. For some companies, the stock drops have been so precipitous, sometimes in excess of the market's own free-fall, that stakeholders are looking for blood or money (or both). When the lead plaintiffs influencing the litigation are pension funds and institutional investors, we have learned to expect increased settlements.



## THE YEAR AHEAD

The challenges to buyers in this market are significant. Opportunities, however, can be found. Some lead carriers are intent on retaining market share, while other insurers are looking to distinguish themselves as lead markets for the first time.

There is a trend toward increasing transparency in the D&O buying process. This is a direct result of executives paying closer attention to their coverage in regard to both carrier selection and terms and conditions. Things are not business as usual. Creativity in the marketing of D&O risks will be rewarded, and a flexible renewal strategy should help buyers avoid or perhaps mitigate the potential penalties of the current environment.

## NOT ALL BAD NEWS FOR FINANCIAL INSTITUTIONS

As rough as the D&O marketplace may be for most financial institutions (FIs) these days, the situation is by no means uniformly gloomy. Displaying a subtlety and discretion that may be surprising to some, the markets are not painting all financial institutions with the same broad brush, and in fact new capacity is entering the space. While the market is by no means softening, some of the key providers of D&O coverage for FIs seem cognizant of three reasons to consider these risks:

- Some FIs managed to avoid the pitfalls that dragged so many into the current credit and investment crisis.
- For some that were not so lucky, the worst – including the bulk of the shareholder suits – may be behind them.
- Rising rates are, as usual, an incentive to enter the sector.

As a result, a surprising number of FIs are paying less this year than last year for D&O coverage. For most, rates are up, but in many cases less alarmingly than expected. Virtually no company is untouched by the current economic decline, but some distressed companies are coming out of it fairly clean. If they can make their case, the marketplace will respond, and competition will at least soften the increases they may face.

Making the case may not be simple, but one important first step is early involvement of senior management, especially the CFO. The CFO will best be able to answer the questions underwriters will have about toxic assets and potentially troubled investments. For private companies, the task of differentiation may involve throwing open the books. For public companies, whose books are presumably available, underwriters may want a window into the strategic planning that the insurance buyer has employed to put the darkest days behind them – or to demonstrate that for their risk profile, the picture is not as dark as others may presume.

Many underwriters are still extremely cautious with FIs. D&O suits are still coming in at a fast clip. Some capacity is arriving, though, as the financial crisis passes its second year. Although the big headlines hit in the fall of 2008, the crisis first brought lawsuits as early as the beginning of 2007. Some carriers have watched the rates skyrocket accordingly and are now seeing an opportunity, leading some to enter the marketplace and others already present to adopt a more aggressive appetite. Others who were hit by losses are staying in – often with the same insureds – to recoup those losses.

Storm clouds predominate, but we glimpse the occasional patch of blue sky.

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[1] "Please Think This Over," Leamer, Edward E. *The Economists' Voice*: Vol. 5 : Iss. 5, Article 7 (2008).
[2] *Securities Class Action Settlements, 2008 Review and Analysis*, Cornerstone Research.