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What is happening to the D&O Insurance market?

On the tail of a tumultuous 2008, through the first quarter 2009 and less than 100 days into a new U.S. presidential administration, we face a new global economy. Businesses worldwide are re-examining balance sheets and considering strategies to ride a global recession amidst decreasing consumer spending. In an economic crisis, a knee-jerk, “hard market” reaction is historically habitual, but not entirely dispositive in light of the new economic paradigm.

A hard or soft market, at its most fundamental level, rests in the laws of supply and demand. But it remains uncertain whether subprime aftershocks will significantly decrease the abundance of capacity that was accrued through the end of twentieth century, and whether current financial stresses will alter insurance purchase habits. Could a weakened demand by cash-strapped buyers negate the impact of a shrink in capacity?

Broadly speaking, though insurer’s investments were severely battered in 2008, not a single P&C or life insurer went bust last year. The heavily regulated nature of insurance and reserves, in particular, has enabled insurers to assert claims paying ability despite, and amid, sinking share prices and damaged investment portfolios.

Thus far, the 2009 D&O insurance market remains selective and split. For risks with subprime wounds, renewals and new placements are proving difficult, as underwriters continue to view companies in the financial services and real estate sectors with abundant caution. For certain risks free from credit wounds, capacity remains adequate and rates continue at a competitive pace, although recent premium decreases have slowed.

With so many mysteries on the horizon, it is important to examine traditional market drivers—the facts that we know—to best prepare for the future.

The Good News

Consistency

Extraordinary financial turmoil has not destroyed the insurance marketplace. Unlike the auction rate securities market, an uninterrupted stream of demand and supply continued throughout 2008. Insurance underwriters have jockeyed for position and replacement on programs, but access to Management and Professional Liability insurance remains generally strong.

Capacity

The steady increase in primary D&O capacity that grew in the last decade has helped temper reactionary market contraction to current events. The D&O market is mature and may draw from over 20 years of crisis events and lessons learned within that history.

Moderation

One source, the Advisen Premium Index, concluded 2008 with a continued decrease in D&O premiums, though the decrease is at less than 1%. The Index appears to be leveling and does not show giant spikes in pricing changes through the fourth quarter of 2008. It is important to remember that companies sidestepping the widening fray of credit issues continue to reap the fruits of a soft market. For risks outside of the financial vortex, it remains possible to purchase substantial limits with broad policy terms and conditions. The perceived market "hardening" of 2009 is neither as quick nor draconian as to take the Index into positive increases for all risks.

The Supreme Court, Inc.

Defense-friendly outcomes in significant legal opinions, such as *Dura*, *Stoneridge*, *Tellabs*, *Schoon*, and *Huntsman*, have caused some pundits to label the nation's highest court as "The Supreme Court, Inc." By refusing to relax pleading standards or modify contractual obligations in exigent economic circumstances, the court has left precedent that is helpful to companies defending securities and other lawsuits. We await current congressional responses that might effect the pro-business decisions, but save one piece of legislation affecting employment practice litigation, corporate defendants maintain the benefit of the Supreme Court's recent rulings.

Median Settlement Values

Examining median settlement values instead of averages helps to keep outlying, "mega settlements" in their context. In 2008, median settlements actually decreased from 2007 to 2005 and 2006 levels. Although average settlements were up in 2008, they were significantly lower than averages from 2005 and 2006.

The Other News—Challenges Ahead

A Volatile Economy

The economic recession and credit crisis have reached global proportions. Insurers have the unfortunate circumstance of losses on both sides of the equation. On the one hand, insurers face underwriting losses based on risks that went sour due to the subprime debacle. On the other hand, insurers who normally rely on investment portfolios to offset those losses have taken their lumps with the soured Dow Jones and the rest of the stock market. With a recent prolonged soft market, large catastrophe losses, and capital strains, some insurance stocks are trading at substantially below book value and the credit squeeze may make the generation of future capital a challenge.

New Nightmares in the Closet

The Wall Street Journal reported that at the height of the \$700 billion hybrid securities boom, insurance companies bought up to 30% or 40% of these instruments. Further financial impairments to insurer's already crippled portfolios could be problematic.

Beating Reinsurer Renewals

Many clients who affected D&O insurance policies at the end of 2008 did so prior to reinsurance treaty renewals. The reinsurance market will exert direct pressure on primary insurers and have begun to tighten treaty terms and conditions. Reinsurers' restrictions in treaty terms may narrow the scope of risks economically palatable to primary insurers. The inability to cede risk out toward the broader market may restrict some D&O underwriting at the primary level.

Securities Class Action Filings

The subprime crisis has directly impacted federal securities class actions filings, which have reached a height not seen since 2004. Last year saw 227 filings, with nearly half the suits related to subprime or credit events. As 2009 begins, filings continue at an aggressive rate, thanks to an influx of Madoff fund litigation. The proliferation of securities class actions is a bellwether for a hardening D&O market.

A New Administration and Regulatory Changes

A new President and a Democratic majority in the executive branch may begin to effect reforms that could broaden D&O liability exposure. Whatever reforms are affected by economic recovery initiatives or new legislation could heighten compliance issues for companies as well as broaden potential remedies. Interpreting clauses that were negotiated before credit reforms could prove a sticky wicket. Reviewing policies in 2009 will be more critical than ever. One needs only to watch a congressional hearing and listen to the colorful hyperbole of the legislature to gain insight into how the congress is viewing duties of Directors and Officers, from the point of view of a regulator, as well as a shareholder.

International D&O

As the saying goes, the world is now flat and the impact of our connectivity is palpable in global D&O risks. In particular, a significant increase in Foreign Corrupt Practices Act actions and settlements in 2008 serve as examples that cross-border risks remain a significant element of D&O risk.

How Much?

Though the future is unclear, prudent directors and officers understand that D&O liability insurance is a necessity and should not be considered a discretionary spending item. As such, the question for D&O insureds in 2009 should not be "if," but rather, "how much?" both in terms of limits purchased and premium paid.

Recent securities class action statistics evidence that increased frequency of shareholder claims has returned, and average settlements indicate that potential severity remains a very real risk.

Insureds will need to go beyond traditional neighborhood benchmarking. The first step to determining adequate limits is by appreciating your entities' individual risk factors. The second is to isolate identify and market inefficiency in underwriting pricing models. Contact an Integro representative or visit us online at www.integrogroup.com to learn more.

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About Integro

Integro is an insurance brokerage and risk management firm dedicated to serving the insurance and risk management needs of complex institutional risks. Integro has offices across North America, as well as in Bermuda and London. Its headquarter office is located at 1 State Street, 9th Floor, New York NY 10004. 1-877-688-8701. www.integrogroup.com.

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