

by Vincent Caracciolo and Tara Cummins

The most common question a D&O broker is asked is, "What is the state of the market?" In the wake of the subprime mortgage meltdown and consequent credit crunch, it is prudent to review current perceptions in the marketplace.

Much of what follows could arguably apply in many market cycles; however, the distinguishing characteristics of the recent credit crisis have soured certain underwriters to wholesale industry sectors and tarnished their view of companies that are seen to be at risk for secondary or tangential impact of the subprime fallout. While always an important part of insurance placement, it is critical for insureds to anticipate, prepare and candidly differentiate themselves from preconceived (and often incorrect) notions that underwriters might have.

The Best of Times, The Worst of Times

For some D&O Insureds, it is indeed the best of times.

Companies sidestepping the widening fray of credit contraction enjoy a continued soft market. Adequate capacity and broad policy terms and conditions are the norm. In this sphere, 2008 renewal premium pricing has seen decreases of 15% and more. Carrier competition for lower risk accounts assists in decreasing premiums and improved terms and conditions. A properly positioned and distinguished Insured can enjoy the benefits of an underwriter's flight to "quality."

Nonetheless, it is important to consider base-line numbers when speaking of percentage decreases. Where was the Insured last year? Insureds who achieved extraordinary savings in 2007 through program redesign may not receive a massive discount at a 2008 renewal because 2007 adjusted prices reflect recently maximized cost savings. Underwriters may suggest that premium rates per million of exposed limits eventually abut minimum required premium levels or that year over year reductions oft run afoul of carrier "rate monitors" if reductions are too swift. Conversely, companies who saw moderate/no price reductions in 2007, and fit carriers' more recent conservative risk profiles, may achieve aggressive price reductions this year.

The worst of times?

Unfortunately, for almost any financial institution with collateralized debt obligations, mortgage-backed debt obligations, or subprime exposures, the market is and has been rapidly hardening. The financial turmoil that accompanies massive write-downs and the consequent anticipated and actual litigation that follows make many D&O underwriters overly cautious. Many underwriters do not want to take on direct subprime risk and many are understandably concerned about litigation arising there from. The unfortunate knee jerk reaction of some underwriters leads to the historically poor approach of throwing the baby out with the bathwater. Clean financial institutions often bear the burden of guilt by association. Companies tangentially exposed to credit risks are punished for the sins of the few highly profiled melt downs.

“Subprime-related” claims have proven to be somewhat unique. Traditionally, large-volume suits such as IPO/laddering cases were straightforward fact patterns with limited scope. However, subprime related litigation is a bit of a different animal, resembling the Windows Pipes screen saver -- a single thread that begins to overlap itself and ends in a jumbled maze of circular inter-connectivity. Investors sue companies for failing to accurately reflect the risk and extent of mortgage-backed securities in their financials. Borrowers sue lenders for failing to disclose risks of products that were sold. Employees sue lenders over retirement funds invested in company stock. Institutional investors, a growing presence in securities litigation, have also thrown their hat into the ring, suing for breach of contract and misrepresentation. Not to be outdone by citizenry, regulators, such as the SEC and the Department of Justice, various Attorneys General, and exchanges such as the NYSE have similarly brought litigation against lenders for failing to disclose the extent and nature of subprime risk and also for illegal lending practices.

The resultant tangle of litigation, combined with massive financial upheaval, make underwriters reluctant to write companies in the subprime sphere. Not surprisingly, the challenge to underwriters is what they perceive as the unknown. Better, some say, to avoid than to underwrite; better to uniformly and draconically penalize the financial community at large, than to surgically apply restrictive terms and conditions.

Alas, not all is lost. Differentiation, education and pairing the correct carrier with FI risks often leads to relatively favorably terms.

Taking Stock

Will the limited hardening market fully reverse the benefits of the soft market's pricing, terms and conditions? Likely not. Hard markets tend to be more limited in scope and duration than the more insured-friendly soft markets. Though it is too soon to judge how far the hardening effects will continue to overflow into overall D&O placements, we can weigh softening factors versus hardening factors to better understand what may be in store.

Hardening Factors

Securities Class Action Filings

Underwriters will argue that securities class action filings are increasing at an alarming rate. 2006 was exceptionally low for filings; D&O premiums similarly saw significant decreases in 2006 and part of 2007. However, the latter half of 2007 saw this trend reverse itself. In 2008, filings trends continue at an aggressive pace, with more than 50 new filings in Q1 alone, over 40% of which were subprime related. Underwriters argue that subprime and credit crisis exposures will lead to even more filings.

Securities Class Action Settlements

Average securities class action settlements increased in 2007 by 43%, to \$33 million and median settlement reached a record \$9 million. Nonetheless, such percentages may be skewed because of the “mega-settlements” impact on the law of averages.

Volatile Economy

While a bit of a bumpy road during the first quarter 2008, the stock market remains relatively stable despite the challenges of an overall economic slowdown and increased commodities prices.

Carrier Losses

Many D&O carriers suffer credit-related loss on dual fronts. On the one hand, insurers face loss through their insureds’ subprime challenges. On the other hand, insurers may experience their own write-downs and investment portfolio losses. This one-two punch may have certain carriers carving back their limits, refusing to renew Insureds’ limits, or exiting lines of business perceived to be unprofitable.

The above factors, taken collectively, might herald a contraction in capacity and a rise in premiums. History suggests however that eager and new capacity seeks to fill voids left by contracting or exiting markets.

Softening Factors

Abundant Capacity

Increased D&O capacity over recent years yields increased competition, which generally has meant more aggressive pricing and better terms and conditions for Insureds. Reactionary market contraction tends to be minimized when there is an overage of capacity.

Decline in Financial Restatements

According to a recent report by Audit Analytics, 2007 saw the first decline in the number of restatements filed since 2001. In addition, restatements overall were less severe. This would indicate that the accuracy of financial statements is increasing, a circumstance of positive impact to underwriters.

Pro-business Supreme Court

Recent Supreme Court decisions, such as *Dura Pharmaceuticals*, *Tellabs* and *Stoneridge*, have proven somewhat friendly to corporations and in certain instances may inhibit plaintiff progress in bringing suit. The lower the volume of litigation, the better the D&O market.

As Yet Unknown

International D&O

Rising international D&O exposure is a byproduct of an increasing global economy. Foreign entities trading on U.S. exchanges face not only evident risk through securities litigation, but also more latent risk such as FCPA enforcement. With new legislation in Europe and beyond accommodating U.S.-styled collective actions and with new SOX-like legislation such as that recently enacted in Japan, D&O exposure is appears to be growing. Many are watching the Deutsche Telekom trial carefully. It

remains to be seen how the U.S. securities litigation paradigm will take foot in Europe and what effect it will have on the global D&O market.

The Outcome of Backdating and Subprime Litigation

While numerous backdating investigations were closed without action, both derivative suits and securities litigation have resulted from options backdating. Several of these matters have settled for large sums -- most recently Mercury Interactive at \$117 million, the highest backdating class action settlement to date. Though a recent study suggests that options backdating settlements may be "cheaper" than other forms of securities litigation, this chapter has yet to be closed and the study does not include derivative actions nor consider associated costs, such as defense fees, etc.

As D&O markets struggle through the subprime morass, its true impact will not be determined until there is an appreciation of the full extent and impact the associated litigation and investigations. It is simply too early to tell how damaging the credit crisis will be on Insureds and Insurers. Next up, auction rate securities investigations and lawsuits as a new chapter of subprime/credit crisis-related litigation.

This is Not Your Father's D&O Market

D&O is not a fledgling coverage line. This is a robust and mature marketplace with over 20 years of lessons learned. Underwriters and clients alike have developed an appreciation for the risks at large. The D&O marketplace has weathered many a financial storm and will continue to do so.

It is important in any D&O marketplace that your insurance broker has the sophistication to successfully navigate your company through it to great success. Integro has the expertise to take on your risk issues with creativity, passion and innovation. We also have the commitment to exceed your expectations every chance we get.

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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