



State of the Market for Directors' & Officers' (D&O)

August 2020



Gallagher

Insurance | Risk Management | Consulting

In this ongoing hard market cycle, rather than issuing another market commentary, Gallagher's D&O team thought it would be beneficial to help clients look at the D&O marketplace in a different light; one where we consider underwriting pricing and capacity (or 'market risk' - which clients have no control over), as well as 'company risks' (which clients can control).

By working with our clients on their company risks, we can help to enable a positive renewal outcome relative to the marketplace.

To help demonstrate this, we have decided to express the Directors' and Officers' (D&O) insurance market in the below basic formula:

$$P = 1.\alpha + \beta$$

P represents the premium value: the premium / price that the client will pay for cover.

Alpha (α) represents company risks: these are the variables that clients have control over, and therefore ought to be focusing on.

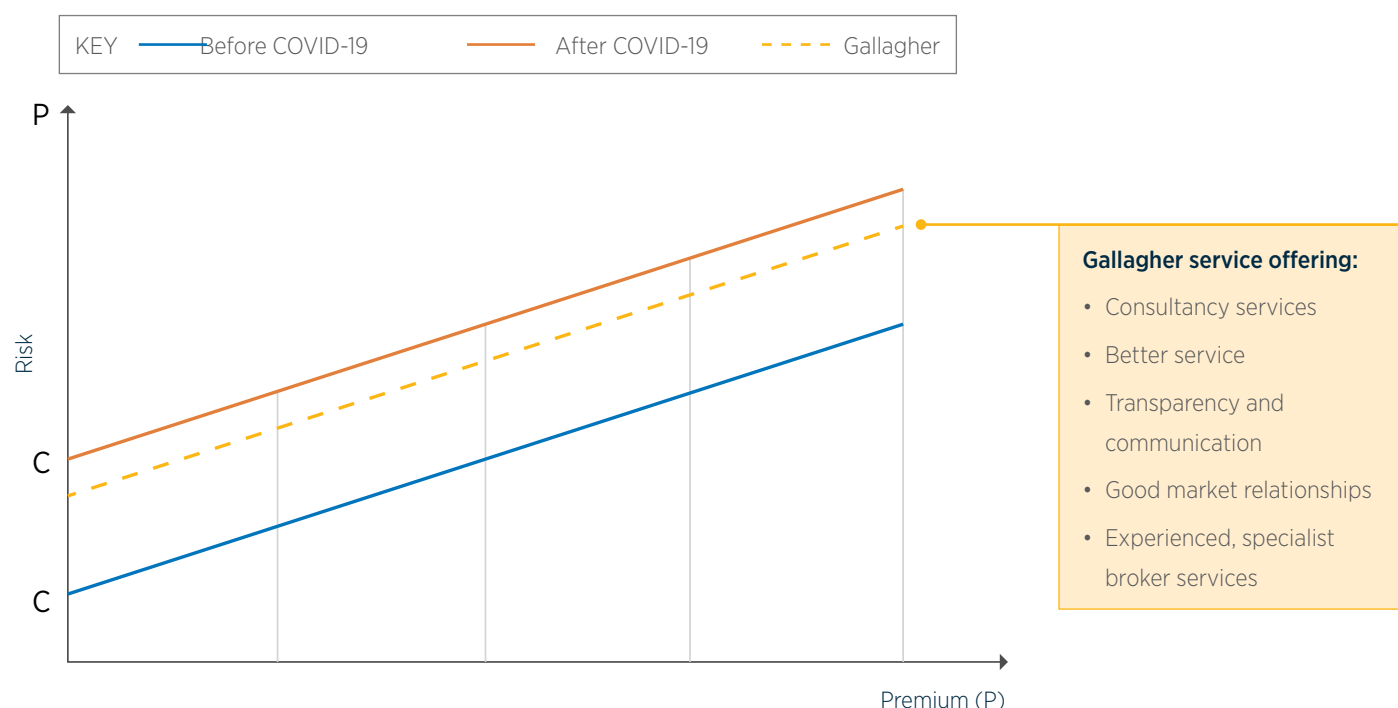
Beta (β) represents market risks: the variables that clients have little or no control over.

For the past three years, the London insurance market has been an extremely challenging place to do business. D&O and Management Liability, in particular, has endured some extreme market hardening. In our view, conditions will continue to get tougher as we move through an uncertain 2020 and into 2021.

All stakeholders are struggling to understand the implications of disrupted supply chains and muted financial markets. Increased uncertainty has led to increased market volatility and, when paired with government measures implemented to fight COVID-19 (such as social distancing), the result has been a stalled economy - one which is bordering on recession.

But, as we begin to transition out of the public health crisis and into a period where we will start to see the full economic impact, how businesses continue to respond to these trying times is key.

Market price comparison pre and post COVID-19



Key	
P = Premium	X = time
α = company risk	Financial stability, corporate governance, US exposure, majority shareholder(s), mergers and acquisitions (M&A), share price performance and claims.
β = market risk [Supply of Capital + IS(0:1) MK(0:1, 1-1.2)(MP)]	Supply of capital in the market and minimum premiums, market capitalisation and industry sector.
1 = Standard offering from insurers	If 1 = standard offering / value-add from insurers. So anything <1 = broker's ability to undercut the market standard pricing which clients will pay.

Note: assume that everything is minimum and constant from one year to the next. Should the minimum in the market go from 1 per million of limit to 2 per million, on a low exposed D&O risk, the premium will still double.

The first theme to note in the above graph is that the starting point in which we begin pricing risks has now changed (c). The UK D&O landscape has been altered by increased class actions and changing legal and regulatory environments globally, emphasising the accountability and liability of directors and officers. Companies that used to be partially shielded from claims exposures in other territories, despite purchasing multinational D&O programmes, are now having to take into account global claims trends. It is no longer just US traded companies that are suffering.

As a result, the market has seen significant increases in premiums, retentions and cover restrictions in all sectors, geographies and for all types of companies.

Alpha (α)

The client can control the variables in the company risk (alpha). In order for clients to maximise their savings versus the market, clients must focus and improve on the variables that they can control.

These include:

Financial stability – this is critical, as solvency is a material risk factor for insurers. If you have public debt, the insurers will peer analyse this measure. Additionally, they will look at liquidity, cash positions, leverage and debt maturity when measuring risk.

The weighting placed by insurers is 1-10 (FS) (with 1 being debt free/no concerns and 10 being solvency issue in next 12 months)

Corporate governance – this is an equally important point. It is vital to have these controls and procedures in place, as this will help reduce insurers' concerns over the potential frequency and the severity of claims. Entities that are well managed, with excellent corporate governance, will stand a better chance of seeing a reduction in the premium. *The weighting is 0.5-2.5 (CG)*

US exposure – US exposure tends to be a point of concern for underwriters as, historically, the US has been where the most frequent and severe claims have occurred. This ranges from no assets located in the USA to a full Nasdaq/NYSE listing.

The weighting is 1-10 (USA)

Majority shareholder – this variable has changed throughout the years. Previously, having a major shareholder was considered a positive by underwriters, as there were less shareholders to sue;

however, in recent times, this has given rise to claims, as majority shareholders have more control and influence over the alpha side of the equation. *The weighting is 1.1-5 (MS)*

Mergers and acquisitions – the amount and area of the M&A that the business conducts will affect the weighting, as there will inevitably be some unhappy stakeholders. *The weighting is 1-1.25 (M&A)*

Share price performance – factors such as the level of volatility and poor performance of the business and, therefore, the share price will affect this weighting. A volatile share increases the chances of a securities class action being brought against the company and key individuals. *The weighting is 1-5 (TC)*

The alpha is comprised of all the above –

$$FS + CG + US + MS + M\&A + TC$$

The implications on clients' D&O policies – particularly for those who have purchased D&O cover with the aim of protecting their personal assets – could mean that the structure and breadth of the policy can leave individuals exposed to personal losses when the policy is instead utilised for corporate protection.

The purchase of a Side A D&O policy will have an effect on the beta side of the equation – this is the reason why, especially at this moment in time, coverage selection is critical and should be a key consideration. Purchasing a Side A only programme will increase the market capacity (i.e. D&O limits) available by around 25%, so this would be up to a 0.75 weighting.

How clients respond to COVID-19 will naturally also have an effect on the weighting of the equation. As companies of all sizes begin to re-open and operate in the 'new normal', it is likely that certain companies (and, therefore, their directors and officers) will be singled out for their handling of the crisis by customers, employees, regulators, or shareholders, and could face litigation for the perceived 'mismanagement' of their company during the crisis.

These claims could be related to the decisions made about when (or how) the business managed employee or customer safety, how the company communicated to customers or shareholders, or how the business failed to be compliant with rules, regulations or laws – and test cases will certainly inform whether or not we see an uptick in litigation relating to corporate management of the COVID-19 crisis.

Beta (β)

Looking to the beta side of the equation, we can see that the factors included are those dependent on the natural cycle of the market - those factors which clients do not have control over.

The market risk is essentially the amount of available underwriting capacity, which is directly correlated to capital in the industry sector. This concept is binary (0:1) and has no weighting in the equation.

Beta includes:

Supply of capital in the market and minimum premiums – this directly affects the available underwriting capacity in the market and, as we move out of the pandemic, we are seeing signs of new capacity in the D&O sector (albeit there continue to be further casualties, with insurers being forced out of the market due to the volume of losses sustained in recent years). Insurers who previously did not entertain this line of business are now interested in writing financial lines insurances, in a period where D&O premiums are at a record high.

Market capitalisation – will inevitably have been affected by COVID-19. This is also binary (0:1). A large market capitalisation will preclude certain insurers from participating. Once this is past a certain point, it will have a significant impact on the weighting of the equation (up to 1.2). This is not a linear concept, meaning that, often, retentions can be affected more than premiums in this variable.

Industry sector – unsurprisingly, the aviation, hospitality, travel and leisure sectors have become incredibly challenging when designing D&O insurance programmes, with additional exclusions being applied, along with specific requests for COVID-19 underwriting information.

This scrutiny is now moving into other industries, especially retail and financial classes, and we expect the majority of sectors will be affected in some way. As a result, D&O insurers are facing an uncertain few months.

Standard insurer offering (1) – how Gallagher can help

Standard insurer offering $P = 1.\alpha + \beta$

Gallagher offering $P = 0.8.\alpha + \beta$

In spite of the pandemic, and all the market and company factors we have explored, Gallagher remains open for business and fully operational during this lockdown period, and we appreciate just how uncertain times have become for all of our clients - especially on an individual basis.

If you are concerned about the level or breadth of your D&O cover, or would like to know more about protecting your personal assets, please get in touch with us now.





Gallagher's D&O team can offer support through the following:

Client first approach – we pride ourselves on our on-going commitment to clients. We treat every client as if they were a new client. We do not have a sales team that bring in clients and then pass them on to a service team that they have never met. Clients have long-standing relationships with us, which helps us have greater understanding of each other and enables better communication, better service and enhances the efficiency of the insurance placements. Each member of your service team will be available to you as and when you need them. For each role in the account team, we have a deputy in place. We believe that this team represents an excellent, diverse, yet complementary pool of broking, account management, claims and consulting expertise.

Being consistent and stable – we recognise the importance of team continuity, the building of knowledge and trusted relationships. The experience that our team will build in understanding your risks, operations, challenges and its organisational culture will be invaluable. We have robust strategies for staff retention, which include maintaining a fully staffed business. Gallagher Financial and Professional Risks comprises of over 100 staff and continues to invest in attracting new practitioners. The management liability team has been very stable for a number of years and is based on the team being talented, motivated and successful.

Our international presence – we have offices worldwide. In addition to our growing number of international offices, we also have access to the Gallagher Global Alliance, which exploits synergies with Gallagher offices and some of the leading partner brokerage firms in over

150 countries, meaning that we are able to track the legal, cultural and economic factors that could affect our clients' insurance, employee benefits and risk management needs.

Market-leading claims handling – we have a close relationship with our dedicated D&O claims team, who sit with us in London, which has proven to improve communication, turnaround time and, most importantly, claims outcomes. We pride ourselves that our D&O claims team has been able to secure claims payments for clients that have been unobtainable elsewhere; as, ultimately, this is why you buy the insurance in the first place.

D&O RISK MANAGEMENT AND CONSULTING

Collectively, consultants at Gallagher have decades of experience working with organisations protecting their people, operations, and information through intelligence collection, threat assessment, asset identification, risk analysis and project management.

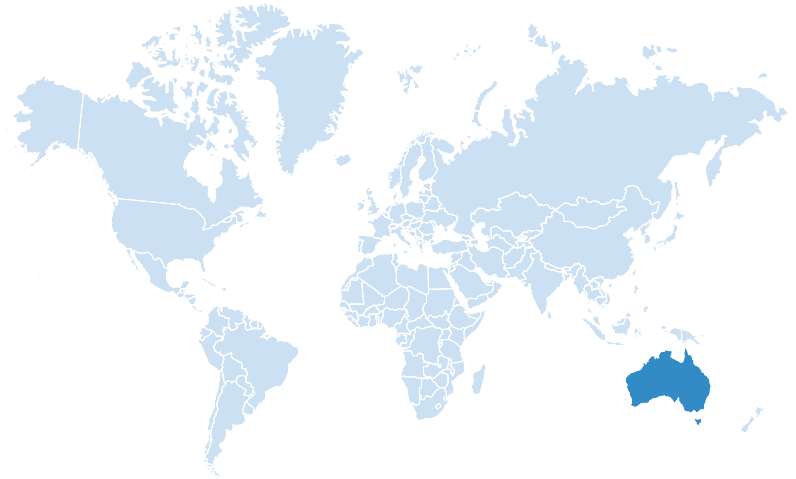
Cascade is a powerful tool for strategic decision-makers responsible for protecting their firms. It focuses on simplifying the entire intelligence collection and risk assessment process in a way which is scalable across huge organisations and which is consistent and dynamic.

- For intelligence, make it simple to analyse and organise potential threat information and to monitor the effects of risk treatment through data.
- For threat, provide a graphic and dynamic way of monitoring and changing intent, capability and tactics.
- For assets, create a canvas to record and maintain location, criticality, vulnerability, documents, pictures and asset types.
- For risks, build a one-click method for connecting threats to assets and calculating risk scores - and carrying out dynamic risk assessment.
- For projects, organise risk treatment measures by both risk and asset and making it easy to continuously monitor their progress.



TERRITORY UPDATES

Australia



The D&O marketplace for ASX-traded risks still continues to harden – both domestically and in London. This trend began around 18 to 24 months prior to the first signs of hardening in the UK and US markets and largely stems from the increased frequency and severity of D&O claims generally, but in particular, securities class action litigation. This is driven by stringent continuous disclosure obligations on publicly-traded companies, an active regulatory and litigation environment, with well-established litigation funders and third party financiers, as well as the rising costs involved in defending litigation. This coincided with an oversupply of D&O insurance capacity, decreasing premium levels, as well as widening terms and conditions.

Some companies, who have seen the cost of their D&O insurance skyrocket (particularly the costs associated with coverage for securities claims against the entity), are opting to sub-limit their Side C (i.e. cover for securities class action claims against the entity) limits or are dropping Side C cover altogether, exposing their balance sheets to such litigation, but also allowing them to reduce their premium spend and to preserve more limits for the individuals.

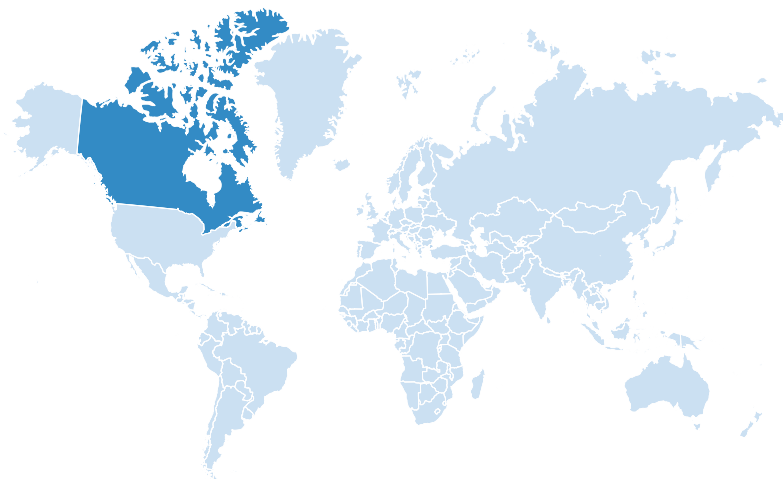
The average Australian Securities Exchange (ASX) securities class action costs between AUD50m and AUD70m to defend and settle, much of which is usually met by D&O insurers². The Australian D&O premium pool has been insufficient to pay for losses arising just out of securities class actions – not to mention non-securities related claims. Many of the insurers who have traditionally written ASX-traded D&O insurance will no longer consider low attachment points or, in some cases, no longer write this class of insurance. As the supply of capacity has dried up, insurance placements have become more challenging, restricted and expensive.

Increased rates (sometimes multiples of expiring levels) and retentions are, however, starting to attract interest from new entrants, as well as from insurers who traditionally have not focused on ASX-traded business and, therefore, do not have the tail of losses in the territory. Australian risks are seen by some insurers as a way to diversify books which have become heavily weighted towards US-traded risks in recent years, as the levels (and costs) of defending US litigation continue to rise.

Whilst we expected some new capacity to slow the rate of the premium increases in 2020 and do not expect to see premiums continue to multiply, until it is possible to generate significant competition (particularly on the primary and low excess layers) and for insurers of ASX-traded business to return to somewhere close to profitability, we do not expect rates to stabilise in the short or medium-term either.

² <https://www.clydeco.com/en/insights/2020/06/covid-19-australia-predicting-securities-class-a>

Canada



Canadian companies previously enjoyed an abundance of D&O capacity, broad terms and comparatively low rates. However, Canada began to experience a drastic shift in the D&O market in 2019, primarily due to class action litigation emanating from the USA, which accelerated in Q2 of 2020 with the oil price crash, onset of the COVID-19 pandemic and the resulting financial crisis. The impact has been to both capacity and rate, with excess insurers, in particular, looking for 'rate correction' after years of providing reductions or flat renewals, despite increases at the primary and first excess layers. Rate inversions on excess layers are now commonly seen at least once on larger limit towers. No company is immune - regardless of industry sector, public or private - D&O premiums are up for all companies.

Tightening of underwriting guidelines has resulted in capacity being withdrawn from Canadian risks, with markets citing rate inadequacy and limit management as the primary reasons. While USD10m limits are still being deployed, blocks of USD20m and USD25m are virtually non-existent and USD5m limits are becoming commonplace. A trend has developed in Quebec, that is seeing both domestic and foreign markets shy away from offering primary D&O limits for Quebec-domiciled companies, because of the unlimited defence-outside-the-limits mandated by Quebec law. In fact, some Quebec companies are looking to re-domicile to another province purely because insurance is unavailable.


While the number of claim and potential claim notifications to insurers has increased, many insolvency-related, litigation remains relatively stable in Canada. In 2019, there were fourteen Canadian class actions - most of which involved companies dual-listed on a US exchange or from the cannabis sector, which saw a massive market sell-off in the past year. To date, there have been no COVID-19 related class action claims in Canada and the impact of COVID-19 on the D&O market has been relatively immaterial, other than to rate. Underwriters are asking more detailed financial

questions relating to the impacts of COVID-19 and business continuity planning. Occasionally, bankruptcy exclusions are being added; however, in many instances, the exclusions can be softened or removed with more underwriting information.

Certain industries are attracting more underwriting scrutiny in Canada than others. Three sectors stand out:

Fintech – this market was already tough going into 2020 and, while Gallagher has been successful on large placements, there is very limited underwriter appetite. Of the few markets that were interested in this sector in the past, most are now taking a wait-and-see attitude during the COVID-19 crisis. Depending on the client's business model, and with good financial statements, it is possible to find Canadian capacity, although it comes at a significant rate and will often only include Side A D&O coverage. New placements are seeing substantially higher rates than renewals.

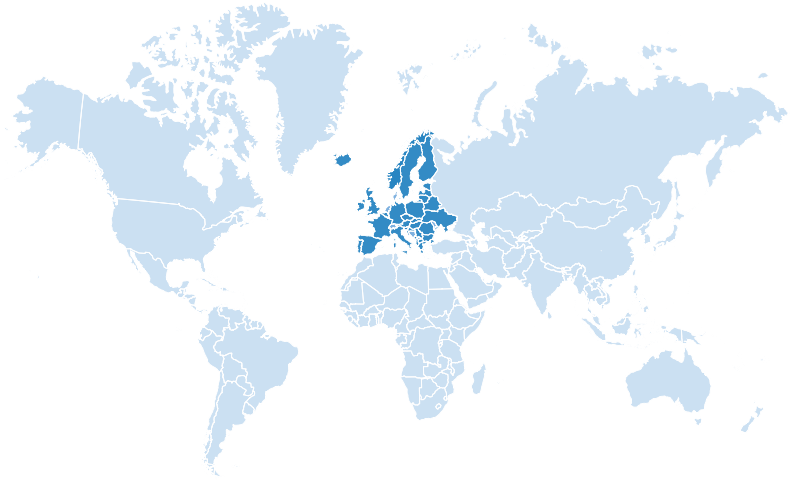
Cannabis – the cannabis market is extremely challenging at the moment. In the past six to twelve months, capacity has been reduced by several insurers choosing to exit the space and appetite changes are widespread due to significant litigation. Even before COVID-19, there were significant balance sheet issues in the cannabis sector, resulting in a high bankruptcy risk across the industry. This made insurers even more restrictive in terms of their appetite for this class. The sector continues to tighten because of underwriting losses, class action frequency, product recall claims, US exposure, and accounting issues. Rates are going up significantly for cannabis companies with international and US exposure, sometimes in excess of 10x. Canadian only cannabis companies are seeing significant rate increases as well. We expect COVID-19 to cause further issues with insurers capacity and pricing.



Oil and Gas – there has been a rapid deterioration of the D&O market for energy risks - particularly those that are dual-listed, have significant US exposure or are Chinese backed. The market had already begun hardening earlier in the year, driven by the unprofitability of the primary book and US securities claims. Some insurers were forced to exit the sector due to ESG positions being taken corporately by their head offices. Add the Saudi / Russian oil price war, lack of demand due to COVID-19, concerns about the overhang of supply and the financial stability of companies globally, and the insurance market retracted quickly.

All markets are reducing their capacity to a maximum of USD10m, and in some cases only USD5m and USD2.5m limits, creating gaps between the primary and first excess layers. These gaps are difficult and expensive to fill. New limits management guidelines mean that many markets cannot offer new limits on energy business or cannot attach below USD30m or USD50m, unless it is the renewal of existing business. The drastic reduction in capacity and increase in price mean that many energy companies are being forced to review their structure and overall limits - either because the capacity is no longer available or expiring limits are too expensive. Taking a higher retention is still an option to contain costs for some clients; but, for others, it is either being forced upon them or will not result in meaningful savings. While the worst market reaction seems to have been during Q2, we do not expect the market to significantly improve anytime soon.

Europe



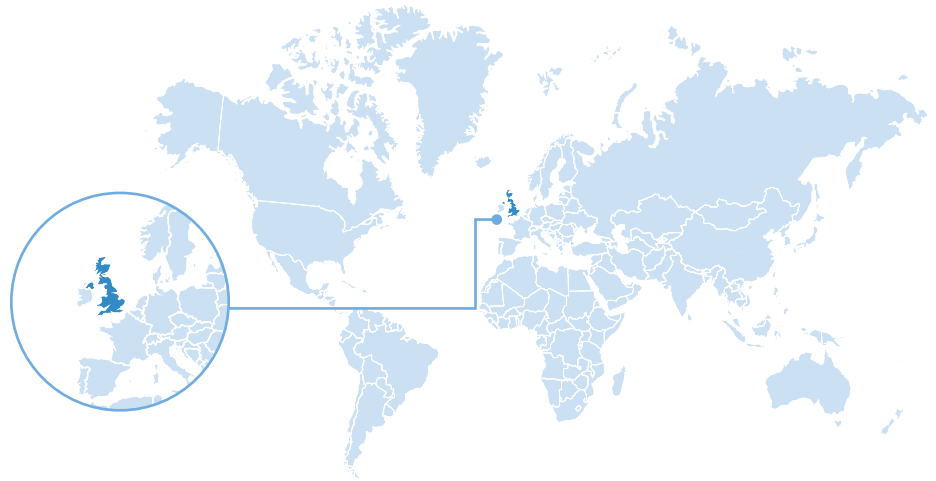
Europe has seen increased regulatory activity and, therefore, D&O claims. Traditionally, we have seen large limits from European insurers, but maximum line sizes are being cut and clients are now needing to build their programmes in more layers. This, also, has undoubtedly changed the litigation process. Programmes historically built with one insurer taking the claims lead, now have group litigation handling becoming much more common.

The European D&O market began to harden around 12 months after the London market, meaning that European insurers had become an increasingly viable option for clients who had previously had their whole programme placed with London insurers.

More European claims and investigations, combined with insurers becoming more joined-up internally, has meant that underwriting appetites and terms across insurers' various offices are now more consistent. Having said that, our view is that accessing the continental European market is a valuable marketing exercise and provides diversification of insurers on programmes.



UK



The UK D&O market has changed drastically in the last couple of years. Economic uncertainty off the back of COVID-19 and Brexit means that we are continuing to see increasing volatility across all industries and significant premium increases will continue across UK public, private and US traded firms.

The impact of COVID-19, in particular, has made the risks of companies in various industries, which for the most part used to be seen as some of the more attractive sectors for D&O insurers (for example, aviation, hospitality, travel and leisure), extremely difficult to place. We expect to see a number of high profile (as well as an even higher percentage of SME) insolvencies in these industries as a result of this virus, which may lead to future litigation.

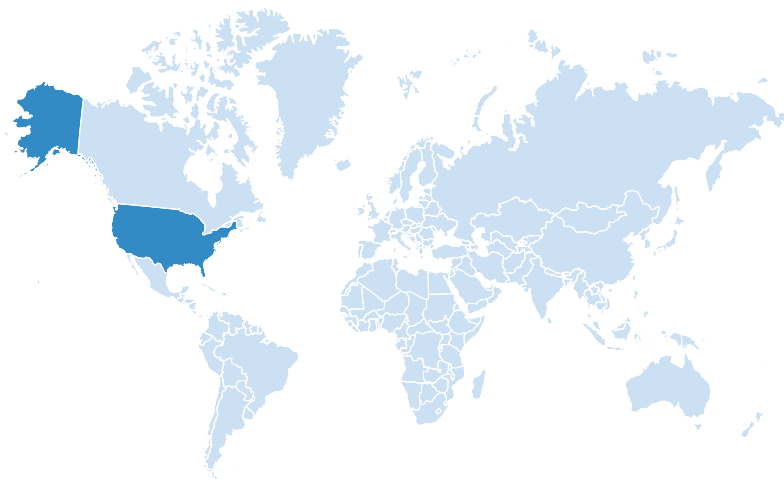
UK domiciled and/or listed risks were, for many years, seen by insurers as a safe haven from some of the other territories that we have just discussed. Competition between insurers for this type of business was high, which drove down premiums and allowed

brokers to broaden wordings. It has become apparently in the past 24 months, however, that there was insufficient premium in the pool for UK risks and that this part of the insurers' books has, in fact, been very unprofitable. Rate rises on a percentage basis, to the point where the insurers believe that they are no longer making a loss, have therefore been more drastic, despite other territories still having higher levels of litigation.

The D&O landscape in the UK has been drastically altered by increased class actions and changing legal and regulatory environments globally - emphasising the accountability and liability of directors and officers. Companies that used to feel shielded from claims exposure in other territories, despite purchasing multinational D&O programmes, are now having to take into account global claims trends. UK companies with shares traded in the US, regardless of being issued unsponsored ADRs, are now being heavily scrutinised by insurers.



US

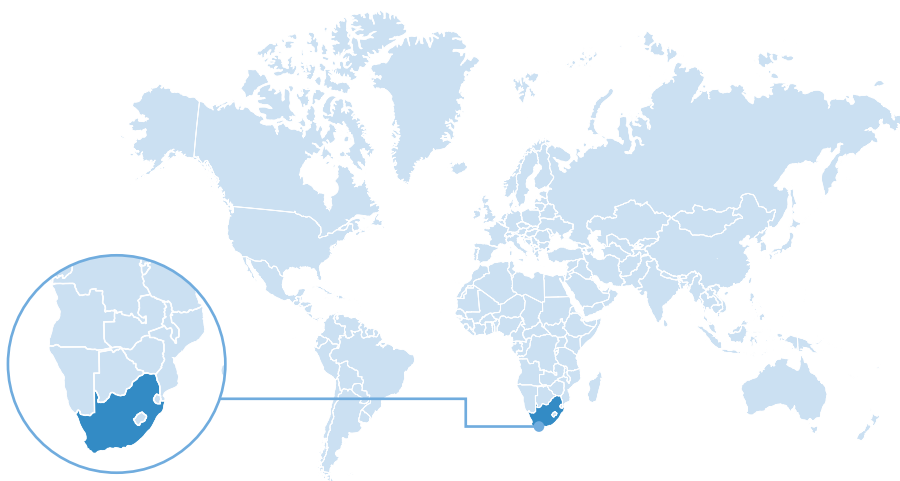


The US remains relatively unchanged from our last update, with US public companies having seen continuous premium increases across the board, albeit off of a higher base during the soft market. Now, we expect pricing for US listed placements to start levelling out somewhat towards the end of 2020. The majority of US clients will have experienced significant adjustments to their insurance programmes over the past 12 to 18 months and, although we do not expect to see any decreases or flat renewals, we think that any increases will not be as drastic as previously. Retentions will likely remain unchanged if these have been adjusted in prior years.

Capacity remains an issue still, with certain insurers continuing to reduce line sizes, as well as choosing to pull out of certain accounts altogether. Unfortunately, this means that clients may not have the same limit available to them as they have done in previous years.

On the plus side, the addition of Convex Group - a new London market open to writing Financial Lines - who will be actively targeting US domiciled and listed placements, brings some welcome new capacity. Initially, Convex will not be looking to write primary lines on policies, but will look to operate and offer lines lower down within the programme, including first or second excess lines. This will assist with capacity reductions within the insurance programmes and will slowly begin to alleviate the lack of capacity within the marketplace.

South Africa



In South Africa, capacity is largely still available for locally listed companies and many programmes can be completed in the local market. The shrinkage in capacity has not been as severe as elsewhere in the D&O marketplace; however, South African companies that are listed in the US still need worldwide capacity

to complete their programmes. The market in London for South African risks remains vibrant, as before, although underwriters are increasingly more selective and are scrutinising the pricing and retention levels of any locally placed capacity.

CRIME UPDATE

The Crime insurance market also continues to suffer. Claims continue to come in thick and fast. Considerable in quantum, losses are frequent, and rarely are they long tail. The Crime insurance market is considerably smaller than the D&O market in terms of relative premium, but the regularity, size and difficulty of recent claims in this space has started to take its toll.

We are still seeing two to three insurers are required on any given placement, regardless of the limit, and additionally some broker facilities are not being renewed. Sompo insurance recently joined a growing list of insurers that have withdrawn entirely from the Crime market, leaving the market short of primary insurers. With only a small handful of options available and with insurers generally only keen to write on a co-insurance basis, most clients require each of these primary insurers to participate if a renewal is to complete. Sompo's exit, therefore, has seen available capacity drop further.

The excess Crime market, unlike the excess D&O market, is not much larger than its primary market.

Also, with a lack of insurers willing to write Crime in isolation, as they become more selective in writing the D&O, it's likely to cause a negative knock-on effect to the Crime market.

As companies continue to focus and address risks of social engineering, their attention has been from more traditional loss categories, including employee dishonesty and employee theft. Nevertheless, we are seeing increases in all of these claims categories – and no dip in social engineering claims to offset this rise.



For more information, please contact:

David Ritchie

Managing Director, D&O

T: +44 (0)20 7204 8565

E: David_Ritchie@ajg.com

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