Rising Insurance Prices and Intensifying Risks

5 D&O Priorities for 2021

March 2021

While 2020 will be remembered as a difficult year for many people and organizations, the year ahead is not likely to be much easier for public company directors and officers. As companies and senior leaders plan for 2021, managing directors and officers liability (D&O) insurance programs and related risks will be crucial. Here are five D&O trends that risk professionals should watch closely.

1. INSURANCE MARKET CHALLENGES PERSIST

As 2020 draws to a close, the global commercial insurance market remains difficult, especially for US buyers of D&O insurance: **In the third quarter of 2020**, D&O pricing for public companies rose more than 50%, with more than 90% of Marsh clients renewing with rate increases. In addition to higher pricing, public companies also face narrowing coverage, with underwriters no longer willing to provide some coverage enhancements that were previously available.

With competition and capacity limited, insurers are taking more aggressive negotiation stances on both pricing and coverage. This is especially true for harder-to-place risks, including life sciences and technology companies, cryptocurrency market players, and companies that are preparing to go public.

D&O capacity challenges are not limited to the US. While the London market has traditionally provided a supplement to domestic capacity for US companies, underwriting interest in US risks has waned. Meanwhile, non-US companies that have historically secured D&O coverage from London insurers are now hoping other markets, such as the US, can help provide capacity.

Amid these challenges, companies are often being forced to make difficult choices, including reducing their limits and retaining more risk. Companies are also more focused on potential alternative risk transfer solutions where either capacity is lacking or pricing is deemed too egregious.

Although some recent new market entrants should help increase supply and temper pricing increases in the long run, it will take some time before their influence is apparent. Difficult conditions for D&O buyers are expected to continue into 2021.

2. DERIVATIVE LITIGATION TAKES CENTER STAGE

While the pandemic has had some effect on the D&O insurance market, there are several reasons why D&O prices are increasing, one of which is the ever-increasing cost of securities litigation. Public companies were targeted in more than 400 securities suits in each of the last three calendar years, and are **on pace to see another 350 this year**, according to data from NERA Economic Consulting.

An increasingly large share of these suits are derivative actions. Unlike traditional shareholder suits, which allege that companies and their senior leaders have violated their duty to shareholders, a derivative action is filed on behalf of a company against individual directors and officers, who are alleged to have violated their duty to the company. Many recent derivative actions are so-called “event-driven” suits, alleging that senior company leaders have failed to adequately respond to high-profile events and trends, including cyber-attacks, climate change, and allegations of sexual harassment.

In addition to growing in frequency, derivative suits are becoming more costly. While plaintiffs in derivative suits have historically settled for attorneys’ fees and changes in corporate governance — for example, a commitment to improving cybersecurity — they are now looking for compensatory damages as well.

As derivative settlements are nonindemnifiable in most states, protection against them is found in Side-A D&O coverage only. The Side-A portion of a D&O policy provides personal asset protection for directors and officers; without adequate limits for this portion of a policy, directors and officers could be responsible for paying large settlement costs out of pocket. Unfortunately, while Side-A coverage has historically been readily available and affordable, the cost is now increasing as a result of the increase in derivative action frequency and severity.

3. ESG ACTIVISM CONTINUES

Shareholder activism remains a significant concern for public companies and their directors and officers — and continues to succeed in altering corporate behavior and the balance of power between shareholders and boards. While activists have often made a variety of demands, including that companies be sold or broken up or directors of their choice be appointed, they are increasingly focusing their energies on environmental, social, and governance (ESG) issues. Notably, activists are demanding that companies prioritize diversity — across workforces and at the board level — and climate change.

Climate change, in particular, appears to be a topic that activists will continue to focus on in 2021. Shareholder activists are seeking greater climate-related disclosures in financial statements and that companies enact environmentally friendly policies, including taking steps to reduce their carbon footprints.

As activists pursue action on ESG issues, a worry for public companies is whether and how D&O policies will respond. Coverage for activism has traditionally been limited and varied by insurer and based on the nature of specific activities. There has been, however, a push among policyholders in recent years to clarify coverage. Insurers, meanwhile, have considered developing specific activist defense coverage grants; without such grants, however, insurers have generally determined whether to provide coverage on a case-by-case basis.

4. A FOCUS ON BOARD DIVERSITY

Achieving greater diversity and inclusion within boards has become an important objective for many stakeholders.

A number of public companies have been targeted in securities suits demanding that boards become more diverse. To date, these have generally taken the form of shareholder derivative actions alleging that directors and officers have breached their fiduciary duties by making false assertions about their commitment to diversity and the inclusion of women and people of color.

State governments — led by California — have also started to take action. In 2018, California passed **SB 826**, which required that public companies based in the state have at least one woman on their boards by the end of 2019 and ensure greater representation by the end of 2021. For companies with at five directors, at least two would need to be women; for companies with six or more directors, at least three would need to be women.

Earlier this year, California passed AB 979, which requires companies to have at least one director from an underrepresented community on their boards by the end of 2021. Similar to SB 826, **AB 979** requires greater representation going forward: By the end of 2021, companies with five to eight directors must have at least two from underrepresented communities, and those with nine or more directors must have at least three from these communities. The bill defines directors from “underrepresented communities” as being those who self-identify as Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, Alaska Native, or LGBT.

A first-time violation of each of the California laws carries a penalty of $100,000; subsequent fines are $300,000 for each violation. Beyond California, other states — including Illinois, Maryland, New York, and Washington — have passed laws requiring greater diversity on boards, more detailed reporting on board makeup in financial statements, or that governments conduct studies on board representation.

Securities exchange operators are likewise concentrating on diversity. On December 1, **Nasdaq filed a proposal** with the Securities and Exchange Commission to require most Nasdaq-listed companies to have a least one female director and one director who self-identifies as either an underrepresented minority or LGBTQ; compliance would be required within two to five years of the SEC’s approval of the new listing rule. The New York Stock Exchange, meanwhile, **formed an advisory council in 2019** to promote diversity and inclusion “by connecting diverse candidates with companies seeking new directors.”

As shareholders, states, and exchanges press this issue, insurers are taking notice. Underwriters are asking detailed questions about board composition during renewal discussions, a trend that is likely to continue. And given the potential for costly legal decisions and settlements or regulatory actions, companies that do not demonstrate their commitment to diversity could see their standing with underwriters weaken.

5. MORE RESTRUCTURINGS TO COME

2021 will likely be a year of significant change for many companies, including in how they are structured. Consider the following:

- Even amid significant economic uncertainty, some 200 special purpose acquisition companies (SPACs) — also known as “blank check” or shell public companies — will be actively seeking to complete reverse mergers with private companies in 2021 after being launched over the last two years. The volume of SPAC D&O insurance placements in 2020 and the potential volume of reverse mergers/business combinations (also known as de-SPACs) will likely put added pressure on insurers, available limits and capacity, and buyers’ retentions and premiums.
- The number of initial public offerings (IPOs) launched through the first three quarters of 2020 was up more than 20% from the same period in 2019, and **the third quarter was the busiest since 2000**, according to Renaissance Capital. Although some companies used direct listings as an alternative to IPOs in 2020, Section 11 liability exposures exist for companies taking either approach. Some 2020 court decisions, including ***Restoration Robotics***, were considered wins for companies considering IPOs, but underwriters remain concerned about their exposure and will likely continue to scrutinize companies going public in 2021.
- **22,391 businesses filed for bankruptcy in federal courts** in the year ending September 30, 2020. Although this is slightly less than the number of filings in the previous 12 months, more bankruptcies are likely in 2021 given the continued uncertainty about the state of the economy and potential pace of its recovery. Underwriters, meanwhile, are carefully analyzing companies’ financials and, in certain circumstances, adding insolvency exclusions to their policies.

Despite a lull in corporate restructurings at the start of the pandemic, activity has significantly picked up and is expected to continue in 2021.

A SPOTLIGHT ON SIDE-A COVERAGE

The growing number and intensity of risks for public companies highlights the need for them to ensure they have robust insurance coverage in place. And with directors’ and officers’ personal assets potentially at stake, ensuring sufficient Side-A coverage is especially important.

While many companies already purchase Side-A coverage as part of their D&O insuring agreements, they often share limits with Side-B and Side-C coverage for claims against the company, which means that Side-A coverage can be quickly exhausted. As personal risks for directors and officers grow, companies should consider purchasing dedicated Side-A coverage that sits above the traditional ABC coverage tower.

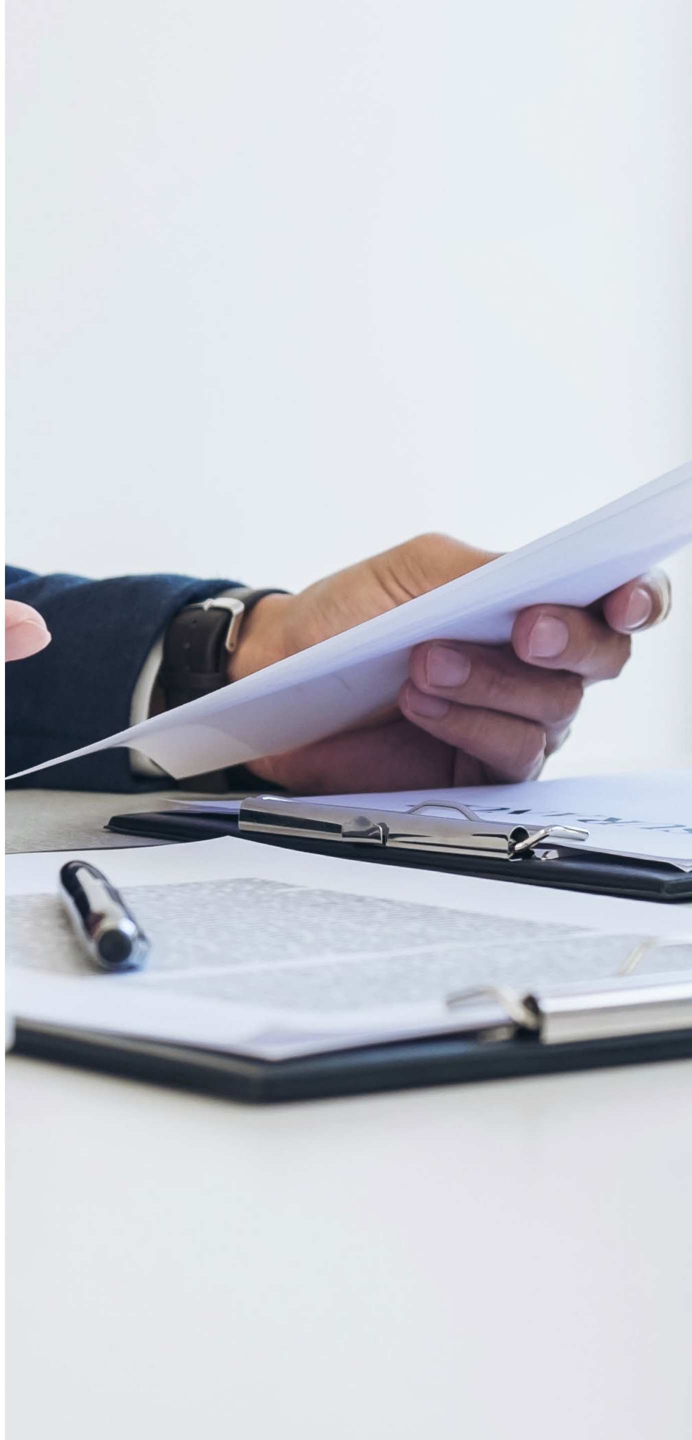
It’s important that Side-A coverage be a difference in conditions (DIC) policy, which is generally broader than traditional Side-A coverage and will drop down if a traditional ABC policy does not respond. And, although it may be difficult given current conditions, risk professionals should work with their advisors to negotiate as few exclusions as possible.

MANAGING 2021 RENEWALS

As public companies ready themselves for potentially more difficult D&O insurance renewals in 2021, it's important to remember some best practices. Starting early is crucial, especially if you intend to market your program. It's also important to focus on building personal relationships with insurers — if underwriters see you as people rather than a company, it may be more difficult for them to say no to you.

Risk professionals should also:

- **Manage expectations for senior leaders.** C-suite executives and boards, along with those directly involved in insurance transactions, should be prepared for renewal and negotiation processes to be more difficult and time-consuming. Be ready to provide more detailed information to insurers than during past renewals. And stay in regular contact with your broker about your application status and any underwriting concerns.
- **Set a clear strategy before beginning renewal discussions.** Your organization's priorities could be significantly different from those of your peers. Work with your broker to create a plan based on your unique risk appetite, culture, and budgetary considerations. As part of that planning process, you should articulate your primary objective(s) — for example, reducing premium expense or ensuring robust coverage (even if at additional cost) — and clarify your priorities: What do you need to accomplish, and what would simply be nice to accomplish?
- **Involve senior leaders in negotiation processes.** Robust data and quantitative information are important elements of an underwriting application, but so is context — and nobody is better positioned to tell your story than your senior leaders, especially when it comes to D&O risk. Personalizing the process through meetings involving senior leaders and key insurer executives can help you provide a more complete picture to underwriters and better differentiate your risk.
- **Consider different approaches.** As commercial prices continue to increase, alternative solutions could become more attractive. Risk professionals should consider altering their program structure, including adjusting deductibles/retentions, limits, and/or participating insurers. Expanding relationships with specific insurers, meanwhile, could allow for greater access to capacity. Managing D&O risk via a captive could also help to control costs while still ensuring robust protection. And some companies have expressed interest in D&O trusts, through which companies can set funds aside in a bank account managed by a trustee, who can indemnify directors and officers and pay out in the event of claims according to the terms and conditions outlined in a contract between the company and trustee.



Meet the team

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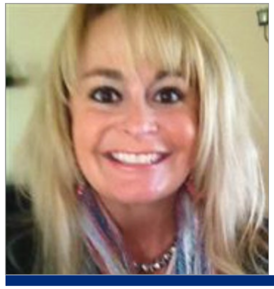

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