

Market Conditions

JANUARY 2019

Harder Market for D&O Arrives as Most Trends Support Concerns

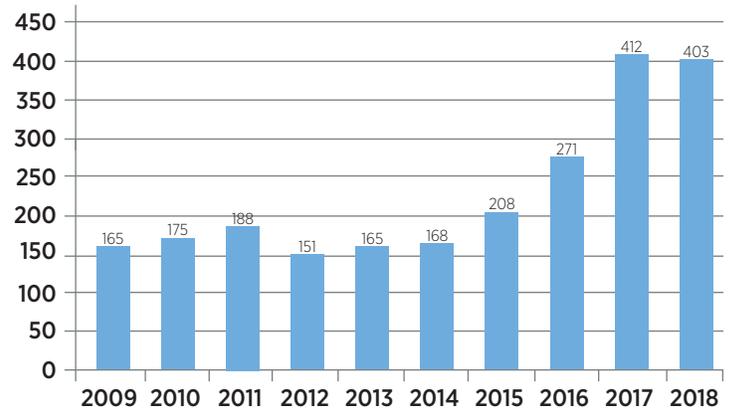
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As we look to forecast the state of the D&O marketplace in 2019, there is plenty of data to review and much of it is noteworthy. If 2017 was a year in flux, then 2018 began to turn the corner into a market with dramatically more underwriting discipline and backbone than anything in the previous 10 years outside of the financial and homebuilding sectors during the most recent financial crisis.

Our view of 2019 includes the following thoughts: 1) a new breed of plaintiff attorneys are focused on operational and event-based claims, which will continue to rise toward an importance last felt in the 1990s; 2) the newer D&O claim activity will include more claims against medium-sized public companies, cases dismissed more often, higher relative settlements when cases are not dismissed, and higher defense costs connected to the smaller settlements; 3) merger-objection claims will continue to be brought in federal courts with increasingly higher costs. Carriers will respond with demands for higher premiums in order to address the current health of their books, and we must be prepared.

THE “NEW NORMAL” FOR FEDERAL SECURITIES CLASS ACTIONS

In reaction to these factors noted above, we see carriers pointing to adverse trends such as the federal filings shown in Graph 1, and pushing premium increase across the board. And for the first time since 2003, some attention will be given to whether key excess layers have sufficient pricing to support claims activity that is bumping into previously safe layers. Newer D&O market entrants from 3 to 5 years ago are no longer intent on disrupting long-term relationships, but rather looking to hold onto gains they may have made and proceed more cautiously, or even conserve capacity in some cases. In other words, the D&O marketplace in 2019 will be looking for profitability instead of market share.

Graph 1: Securities Class Action Claim Trends


D&O PRICING IS ALREADY INCHING UP

Price changes so far in the D&O world per the Council of Independent Agents and Brokers (CIAB) are minimal but noticeable as shown in Graph 2, which tracks the ups and downs of each quarter’s worth of D&O renewals.

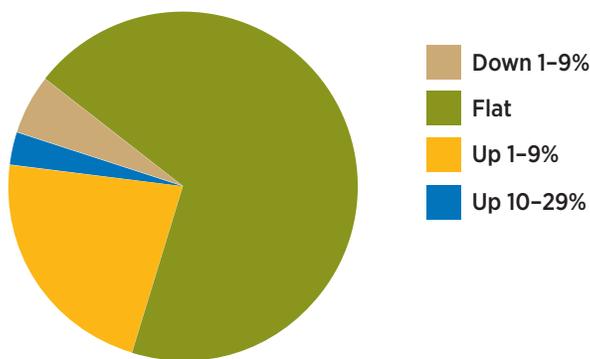
Graph 2: D&O Market—Renewal Price Movements


Market Conditions

JANUARY 2019

Although small, prices are clearly going up on average for each of the 2018 time periods measured. That said, the leading carriers are trying to break out from a concentration of flat renewals that have been quite typical over the last two years, including in the last quarter of data from CIAB (Q3 2018) as shown in Graph 3. We sense a much bigger shift underway already in Q4 2018 and continuing throughout 2019. This means current increases in the 3–5% range on the majority of publicly traded companies evolving to standard requests of 10% increases on primary D&O with similar expectations from carriers on first excess layers.

Graph 3: CIAB Survey—D&O Renewal Pricing



In Graph 3, we see the yellow segment of single digit increases, which has been expanding throughout 2018, as noted above. In 2019, we expect flat renewals will be particularly less likely for publicly traded companies. In our December 2017 market outlook, we said “Don’t be surprised if some primary carriers target increases toward 10% if their claims experience continues to develop poorly.” Based on Q4 2018 renewals, it looks like our forecast was spot on. Expect that tension between carrier targets and client desires for their renewal results to be prevalent throughout 2019.

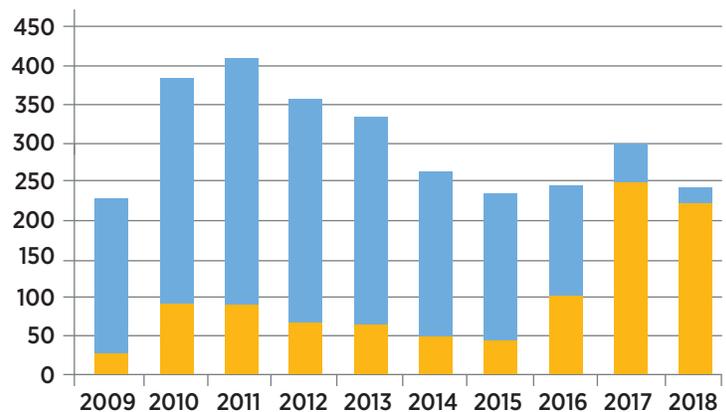
In no particular order, we next run through additional top issues in the D&O market to consider as 2019 incepts.

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 have not gone away and now represent a core portion of the federal court securities claim counts given in Graph 1; in fact, the M-O claims represented 48% of the 412 claims shown for 2017. Formerly brought

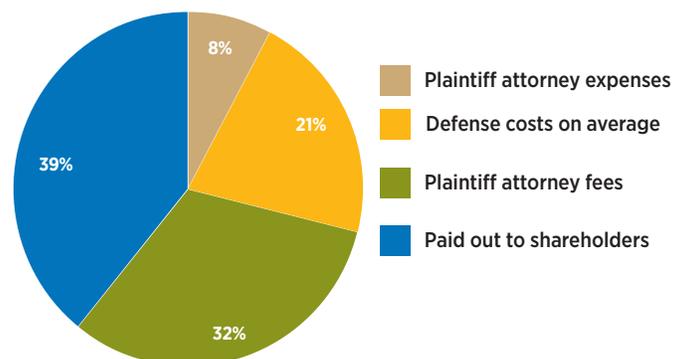
primarily in state courts, the Delaware Chancery Court *Trulia* decision (decided early in 2016) dramatically impacted plaintiff strategy, ultimately pushing M-O claims toward federal courts. See Graph 4 to track the shift in where M-O claims are brought (source: Advisen, with 2018 estimated). Most often, these M-O suits result in additional disclosures and plaintiff attorney fees, and maybe a small settlement. While typical M-O claim costs are far below the average cost of other federal securities claims, their cost has been growing.

Graph 4: Federal v State Merger-Objection Claims



Courtesy of a study by Chubb, we have greater insight into the claim cost components of an M-O D&O claim. See Graph 5 for approximate details. The good news is that many such claims are still dismissed, resulting in defense costs only.

Graph 5: Breaking out Merger-Objection Settlement Costs



Market Conditions

JANUARY 2019

LARGE DERIVATIVE ACTIONS CONTINUE

Derivative claims continue to be about 10% of all D&O claims per Advisen data and we noted about 150 of these cases in 2018. Their continued importance is part of a paradigm shift of about a decade ago whereby sharper plaintiff attorneys have sought more money from derivative action settlements and succeeded in a handful of cases. Derivative actions are dangerous because typically shareholders are suing on behalf of the company and asking individuals to use their own money to effectively “repay” the company for alleged losses. Chart 6 shows our top 12 for large derivative settlements. We expect two or three such large cases to settle each year going forward.

Chart 6: Large D&O Derivative Actions

Year	Settlement (\$M)	Company
2014	275	Activision Blizzard
2013	139	News Corp
2015	138	Freeport-McMoran
2005	122	Oracle
2009	118	Broadcom Corp
2008	115	AIG
2017	90	Twenty-First Century Fox
2017	90	PG&E Corp
2011	89	Del Monte Foods
2010	75	Pfizer
2012	63	Bank of America
2017	60	Community Health

LARGE D&O CLAIMS SETTLED IN 2018

The Gallagher-Advisen joint venture on cataloging D&O claims from 15 years ago was the seedling that has evolved into a forest of Advisen’s own database—the largest of its kind. We ran through this database filtering for D&O claims that were securities actions settled in 2018 (using resolutions of proposed settlement, tentative settlement and final settlement). One claim (JCPenney) was also on our 2017 list as the settlement was not finalized in the year it was first agreed to. See the list on Chart 7 for our top 12.

Chart 7: Large D&O Settlements—2018

Company	Value	Type
Petrobras	\$2.95 billion	SCA
Wells Fargo	\$480 million	SCA
Wilmington Trust	\$200 million	SCA
Pershing Square Capital	\$194 million	SCA
Lending Club	\$125 million	SCA
CBRE Group	\$100 million	SCA
JCPenney	\$97.5 million	SCA
Valeant Pharmaceuticals	\$96 million	SCA
Starz	\$92.5 million	SCA
Twenty-First Century Fox	\$90 million	Derivative
VEREIT Inc	\$85 million	SCA
Yahoo! Inc	\$80 million	SCA

In reviewing 2018 and thinking about 2019, we would like to highlight two of these D&O claim settlements as part of trends that merit our attention going forward. Twenty-First Century Fox was brought as alleged mismanagement of what pundits deemed workplace sexual harassment issues. Yahoo! was related to a [Cyber] data breach incident. Both of these situations are not alone as we examine claim trends, including many claims not yet settled.

Market Conditions

JANUARY 2019

D&O CLAIMS DRIVEN BY DATA BREACHES

In Chart 8, we throw down 12 notable D&O claims from the last 4 years where the D&O claim was triggered by a Data Breach. The amount of the Yahoo! settlement makes us wonder about future outcomes.

Chart 8: Significant D&O Claims from Breach Events

Company	Filing Date	Status
Intel	February 1 2018	Pending
Advanced Micro Devices	January 15 2018	Pending
Qudian Inc	December 12 2017	Pending
Paypal	December 6 2017	Pending
Equifax	September 11 2017	Pending
Uber	August 2017	Settled, Sept. 2018—\$148 million
Yahoo!	January 24 2017	Settled, March 2018—\$80 million
Wendy's	December 6 2016	Settled, 2018 for \$3.4 million, plus remedial action, \$950,000 in Plaintiff's fees
MobileIron	August 5 2015	Settled, \$7.5 million
Home Depot	August 2015	Dismissed, but settled for nominal amount
Wyndham	May 6 2014	Dismissed
Target	February 3 2014	Dismissed

D&O CLAIMS DRIVEN BY WORKPLACE MISMANAGEMENT

In many of the most recent headline cases, we note sexual harassment as the leading category of workplace mismanagement, or the board acceptance of workplace misconduct. We also see a large increase in discrimination cases as well. Certainly, the trend for more women to speak up about inappropriate situations and put a stop to often outrageous behavior has led to more D&O claims regarding corporate management's inability to control, prevent or stop such workplace issues. One of the first notable employment practices liability claims that led to a D&O claim was the Texaco race discrimination case that

resulted in a \$176M settlement late in 1996. In the bulleted list below, we simply list recent D&O claims from 2017/2018 that were precipitated by sexual harassment issues. Almost all (except for the first one already discussed above) have cases pending, not resolved.

- Twenty-First Century Fox
- National Beverage Corporation
- Papa John's International
- Nike
- Barnes & Noble
- CBS
- Signet Jewelers
- Liberty Tax
- Wynn Resorts

EVENT-BASED D&O CLAIMS

A recent trend of significance is what some view as a return to event-based D&O claims that jump on negative press releases about anything from cost overruns to tax issues to fires. The latter seems especially relevant lately. Consider the following two D&O claims and the events triggering the claims listed below.

- **Arconic** – Directors and Officers of this manufacturer of cladding panels used to refurbish the Grenfell Tower in London were sued subsequent to a fire, saying investors were misled about the company's products.
- **Anadarko** – a fire at an oil tank battery on May 26, 2017 led to the shutdown of ~3,000 vertical wells. Discussion of reactivating the wells was not prevalent until at least two months later.

With people killed in both instances, liability suits are not unexpected but D&O suits are historically unlikely—not so this time. We attribute the change to the newer mix of plaintiff attorneys testing D&O liability theories, and expecting to be paid for their efforts as well.

One noteworthy event-based D&O claim that settled recently would be the \$90M PG&E Corp derivative action claim cited on Chart 6.

WHERE IS D&O CLAIM SEVERITY GOING?

Over a year ago, we predicted the next move for D&O claim settlement averages was down—and we were right—at least temporarily. While this may help carriers going forward, they have an unusually large number of open claims and they have a lot of value attached to them. Cornerstone's Midyear 2018 report suggests a return to more costly D&O claims as its Disclosure Dollar Loss

Market Conditions

JANUARY 2019

Chart 9: D&O Claim Settlement Costs (in \$M excluding defense costs)

Year	Cornerstone Average	Cornerstone 75th Percentile	Cornerstone 90th Percentile	Inflation Adjusted NERA Average	Cornerstone "High" Percentile
2008	32.4	21.6	57.4	36	39.5
2009	42.9	22.9	75.9	48	49.4
2010	40.1	28.1	89.5	45	58.8
2011	22.8	19.6	45.5	34	32.6
2012	65.4	37.9	122.8	39	80.4
2013	76.1	23.3	86.8	57	55.1
2014	18.9	13.6	51.8	36	32.7
2015	40.7	16.8	97.2	54	57.0
2016	72.0	33.7	149.1	44	91.4
2017	18.2	15.0	34.5	25	24.8

The NERA Averages exclude settlements >\$1B, M-O cases, \$0 class settlements, IPO Laddering.

The "High" Percentile column is the average of the Cornerstone values at the 75th and 90th percentiles

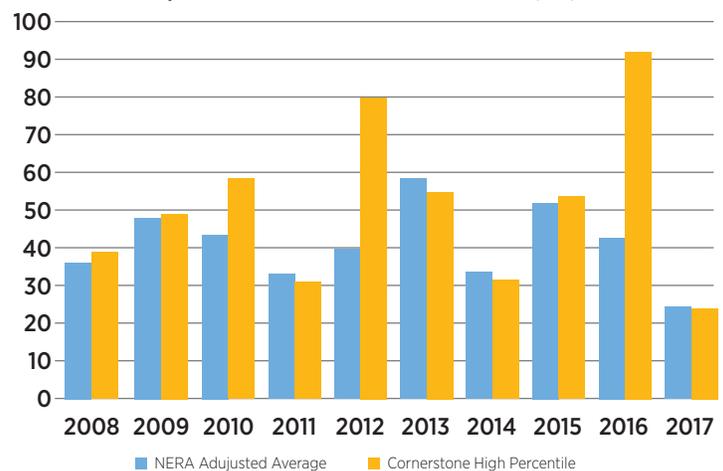
(DDL) Index "skyrocketed" in the first half of 2018. Their DDL index aggregates market cap drops for all companies within the time period measured having securities class actions brought against them.

Another carrier concern is the rising cost of defense. This begs a solution as one defense approach does not fit all sizes. The emerging plaintiffs' bar for D&O claims is apparently wreaking havoc on some medium-sized cases as companies defend against plaintiff attorneys with limited inventory and high aspirations.

From a completely factual point of view, we do note the substantial drop in D&O claim severity in 2017 per industry observers Cornerstone or NERA. Chart 9 shows huge drops in average D&O claims severity, though measured differently. Cornerstone includes outliers though has a narrower definition of a D&O claim. NERA has a broader definition to start but excludes claims >\$1B, M-O claims, IPO laddering and all \$0 class settlements—a more consistent approach.

To compare the two methods, we examined the 75th and 90th percentiles from Cornerstone Research, which effectively eliminate the impact of outliers both large and small. Therefore, we found an appropriate comparison between the NERA averages and the average between Cornerstone's 75th and 90th percentiles and we display that

in Graph 10. There it is easy to see that 2017 is a real and favorable departure from historical D&O settlement costs; while 2017 results may be an aberration due to large cases pending and settlement timing slowing down in 2017, we wonder whether similar results are possible for 2018 once tabulated.

Graph 10: Securities Claims Cost Trends (\$M)


Market Conditions

JANUARY 2019

D&O COVERAGE QUALITY

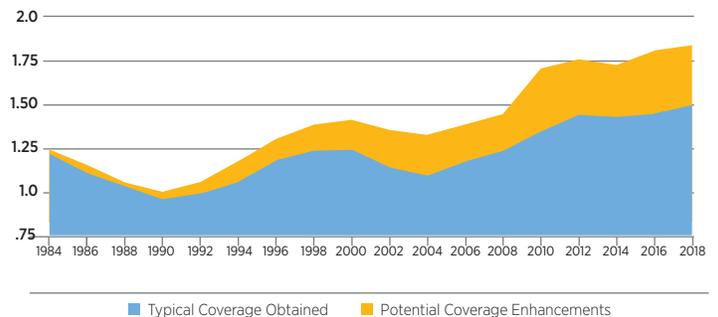
The quality of D&O coverage remains excellent, with a history of huge coverage innovations since 2010 and we expect coverage to remain strong in 2019 despite some limited efforts by some carriers to restrict coverage going forward. Beyond language improvements with fewer exclusions and watered-down exclusions (e.g., Entity v Insured, Pollution, Conduct), there have been other positive developments including stacking of derivative demand investigation limits, books and records demand coverage and some positive clarifications regarding M&A-related claims handling and plaintiff attorney fees.

Graph 11 shows a history of D&O coverage quality illustrating our commentary above using unique metrics. Developed initially for *Risk Management* magazine in 1996, the Norton-Bastian index measures the average value of the D&O policy from the leading D&O carriers and compares “off-the-shelf” policies to fully endorsed ones. Thus, the yellow portion of the graph represents coverage gaps that can be closed by negotiation.

As an example, here is a list of 14 negotiable items that have become popular, especially over the last five years. The most recent increase in the index is driven from improved sublimits and excess form flexibility as well as from several nominal, though positive, changes in the primary policy language. 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.

- Coverage for Plaintiff Attorney Fees
- Nominal Defendant coverage for Securities Claims
- Event Study coverage
- Only one exclusion applies to Side-A (conduct)
- M&A Coverage for alleged aiding and abetting
- Notice given and accepted
- Books and Records demand coverage
- Greater sublimits on Derivative Demand Investigations
- Claim definition to include cover for subpoenas
- Asset protection from enforcement units
- Notice of circumstances applies to potential versus alleged wrongful acts
- Include cover for controlled partnership entities
- Exclusion preamble to apply only to that portion of loss
- Improve post-policy claims reporting language

Graph 11: Norton-Bastian D&O Policy Coverage Quality Index



CONCLUDING THOUGHTS

There are a few important takeaways from our forecast of 2019 D&O Market Conditions. They include:

- The trend for significant numbers of federal M&A claims and non-U.S. securities actions will continue; record numbers of class actions will be the new normal and carriers will feel pressure to underwrite carefully. Some may view these newer M&A claims as today’s replacement for the hostile takeover claims of the 1980s.
- Pricing levels will increase on average throughout the year, with the most pressure on primary and first excess layers. Publicly traded clients will be differentiated by financial condition, claim history, industry, size, historical premiums and carrier relationships. While the primary carriers may request increases most often in the 5% to 15% range, certain U.S. market segments (e.g., tech/life sciences) and foreign headquartered business with ADRs may see more dramatic increases.
- Excess D&O layers will play less of a mitigating role for price increases in 2019, as competitive forces show mild reductions, especially in the layers attaching less than \$30M. All excess layers will be scrutinizing their price per \$ million metrics and less likely to help offset increases in lower layers during 2019 renewals.
- Market competitiveness as represented by the number of carriers writing D&O (capacity) will move backwards in some sectors for the first time since 2001–2003. Even newer capacity becomes cautious.
- Medium-severity claims brought by emerging plaintiff attorney firms will continue to grow and associated defense costs may seem unduly high versus historic levels.

Market Conditions

JANUARY 2019

- 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 clearly being tested.
- Dismissal rates should remain very high, hopefully exceeding 50% as a whole, as we continue to see a substantial number of “weaker” D&O cases in the mix.
- D&O Coverage quality will remain very 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.
- Finally, it is worth mentioning that many of the trends identified in this market report run parallel to those in 2001, prior to September of that year. For example, compare the stock market leading up to that time period, the D&O claims backlog, the recent history of continued declines in premium and record frequency in securities class actions—all suggesting a harder market reaction by carriers is coming fast unless something changes.

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