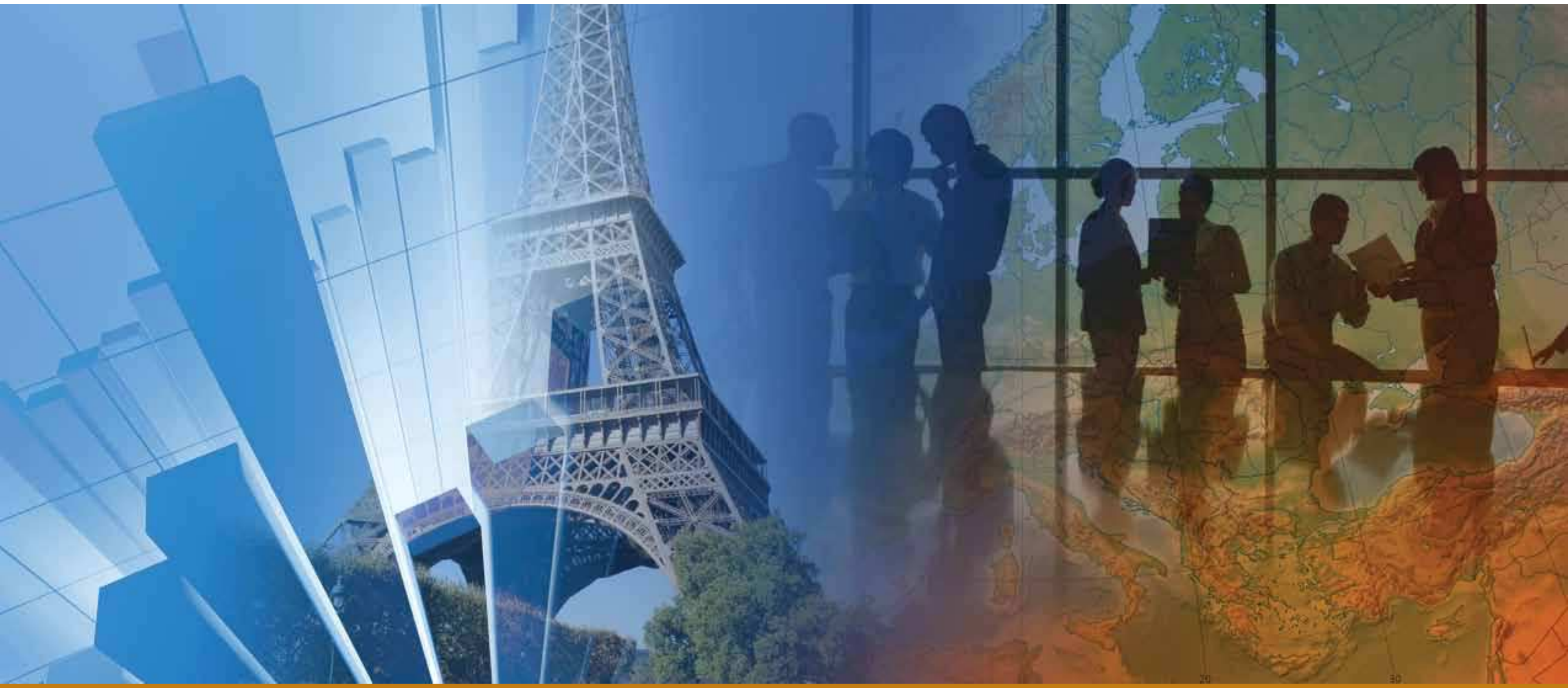

THE STATE OF THE EUROPEAN D&O MARKET SPRING/SUMMER 2014

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Directors and Officers Liability Insurance (D&O) is now regarded as essential insurance protection for many public company decision makers.

Executive Summary

In an environment where directors and officers of both large public companies and SMEs increasingly recognize their exposure to regulatory enforcement actions and lawsuits, demand for D&O insurance continues to grow. This increase in demand, however, has been more than met on the supply side of the equation. Insurers have proved eager to deploy capacity in a line of business that is growing, and which is perceived as profitable despite increased claims frequency. D&O pricing has stabilized somewhat, but growing market capacity will hold rate increases in check for the foreseeable future.

Introduction

Directors and Officers Liability Insurance (D&O) is now regarded as essential insurance protection by many public company decision makers. In recent years, D&O also has rapidly grown in favor in the private company sector. D&O protection is increasingly viewed as a prerequisite for serving on a board.

Extensive changes in the legal and regulatory environments of many European countries mean that it is far more likely that the directors and officers of both large and mid-size companies will be named in lawsuits, or will be targeted in regulatory investigations and prosecutions. The heightened exposure of directors and officers is attributable to a number of factors:

- Governments responded to the corporate accounting fraud scandals of the first half of the 2000s and the financial crisis and recession of the second half with new regulations, heightened regulatory scrutiny, and stronger enforcement initiatives;
- A number of European countries have implemented changes in their legal systems that make it easier for aggrieved shareholders to collectively bring actions against directors and officers;

Claim frequency has increased, especially claims arising from regulatory and employment-related actions. Nonetheless, D&O rates have fallen, and the market remains competitive, especially for SME business.

- Business insolvencies increased as a result of the financial crisis; and
- The number of employment-related suits increased as a result of the recession.

Claim frequency has increased, especially claims arising from regulatory and employment-related actions. Nonetheless, D&O rates have fallen, and the market remains competitive, especially for SME business. This is due to the volume of insurance capacity attracted to a line of business that is growing in an otherwise mature and largely saturated non-life market. Even during the economic downturn, when overall non-life premium fell as companies scaled back or closed their doors entirely, the take-up rate for D&O continued to increase. In fact, the credit crisis and recession, which were catalysts for regulatory actions, shareholder suits, suits by bankruptcy trustees, and suits by employees, seemingly stimulated demand for the coverage. The line of business continues to offer substantial growth potential for insurers. In the UK, for example, a 2012 Datamonitor survey found that only 27 percent of SMEs purchase D&O insurance.[1]

The state of the European D&O market in June 2014 is overall similar to 15 months ago, when Advisen last produced this report. We observed that a state of affairs characterized by increasing claims frequency and decreasing rates was not sustainable, though we did not foresee a correction in the near future. That forecast was based on the observation that an abundance of insurance capacity combined with the perceived profitability of D&O business would assure that the market remained competitive.

First quarter statistics produced by Marsh indicate that D&O rates are largely stable.[2] Barring any major disruptions, pricing in the European D&O market should remain stable, policy terms are likely to remain favorable to buyers, and capacity will be abundant throughout 2014.

The drivers of D&O demand

Advisen estimates the European D&O market at the beginning of 2014 at approximately €1.90 billion, up only marginally over 2013. The take-up rate continues to grow, but the premium volume produced by the increase in the number of insureds has been substantially offset by rate erosion.

The increase in uptake for D&O insurance is directly correlated with the perception that the individuals making corporate decisions are under increased scrutiny by regulators, *Directors and officers – especially those of public companies – also may feel more exposed to liability as a result of corporate governance reforms in many countries that increase transparency and, in some cases, accountability.*

shareholders, and other stakeholders; that European culture is growing more litigious; and that the economic environment continues to make it more likely that directors and officers will be targeted in investigations and lawsuits. For SMEs, the ongoing impact of the economic downturn also makes employment-related actions more likely.

According to a recent survey of 120 individuals from public and private sector organizations, mostly in the UK, conducted by Willis Group Holdings and international law firm, Allen & Overy LLP, the top five perceived risks to directors and officers are:

- regulatory and other investigations and enquiries (89 percent of respondent)
- criminal and regulatory fines and penalties (69 percent)
- anti-corruption legislation (58 percent)
- securities and/or shareholder claims (51 percent)
- the risk of being sued abroad (50 percent)[3]

Directors and officers – especially those of public companies – also may feel more exposed to liability as a result of corporate governance reforms in many countries that increase transparency and, in some cases, accountability. While most listed companies in Western Europe already purchase D&O insurance, this increased exposure has encouraged companies to purchase higher limits or to restructure their programs to provide broader coverage. Many companies in Czechoslovakia, Lithuania, Estonia, and other Eastern European companies are now routinely buying D&O whereas five years ago few bought the product at all. Interest from companies in these countries is mainly driven by regulation – many now have their own versions of the US Sarbanes Oxley Act or the UK Companies Act.[4]

Claims

Reliable D&O claim statistics are not publically available, but brokers and underwriters concur that regulatory actions and employment-related suits are among the most significant sources of increased D&O claims frequency. Lawsuits related to bankruptcies also are translating into increased D&O claims. Shareholder suits are far less common, though a number of countries have made it easier for shareholders to collectively bring action against directors and officers.

Regulatory oversight and enforcement actions grew in the wake of major accounting scandals such as Enron in the US and Parmalat in Europe.

Regulatory actions

Companies across Europe are under heightened regulatory scrutiny, and are more likely to be subject to enforcement actions. As noted above, regulatory investigations and enquiries were identified as the risk that posed the greatest concern to directors by 89 percent of respondents in a 2014 survey conducted by Allen & Overy and Willis.[5]

Regulatory oversight and enforcement actions grew in the wake of major accounting scandals such as Enron in the US and Parmalat in Europe. More recently, in response to the financial crisis, governments have increased regulatory activities and have invested in more robust and comprehensive enforcement, especially in the financial sector. In addition to regulations arising from accounting scandals and the credit crisis, directors also may attract the attention of regulators in various other areas – including health and safety, pollution and the environment, and competition and cartel activity – all with divergent agendas. Legislation such as the Environmental Liability Directive and the UK Corporate Manslaughter Act can put further pressure on directors and officers. Directors and officers of multinational companies are exposed to investigations and regulatory actions coordinated across national borders by regulators in Europe, the US, and elsewhere.

Bankruptcy-related claims

Corporate insolvencies in Europe increased 38 percent during the height of the financial crisis between 2007 and 2009.[6] Bankruptcy remains a major D&O exposure across all Europe.[7]

Liquidators have the responsibility to maximize insolvency proceeds, and they have the power to bring claims against the directors and officers for mismanagement, misrepresentation, fraud, or for allegations of directors conducting business for their personal profit rather than in the best interest of the company and its shareholders. Outside the United States, about 80 percent of lawsuits against directors and officers of companies in bankruptcy are brought by trustees on behalf of creditors.[8]

In the UK, the Department for Business Innovation & Skills (BIS) published an August 2013 discussion paper entitled "Transparency & Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business." The UK Government recently published its response, which signals its intent to introduce most of the changes. Within the changes is a proposal to place greater personal liability on directors for misconduct, making them responsible for compensating creditors who have suffered a loss as a result of a director having been fraudulent or reckless. According to Willis' Francis Kean, "it seems likely that, if

Suits by employees against a company and its directors and officers are the most significant source of D&O claims involving SMEs.

enacted, these powers will represent a powerful supplement to the weapons in the hands of a liquidator which could be turned against directors of insolvent companies."[9]

The European Commission forecasts an improving economy in 2014. According to the Spring 2014 forecast: "leading indicators point to GDP growth gaining momentum in the near term."[10] Economic growth should reduce the number of insolvencies. German local courts reported a 1.2 percent decrease in business insolvencies in February 2014 as compared to the prior year, continuing a trend that began in November 2012.[11]

Employee suits

Suits by employees against a company and its directors and officers are the most significant source of D&O claims involving SMEs.[12] Employees have the right to bring claims against directors and officers as well as the company itself for employment-related wrongful acts such as harassment, discrimination, wrongful deprivation of career opportunities, wrongful dismissal, and retaliation.

Shareholder suits

While no European legal system is as favorable to plaintiffs as the US system, a number of countries now provide mechanisms through which disgruntled shareholders can collectively bring suits against directors and officers.

The United States was previously viewed as the venue of choice for shareholder litigation because of its plaintiff-friendly class action system and the fact that US Federal courts had few issues with applying US securities fraud laws to claims coming from outside the country. This changed in 2010 due to the US Supreme Court decision in *Morrison et al v National Australia Bank Ltd et al*. In this case the court held that US law against securities fraud does not apply to investment deals that occur outside the country, even if they have domestic impact.

As a consequence of *Morrison*, some analysts expected European shareholders to be more likely to file lawsuits in their local jurisdictions.[13] There has not been a surge in European shareholder litigation, however. Despite more liberal legal systems, many European countries still make it comparatively difficult and expensive to pursue shareholder suits.

The Netherlands has emerged as a possible European alternative to the United States for shareholder litigation. In January 2012, the Amsterdam Court of Appeal held for the first time that a collective securities settlement is legally binding in a case where none of the liable parties and few of the claimants were domiciled in the Netherlands. While the

In some European countries – with Germany being the most notable example – suits against directors by their own companies are more common than suits brought by shareholders.

Netherlands remains poised to become an alternative venue for aggrieved shareholders to obtain compensation for shares bought outside of the United States, an avalanche of shareholder litigation has yet to materialize.

In some European countries – with Germany being the most notable example – suits against directors by their own companies are more common than suits brought by shareholders. In fact, companies suing their own directors and officers represent more than two-thirds of all D&O claims in Germany.[14] German cases typically are a product of the country's two-tier board system – a Management Board, which is responsible for managing the company, and a Supervisory Board that oversees and appoints the members of the Management Board. When Managing Directors breach their duties, resulting in a financial loss to the company, the Supervisory Directors may sue the managing directors responsible for incurring the loss.[15]

In some European countries, derivative actions – where shareholders sue directors or officers on behalf of the company – are and the most common form of shareholder litigation. In some jurisdictions they are the only form of redress permitted to shareholders. The UK Companies Act 2006 broadened the circumstances in which derivative actions can be brought in that country.

Criminal actions

Most countries have laws under which individuals can be charged for criminal activity for their actions as corporate directors or officers, with some countries such as Germany being especially inclined to use the threat of criminal liability to motivate director behavior. A report by Deloitte prepared for the UK Office of Fair Trading found that criminal penalties was first on the list of factors that motivate directors to comply with competition rules.[16]

In one recent, well-publicized case, the former owner of Italian insurer Fondiaria-Sai, Salvatore Ligresti, his daughters Giulia and Jonella, as well as two former managers were arrested as part of a criminal investigation into false accounting and market manipulation. The alleged crimes relate to a €600 million deficiency in the insurer's loss reserves that was not disclosed to the market. In a separate but related action, an Italian judge recently ordered the seizure of €120 million euros from the former owners and managers as part of a civil lawsuit brought by the company's new owner.[17]

Of growing concern to directors and officers are allegations of violations of anti-bribery laws such as the US Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act.

In the aftermath of the global financial crisis, directors and officers of financial institutions may find they are more frequently targeted for criminal investigations. In the UK, for example, the Parliamentary Commission on Banking Standards (PCBS), in its report entitled 'Changing Banking for Good', recommended the creation of a new criminal offence of reckless mismanagement of a bank, which the Government has accepted in its response to the report. The new offense will apply to those individuals falling within the new Senior Persons Regime.[18]

Of growing concern to directors and officers are allegations of violations of anti-bribery laws such as the US Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act. Governments are increasingly prosecuting individuals, not just corporations, for violations of such laws.

The US Department of Justice (DOJ) and the US Securities and Exchange Commission (SEC) jointly enforce the FCPA. Both have significantly ramped up enforcement of the act and have routinely targeted European companies. In fact, most of the largest settlements to date have involved European organizations. German engineering company Siemans AG resolved allegations of FCPA violations with the DOJ and SEC for $800 million, constituting the largest FCPA penalty ever imposed. Other European companies in the top 10 include BAE (UK: $400 million), Total S.A. (France: $398 million), Snamprogetti Netherlands B.V. / ENI S.p.A (Holland/Italy: $365 million), Technip S.A. (France: $338 million), Daimler AG (Germany: $185 million), and Weatherford International (Switzerland: $152.6 million).[19]

A 2013 decision involving three executives of Magyar Telekom Plc, a Hungarian Telecom that is majority owned by Deutsche Telekom AG, demonstrates the extraterritorial reach of the FCPA. In ruling on a motion to dismiss, Judge Richard J. Sullivan of the Southern District of New York found that, despite the fact that none of the defendants had ever lived in the United States, conducted business there, or "intended" to cause an injury in the United States," all three Defendants had "minimum contacts" with New York sufficient to reasonably anticipate being brought before a United States court."[20]

The UK's Bribery Act 2010 also is a source of concern to directors and officers. This legislation is much broader than the FCPA as it also applies to private companies and personnel, whereas the FCPA applies to government officials. Thus far, enforcement activity has fallen below what many expected, though that may be changing. Under the influence of

D&O policies are not designed to cover criminal wrongdoing, and typically will not respond to fines and penalties.

the new Director, David Green, the Serious Fraud Office updated and modified guidance in October 2012, adopting a harder line towards individuals suspected of violating the act.[21] To date there have been three convictions, nine charges, and a growing number of arrests.[22] Earlier this year Green proposed an amendment to the Act that would expand the law's coverage and lead to the possible blacklisting of companies.

Germany's anti-corruption laws have received far less press than the UK Bribery Act, but Germany has been much more active than the UK in pursuing bribery cases, trailing only the U.S. (88 cases versus 138 for the U.S. as of June 2013).[23] The German Criminal Code prohibits bribery involving German public officials and parliamentarians, as well as bribery in domestic and international business transactions. The law applies to individuals, not to corporations. Companies, however, can be held liable under Germany's Administrative Offenses Act for an act of corruption by a person with managerial responsibilities.

D&O policies are not designed to cover criminal wrongdoing, and typically will not respond to fines and penalties. The wording of many policies, however, permits recoveries of defense costs up until the point of a final adjudication by a court.

Privacy and network security

Privacy and network security issues are a growing concern to directors and officers around the world, especially in the wake of the Target breach in the United States which led to the resignation of the company's well-respected CEO and a barrage of lawsuits. Network security is increasingly viewed as a board level issue, and directors risk being sued if it is neglected and their companies experience a serious loss. According to Mintz Levin attorney Heidi A. Lawson, "shareholder litigation in the cybersecurity context will typically allege a failure by the board to oversee and prevent the loss."[24]

While cyber-related shareholder suits have thus far been a largely American phenomenon, European boards seem to be doing a better job of managing the exposure, according to a Carnegie Mellon University CyLab survey. CyLab found that only 28 per cent of U.S. company boards have established a risk/security committee as compared to nearly 60 per cent of European companies, and only 44 per cent of U.S. boards review top-level security policies, compared with 62 per cent of European boards.[25]

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Defense costs

In the United States, defense costs have been a highly significant component of D&O claims, often far exceeding payments to plaintiffs. Europe is catching up, and for similar reasons. Especially in complex litigation involving multiple defendants, a large number of lawyers, including monitoring counsel, may be involved. Additionally, as regulators continue to turn up the heat on many European companies, directors and officers will turn to their D&O policies to help offset costs that may be incurred in investigations and enforcement actions.

The D&O Market

D&O and the market cycle

The D&O market is frequently discussed as if it is a self-contained insurance ecosystem, but its behavior is often driven by factors influencing the broader non-life insurance market. In most cases, the D&O line is supported by the same capital base as supports other commercial lines. It is therefore subject to the same ebb and flow of capital that influences the overall market cycle. For the past several years the broader market has been mired in the soft phase of the cycle. The market has been overcapitalized, meaning that the supply of insurance capacity exceeds the demand for that capacity, which puts downward pressure on prices.

D&O, with certain exceptions, has largely tracked the broader non-life cycle. Rates have stabilized somewhat, but the market remains competitive. The line remains profitable and capacity abundant, making it difficult for underwriters to push through rate increases. According to Marsh, of the five large European countries tracked in their *Global Insurance Market Quarterly Briefing*, only Italy saw D&O rates increase in the first quarter of 2014. France saw rates fall, while Germany, UK, and Spain experienced stable D&O pricing.[26]

While the sovereign debt crisis that threatened the economic viability of several European countries, and even of the entire Eurozone, has abated, a number of countries continue to struggle to regain their footing. Insurers, however, seemingly are sanguine about the potential impact on commercial D&O. In troubled Spain, for example, Marsh noted in 2013 that "D&O is one of the more stable lines of business" except for companies in industries most affected by the economic downturn.[27] Spain is now enjoying a comparatively strong recovery, which may attract yet more capacity to that country, putting additional pressure on rates.

Although most lines of business tend to follow the same market cycle trends, not every segment always moves in unison with the overall market.

Although most lines of business tend to follow the same market cycle trends, not every segment always moves in unison with the overall market. Insurers allocate capacity according to where the greatest opportunity exists at any point in time, and may elect to cut back in, or altogether discontinue their participation in, unprofitable segments. Such was the case for financial institution (FI) D&O in 2009, when rates spiked in response to the financial crisis. This sort of sector-specific hardening, however, tends to be comparatively short lived. Rising rates attracts capital back into the segment, and the factors causing claims to rise often are temporary. FI D&O rates in many countries, for example, have fallen substantially from their highs in the immediate wake of the credit crisis. They continue to fall in certain segments of the market, though the broader trend has now shifted towards stable, and in some cases firmer, pricing. Marsh notes that in the first quarter, Italy and Spain saw rates for financial institutions rise.[28]

The public company market

Among public company directors and officers, the conversation long ago passed from "should we buy D&O" to "how much and what types of D&O should we buy." The market is mature and largely saturated, with future growth closely tied to the performance of the overall economy. In fact, as a result of economic and business conditions, the public company market has been shrinking: the number of listed companies in Europe fell 14 percent between 2009 and 2012.[29]

Per-program capacity is abundant – as much as €700m in some segments of the market. According to Aon Deutschland, this is about double the insured sum bought by most large German corporations.[30]

The SME market

The SME segment is both growing and competitive. Growth is being driven by concerns about regulatory scrutiny and, especially, employment-related claims.[31] Competition is driven by the attractiveness of a growing market that is widely perceived as profitable despite increased claims frequency. Consultancy Datamonitor notes that many insurers "are looking to increase penetration among SMEs to increase income,"[32] and that SMEs "will be the primary driver of the market's growth in the next few years."[33]

While the pace of companies buying coverage for the first time seems to be growing at a steady rate, there remains significant growth potential in this segment. As previously noted, a 2012 Datamonitor survey found that only 27 percent of UK SMEs purchase D&O insurance.[34] Another survey found that only 19 percent of Spanish SMEs purchase D&O protection.[35]

In a competitive and increasingly sophisticated market, insurance buyers have a growing menu of options to choose from when structuring a D&O program.

The FI market

Banks and other financial institutions continue to attract a high level of regulatory scrutiny in the aftermath of the financial crisis and as a result of the continued precarious economic environment in Europe. Nonetheless, the FI market throughout much of Europe remains competitive. FI risks in some distressed nations saw rates more than double,[36] but throughout much of Europe the reaction to the financial crisis was less severe, and rates soon began to drift downward. Global Tier 1 banks, especially those with legacy issues, continued to face hardening rates and lack of insurer appetite, but in general the market remained fairly soft in 2013.[37] Marsh notes that, in the first quarter of 2014, of the western European countries, only Italy and Spain saw rates for financial institutions rise.[38] Willis forecasts the FI market to remain stable in 2014.[39]

Coverage options

In a competitive and increasingly sophisticated market, insurance buyers have a growing menu of options to choose from when structuring a D&O program. According to Datamonitor, in the UK "competition continues to be played out through not only rates but expanded wording," and that "the balance of power in influence on policy wordings is shifting from insurers to brokers."[40]

Although a single Freedom of Services policy is acceptable coverage throughout the EU – and many insurance buyers elect this option for their EU exposures – some insurers have moved away from "one size fits all" policies, and offer policies tailored to address legal systems and business practices by country. In Germany, for example, insurers have responded to a new law requiring large deductibles for individual directors under an organization's D&O policy with individual director policies. Most insurers offer an array of coverage extensions to customize D&O policies to an organization's specific needs.

Companies with foreign operations increasingly recognize that a single policy issued in the home country may not provide the expected coverage for claims brought in foreign countries. D&O policies typically provide worldwide coverage, but many countries require local policies. Additionally, a single global policy can cause complications with local premium tax requirements and may result in adverse tax consequences for claim payments. As a result, a robust market has emerged for complex D&O programs that provide both global and local coverage, and have become a basis for competition for large insurers that are able to provide or arrange for coverage in countries across the globe.

New standards of transparency and accountability, easier access to the courts in many countries, and a generally more litigious environment further contribute to the likelihood that directors and officers will be sued.

D&O and the changing threat landscape

The risk profiles of organizations of all sizes are being reshaped by economic, social, and political forces. Perhaps no other line of insurance is as responsive to these changes as is D&O. The directors and officers of European companies, both mid-size and large, are faced with a growing list of threats to their personal assets, including prosecutions by regulators and lawsuits by a broad array of parties including shareholders, customers, competitors, employees and even their own companies. New standards of transparency and accountability, easier access to the courts in many countries, and a generally more litigious environment further contribute to the likelihood that directors and officers will be sued. The situation is unlikely to become less complex or less threatening anytime soon.

Of concern to directors and officers with UK exposures are the recommendations contained in the BIS discussion paper, "Transparency & Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business," which the UK government now intends to implement. According to Willis' Francis Kean, "the paper contained some far-reaching and eye-catching proposals which ... would, if implemented, have some profound effects on the way in which UK companies are governed, managed, and controlled."[41]

Fortunately for directors and officers, a highly competitive insurance marketplace for D&O insurance has assured that insurance protection has largely kept pace with changes in the dynamic threat landscape. Coverage generally is broad enough to provide protection against many emerging exposures.

Abundant capacity and profitability in most segments assures that the D&O market will remain competitive for the near future. Rates are stabilizing in many areas, but a genuine hard market seems unlikely. Brokers note that underwriters are becoming more selective, but they largely are unable to push through rate increases except in certain distressed segments. Broad coverage remains the norm and insurers continue to introduce product innovations. ■

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