

January 2020

Client Alert: London D&O Market Conditions

The London D&O market experienced significant dislocation in 2019, with many leading D&O insurers seeking to reduce capacity, increase retentions, and re-set pricing levels for many D&O insureds. The causes for this are varied, and the root of this environment may stem from macroeconomic conditions arising several years ago, along with a different historical underwriting approach by many London D&O insurers. Further, emerging loss trends have created a particularly challenging market for entities traded on United States exchanges, but domiciled elsewhere (“Foreign-Domiciled Entities,” or “FDEs”).

This Alert will examine some of the underlying factors, as well as provide recommendations as clients prepare for 2020 renewals in the London D&O market.

Underlying Reasons for the London D&O Market Conditions

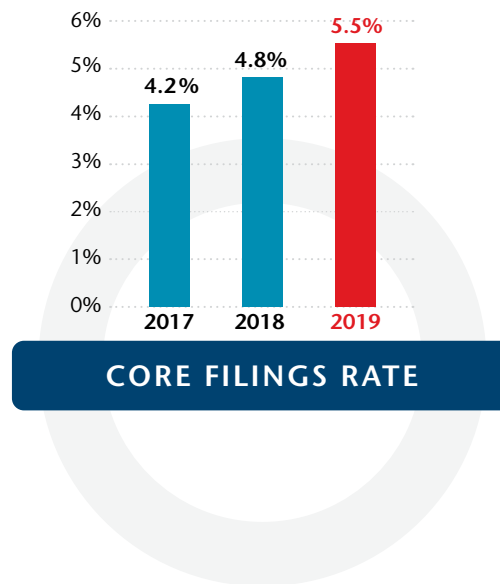
U.S. Claims Environment

Exposures from U.S. securities class actions have increased in recent years. In 2019, Securities Class Actions (“SCAs”) continued at near-record levels, with 428 new SCA filings across federal and state courts in 2019. The 428 SCA filings are nearly double the 2005 – 2019 annual average number of 215. Even excluding merger objection suits from the 428 SCA filings, 5.5% of public companies in the U.S. were subject to a traditional securities suit in 2019. This “core litigation rate” is the highest it has ever been, exceeding even the elevated levels experienced in 2017 (4.2%) and in 2018 (4.8%).¹

Additionally, FDEs seemed to comprise an overly-large number of the U.S. D&O suits. According to AIG²:

Companies based outside the U.S. have continued to attract interest from the plaintiffs’ bar in Q3 2019. The vivacity of these plaintiff targets seems to show no sign of abating any time soon. There were 15 class actions against foreign filers in the quarter, out of a total of 112. Further analysis reveals that 13 of these were core filings, out of a total of 60 core filings in the quarter. This results in a rate of class actions against foreign filers of 21.7% of total core filings -

U.S. Exchange-Listed Firms¹



notable considering that foreign filers make up only 17% of all U.S. listed companies. This figure is down marginally from the 23% in the first half of 2019, but still is an over-proportional representation amongst the total core filings we would expect for the number of foreign filers.

As a side note, it should be noted that demand for London D&O capacity from U.S.-listed companies is believed to have grown over the past decade.

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¹ Securities Class Action Filings, 2019 Year in Review. Cornerstone Research.

² U.S. Securities Class Actions, International U.S.-Listed Companies, Q3 2019. AIG.

January 2020

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According to Public Broadcasting Service, “Since the 1980s, more than 50 American companies have [completed inversions]... with 25 such deals in the past five years [prior to 2017] alone.”³ Bloomberg identifies 85 tax inversions completed by U.S. companies to other jurisdictions.⁴ The impact to the London D&O market is that the vast majority of these FDEs placed the majority of their D&O insurance in the London market (largely for regulatory and tax compliance reasons). This shift of D&O

demand to the London market created a greater exposure of the London D&O market to FDEs, as typically, many of these new-to-London D&O insureds formerly had purchased in the U.S. D&O market. Settlements paid to FDEs related to U.S. SCAs in recent years is believed to be billions of dollars (including the \$2.95 billion Petrobras settlement). While these losses were not paid exclusively by London D&O insurers, much of the burden for these losses likely fell in the London D&O market.

Australia Claims Environment⁵

ISS Securities Class Action Services (“ISS”) issued a report in October 2018, indicating that securities class action litigation grew “markedly” in the ten years prior to the report. Further, ISS indicated that, outside of North America, Australia “is the jurisdiction in which a corporation is most likely to find itself defending against a class action.” The settlement recoveries have been quite substantial,

exceeding over \$1 billion. As settlements and loss payments grew in the Australia D&O market, Australia D&O rates increased. It is believed that this led to some Australian D&O placements transitioning to the London D&O market following firming conditions in the Australian D&O market. Therefore, it is expected the Australian claims environment also is impacting London D&O insurer results.

High Profile Corporate Scandals

Numerous corporate scandals against international companies have led to massive claims against these companies, often impacting the London D&O market. One example is Petrobras, which agreed to pay \$2.95 billion to settle a U.S. SCA related to

corruption allegations. It is believed to be the largest such payout in the United States by a foreign entity.⁶ This lawsuit was just one example of many stemming from various corporate scandals in Brazil and Latin America, which include companies in the construction and meatpacking industries.

Increased Regulatory Investigations⁷

Regulatory scrutiny is driving not only increased D&O claims frequency in the UK, but also rising settlement costs. According to Chubb, the average costs for large losses has tripled, and the number of claims has increased by a third in the most recent decade. Further, “The SFO (Serious Fraud Office) is increasingly using

deferred prosecution agreements...the focus on co-operation heightens the risk of subsequent individual prosecutions for associated Directors and Officers.” SFO inquiries can lead to criminal investigations, resulting in significant investigative and defense costs, as well as potential involvement of hundreds of individuals at the target company.

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³ Corporations go overseas to avoid U.S. taxes. <https://www.pbs.org/newshour/show/corporations-go-overseas-avoid-u-s-taxes> Accessed 15 January 2020.

⁴ Tax Inversion Tracker. <https://www.bloomberg.com/graphics/tax-inversion-tracker/>. Accessed 24 January 2020.

⁵ Navigating the Australian Securities Class Action Landscape. ISS Securities Class Action Services. 23 October 2018.

⁶ Petrobras to pay \$2.95 billion to settle U.S. corruption lawsuit. www.reuters.com. Accessed 23 January 2019.

⁷ Directors and officers claims are increasing both in cost and severity. Chubb. January 2019.

January 2020

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Historical Perspective – Underwriting Approach

For many years, London D&O insurers applied different pricing methodologies for FDEs. The factors contributing to this are understandable; often the London underwriters were responsible for many classes of business emanating from various geographies in addition to U.S.-listed companies, including Australia, Europe, Middle East & Asia, and the United Kingdom. The litigiousness of these countries (at least historically) was generally much lower than

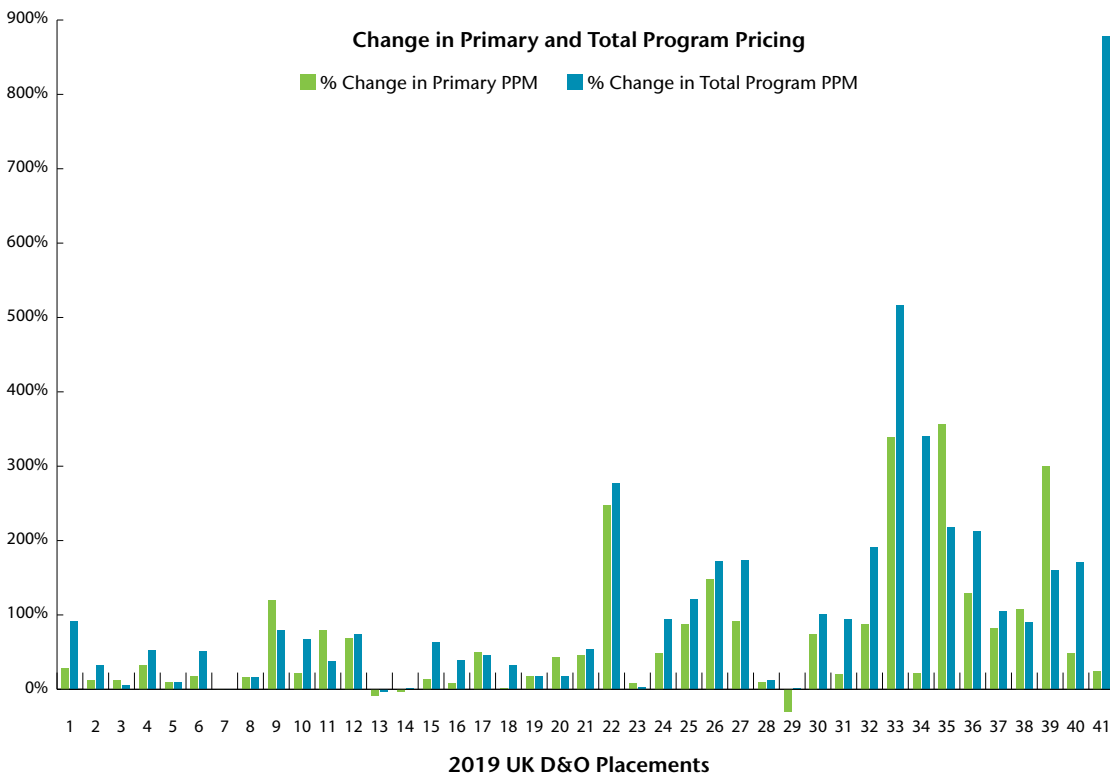
the U.S., thereby leading to fewer D&O claims, thereby leading to lower D&O incurred loss, thereby leading to lower sustainable pricing levels. While historically there was some differentiation in the London D&O market between U.S.-based risk and all others, it often was possible to achieve lower D&O pricing in the London market vs. the U.S. market for the same risk, as London underwriters imputed loss trends from their overall book to the U.S. portion of it.

The Reaction

The reaction from London D&O insurers has been significant. Many insurers have sought to reduce capacity, thereby limiting exposure to any one claim. Many insurers have sought to increase

retention levels, thereby reducing exposure to smaller claims. And finally, nearly all London D&O insurers have sought to increase premium rates, as evidence by Aon's data (as of January 2020).

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Source: Aon Data

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Conclusion

It is apparent that London D&O insurers believe a re-set in D&O terms is necessary in order to address loss trends within their D&O books, particularly for U.S.-listed companies. Reviewing publicly-available claims trend data, it is natural to infer that loss trends have increased. Further, if historical London D&O pricing was starting from an insufficient level, the necessary re-set is significant. 2019 was a challenging transition year in the London D&O market, and the trend is expected to continue in 2020. Clients can prepare for this reality by taking the following steps:

- Recognize the renewal environment will be extremely challenging and communicate this to internal stakeholders accordingly. Possible outcomes include reductions in available at capacity at renewal. Identify priorities at renewal (i.e., maintain current levels of limits, particularly A/B/C limits, or minimize pricing?).
- Meet with underwriters with decision-making authority in the London market. Relationships matter in the U.S. and are arguably even more important in the London insurance market.
- Identify alternative approaches and program structures. For example, the Bermuda market could be a potential solution for excess capacity and alternative program structures may help ease the renewal process.

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