Commentary: The Rainy Season Arrives as D&O Market Begins to Tighten

By Peter Taffae

Hopefully D&O policyholders have been putting some premium away for a rainy day, because it has started to drizzle and thunderstorms are just around the corner. The end of the soft market is in sight.

The last "hard" market occurred 15 years ago. It was quick and decisive, lasting approximately 18 months. Insureds experienced higher premiums (increases of up to 1000 percent were not unusual), increased corporate retentions (some Fortune 100 companies took $5 million), reduced limits ($10 million from one underwriter was a lot), and new restrictive contracts.

Although some might say the hard market lasted 15 years because today's pricing is still above 1984 premiums, I do not agree. Policies have never been as broad, with the exception of the Insured vs. Insured Exclusion and Presumption Indemnification Clause (both of which, I believe, were always the intent of the D&O policy). With premiums around the 1984 pricing range and policies much broader in coverage, we are in a soft market.

Depending on the insured, premiums have started to increase and underwriters are taking passes on certain business. From an underwriter's prospective, premiums need to increase due to a number of negative actions that have impacted their profitability.

There are many similarities today with the events leading up to the hard market of the mid-'80s. In the mid-'80s, we had just finished a boom time and a new record for IPOs.

This past year saw a record number of IPOs, half of which were Internet companies. There will be a large number of dot-com companies that will not survive. A remarkable 73 percent had no earnings. Remember, when all else fails, the D&O policy is looked at as an asset, both from a plaintiff's and creditor's prospective.

In the early '80s, mergers and acquisitions (M&A) were occurring at record levels. This is also true today. Then it was based on high-yield bonds. In retrospect, one could argue that the high-yield bonds were a false promise issued on a certificate.

Today, the stock of Internet companies is contributing a great deal to the M&A activity. Large Internet companies with little or no net income are buying large traditional brick-and-mortar companies as well as Internet competitors with stock.

As long as the new (surviving) companies are not making a profit, could the same be true today as it was in the '80s?

In the most recent Tillinghast-Towers Perrin D&O Survey, one out of three stockholder claims arise out of a merger or acquisition. Underwriters are starting to anticipate that the situation will be worse this time around.

The key for brokers and insureds will be to minimize the impact of the hard market by differentiating your clients, seeking those with strong positive underwriter relationships. Many brokers would agree that in the hard market of '80s, getting the attention of an underwriter was half the challenge.

How bad will it get? That depends on whose perspective you take. The underwriters will say that it has been too long since D&O premiums were adequately priced, that the business world is changing faster then ever before, that litigation is more frequent and more expensive.

Thousand percent increases were not uncommon the last time around, as were seven-digit retentions. People who were here during the 1985 hard market do not think it will be as bad this time around, but almost everyone believes it will be fast and decisive.

One reason the increases in premium will not be as steep this time is the availability of additional capacity. During the last hard market, companies like ACE, XL and others were formed to address the needs of insureds. Today, the Bermuda markets can provide over $100 million in additional capacity.

Domestic markets also began writing D&O post-1986. These "new" markets are strong and have more experienced underwriters.

Probably the main reason the increase will not be as dramatic is that state legislatures will not allow their constituents to be "penalized" like 15 years ago. Government's involvement and political power is not new, as we experienced with Northern California corporations' passing of the 1995 Private Securities Reform Act.

Lastly, and equally important, is that most insurance commissioners are now elected officials and their priorities may have changed in the last 15 years.

There are a few steps that can be taken to minimize the effects of a hard market. Choose a broker with experience that combines the relationships that will get the underwriters' attention and the knowledge of innovative ways to meet the insureds' objectives without compromising the underwriters.

Getting an early start can only help. A well-designed and presented submission is always welcome, and if put together in a comprehensive fashion, it will allow underwriters to spend more time on your account.

Remember, rain is a necessary part of nature-it allows things to grow (including opportunities), and before long the sun comes back out.

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