

Market Conditions

JANUARY 2023

A Review of the Public Company D&O Marketplace: Capacity and Competition Are Back

By Phil Norton, Ph.D.

INTRODUCTION

The Directors & Officers (D&O) market for US public companies finally flattened out by the end of Q1 2022, after some significant challenges in 2020 and 2021. And by the end of Q2 2022 we began to see material decreases in premiums in most sectors, as well as some retention decreases. Driving some of the decreases were additional quotes for primary D&O as carriers showed more appetite as the year progressed. As we kick off 2023, we are seeing double-digit declines for most renewals, although the size of decreases may abate toward the end of the year.

Recognize first that the 2019–2021 time period showed us three consecutive years of substantial price increases, accompanied by larger retentions for most clients and even a few of the more difficult placements struggling for their full capacity. In contrast, while prices were going up dramatically in this time period, securities class-action lawsuits (SCAs) were coming back to earth with half as many D&O claims in 2021 and 2022 compared to just a few years earlier (as you will see on Graph 1).

These dynamics and more sparked an impressive combination of both new and established carriers anxious to compete for more D&O insurance business. The competition was first evident by the end of Q1 2022 when pricing began to move toward flat renewals. And by the end of Q2 2022, competition was extensive with 20% decreases possible for some companies with favorable or improving risk factors. But also keep in mind that we expect clients with smaller increases in the difficult market are then likely to get smaller decreases in the current softer market. Note that carriers are always reviewing their various rate per million criteria based on your risk profile.

As we head into 2023, we expect to see further reductions in D&O rates, although decreases will be less than the reductions in 2022. However, underwriters will continue to be very cautious with less financially healthy companies or those with recent D&O claims. And those with recent IPOs (last two years) are candidates for the largest decreases in premium and retention.

WHAT WE SAW IN 2022

Similar to 2021, we saw an inflection point near the end of Q2, but by this time in 2022 we moved toward healthy premium decreases instead of the simply smaller increases we saw near the end of Q2 2021. Although pricing continued to vary based on industry sector, overall size and growth in exposures, we saw a broader interpretation of financial health and outlook for the business in 2022, and this helped drive competition. But the biggest driver of competition and

the critical factor for price decreases was extra capacity, with several new D&O carriers entering the US market plus established carriers protecting their renewals from competition with reduced pricing. Some established carriers also became more aggressive on new business themselves. We further note that D&O claim trends were mostly positive in 2022, and that may have justified much of the optimism leading to increased competition.

The carriers were still actively underwriting the risks, but there were just more of them at each layer doing so, including primary. Clients can take advantage of the fact that not all D&O insurers have the same opinion of their risk profile. This happened more frequently in 2022. And yes, industry and business sector along with other underwriting criteria drove much of the carrier decisions in the second half of 2022 as to whether a decrease was merited and, if so, what size decrease was appropriate.

CURRENT STATE OF THE D&O INSURANCE MARKET

The most important questions to ask as we assess the current D&O marketplace for publicly traded companies is where is the competition coming from and why have D&O carriers shifted their underwriting positions.

Notably, some of the competition is coming from the approximately 20 newer D&O markets playing significant roles in competing against current pricing levels; some of these markets are unique to the UK or Bermuda and may be targeting only a small portion of the US market, but many new ones started focusing on the broad spectrum of US businesses, especially by the end of the first half of 2022.

Perhaps of greatest impact, many established markets are now willing to aggressively quote primary D&O. As an example, a publicly traded risk with even minor challenges most often obtained one to three primary quotes about a year ago. But our 2023 forecast is for much more interest at primary and lower levels of your D&O insurance program than the last few renewals. And increased competition at the primary level will lead to savings throughout the entire D&O program, as excess carriers price off of primary rates, and those carriers not winning the primary layer then regularly compete for a position in the excess layers of the tower.

So why are carriers currently taking a more competitive stance on new business? While most D&O carriers saw record premium levels in 2021, they are still keen to grow their business in 2023. But in between, we saw the trend for new listings slow down considerably in 2022, due to

Market Conditions

JANUARY 2023

fewer IPOs in particular. This means more pressure on growth coming from existing businesses. And since D&O carriers have generally returned to profitability (based on our interviews with the top D&O underwriting executives), they are not afraid to compete for business to fuel their growth.

And finally then, to round out the market assessment with the real story behind the story, why have D&O loss ratios shown some improvements?

As noted by [Cornerstone Research in its 2022 midyear report](#), frequency of SCAs has stayed down — at roughly half the peak levels of recent years. Further, severity appears to be down or mostly stable in all sectors except communications, which saw multiple massive D&O lawsuits in 2021. From our perspective, the highly favorable dismissal rate (as shown on Graph 4) makes carriers think more about getting the retention right, thus leaving more flexibility to move down on premium.

Not surprisingly, this optimism also relates to another positive development in the current D&O marketplace, namely a shift back to coverage discussions and more opportunities for improved coverage. Many carriers are releasing new forms and looking to be more competitive with coverage quality as well.

On the downside, the impact of the bear market, layoffs at some companies, inflation and the threat of recession all point to the possibility of additional caution being more prevalent at some point in 2023. Further, we are seeing and thus expect the possibility for 2023 to see more M&A, including complex SPAC-related transactions, which have already been trending adversely (see the following claims analysis for more details). In general, economic conditions may also lead to more bankruptcies, which may also trigger D&O claims.

Finally, it is worth noting that the most significant improvements in the current marketplace continue to be recent post-IPO companies who are benefitting from key changes to their litigation background. In particular, the Delaware Supreme Court *Sciabacucci* decision in March 2020 was a huge help, as this ruling allowed corporations to adopt provisions requiring shareholders to bring Securities Act claims in federal court. Thus state court actions known to be more volatile, or parallel actions in both state and federal courts known to be quite costly, were suddenly prevented. *Sciabacucci*, in effect, counters the *Cyan* ruling of March 2018, which essentially hardened the IPO D&O market overnight. Of further interest, Gallagher was one of only two brokers who financially supported the *Sciabacucci* litigation, which has now proven to help private and public corporations across the US and is a key factor for D&O underwriting improvements in this space.

EXAMINING D&O CLAIMS TRENDS

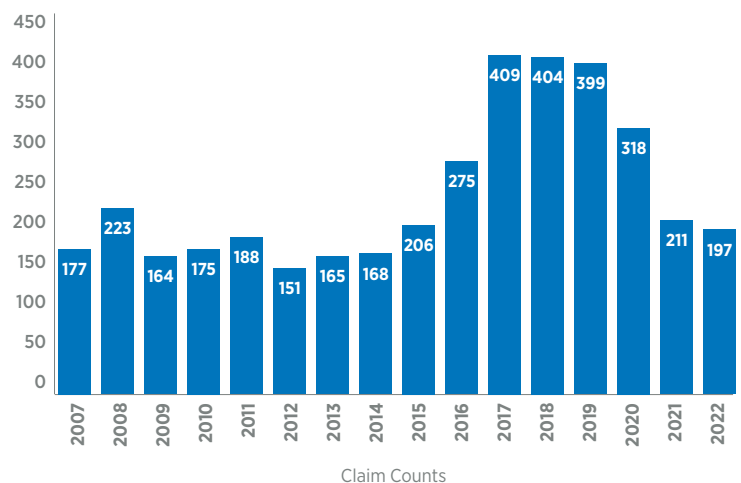
The rest of this annual report on the public D&O marketplace examines historical trends and offers further elaboration in regards to our optimistic outlook. We definitely are seeing benefits from the principle of supply and demand at work, with new competition in most sectors and usually across all layers of your D&O insurance program. The level of competition has been surprisingly intense in some cases, but possibly backed by improved claim results. Below, we dive deeper into the claims trend topics.

What is the new normal for federal SCA frequency?

Throughout the hard market, D&O carriers pointed to adverse frequency trends such as the federal filings shown in Graph 1 in years 2016 to 2020 as the single most important driving force in carrier costs. From our perspective, the federally filed merger-objection (M-O) claim frequency trend, other than SPAC-related claims, is no longer a costly issue. Such M-O claim costs were generally small compared to other types of D&O claims, but the carriers' loss ratios were hit hard due to low retentions and high frequency of claims driven by M&A activity. Now, retentions are up and federal M-O claim frequency is down significantly.

Going forward, it also seems clear that the new normal is not 400 claims per year, but closer to 200 SCAs per year, similar to years 2007 to 2015 on Graph 1. As predicted almost two years ago, the blip of extra SCAs is resolving itself back to this steady state of about 200 SCAs being typical. Carriers and clients should both benefit from this return to the longer-term trend line.

Graph 1: Securities Class Action Claim Trends



Source: Data collected from [Stanford Securities Clearinghouse](#) and Cornerstone Research

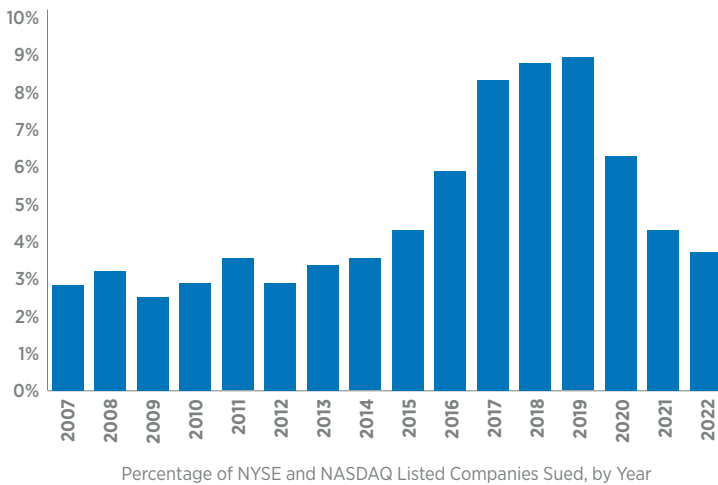
Market Conditions

JANUARY 2023

The probability that a publicly traded company has a D&O claim is also decreasing.

A deeper dive into D&O claims frequency trends is available by examining the probability of an SCA. Following Cornerstone’s methodology, one compares the number of NYSE-and NASDAQ-listed companies sued to the number of companies listed on those two exchanges. Per Graph 2, the combination of fewer listed companies and more SCAs produced an approximate tripling of the chances a public company is sued, when comparing 2017–2019 to 2007–2014. But according to Gallagher estimates, 2022 shows a third straight decline from this high-water mark, due in part to fewer SCAs. Another contributor to the recent decreases in probability of a D&O class action is the increase in the number of traded companies, particularly from the huge number of new listings in 2021. It is the combination of SCA claim counts dropping since 2019 plus having quite a few more listed companies since 2019 that reduces the probability of an SCA nicely. This is good news, as it means carriers have more companies now (many of which were created by the IPO process) that they are collecting premiums from to pay D&O claims (whose frequency seems fairly stable now).

Graph 2: Probability of a US D&O Class-Action Claim



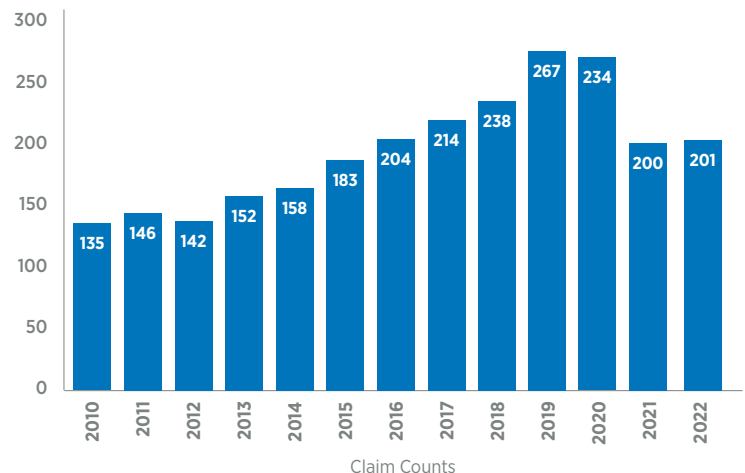
Source: Data collected from [Stanford Securities Clearinghouse](#) and Cornerstone Research. 2022 probability estimated by Gallagher and subject to future revision based on review of stock listings.

M-O cases are down and are less relevant.

D&O claims related to acquisitions have been problematic for decades, dating back to the driving force for some companies purchasing D&O in the 1980s. But the M-O claims that suddenly exploded in the state courts about 10 years ago became a real issue for D&O carriers. Then, post *Trulia*, this substantial claim frequency in the state courts shifted and evolved into a significant portion of the federal court securities claim counts given in Graph 1. Indeed after the *Trulia* dismissal, a Delaware Chancery Court decision in early 2016, many other state courts increased their dismissal rates for M-O claims as well. And the shift to federal courts was pronounced as nearly half the SCAs tabulated for 2017 and 2018 were M-O claims. Not surprisingly, the percentage of M-O claims brought in federal court also trended up, surging from 20% in 2015 to 85% in 2017.

Further, our own review showed that 2020 M-O suits represented only 30% of the federal SCA claim counts — implying a real trend toward fewer federal M-O cases overall, which is exactly what has occurred. In fact, we predicted this trend toward less frequency once the very high dismissal rate was identified. Per the report *Cornerstone Research SCA Filings 2021 Year in Review* (CR Filings 2021 report found [here](#)), “M&A filings continued to have a much higher rate of dismissal (92%) than the core federal filings (48%) over the period 2011 to 2020.” However, we note that not all types of M&A claims are receding, if we consider federal cases with reverse merger objections — meaning SPAC or DeSPAC litigation. In those types of cases, a somewhat related trend has evolved and become significant (and is charted further as part of Graph 5). But next we use Graph 3 to show SCA frequency by year with the M-O claims removed, which are the core filings in the CR Filings 2021 report. Once again, recent improvements are identified.

Graph 3: Core SCA Filings per Year (M-O Excluded)



Source: Data collected from [Stanford Securities Clearinghouse](#) and Cornerstone Research
Note: Includes state filings

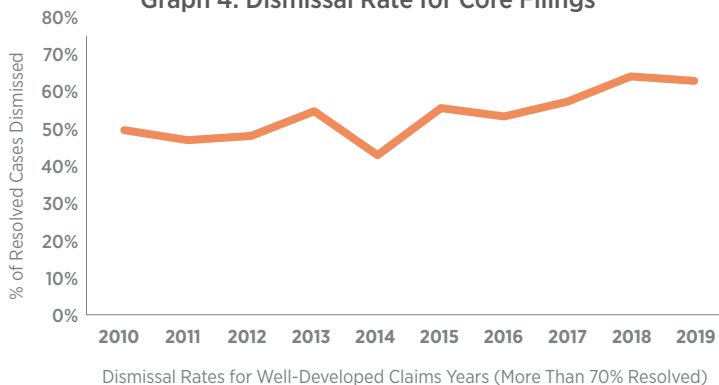
Market Conditions

JANUARY 2023

Dismissal rates for core federal 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, with an average dismissal rate from approximately 1,654 resolved cases over 10 years now at 50.6% (and will be higher if any now-open cases are eventually dismissed). There are reasons that trend may 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 as well as these higher dismissal rates. That said, be aware that many of their cases are very significant and have included some mega-settlements (settlements of more than \$100 million) over the last several years.

Graph 4: Dismissal Rate for Core Filings



Source: [Cornerstone Research Securities Class Action Filings 2021 Year in Review](#) (Figure 17)

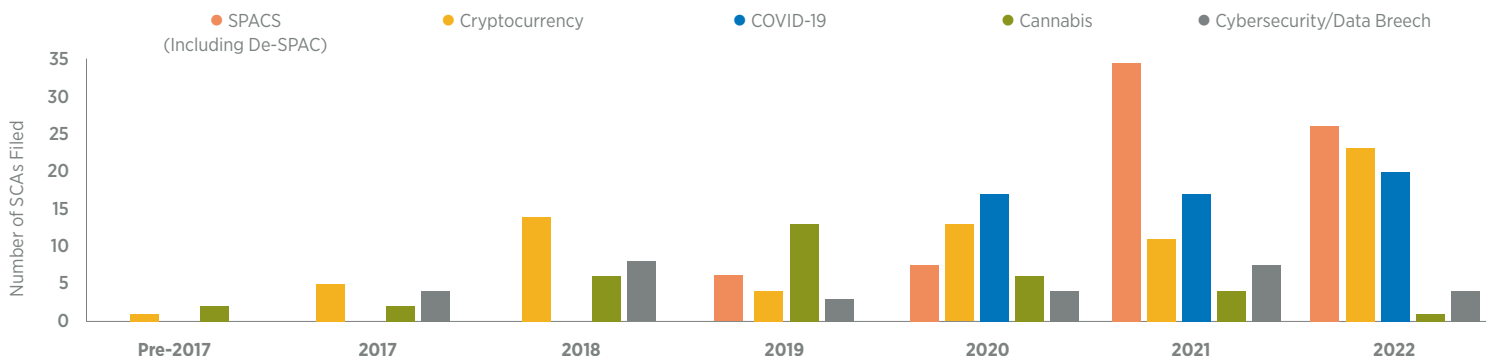
Trending.

The formerly emerging plaintiff attorney firms are now established enough to have permanently changed the landscape for what types of D&O claims are brought and, in many cases, the process for settlement has been altered as well. Such newer D&O plaintiff attorney firms continue to account for 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) per their annual reports on the top 50 plaintiff attorneys in terms of SCA settlements (recent report [here](#)), three newer law firms continue to be especially impactful, namely Rosen, Pomerantz and Glancy. Industry observers have identified a few trends attributed to these newer attorney firms when it comes to their D&O litigation style, including:

- Initiating cases on the basis of an event (operational, product-based, environmental, cyber, workplace-related, safety, preventative measures [fire] and so forth)
- Asking for larger settlements in proportion to the initial damages sought
- Erratic as to when they sincerely engage in settlement discussions — often later yet sometimes earlier in the claims cycle than most other litigation

Also trending are the types of claims being brought, especially over the last three to five years. In Graph 5, we display the year-by-year number of SCAs brought that relate to newer types of claims.

Graph 5: Trending Types of SCAs



Source: Data collected from [Stanford Securities Clearinghouse](#)

Market Conditions

JANUARY 2023

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 25 large (settlements valued at \$50 million or more) derivative settlements from roughly the last 12 years. In fact, the clear majority of the cases noted in Chart 6 come from the last five years. This is consistent with our strategic emphasis on Side A limits in your D&O insurance program, and up-to-date risk modeling and limits analysis in general, as it is more important now than ever.

Chart 6: Sample of Large D&O Derivative Actions*

COMPANY	SETTLEMENT	RESOLVED
Wells Fargo ¹	\$388 million	2020
Alphabet	\$310 million	2020
Renren ²	\$300 million	2022
VAREIT (formerly A.R.C.P.)	\$287 million	2020
Activision Blizzard	\$275 million	2014
Boeing	\$238 million	2021
First Energy	\$180 million	2022
McKesson	\$175 million	2020
AIG	\$150 million	2010
News Corp	\$139 million	2013
Freeport-McMoran	\$138 million	2015
Cardinal Health	\$124 million	2022
Altria Group	\$117 million	2022
NCI Building Systems	\$100 million	2022
Twenty-First Century Fox	\$90 million	2017
PG&E Corp	\$90 million	2017
Wynn Resorts ³	\$90 million	2020
L Brands	\$90 million	2021
Del Monte Foods	\$89 million	2011
Pfizer	\$75 million	2010
HSBC	\$73 million	2020
Bank of America	\$63 million	2012
Community Health	\$60 million	2017
Tesla ⁴	\$60 million	2020
New Senior Investment Gp	\$53 million	2019

*Sample settlements were restricted to those pending or resolved in 2010 or later.

¹Wells Fargo settlement consisted of \$240 million cash, \$80 million injunctive relief and \$68 million fees

²Original Renren settlement rejected by court Dec2021; revised settlement done 9Jun2022.

³Wynn Resorts settlement includes \$41M cash and \$49M corporate governance reforms.

⁴Tesla was originally a partial settlement, but finalized in Aug2022 with no change in cost.

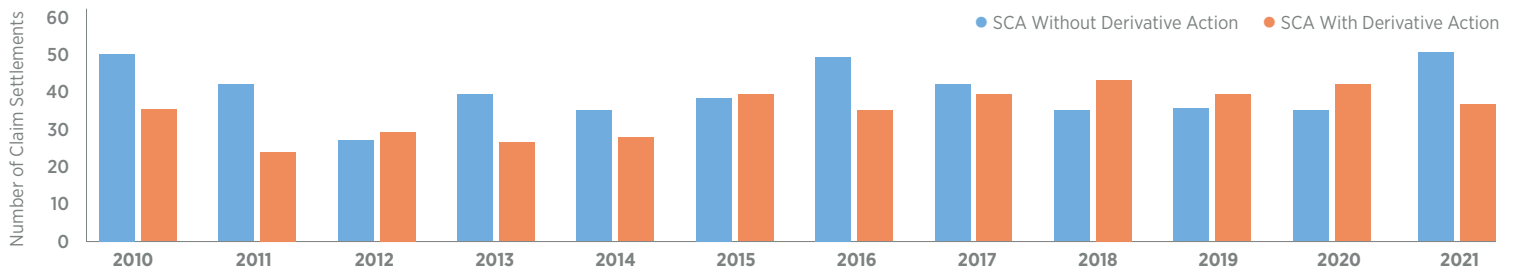
Sources are all public information, including press releases, articles and The D&O Diary.

Market Conditions

JANUARY 2023

We also note that the trend for SCAs to be accompanied by a derivative action is no longer a trend — it is a consistent part of D&O claims as about 50% of SCAs are accompanied by a derivative action as demonstrated by the 12 years displayed in Graph 7.

Graph 7: Trend for SCAs With Derivative Actions



Source: [Cornerstone Research: SCA Settlements — 2021 Review and Analysis, March 24, 2022.](#)

LARGE D&O CLAIMS SETTLED IN 2022

Each year for more than two decades now, we review a sample of the larger settlements that resolved in that year. We often 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 2022. Much of our work is also sourced or confirmed by Institutional Shareholder Services publications (e.g., their January 3, 2023, report found [here](#)), the D&O Diary and original court settlement papers. Note that sometimes claims will cross from one year to another as their agreed settlement finally obtains court approval in a future year. See Chart 8 for large D&O claims from 2022 that settled or are agreed in principle for settlements valued at \$100 million or more.

Chart 8: Sample Mega D&O Settlements — 2022

COMPANY	VALUE	NOTES
Twitter	\$810 million	SCA
Teva Pharmaceutical Industries	\$420 million	SCA
Renren	\$300 million	Derivative
First Energy	\$180 million	Derivative
Luckin Coffee	\$175 million	SCA (IPO, ADS)
Blackberry Limited	\$165 million	SCA
Granite Construction	\$129 million	SCA
Cardinal Health	\$124 million	Derivative
Altria Group	\$117 million	Derivative
Walgreen Co	\$105 million	SCA
Novo Nordisk	\$100 million	SCA (ADR)
Stamps.com	\$100 million	SCA
NCI Building Systems	\$100 million	Derivative

Market Conditions

JANUARY 2023

LOOKING AHEAD AT THE 2023 D&O MARKET

Notably, a year ago in our [January 2022 D&O market conditions paper](#), we correctly predicted the following items that perhaps merit some additional comments at this time as we consider the 2023 marketplace for D&O.

- Market competitiveness as represented by the number of carriers and their actual capacity being deployed regularly will continue to move up, and the newer capacity will gradually become more aggressive. **Carriers have actually been even more aggressive than we expected, and thus premiums have decreased more than expected in many cases.**
- A handful of established carriers (other than the current top three D&O market share leaders) will start quoting primary D&O layers more often in 2022. **We are now seeing many more primary quotes, especially for sought-after risks. This expected shift is definitely here.**
- Frequency of securities claims will return to levels more similar to the 2010 to 2015 time period. Annual SCA claim counts will no longer approach 400 — or even close. **Now resoundingly true, and we think driving the competition and favorable pricing.**
- Dismissal rates are likely to remain high, clearing 45% as a longer term target, as we work through some weaker D&O cases in the mix. **Indeed dismissal rates for SCAs remain high, and we calculate they will actually exceed 50% for the 2010–2019 time period.**
- D&O coverage quality will remain high, though we foresee firm market resistance to further expansion. **This prediction was fulfilled with carriers offering high-quality D&O policies upon negotiation, and now in 2023 a real shift back to coverage discussions and improvements.**

Further, our conclusions about the renewal process in 2022 extends to 2023, namely that the keys to beating the averages are to start early with your D&O renewal, communicate effectively with underwriters and demonstrate that your company's specific risk factors merit more attention at this renewal.

- Be prepared to talk about environmental, social and governance (ESG), as such issues now have greater carrier interest and could present new claims problems for the future.
- Know which carriers favor your business sector. Splashing the entire market with requests for quotes can go very badly, but a focused canvassing of D&O carriers with appetite for your risk has proven to lead to excellent results in 2022 and will work equally well in 2023.
- Don't forget about quality. The quality of your D&O carriers is critically important. The coverage form and the ability and willingness of the carrier to pay claims — and the effectiveness of their claims handling team — should not be overlooked.

Market Conditions

JANUARY 2023

CONCLUSION

As with any good news, some healthy caution is recommended. We believe that despite lower prices, carriers continue to underwrite carefully, with many concerns to evaluate and take into account. Some of the current issues being considered often include:

- Heavier emphasis on ESG issues, as noted in the prior section, especially given the anticipated release of the SEC's final rules for climate disclosure
- A deep dive into cybersecurity measures and cyber insurance as they relate to D&O concerns
- Impact from the pandemic, or any potential threats to ongoing business health or expansion
- Inflation, which ramped up in 2022 and the potential for recession, will impact overall costs negatively
- The remaining backlog of securities claims that could have a higher than average cost

All the above conclusions aside, carriers still emphasize to us that the client's risk profile remains the primary variable dictating renewal outcomes. Therefore, expect that the client's market cap and historical pricing levels, as well as the unique industry, loss experience, location, financial health, communication style and other individual account nuances, will continue to have a substantial impact on D&O renewals.

Finally, one thing evident from the highly nuanced nature of the D&O marketplace is that the value of having an insurance broker who is a true specialist becomes imperative. Many of the conclusions pulled into this paper have been sourced from client experiences using the vast network of Gallagher specialists — coverage and industry specialists who deploy their expertise in planning, preparing and executing difficult negotiations in order to drive better solutions in the face of D&O marketplace challenges.

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Dr. Phil Norton is recognized worldwide for his expertise on D&O, with hundreds of publications and having presented on this topic for over 30 years in seminars ranging from the US to Europe, China, Japan and Bermuda.

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