

What to Expect in D&O Pricing Trends

The soft market for insurance won't last forever. Here's what to look out for.

By Priya Cherian Huskins

So far, the credit debacle and backdating cases haven't had an immediate impact on the price of Directors and Officers (D&O) liability insurance. The market has remained soft, despite some high-profile settlements, such as the proposed \$117.5 million agreement with shareholders of Mercury Interactive over options backdating.

A report by Bear Stearns issued in September indicates that, in general, prices have fallen by 50 percent since 2002, the height of the last wave of accounting scandals. Towers Perrin has found that insurance prices have dropped 18 percent in 2006 alone.

While companies, and indirectly their boards, are reaping the benefits of a soft market, it won't last forever in the highly cyclical insurance business. They are likely to suffer a reversal to a much firmer market will follow in the future. History is instructive of this point. By using empirical data, however, a strategy can be developed to stabilize costs over time.

Today's market is still not as soft as in 1998 when D&O insurance carriers were offering multi-year deals for extremely low pricing. At that time, even high-risk technology companies were able to purchase their first \$5 million of insurance coverage for less than \$70,000. When these multi-year deals ended in 2001, however, some of these same companies suddenly were being

charged upwards of \$300,000 for a single year for that same \$5 million of coverage.

What goes into the pricing of D&O insurance? There is naturally a relationship between the frequency and severity of the risk that insurance carriers are assuming and the premium companies must pay for their D&O insurance. Less obvious are some of the other factors that also affect the price. These factors include overall market capacity, the availability of reinsurance, an individual carriers' ability to cross-sell other lines of insurance, investment returns, and each policy holder's need to maintain continuity of coverage from year to year.

Public company D&O insurance policies are typically designed to respond when directors and officers are sued for wrongful acts related to fulfilling their duties. These policies will also typically respond on the company's behalf if the suit relates to the company's securities.

The Class-Action Reaction

For public companies, the most severe risk has historically been the threat of securities class-action lawsuits. When filing rates and the dollar amounts involved for these types of lawsuits are up and the cases being brought involve large dollars, insurance carriers generally increase their prices for D&O coverage. Right now, filing rates are down. In 2002, the plaintiffs' bar filed 212

securities class-action suits; in 2006 the plaintiffs' bar filed only 107 securities class-action suits, a decrease of nearly 50 percent. This reduced frequency is the biggest factor contributing to the soft market in D&O insurance.

To be sure, 2006 saw a lot of activity in the D&O liability space associated with stock-option backdating. However, of the approximately 200 public companies that announced that they had issues with stock-options back-dating, only 37 had shareholder class-action lawsuits filed against them. Most of the suits were derivative suits, a type of litigation that historically has not led to settlements as large as those of securities class-action lawsuits. Meanwhile, it appears that the Securities and Exchange Commission (SEC) is only pursuing the most egregious cases. Last month, it dismissed three more cases without taking action.

Supply and demand naturally play an important role in the pricing equation. Public companies always want to purchase D&O insurance, so demand is relatively steady. However, D&O insurance carriers do not always want to take on the risk at the prevailing market price. These carriers may consequently exit the market. When there are fewer insurance carriers willing to write D&O insurance, when supply is down, pricing, of course, goes up.

Also relevant to the capacity issue is the way most D&O

insurance programs are formed. Most consist of a combination of a primary layer of insurance offered by one insurance carrier and several more layers of insurance—referred to as “excess layers”—offered by other insurance carriers. Each excess layer responds to a claim only after the underlying layer has been exhausted. Because each successive layer is theoretically more remote from being accessed by the insurance buyer, the pricing for each successive layer of insurance is less than the previous one.

This primary/excess dynamic relates to the capacity issue in this way: when more carriers are will-

reinsurance. Purchasing more reinsurance might allow these carriers to offer more D&O coverage in the marketplace, further lowering D&O insurance prices.

The Cross-Sell Discount

Another reason insurance carriers might choose to offer D&O insurance at particularly attractive pricing is because it is such a high-profile line for a company. Providing an insurance buyer with its D&O insurance often ensures a close relationship between that insurance carrier and the buyer. This tight relationship in turn creates an opportunity for the effective cross-selling of other insurance

in D&O insurance pricing.

The concept of “continuity of coverage” in D&O insurance largely explains why insurance carriers are willing to compete so fiercely with each other to write D&O programs, even when pricing is low. The impact of failing to maintain continuity of coverage is potentially so detrimental to the scope of coverage that policy holders are loath to change insurance carriers unless very substantial improvements are offered in terms and pricing. As a result, incumbent insurance carriers who obtained and maintained D&O insurance business when prices were low are able to profit from this business when prices go back up, due to this tradition of customer loyalty.

For most publicly traded companies, the most severe risk has been the threat of securities class-action lawsuits. When filing rates for suits are down, so too are prices.

ing to compete for the primary layer of insurance (or lower excess layers), the supply-demand dynamic works in favor of companies. The same thing happens when individual insurance carriers decide to increase the limits that they are willing to offer any one insurance buyer.

Yet another aspect of capacity is the availability of reinsurance in the D&O insurance marketplace. When there is a lot of reinsurance money available and the premium rates are low enough, D&O insurance carriers may well decide to purchase ever more

products by the insurance carrier.

Although most insurance companies want each separate line to be profitable, insurance brokers are often able to negotiate deals that might result in unusually good pricing for one particular line of insurance because the same insurance carrier is also writing other, more profitable lines of insurance for the same buyer.

Finally, D&O insurance carriers invest their profits in the financial markets, of course. Favorable returns available in the financial markets in recent years have also contributed to the current softness

Continuity Exposure

Continuity is also a very important feature of the D&O insurance policy. For instance, the insurer’s response to a particular claim is dependent on whether the policy was in effect at the time the claim was first made, assuming that the facts underlying the claim are not otherwise excluded. One way the underlying facts might be excluded is if there is a “break in continuity,” something that often happens when an insurance buyer changes carriers.

The result of advancing the prior and pending litigation date is both the exclusion from the new policy of any past and pending litigation, as well as the exclusion from the new policy of any future claims that involve facts related to any prior and

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pending litigation. This may be the case even if the relationship is fairly tangential. In some cases, the exclusion may even apply to facts that have not yet resulted in any litigation, such as the facts involved in an ongoing investigation that are as of yet indeterminate status and still pending further review. Since there may also not be coverage on any older, expired D&O policy for what by now has been excluded from the new policy, there may suddenly

the difference in pricing and contractual terms obtained by companies with superior versus inferior corporate governance can be significant in a tight market. This is a function of the inescapable fact that an insurance buyer with no claims is a profitable client for any insurance carrier.

■ Understand your actual risk profile. Instead of simply riding the market wave, use available statistical data to model your particular company's risk profile and

The impact of failing to maintain continuity of coverage is potentially so detrimental to the scope of coverage that policy holders are loath to change carriers unless substantial improvements are offered.

be a gap in coverage for the insurance buyer's directors and officers. Thus "breaking continuity" can result in loss of insurance coverage for a claim.

Getting the Best Deal

How can you help your company achieve some predictability for your D&O insurance pricing as well as superior contractual terms? Be sure to factor in the following points:

■ Weigh your options carefully before considering the benefits of a new entrant in the D&O insurance marketplace or even an insurance carrier who has historically offered inconsistent amounts of capacity. These carriers may not stay in the market for long, so directors need to query their potential carrier on its long-term plans in the market, as well as to assess how an exit could result in a loss of continuity if that new entrant decides to abandon the market.

■ Consider the importance of good corporate governance. Although it's more difficult to see the impact of outstanding corporate governance in a soft insurance market,

purchase insurance on that basis. The key to this strategy—which is one that will ultimately drive both the size and the pricing of your D&O insurance program—is to be able to demonstrate to the insurance marketplace why your risk profile deserves the pricing you are seeking. This exercise will also give you a better understanding of the amount of coverage that you truly need.

Remember, D&O insurance is not a commodity. Each insurance policy is a highly negotiated financial instrument, and the devil is surely in the detailed fine print. All too often, D&O insurance purchasers become so focused on pricing that they fail to keep their eye on the actual insurance contract terms that they are receiving.

No matter how cheap the policy, you still paid too much for it if its terms and conditions are not what you thought you were getting. **D**

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