

# Market Conditions

JANUARY 2020

## The Hard Market for D&O Set to Continue Throughout 2020 As Carrier Concerns Remain

A Review of the Public Company D&amp;O Marketplace

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Our forecast for the state of the D&O marketplace in 2020 is initially “more of the same.” This past year saw consistent price increases across the board from 3% near the beginning of the year to an average of 30% or more toward the end of 2019. The market segments hit much worse than average were life sciences, pharmaceuticals and biotech accounts. Technology in general saw very large increases (especially software companies), as did newer companies, especially those with less than five years since an IPO or similar event, and reverse flow accounts (corporations operating mainly in the U.S. but domiciled outside the U.S.). On the brighter side, financial institutions typically did much better than these averages for the most part because they already had significant premium increases during the financial crisis. REITs were a most favored class of business, thanks in large part to fewer large losses historically.

In last year’s market conditions report, we noted that “we need to prepare for carriers insisting on increases, even if small in order to address the current health of their books.” While our advice was accurate, the small increases in January quickly became substantial increases by June.

Our expectations as signaled by many of the insurance company executives is for large increases throughout all of 2020, but we also dare to say that the second half of the year in 2020 will not be as bad as the second half of 2019. Why? Because a) most carriers will have reduced their loss ratios substantially by then, and b) carriers will give consideration to the fact that the largest increases for 2019 were taken in the second half of that year, and lastly, c) new or renewed capacity may return to the marketplace by then.

In the meantime, here is what the next set of renewals will look like, in order of carrier priority:

1. Capacity on each risk will be reviewed; most cuts in capacity took place in 2019, but a few more are left for 2020. In short, \$15 million layers will be rare and \$5 million layers more commonplace than previously.
2. Retentions will be carefully reviewed and in many cases, new minimums enforced; split retentions with a special deductible for M&A risk will continue to be prevalent with medium-sized companies.
3. Price increases will take effect across the board and remain in the double digits for commercial companies, while financial institutions will largely see moderate single-digit increases.

This report will examine historical data, both to 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.

Themes already noted that will continue in 2020 include:

- Large frequency of securities class actions (SCAs) driven by a newer breed of plaintiff attorneys that are focused on operational and event-based claims.
- A higher proportion of listed companies being sued—yes—but also a recent trend of many more medium-sized companies being sued as the event-driven motivation leads the pack. And their settlement values may be “irrationally” large as some plaintiff firms with less litigation inventory advise their clients to hold out.
- Merger-objection claims will continue to be brought in federal courts and generally increase in costs that are no longer “nominal,” as defense costs and plaintiff attorney costs drive total claim costs toward \$5 million.
- Also as predicted last year, we said that “attention will be given to whether key excess layers have sufficient pricing to support claims activity that is bumping into previously safe layers.” Ultimately this statement became true as respects all layers.

And to close the summary with good news generally ignored, client win rates should remain at historical highs. This means SCAs getting dismissed more than 60% of the time—in fact, based on 2017-2018 resolutions, we calculated 69% dismissal rates for merger-objection suits and about 59% for more typical SCAs unrelated to M&A activity.

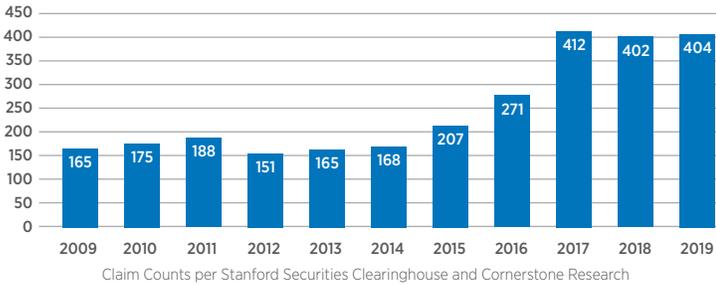
### THE NEW NORMAL FOR FEDERAL SECURITIES CLASS ACTIONS CONTINUES

As noted above, D&O carriers point to adverse frequency trends, such as the federal filings shown in Graph 1, as the single most important driving force in carrier costs. Clearly with more plaintiffs and more claims, some of the good news on dismissal rates is simply being overwhelmed. Combined with the fear of increasing severity and a historically high backlog of unresolved cases, deep concern is given to a world with 400 SCAs per year.

# Market Conditions

JANUARY 2020

**Exhibit 1: Securities Class Action Claim Trends**



## D&O PRICING IS UP FOR ALL COMPANIES

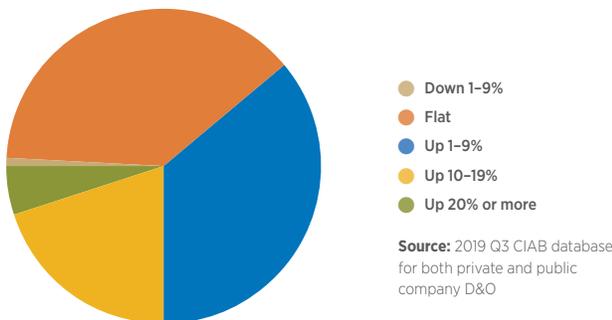
Recent price changes in the D&O world per the Council of Independent Agents and Brokers (CIAB) are noticeable as shown in Graph 2, which tracks the ups and downs of each quarter's worth of D&O renewals. This graph is based on renewals for both private and public companies, and thus shows a weighted average of the two trends. Small and medium-sized private companies are faring quite well in this marketplace, while large private companies often face huge percentage increases due to changes in minimum pricing parameters. The main takeaway from this graph, then, is the shape, which shows an unusually steep upward trend.

**Exhibit 2: Overall D&O Market—Renewal Price Changes**



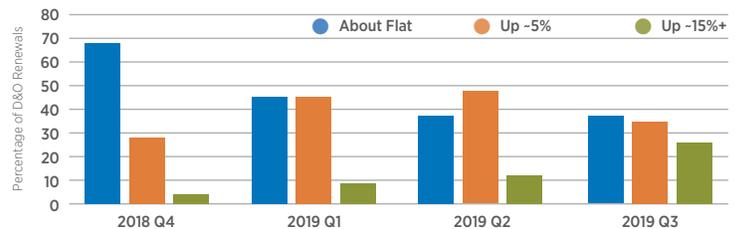
The next graph (Graph 3), also prepared from CIAB survey data, breaks down the nature of the increases. Here we see a clear demonstration of carrier discipline as less than 1% of all renewals had small decreases while -25% saw rather dramatic increases in their D&O premiums.

**Exhibit 3: CIAB Survey—D&O Renewal Pricing**



In Graph 4, we illuminate the quarterly changes to note the progression of the hard market over the last four quarters of CIAB survey data. There, the orange and green bars denoting significant increases go from barely half of the “About Flat” blue bar in 2018 Q4 to easily 50% greater than the blue bar in the 2019 Q3 results.

**Exhibit 4: D&O Market Shift by Quarter—All Companies**



Having reviewed the D&O marketplace performance and expectations, we now turn to a more in-depth look at some of the underlying causes and other top D&O-related issues to consider as year 2020 similar.

## M&A CLAIMS HAVE SHIFTED

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 recently became cemented as a core portion of the federal court securities claim counts given in Graph 1; in fact, by our rough calculations, M-O claims represent about 47% of the SCAs filed in 2017 and 2018. So the impact to overall federal claim counts is significant.

Formerly brought primarily in state courts, the Delaware Chancery Court's Trulia decision (made early in 2016) dramatically affected plaintiff strategy, ultimately pushing M-O claims toward federal courts. Per data from Advisen, the percentage of M-O claims brought in federal court surged from 20% in 2015 pre-Trulia to 85% in 2017 post-Trulia. Most often, these M-O suits result in additional disclosures and plaintiff attorney fees, and maybe a small settlement. Although typical M-O claim costs are far below the average cost of other federal securities claims, their cost has been growing steadily in the past five years, with total costs for those M-O claims settled reaching \$5 million.

Courtesy of a study by Chubb, we have greater insight to the claim cost components of an M-O D&O claim. For example, a typical cost breakdown for an M-O claim with \$5 million of total costs would have \$2 million being paid out to the shareholders, another \$2 million for plaintiff attorney fees and expenses, and then \$1 million in defense costs.

While that may seem appalling given the weakness of some of the litigation brought, the good news is that about two-thirds of these cases are being dismissed, resulting in defense costs only.

# Market Conditions

JANUARY 2020

## NEWER D&O PLAINTIFF ATTORNEY FIRMS ON THE RISE

The newer D&O plaintiff attorney firms continue to be a substantial portion of filings, and further, they were on the majority of cases resolved in 2019 by settlement. This, according to the Institutional Shareholder Services (ISS) report that we cite in building the following chart for the top 5 plaintiff attorney firms by number of D&O (SCA) settlements in 2019.

### Exhibit 5: Top Plaintiff Attorneys (2018)

By number of settlements handled per ISS Report

Firm Name	Value of 2018 Settlements	Number
Pomerantz	\$3,272M	20
Robbins Geller Rudman & Dowd	\$549M	17
Bernstein Litowitz Berger & Grossman	\$1,352M	15
The Rosen Law Firm	\$59M	14
Glancy Prongay & Murray	\$182M	12

Source: ISS Securities Class Action Services "The Top 50 of 2018"

Only Robbins Geller and Bernstein Litowitz have an established history of bringing cases against directors and officers. Thus, almost 60% of the cases settled in Chart 5 were brought by newer (also known as emerging) plaintiff firms.

These newer firms (Pomerantz, Rosen, Glancy and the like) have also proved to be less likely to comply with "historical norms" in the sense that they have been a large part of the chaos caused by:

- 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 a negative press release or stock price drop
- Asking for outsized settlements in proportion to the initial damages sought
- Erratic as to when they may seriously engage in settlement discussions; often later or even earlier than most

As pointed out in my previous D&O market condition reports over the last two years, one thing is for sure: the newer plaintiffs are driving carrier loss costs up significantly through sheer volume as well as some cases with increased severity.

## LARGE DERIVATIVE ACTIONS CONTINUE

Derivative claims continue to be about 10% of all D&O claims as defined by industry experts at Advisen. As such, we have noted about 150 of these type of cases each year for about a decade now. Their continued importance is part of a paradigm shift that indeed started just over a decade ago whereby sharper plaintiff attorneys redirected their focus and began to seek much more money from derivative action settlements. They succeeded in enough cases to get the attention of many more plaintiff attorneys, and so it goes.

Derivative actions are dangerous 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 list of 16 large derivative settlements from roughly the last 10 years. We correctly predicted three large Side A cases to settle in 2019 and are upping our 2020 prediction to about five as we are aware of some serious open claims of this nature.

### Exhibit 6: Large D&O Derivative Actions

Company	Settlement (\$M)	Year
Wells Fargo	388	2019
Activision Blizzard	275	2014
News Corp	139	2013
Freeport-McMoRan	138	2015
Oracle	122	2005
Broadcom Corporation	118	2009
AIG	115	2008
21st Century Fox	90	2018
PG&E Corporation	90	2017
Del Monte Foods	89	2011
Yahoo!	80	2018
Pfizer	75	2010
Akorn	74	2019
Bank of America	63	2012
Community Health	60	2017
New Senior Investment Group	53	2019

# Market Conditions

JANUARY 2020

## LARGE D&O CLAIMS SETTLED IN 2019

Each year we review the larger settlement that resolved. 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 2019. Some claims (for example, Cyan) cross from one year to another as their agreed settlement finally obtains court approval. See the list in Chart 7 for some significant claims.

### Exhibit 7: Sample D&O Settlements—2019

Company	Value	Notes
Wells Fargo*	\$388 million	Derivative
Cobalt International Energy**	\$220 million	SCA; Bankruptcy
Walmart	\$160 million	SCA
Fiat Chrysler Automobiles NV	\$110 million	SCA
Orbital ATK	\$108 million	SCA; Restatement
Endo International PLC	\$83 million	SCA; Opioids
Alibaba Group	\$75 million	SCA; 33 Act §11 (IPO); State Court
SunEdison	\$74 million	SCA; Bankruptcy
Akorn	\$74 million	Derivative; SCA; Merger-Obj
HeartWare	\$55 million	SCA
New Senior Investment Group	\$53 million	Derivative
RH (Restoration Hardware)	\$50 million	SCA
FleetCor Technologies	\$50 million	SCA
BHP	\$50 million	SCA
Puma Biotechnology	\$45 million	SCA; Trial
Stericycle	\$45 million	ADR; SCA; 33 Act §11
VEREIT (American Realty ...)	\$43 million	SCA; Opt-out
RCS Capital	\$31 million	SCA; 33 Act §11
Calamos Asset Management	\$30 million	State Court; SCA; Merger-Obj
Truecar	\$28 million	SCA
Adtalem Global Education	\$28 million	SCA
Flower Food Processing	\$21 million	SCA
Alere	\$20 million	SCA
Chiasma	\$19 million	SCA; 33 Act §11 (IPO)
Investment Technology Group	\$18 million	SCA
Ubiquiti Networks	\$15 million	SCA
Cyan*	\$15 million	SCA; 33 Act §11 (IPO)

\*More details later in this paper

\*\*Unclear whether \$220 million is collectible as stated in settlement docs

## ELABORATION ON 2019 SETTLEMENTS OF INTEREST

While there are several claims from the last year that settled and merit further discussion, we selected a couple to elaborate on here.

### Wells Fargo

Plaintiff alleged that the Defendants, in an effort to inflate and manipulate the market price for Wells Fargo stock and increase their own compensation, sanctioned the corporate policy of promoting and maintaining an aggressive sales culture that resulted in employees creating unauthorized phony deposit and credit card accounts, victimizing clients by unwittingly enrolling them in online banking services, and ordering debit cards for clients, all without the clients' consent or knowledge. Plaintiff further alleged that Defendants imposed unrealistic sales quotas on its employees, and adopted policies that have, predictably, driven its employees to engage in fraudulent behavior to meet those unrealistic goals. Meanwhile, the board ignored the massive unlawful activity. On December 12, 2018, the parties accepted a mediated agreement with a monetary payment of \$240 million to be paid by the insurers to Wells Fargo. The parties agreed that the corporate governance reforms and the clawbacks set forth have a value to Wells Fargo of \$80 million, for a total settlement value to Wells Fargo of \$320 million. However, Plaintiffs' counsel was awarded an additional \$68 million. Hence, the all-in cost was \$388 million.

### Cyan

This was first filed on April 1, 2014, as a class action lawsuit in the Superior Court of California, County of San Francisco, in relation to its IPO priced in mid-2013. Although the court approved a relatively small settlement in 2019, the importance of this case hinges on jurisdictional issues decided in 2018.

Indeed, this seemingly unremarkable IPO D&O claim became a landmark D&O claim as Plaintiffs challenged whether the complaint had to be brought in federal court (versus state court or multiple courts), and ultimately the Supreme Court found that the legislation of PSLRA and more recent SLUSA failed to make it clear that federal courts were required for 1933 Act claims (largely IPOs). This Cyan decision meant defending SCA cases on multiple fronts was a likelihood for IPOs subject to the 1933 Act, and thus hardened the IPO market instantly.

# Market Conditions

JANUARY 2020

## WHERE IS D&O CLAIM SEVERITY GOING NEXT?

Three years ago, we predicted the next move for D&O claim settlement averages was down—and we were right. However, we also realize how we formulated our forecast and thus why there may be valid causes for concern with respect to D&O claim severity regardless.

Our forecast looked at the mix of claims within the SCA bucket, and as a higher proportion of M&A claims came in at a much lower cost than other federal class actions, the overall average cost was bound to drop. Indeed, Chart 8 details data from Cornerstone and NERA that each show significant drops in average D&O claims severity in 2017-18, though measured differently. Cornerstone includes outliers but has a narrower definition of a D&O claim. NERA has a broader definition to start but excludes claims greater than \$1 billion, M-O claims, IPO laddering and all \$0 class settlements—a more consistent approach. We found that roughly the 80th percentile of Cornerstone’s no-outlier, no-small-case removal approach was equivalent to the NERA adjusted average. The initial drop from 2016 to 2017 in typical settlement costs is quite noticeable either way.

But carriers’ cause for concern is more along two other lines of thinking: 1) although average claim costs are clearly down, the sum of the claim costs is likely increasing—as recent frequency is about double historical norms, and 2) per the January 29, 2019, NERA report, 2018 finished with 660 SCA cases pending, and of those, 114 had been brewing for more than five years. Fear of the unknown open claim settling out for a mega-cost seems to be a valid concern.

And another carrier concern is the rising cost of defense. As already noted, the medium-sized companies may be most affected as one defense approach does not fit all sizes. Further, from a plaintiff firm’s perspective, they may test defense counsel unduly if they have limited litigation inventory and thus higher aspirations for each of their cases.

## Exhibit 8: D&O Claim Settlement Costs (Excluding Defense Costs)

Year	Cornerstone’s Average Costs in \$M”	Cornerstone’s 75th %-ile	Cornerstone’s 90th %-ile	Inflation-Adjusted NERA Average	Cornerstone’s “High” %-ile
2008	32.4	21.6	57.4	37	33.5
2009	42.9	22.9	75.9	49	40.5
2010	40.1	28.1	89.5	47	48.5
2011	22.8	19.6	45.5	35	28.2
2012	65.4	37.9	122.8	40	66.2
2013	76.1	23.3	86.8	59	44.4
2014	18.9	13.6	51.8	37	26.3
2015	40.7	16.8	97.2	56	43.6
2016	72.0	33.7	149.1	46	72.1
2017	18.7	16.0	36.0	26	22.7
2018	64.9	25.0	60.0	30	36.7

The NERA averages exclude settlements >\$1B, M-O cases, \$0 class settlements, IPO laddering

The “High” percentile column is the weighted average of the Cornerstone values at the 75th and 90th percentiles

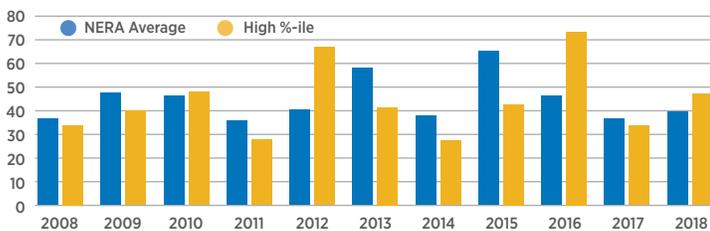
The “High” percentile column represents about the 80th percentile, which approximates the NERA average percentile

# Market Conditions

JANUARY 2020

To compare the results of the NERA adjusted claim settlement cost versus our “High” percentile (~80th percentile) from the unadjusted Cornerstone Research results, we produced Graph 9. There it is easy to see that the last two years are favorable departures from historical D&O settlement costs; further, it gives you the sense that \$40 million is probably a good selection of typical claim settlement averages over a longer period.

**Graph 9: Securities Claims Cost Trends (\$M)**

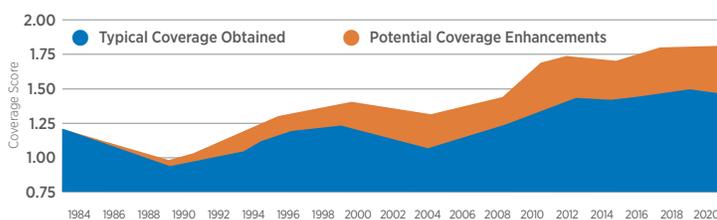


## D&O COVERAGE QUALITY

The quality of D&O coverage remains excellent, with a history of huge coverage innovations since 2010. Coverage expansion appears to have stopped for the most part in 2019, and some “enhancements” may not be as automatic as they were 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 2020 despite efforts by some carriers to restrict coverage. Derivative demand investigation limits are already under scrutiny as we head into 2020, but clients clearly want and appreciate that coverage expansion, so expectations are for it to remain in some fashion.

Graph 10 shows a history of D&O coverage quality using proprietary metrics. Developed initially for Risk Management magazine in 1996, the Norton-Bastian index measures the average quality/value of the D&O policy from the leading D&O carriers by reviewing numerous policy provisions and grading them. It then compares off-the-shelf policies to fully endorsed ones. Thus, the orange portion of the graph represents coverage gaps that can be closed by negotiation.

**Graph 10: Norton-Bastian D&O Policy Coverage Quality Index**



As an example, the short list of coverage enhancements below is composed of older ones that we would expect to be employed for your D&O policy barring an unusually negative view of your risk by carriers. Indeed, every client risk profile is unique, as is each carrier’s attitude toward such coverage enhancements, so obtaining these or similar improvements is not a certainty. However, this gives you an idea of some of the items making up the orange portion of Graph 10.

- Coverage for plaintiff attorney fees
- Nominal defendant coverage for securities claims
- Event study coverage
- M&A coverage for alleged aiding and abetting
- Notice given and accepted
- Books and records demand coverage
- Coverage sub-limits for derivative demand investigations
- Claim definition to include cover for subpoenas
- Exclusion preamble to apply only to that portion of loss
- Improved post-policy claims reporting language

## CONCLUDING THOUGHTS

There are a few important takeaways from our forecast of 2020 D&O market conditions. They include:

- Record numbers of class actions will be the new normal with 400 SCAs per year now expected, and carriers will feel pressure to underwrite carefully.
- A big portion of the SCAs will be M-O cases brought in federal court, and M&A activity could drive that number up or down.
- Pricing levels will increase throughout 2020, perhaps less intensely toward the end of the year. Increases will be in all layers, but likely higher percentages in high-excess ABC and lower percentages possible for excess Side A.
- Publicly traded clients will be differentiated by financial condition, claim history, industry, size, historical premiums and carrier relationships. Any one of these can create substantial upward (or downward) pressure.
- Market competitiveness, as represented by the number of carriers and their actual capacity being deployed regularly, will continue to move backward in most sectors. And newer capacity will play very cautiously.

# Market Conditions

JANUARY 2020

- Medium-severity claims brought by emerging plaintiff attorney firms will continue to grow, and associated defense costs may seem unduly high versus historical levels.
- We expect to see more event-based claims, including triggers from missed earnings, product-based issues and operations-oriented situations, as well as more claims generated from cyber breaches and sexual harassment or discrimination. The emerging plaintiff firms are the likely champions of such claims. These types of cases may be harder to prove, but the waters are beyond being tested—the flood is on.
- 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 market resistance to further expansion.
- 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.
- Lastly, it is worth mentioning that many of the trends identified in this market report continue to run parallel to those in 2001, including the stock market leading up to that period, the D&O claims backlog, the recent history of continued declines in premium and record frequency in securities class actions—all suggesting 2019 results were predictable.

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