

Market Conditions

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The Hard Market for D&O Set to Continue — Again

A Review of the Public Company D&O Marketplace — January 2021

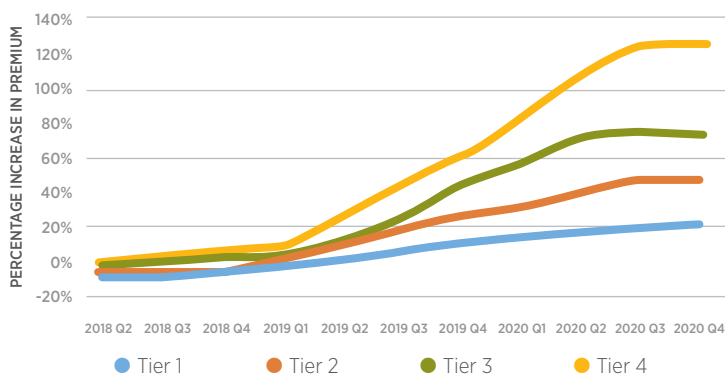
Phil Norton, Ph.D.

Our forecast for the state of the Directors and Officers (D&O) marketplace in 2021 is once again more of the same. To review, 2019 was a firming market with consistent price increases starting at 3% average and finishing at 30%. True hard market conditions were evident throughout 2020, as COVID-19 brought financial stress that added fuel to the hard market flames, primarily caused by the sustained new normal of 400 securities class actions (SCA) per year. Our optimism about any light at the end of the tunnel is still premature, as most carriers predict 2021 price changes to be similar to 2020. We disagree — but only slightly — as we see signs that, while 2021 will be another year of increases, such increases will be smaller.

Before COVID-19 shut down the economy, we preferred to describe the market as firm versus hard, because capacity was still available for the most part, and terms and conditions were unchanged. However, Q2 of 2020 easily earned the hard market designation, as every aspect of our D&O placements was impacted: premium, retention, capacity, excess attachment decisions, and even terms and conditions.

Perhaps the most interesting aspect of the 2020 D&O hard market was the evolution of underwriting by class of business, what we call the hard market expansion. Clearly, the difference between pricing for the “lowest” 20% (or most difficult accounts) and the “highest” 20% (or best accounts) has gone from being nearly imperceptible (maybe plus or minus 5%) to being dramatically different — say by 100-plus percentage points. See Graph 1 for this trend.

Graph 1: The D&O Hard Market Expansion



The obvious question is what accounts are in which tier? Here are the current rules of thumb.

- **Tier 1** accounts are primarily financial institutions with healthy balance sheets, good earnings and no significant claims.
- **Tier 2** accounts are the best of the commercial accounts — some manufacturing, some services, but overall top performers may come from almost any class, including retail.
- **Tier 3** ranges from typical accounts in technology as well as established biotech and pharmaceuticals, perhaps homebuilders, and then some challenged accounts from other sectors.
- **Tier 4** accounts are the most difficult industry sectors, including recent IPOs, younger biotech companies, airlines, automotive to an extent, some transportation (think rental car companies but not UPS or FedEx), some REITs and some retailers (especially if limited online sales), some restaurants (especially if limited drive-through capability), energy, higher education, hospitality, and any account in the vicinity of insolvency.

We have found the keys to beating the averages are to get ahead of the renewal, communicate effectively with underwriters and demonstrate your risk factors to re-class you down a tier if possible. We do have strong reason to hope that 2021 increases may be muted compared to 2020 because:

- Carriers we have spoken with have reduced their loss ratios significantly over the last two years.
- Carriers may see further benefit from either reduced 2020 SCA frequency or sustained case dismissal rates above 50%.
- New or renewed capacity may return to the marketplace throughout 2021.

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In turns of placement results, here is what carriers are signaling us to expect in 2021, in order of carrier priority:

1. Capacity on each risk will be reviewed intently; even though most cuts in capacity took place in 2019 and 2020, there will be a few more capacity cuts left for 2021. Layers of \$15 million in limits are now rare. \$5 million layers are more commonplace than ever. And some carriers have established rules to provide no capacity to some sectors, even to stellar risks within such sectors.
2. Excess attachment points are moving up, as some excess carriers formerly attaching at \$25 million on average are looking to attach at \$50 million going forward, for example.
3. Retentions will also be carefully reviewed and in many cases, new minimums will be enforced; we believe most retention increases took place in 2020, and thus expect less increases in 2021, absent large growth in exposures. Split retentions with a special deductible for M&A risk will continue to be prevalent with medium-sized companies. IPOs will continue to see very large retentions, as will reverse flow companies.
4. Price increases continue to take effect across the board and remain in the double digits — or more in a few cases.
5. Terms and conditions may see some tightening; expect mild restrictions on a case-by-case basis.

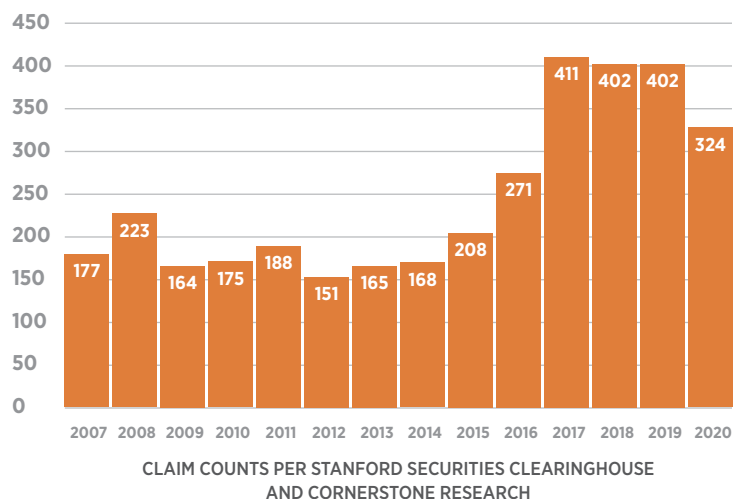
This report will examine historical data to both suggest where the market is now and the reasons behind it. The short version for the market hardening that began in January of 2019 is carrier losses — in terms of increased frequency and perceived severity concerns, which includes both fear of large cases not yet resolved as well as extraordinary increases in defense costs, especially for medium-sized companies with medium-sized settlements. 2016–2019 were unprofitable years for most D&O carriers; so were years 1997–2000. The parallels with the 2001 hard market are remarkable.

The differences are interesting as well. SCAs are being dismissed at record levels. For example, Cornerstone reported last year that, in its review of claims from 2009 to 2018, core federal filings were dismissed at about 50%, and M&A filings were dismissed at close to 90% (see Securities Class Action Filings — 2019 Year in Review, Figure 14, page 15). More plaintiff attorneys, more claims frequency and potentially more cost, per claim, especially with respect to defense costs are all recent trends, and are enough to extend the D&O hard market for another year.

THE NEW NORMAL FOR FEDERAL SCAs CONTINUES

D&O carriers generally point to adverse frequency trends such as the federal filings shown in Graph 2 as the single most important driving force in carrier costs. The fear of increasing severity and a historically high backlog of large unresolved cases add deep concern to a world averaging almost 400 SCAs (including 1933 Act state actions) per year.

Graph 2: SCA Claim Trends



Although the COVID-19 pandemic has negatively impacted the overall insurance marketplace, it may also be responsible for slowing down the pace of D&O claims frequency in 2020, as federal SCA filings dropped by almost 20% from 402 to 324 per the Stanford SCA Filings website. But four claim counts listed on that website were attributed to Forescout Technologies, Inc., and upon review, we advise there are only two distinct cases. Thus, the 2020 SCA claims count becomes 322.

D&O PRICING IS UP FOR ALL COMPANIES

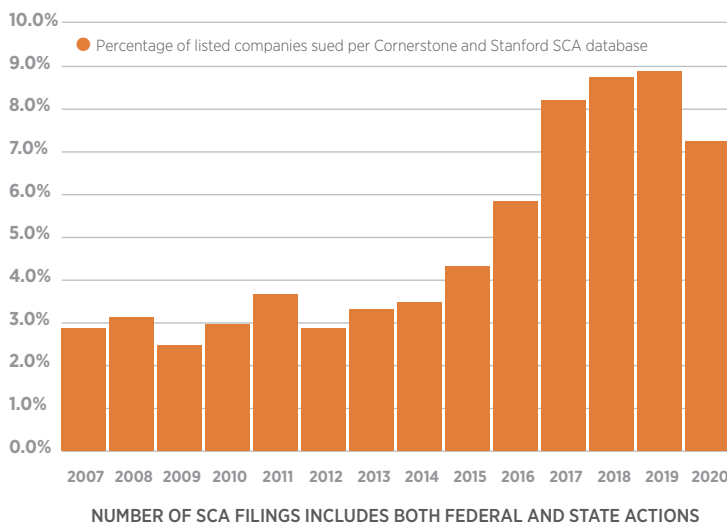
According to several leading D&O carriers, no public company D&O renewals went out the door in 2020 with a decrease; even flat renewals were nonexistent. This makes for a pretty boring pie chart. As an aside, the private company D&O market fared much better, with small and medium-sized private companies typically receiving small increases with an occasional nominal decrease or flat renewal. Notably, large private companies were regularly facing huge percentage increases, often due to changes in minimum pricing parameters. For more information, please see Gallagher’s market conditions report specifically for private and not-for-profit D&O.

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A deeper dive into adverse D&O claims frequency trends is available by examining the probability of a SCA. Following Cornerstone's methodology, one compares the number of companies listed on NYSE and NASDAQ that are sued to the number of companies listed on those two exchanges. The combination of fewer listed companies and more SCAs produces an approximate tripling of the chances a public company is sued over the last 10 years. The significance to the D&O carriers is twofold: More claims mean more cost, but there are many fewer companies to collect premium from, so the loss ratios are accelerated.

Graph 3: Probability of a U.S. D&O Class Action Claim



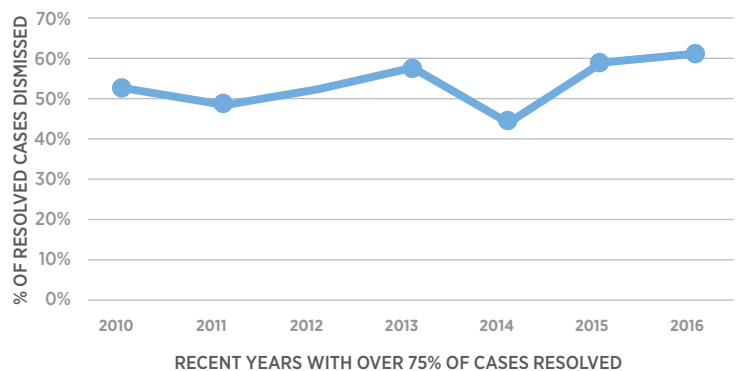
M&A CLAIMS HAVE SHIFTED AND ARE NOW DOWN

D&O claims related to acquisitions have been problematic for decades, but the merger objection (M-O) claims that exploded several years ago in state courts have evolved into a significant portion of the federal court securities claim counts given in Graph 2. In the first two full years after the Delaware Chancery Court *Trulia* decision, M-O claims were almost 50% of the federal SCA claim counts. Formerly brought primarily in state courts, M-O cases post the *Trulia* dismissal (in early 2016) began to shift toward federal courts. Per data from Advisen, the percentage of M-O claims brought in federal court surged from 20% in 2015 to 85% in 2017 post-*Trulia*. However, in 2020, these M-O suits were only 30% of the federal SCA claim counts, suggesting a real trend toward fewer M-O cases overall. This trend is further supported by the very high federal M-O case dismissal rates cited earlier in this paper.

DISMISSAL RATES FOR CORE FILINGS ALSO LOOK FAVORABLE

Cornerstone Research defines core filings by removing non-standard SCAs, primarily M-O cases. Graph 4 shows that even non-M-O federal SCAs are being dismissed at record levels in recent years. We expect that trend to continue, as many of the newer D&O plaintiff attorney firms are very quick to bring lawsuits, including many that are weak to start with and rightly dismissed. Thus, this newer brand of plaintiff contributes to both the trend for more SCA claims and these higher dismissal rates. That said, many of their cases are significant as well.

Graph 4: Dismissal Rate for Core Filings



EMERGING D&O PLAINTIFF ATTORNEY FIRMS CONTINUE TO IMPACT RESULTS

Studies continue to show the impact of newer or emerging plaintiff attorney firms whose number of lawsuits and settlement values have ramped up in the last five to 10 years. Such newer D&O plaintiff attorney firms continue to be a substantial portion of filings and, in recent years, are now on the majority of cases resolved by settlement. According to the Institutional Shareholder Services (ISS) report cited herein, three newer firms continue to be impactful, namely Rosen, Pomerantz and Glancy. See Chart 5, where all three of these firms are in the top five for 2019 by number of settlements, and helped clients collect approximately \$800 million in 2019 settlements.

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Chart 5: Top Plaintiff Attorneys—2019

(by Number of Settlements Handled per ISS Report)

Firm Name	Value of 2019 Settlements	Number
Robbins Geller Rudman & Dowd	\$561 million	17
Glancy Prongay & Murray	\$148 million	13
The Rosen Law Firm	\$438 million	12
Labaton Sucharow	\$156 million	10
Pomerantz	\$208 million	9

Source: ISS Securities Class Action Services “The Top 50 of 2019”

The other factors impacted by emerging plaintiff attorney firms—and less discussed than their dramatic impact on the increase in D&O claims frequency—come from a different style of litigation. In general, defense counsel and other industry observers suggest the possibility for further disruption due to:

- Initiating cases on the basis of an event (operational, product-based, environmental, cyber, workplace related, safety, preventative measures (fire) and so forth)
- Suing medium-sized companies more often and seemingly due to negative press release/stock price drop
- Asking for outsize settlements in proportion to the initial damages sought
- Erratic as to when they sincerely engage in settlement discussions—often later, yet sometimes earlier than most

LARGE DERIVATIVE ACTIONS CONTINUE

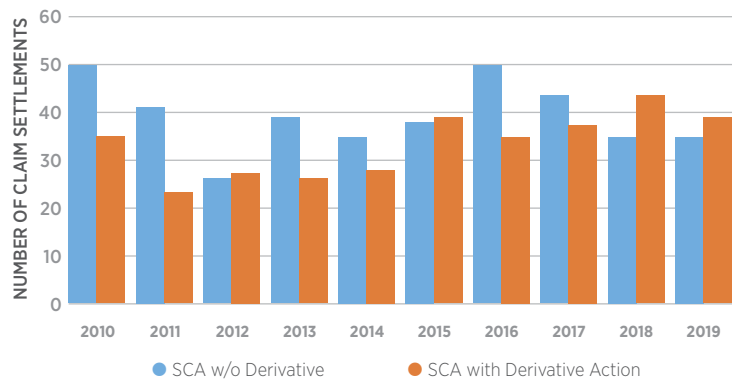
Derivative actions are often considered the most dangerous type of D&O claim because of their construction, in which shareholders are suing on behalf of the company and asking individuals to use their own money to effectively repay the company for alleged losses. As such, the company may not indemnify any settlement (what we refer to as Side-A only settlements). Chart 6 shows our sample list of 17 large derivative settlements from roughly the last 15 years, but focused on the last several years. 2020 saw one very large derivative action settlement that was announced in 2019 but received final approval early in 2020, namely Wells Fargo, whose \$388 million included \$240 million in cash funded by insurance and an estimated \$68 million in plaintiff attorney fees. In addition, another two new D&O derivative settlements in excess of \$100 million were announced. We probably would have seen more if not for COVID-19 slowing down the pace of claims settlements.

Chart 6: Large D&O Derivative Actions

Company	Settlement (\$M)	Year
Wells Fargo	\$388 million	2020
Activision Blizzard	\$275 million	2014
McKesson	\$175 million	2020
News Corp	\$139 million	2013
Freeport-McMoran	\$138 million	2015
Oracle	\$122 million	2005
Broadcom Corp	\$118 million	2009
AIG	\$115 million	2008
Alphabet	\$103 million	2020
21st Century Fox	\$90 million	2017
PG&E Corp	\$90 million	2017
Del Monte Foods	\$89 million	2011
Pfizer	\$75 million	2010
Akorn	\$74 million	2019
Bank of America	\$63 million	2012
Community Health	\$60 million	2017
New Senior Investment Gp	\$53 million	2019

We also note that the trend for SCAs to be accompanied by a derivative action has increased over the last decade, as displayed on Graph 7. Data is from Figure 9, page 10, of the Cornerstone Research report: SCA Settlements—2019 Review and Analysis.

Graph 7: Trend for SCAs With Derivative Actions



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LARGE D&O CLAIMS SETTLED IN 2020

Each year, we review a sample of the larger settlements that resolved in that year. We start this project by filtering the Advisen D&O claims database (originally launched through a Gallagher-Advisen joint venture) looking for any D&O securities claims in particular that had a proposed or final settlement in 2020. Occasionally, claims cross from one year to another as their agreed settlement finally obtains court approval in a future year. See the list on Chart 8 for some significant claims settled in 2020.

Chart 8: Sample D&O Settlements — 2020

Company	Value	Notes
Valeant Pharmaceuticals	\$1.21 billion	SCA
VAREIT (formerly ARCP)	\$976 million	SCA
First Solar	\$350 million	SCA
Wells Fargo	\$320 million	Derivative
Signet Jewelers	\$240 million	SCA
SCANA Corporation	\$193 million	SCA
Snap Inc.	\$188 million	IPO
McKesson	\$175 million	Derivative
Equifax	\$149 million	SCA
DaVita	\$135 million	SCA
Alphabet	\$103 million	Derivative
Gilat Satellite/Com Tech	\$70 million	M&A related
SeaWorld Entertainment	\$65 million	IPO
Community Health System	\$53 million	SCA
HD Supply Holdings	\$50 million	SCA
FleetCor Technologies	\$50 million	SCA
Terra Form	\$49 million	IPO
Stericycle	\$45 million	ADR; IPO
Sinclair Broadcasting	\$26 million	Derivative
Daimler AG	\$19 million	SCA ADR

WHERE IS D&O CLAIM SEVERITY GOING NEXT?

Carriers tend to watch frequency closely, because it is easier to calculate, we know it much sooner, and thus we can use it to identify trends. With claims severity, it is usually three years before our numbers are reliable, and even then they are inherently more volatile. That said, the average D&O claim cost for a traditional shareholder class action has been running very near to \$40 million for about a decade now. Typically, the average cost is also four times the median cost. NERA, who issues annual reports on the topic, adjusts their average securities claim cost by removing outliers (claims more than \$1 billion and \$0 claims) as well as non-core claims such as all the M-O claims. With this clearer picture as to trend, we see average claim costs trending down. However, we are seeing more middle-market companies being sued recently, so adjusting for size, we again have very consistent claim costs.

Our Chart 8 does suggest claims settled in 2020 were more costly than those settled in 2019, if we were to review the same Chart 8 from last year's report. This may be especially notable if it is the tip of an iceberg of cases pending that carrier executives have expressed concern about throughout the year. The fear is finding a handful of megacost cases in the backlog of open cases. Per Cornerstone research data and analysis published in March 2020, the 10-year backlog of core filings unresolved was 548 cases.

And another carrier concern is the rising cost of defense. As already noted, the medium-sized companies are being sued more, and they may be more likely to have defense costs that are disproportionately large compared to settlement costs. Further, we more often see new/emerging plaintiff firms testing the defense counsel unduly, especially if the plaintiff firm has limited litigation inventory and thus higher aspirations for each of their cases.

D&O COVERAGE QUALITY

The quality of D&O coverage remains excellent, with a history of huge coverage innovations over the last decade. However, coverage expansion stopped in 2019, and restrictions have appeared on occasion in 2020. To be certain, many enhancements are not as automatic as previously, thus requiring the broker to work harder to maintain quality for many of their clients. Looking ahead, we expect coverage to remain strong in 2021, despite some anticipated efforts by some carriers to restrict coverage — in particular for the less attractive risks.

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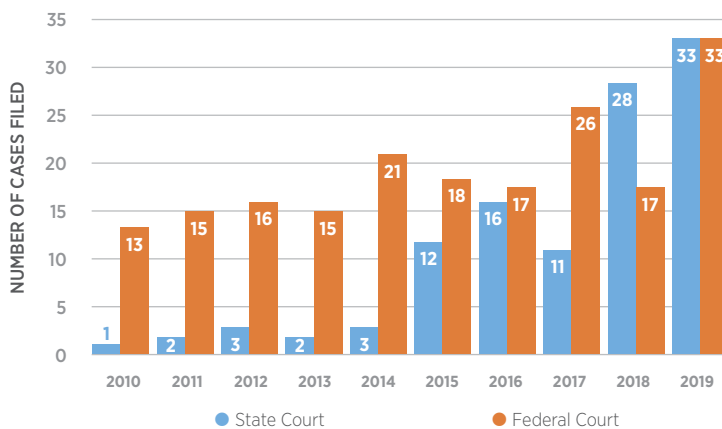
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THE YEAR OF THE IPO

Despite the challenges of the COVID-19 pandemic, 2020 was an excellent year for raising capital through stock offerings. [Renaissancecapital.com](https://www.renaissancecapital.com) counted 218 IPOs (with \$50 million-plus market cap and excluding SPACs), which is the best year since 2014. Due largely to the *Cyan* Supreme Court decision of 2018 regarding jurisdiction, the IPO market hardened ahead of the overall D&O market with substantial increases in premium and retentions as well as significant cuts in capacity. Basically, the Supreme Court found that SLUSA failed to make it clear that federal courts were required for 1933 Act claims (largely IPOs). Therefore, this *Cyan* decision meant defending SCA cases on multiple fronts was a possibility, and certainly allowed for cases to be brought in state courts that are typically less favorable than federal courts. However, the difficult insurance market for IPOs has not slowed down this option for raising capital.

Graph 9 details the trend toward more IPO-related D&O claims being brought in state courts.

Graph 9: IPO Class Action Claims



THE YEAR OF THE SPAC IPO — MAKES TOTAL IPOs A RECORD

Sometimes referred to as a reverse merger or blank-check strategy, special purpose acquisition companies (SPACs) are formed to raise money through an IPO, find a target company to purchase, make the acquisition and register the newly combined companies as a publicly traded corporation. Since the target company has effectively gone from privately owned to publicly traded, this is also noted as an alternative to the traditional IPO approach.

In 2020, we saw more SPAC IPOs than ever. In fact, Matthew Fox of Business Insider quoted Goldman Sachs in recognizing more than 1 SPAC per day has gone IPO since July 2020. SPAC IPOs in 2020 were more than quadruple their 2019 amount, with 248 SPAC IPOs per [SPACInsider.com](https://www.spacinsider.com). Combining SPAC IPOs with traditional IPOs produces a total IPO count that is unsurpassed in recent years.

If the IPO D&O insurance market is tough, then the D&O insurance market for SPAC IPOs has become equally problematic. SPAC D&O premiums have more than doubled recently, and retentions have increased even more dramatically, with typical policies now showing a \$5 million retention — and with pressure to go higher.

SPACs are increasingly difficult to underwrite, especially recently, because specific SPAC targets are unknown (in fact as required by the Investment Company Act of 1940), and we have seen a recent shift to a higher percentage of the ultimate target companies acquired having no EBITDA and sometimes no revenues as well. It is unclear whether the change in average financial condition of the SPAC targets will impact future success, but underwriters are cautious.

Regardless, SPAC-related claims activity has kicked up along with its greater popularity, and former SEC Chairman Jay Clayton has taken notice. Based on a September 24, 2020 interview with CNBC, Clayton suggests the need for a particular focus on how sponsors of blank-check companies disclose their ownership and how any compensation is tied to an acquisition.

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CONCLUDING THOUGHTS

There are a few important takeaways from our forecast of 2021 D&O market conditions. They include:

- Pricing levels will increase throughout 2021, but less so than 2020 is our prediction.
- The client's risk profile will remain the most important variable dictating renewal outcomes. Therefore, expect loss experience, industry, location, financial health, communication style and other individual account nuances to continue to have a significant impact on D&O renewals.
- Increases will be in all layers, but likely higher percentage increases in high excess traditional (ABC) layers.
- Lower percentage increases remain possible for excess Side-A.
- Market competitiveness as represented by the number of carriers and their actual capacity being deployed regularly will finally begin to move up, but the newer capacity will enter the D&O market cautiously.
- Medium severity claims brought largely by emerging plaintiff attorney firms will increase, and associated defense costs may seem unduly high versus historic levels.
- Frequency of securities claims will remain high, but may also continue to be depressed somewhat by COVID-19 times. We may not reach the new normal with 400 SCAs in 2021, but we will likely be close to that level.
- Dismissal rates should remain very high, easily exceeding 50%, as we continue to see a substantial number of weaker D&O cases in the mix.
- D&O coverage quality will remain high, though we foresee firm market resistance to further enhancements.
- Individual D&O protection or dedicated Side-A limits will remain extremely popular; most programs already invest 30% of their total D&O limits into Side-A only layers.
- Many carriers will be profitable, as newer claims are subject to larger retentions, and the dismissal rates will allow D&O claims to once again periodically resolve without a carrier payment.

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