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DECEMBER 2012

What to Watch Now in the World of D&O

Every fall, we assemble a list of the current hot topics in the world of Directors and Officers (D&O) Liability Insurance. While the past 12 months have not seen as many headline grabbing D&O related events as in some past years, the issues that are currently unfolding have had a significant impact on the marketplace. Here is what to watch now in the world of D&O.

number*one*

Is the D&O Market Firming?

The D&O insurance marketplace has reached an inflection point. After years in which D&O insurance purchasers have enjoyed declining premiums and expanding coverage, insurance carriers are seeking higher premiums and, at times, changes in terms and conditions. There is no one single event that has marked this reversal. But rather, there have been events and circumstances that have occurred over a prolonged period of time that have served as the catalyst for a change in the D&O insurance marketplace.

For the past several years, the unwavering laws of supply and demand have strongly influenced the marketplace. Although there is high demand for the D&O insurance product, the supply side is plentiful and there is currently an abundance of D&O insurance "capacity." Since 2004, a growing group of D&O insurers have been pursuing a shrinking pool of publicly traded companies. This basic dynamic has directly led to competitive pricing and very broad terms and conditions. Inasmuch as this has resulted in competitive primary placements, it has dramatically affected the insurance carriers participating on the higher excess placements. High excess participation and corresponding premium has been pressured for premium relief. Thus, despite the heavy toll of liability facing directors and officers, the supply of capacity has dictated the behavior of most D&O insurance carriers.

Three factors have conspired to undermine the competitive conditions that have prevailed until recently. First, 2011 saw

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the second highest level of insured catastrophic losses ever, with more than $100 billion in payouts. From the earthquake in Japan, to major tornadoes, to hurricanes, the overall insurance industry is in the process of paying out major claims from the events of 2011. At this juncture, it is too early to project the costs to the insurance industry stemming from Hurricane Sandy, although we have seen estimates as high as $25 billion. While these property losses do not fall under D&O policies, many insurers participating in the D&O market also write property policies that were involved in these events and are hence feeling the financial effects.

Second, the key financial ratios by which insurers operate their business have been unfavorable. The first is the loss ratio which is a ratio of premiums collected to losses paid — this ratio determines the effectiveness of a company's underwriting. Generally speaking, the property and casualty (P&C) insurance industry aims to keep their loss ratio below 70%. The second is the expense ratio which compares premiums to the expenses of the insurer. Generally, P&C insurers have an expense ratio target of below 30%. The sum of the loss ratio and the expense ratio is called the combined ratio and, as you would expect, insurers aim for a combined ratio of less than 100%. The average loss ratio of several of the leading D&O carriers for 2011 is just under 77%. Once you factor in the expense ratio, it is evident that the D&O insurers are not fairing well.

Third, due to the current low interest rate environment, the insurers are earning only minuscule returns on their interest-sensitive investments. As insurance is a highly regulated business, these investments must be invested in highly rated, conservative vehicles. Given the current investment environment, the returns on these safe investments have been at historical lows. The combination of the recent spike in losses and the depressed returns, have forced insurers to begin to raise premiums to maintain (and in some cases, return to) profitability.

Leading up to Hurricane Sandy, the financial health of the insurance industry was looking much better in 2012. However, even if positive trends continue outside of Sandy's impact, it will take some time before the turnaround begins to again push premiums back down.

Specific to the Public Company D&O market, the situation is very similar to last year. Shareholder class action litigation, traditionally the main exposure for publicly-traded companies, remains stable both in terms of frequency and severity. However, the so called merger objection litigation continues to rattle primary D&O insurers. In 2011, nearly 100% of public companies that were sold for $100 million or more were sued by shareholders alleging breaches of fiduciary duty by directors and officers in connection with the sale. We are still awaiting definitive 2012 information, but all indications are that the trend has continued.

As in many other industries, the various D&O products carry widely dispersed profit margins. Until recently, D&O insurance carriers subsidized the more risky Public Company D&O business with the highly profitable Private Company Management Liability Insurance (MLI) business which includes D&O, Employment Practices Liability and certain other coverages. Over the last two years, the profitability of the MLI book of business has deteriorated significantly. The Private Company D&O losses have risen and the EPL losses increased as a result of the depressed economy and employee-favorable legislative environment. We have experienced greater mandated premium increases and changes in terms and conditions on this line of business. As a matter of fact, the MLI business is experiencing its first hardening market since the coverage was introduced in 1994.

Broadly speaking, the landscape for corporate leaders is overall still very tenuous. Government regulation remains high as the increased oversight proscribed by Dodd Frank continues to become effective. In addition, the divisive environment created by the hard fought presidential contest and the various occupy Wall Street and other similar protests have created a tense backdrop to an economic recovery which remains sluggish at best.

The issues discussed above, among other events, have worked in concert to create the current D&O marketplace. We stress that we are not yet in what we would categorize as a "hard" D&O market, however, it is certainly firming.

number*two*

What are the Trends in the Mergers & Acquisitions Litigation?

The recent trends in M&A related litigation have garnered the most attention from the D&O underwriting community.

For deals with values greater than $100 million, it is nearly a foregone conclusion that the selling company will experience a so-called Merger Objection suit by the company's shareholders.

The M&A suits are generally brought derivatively by shareholders in either state or federal court. The state actions may be brought in a host of jurisdictions such as where the company is incorporated, where the company is domiciled or where the plaintiff resides. Further complicating matters, in the vast majority of deals, litigation is brought in multiple jurisdictions.

The suits most always include breach of fiduciary duty allegations stemming from an alleged failure to adequately shop the deal to prospective buyers, inadequate disclosures in the special proxy statement, and conflicts of interest as a result of positions reserved for the officers of the selling company with the acquiring company.

The suits are often settled for increased disclosures in the proxy statement and the payment of plaintiffs' legal fees. Unfortunately, given the fact that these claims usually involve expedited discovery, defense costs accrue very quickly. These defense costs, taken in conjunction with the plaintiffs fees, often result in total costs in the neighborhood of $1 million.

In the past, these types of cases have not represented a significant claims exposure for D&O insurers. However, with so many more cases being filed and with individual merger deals attracting multiple claims, these cases are becoming problematic for D&O insurers, particularly those that are the most active as primary insurers. A basic assumption of the D&O insurance industry is that D&O claims represent a low frequency, high severity threat. But these M&A claims are exactly the opposite – they represent a high frequency, low severity exposure that D&O insurers likely did not price for, and almost certainly, cannot underwrite. And even if the typical case settles for relatively modest amounts, the claims costs including defense fees are now, in the aggregate, becoming a major issue for D&O insurers. With little exception, primary D&O insurers are demanding higher M&A retentions upon renewal. Thus far, there have been no other coverage restrictions stemming from the M&A litigation wave, but we continue to carefully monitor the situation.

number*three*

Where do we Stand on the Subprime and Credit Crisis Litigation?

The first of the subprime and credit crisis related securities suits was filed in February 2007. Over the course of the following years, over 240 credit crisis securities class action lawsuits were ultimately filed, and during the past five years, the cases have slowly been making their way through the system.

Many cases have been dismissed, and of the cases that have survived dismissal motions, many have been settled. The largest settlement comes from the high profile Bank of America case stemming from the bank's purchase of Merrill Lynch, which settled for $2.43 billion in September of 2012. A number of other cases have settled in recent months, including the Citigroup case which settled for $590 million in August of 2012 and the Bear Stearns case which settled earlier in the summer for $275 million.

The securities litigation related to the subprime meltdown and credit crisis has not produced any settlements on the scale of the mammoth settlements in the era of corporate scandals a decade ago, but in the aggregate and on average, the credit crisis litigation has produced very significant settlement numbers. With these latest settlements, the aggregate amount of all of the subprime and credit crisis-related lawsuit settlements to date is about $8 billion. If you disregard the four largest settlements (which tend to pull the average upward) the average settlement is $73.22 million.

The pace of settlements in these cases appears to have slowed somewhat during 2012 compared to a year ago. During 2011, 22 of the subprime meltdown and credit crisis securities suits settled, including sixteen between January 1, 2011 and August 31, 2011. However, during the same eight month period during 2012, only eleven cases settled.

Though the pace of settlements may have slowed, it does not necessarily mean that we are reaching the conclusion of this aggregate litigation event. Many cases continue to work their way through the system, and some of the higher profile cases are yet to be resolved, including the AIG case and the Citigroup bondholders' case. As these cases and others work themselves out, they will continue to weigh on the results of the affected D&O insurers. It will be some time yet before we can calculate the final tally on the subprime and credit crisis litigation wave.

number*four*

Will Congress take Steps to Increase Corporate Officers' Liability Exposures and Narrow their Protection?

As if it were not enough that through the Dodd-Frank whistleblower provisions Congress has enacted provisions to increase the likelihood of SEC enforcement action, a bill now pending in Congress could increase the size of the penalties the SEC can impose.

On July 23, 2012, Democratic Rhode Island Senator Jack Reed and Republican Senator Charles Grassley introduced a bill titled *The Stronger Enforcement of Civil Penalties Act of 2012* to increase the SEC's civil monetary penalties authority and to directly link the size of those penalties to the scope of the harm and investor losses. The Bill has been referred to the Senate Committee on Banking, Housing, and Urban Affairs.

The Bill proposes to update the maximum money penalties the SEC can obtain from both individuals and entities, and further provides that the penalties may be obtained both in enforcement actions filed in federal court and in the agency's own administrative actions (currently the SEC must file a civil enforcement action in order to seek penalties).

The increased penalties proposed by the new Bill are scaled to the seriousness of the offense. For the most serious offenses (specified as the third tier violations involving fraud, deceit or manipulation) the per violation penalty for individuals may not exceed the greater of $1 million; three times the gross pecuniary gain; or the losses incurred by victims that result from the violation. The maximum per violation penalty the SEC can seek from entities is limited to the greater of $10 million; three times the gross pecuniary gain; or the losses incurred by victims.

For less serious violations, the maximum amount the SEC may seek is correspondingly lower. For individuals, the per violation penalty may not exceed the greater of $100,000 or the gross pecuniary gain as a result of the violation. The equivalent per violation limit for entities is the greater of $500,000 or the amount of the pecuniary gain. The maximum per violation penalty amount for violations not involving fraud or deceit is the greater of $10,000 for individuals or the amount of the pecuniary gain, and for entities, the greater of $100,000 of the amount of the pecuniary gain.

The bill was submitted at the request of SEC Chairman Shapiro, enjoys bipartisan support, and represents policies that President Obama has advocated, so it seems likely to pass into law. The practical implication seems not just to be that the SEC will seek higher penalties, but will seek penalties more often, given the proposed new authority to seek penalties in administrative actions. With greater firepower at its disposal, the SEC may become even more active, and perhaps even more aggressive.

In a separate development, on May 30, 2012, Representative Barney Frank introduced a bill entitled the *Executive Compensation Clawback Full Enforcement Act* that by its own terms is designed to "prohibit individuals from insurance against possible losses from having to repay illegally-received compensation or from having to repay civil penalties." The proposed Act appears primarily addressed to the compensation clawback sections in the FDIC's "orderly liquidation authority" in the Dodd-Frank Act. However, the proposed Act's separate prohibition of insurance for "civil money penalties" appears to address the long-standing question of insurance for civil money penalties imposed on bank officials by the FDIC. The bill has been referred to the House Subcommittee on Financial Institutions and Consumer Credit.

From news coverage of Rep. Frank's introduction of the bill, the proposed Act appears to be expressly addressed to certain compensation clawback insurance products that have been introduced into the marketplace. Frank himself is quoted as saying ""the creation of insurance policies to insulate financial executives from claw-backs is one more effort by some in the industry to perpetuate a lack of accountability."

The proposed Act's provisions also seem expressly designed to address the question of insurance for the FDIC's imposition of "civil money penalties" against senior officials at depositary institutions. The question of insurability of civil money penalties is a long-standing one. The FDIC has taken the position on an individual institution level basis that insurance protecting individual bank directors and officers from civil money penalties is prohibited. But while there was some discussion of, and concern about these issues, the question of insurability of civil money penalties remained an uncertain issue (at least for the banks themselves, if not for the FDIC). However, if Rep. Frank's bill becomes law, or at least of its provisions prohibiting insurance of civil money penalties becomes law, the question would obviously be resolved.

number*five*

What will be the Impact of the Amgen Case now Pending Before the U.S. Supreme Court?

We are presently waiting for the court to hear and decide the Amgen case, for which the Supreme Court granted a writ of certiorari in June. The Amgen case revolves around whether plaintiffs in a shareholder class action must establish the materiality of misrepresentations at the class certification stage. The circuits are currently split on this issue with the second and fifth circuits requiring proof of materiality and the seventh and ninth not requiring proof. To the extent that the court finds in favor of Amgen in this case, it will put up yet another hurdle over which the plaintiffs' bar must jump in order to successfully pursue companies for alleged violations of the federal securities laws. Generally speaking, it should be underscored that over the course of the past several years, the U.S. Supreme Court has shown an unusual willingness to take up securities cases.

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What are the Implications of all this for the D&O Insurance Marketplace?

As previously discussed, we are clearly at a turning point in the marketplace, at least in terms of the primary layers of D&O programs. Wherever possible, primary insurers are looking for premium increases and higher retentions. Coverage still remains very broad and we have not seen any trends develop in terms of coverage restrictions, other than the previously mentioned M&A related retentions.

The high excess D&O market remains very competitive. This dynamic is reflective of the fact that the most concerning loss trends at present are impacting mainly the primary and low excess carriers.

As long as D&O insurance capacity continues to be available at its current record high levels, this dynamic will continue. We are somewhat more cautious about the marketplace this year than in years past due to the problems facing the overall insurance industry, but short of further major catastrophic losses or new financial crises, the marketplace should remain in its current state for the foreseeable future.

ABOUT THE AUTHOR

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