



MICRO-CAPS, MACRO PREMIUMS

Finding D&O in a Hostile Market

- **How SME's are coping with a hardening D&O market**
- **The impact of reducing or dropping coverage**
- **How to increase underwriter "appetite"**



Elon Musk was not influenced by our client, nor by the many who preceded him. While the Tesla CEO's decision to let the D&O markets be damned may not have pleased his directors and officers, our client looked on with amusement. Despite our recommendations, our client came to the same decision as Musk, but a year earlier. While Musk abandoned D&O insurance defiantly, our client joined the many who have done so reluctantly.

Forty years ago, a family-owned oilfield services company was convinced to do a reverse merger. It gave them 80% ownership and 400 partners; shareholders in their now public company. They faithfully renewed their D&O insurance, for the last ten years with the same carrier.

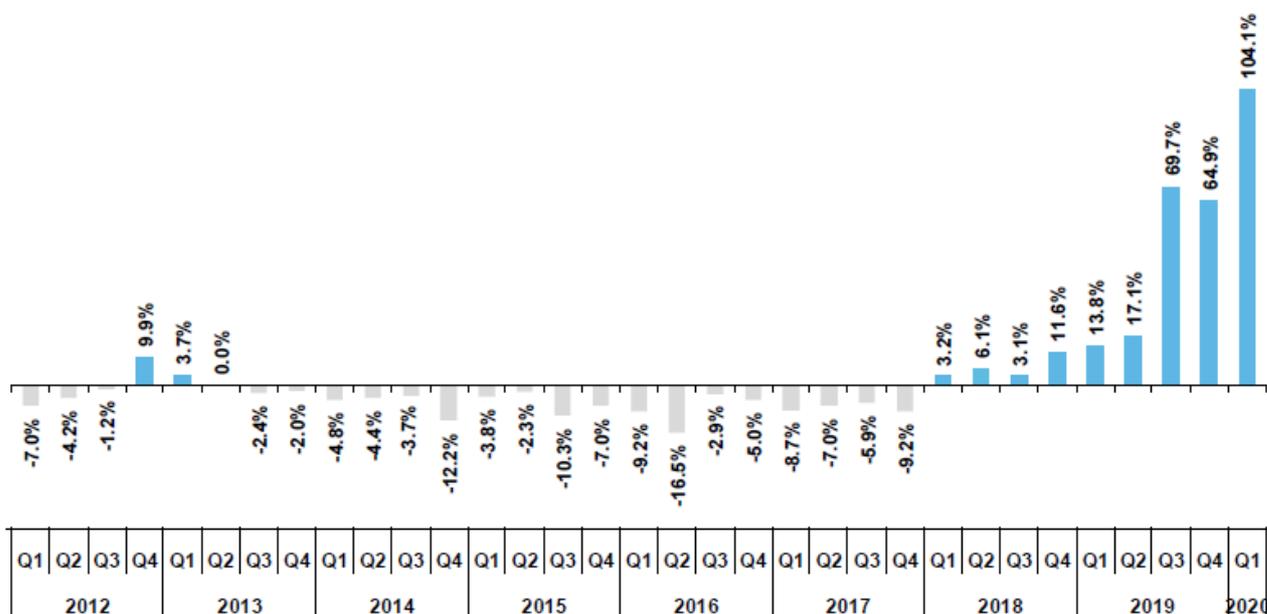
At a time when plummeting crude prices brought new drilling to a standstill and breaking-even would make for a good year, D&O insurance was dropped as premiums reached a level three times their original. The company had already reduced its limit from \$10 million to \$5 million, and now retention was being increased to \$1.5 million. Though claim free for a decade, underwriters lost appetite for energy risks, deteriorating industry financials, and small caps generally. The CEO asked his board members to serve uninsured and rely upon about a million of liquidity and the value of his company shares, at this point an illiquid \$20 million. The company's lead independent director, their banker, a board member for decades, put them on notice that he would need to resign—even though the Bank's insurance covered him. They would not let him serve once the Company dropped their coverage.

There are more than 10,000 companies that trade in the dealer markets, comprised of different parts of the vast over-the-counter market (“OTC”). In terms of numbers of companies, this is about twice the number of listed businesses. Often mischaracterized, OTC companies range from the toxic to the pristine, from non-disclosing entities lacking operations to household names that would easily qualify for listing. Micro-caps are those with valuations starting at \$50 million and as high as \$300 million, and those with valuations below \$50 million are now called nano-caps.

Figure 1: Quarterly “YoY” D&O Price Changes, 2012-2020, AON D&O Pricing Index

QUARTERLY “YEAR-OVER-YEAR” PRICE CHANGES

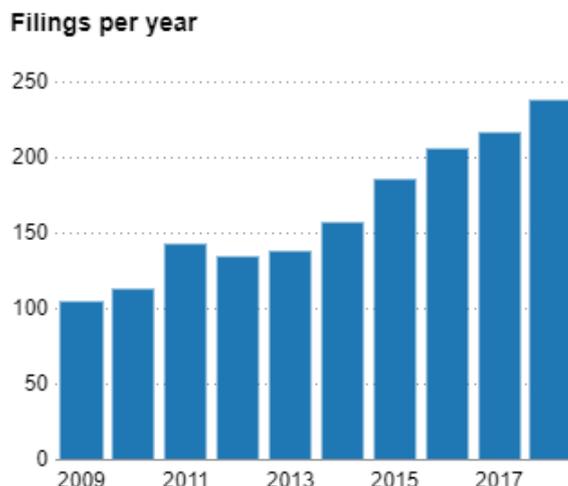
Q1-2012 through Q1-2020



Before attentions rightfully turned to risk managing the pandemic, the D&O insurance markets were well into a correction that most date to mid-2018. Following a decade of accommodating markets propelled by ample capital and new capacity chasing market share, mid-single digit renewals were grudgingly tolerated and a tough sell for underwriters. Many risk managers viewed the uptick as an aberration. 2019 renewals erased that notion along with a significant portion of the prior decade’s savings.

A meaningful increase in class actions, some large settlements and an important decision granting state courts jurisdiction in some IPO class actions (Cyan, Inc., et al. vs. Beaver County Employees Retirement Fund) meant further escalations.

Figure 2: Federal Securities Class Actions Filed, 2009-2018, Stanford Securities Litigation Analytics

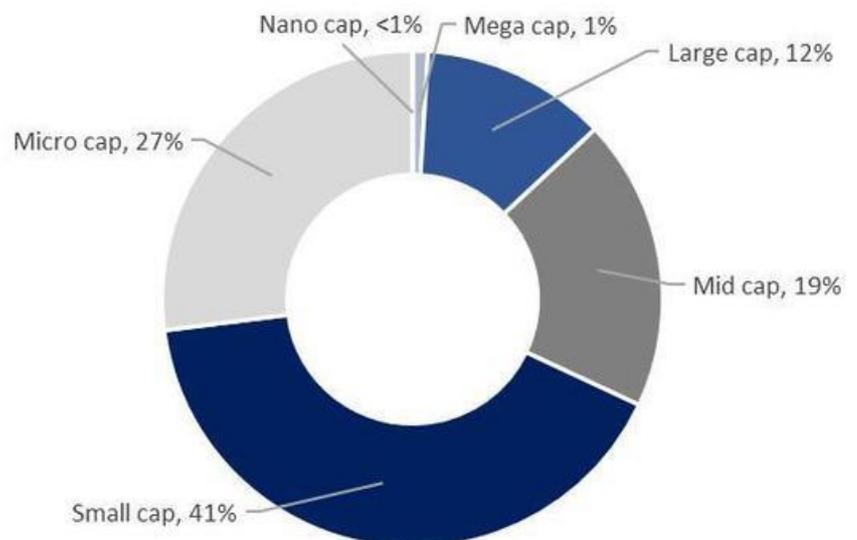


Marsh's monthly survey of average D&O renewal pricing for 2019's first half showed increases well into the low teens for primary layers, with excess placements increasing by double those amounts. These increases further accelerated into 2020, and the ongoing crisis brought reports of 50% to 100% increases for some biotech and financial service names, with some IPOs requiring 10% rates with retentions of \$10 million.

As carriers move to "risk off" with even the best insureds facing constrained capacity and higher retentions, our friends in the oilfield faced the hard choice of compromising their liquidity or forgoing coverage. Moreover, the few carriers still serving the micros and nanos know there's no need to sharpen pencils when they're competing against themselves.

Figure 3: Federal Securities Class Actions by Market Cap, 2009-2018, Stanford Securities Litigation Analytics

CLASS ACTIONS BY MARKET CAP





Aside from getting competent representation, we recommend that small-caps consider:

1. KNOW WHAT YOU ARE GIVING UP

Remember that D&O insurance is claims made coverage so it must be in force when a claim is reported, and your coverage likely extends to events that might have happened years ago. Unless you purchase extended reporting or some form of runoff coverage, you'll lose those protections. And if you do drop coverage, let your retired directors know.

2. IT'S HARD TO RESTART

A hard market makes it more difficult to restart coverage once you've dropped it, and if you do re-enter, anticipate higher premiums than if you had maintained continuous coverage. It's also hard to negotiate retro coverage for that period you were uninsured. Maintaining some coverage is better than none.

3. CONSIDER SIDE A

If you are contemplating reduced limits, or as an alternative to cancellation, consider continuing some Side A coverage only. If you have capably handled compliance matters, enjoyed a stable security price with moderate trading volume, and have no plans for an equity offering, the loss of securities coverage can be tolerated. You will still be obligated to reimburse Directors and Officers, but if you are unable or unwilling to, Side A should respond, and your directors and officers will not be sharing limits with the Company.

4. CONSIDER SIDE A ONLY FOR INDEPENDENT DIRECTORS

In this case you'll be providing coverage only to your independent directors. If you reduce limits, what remains will only be available to independent directors.





5. DON'T STOP REPORTING

Going dark, terminating audits, and limiting reporting rarely helps, as does descending into the OTC classification hierarchy of decreasing transparency, e.g. moving from OTCQX, to OTCQB, or OTC Pink. Sometimes considered a way to reduce public interest, trading and liability, this strategy will not facilitate D&O marketing, and it can stoke investor vigilance.

6. PROMOTE GOING CONCERN AND POSITIVE DEVELOPMENTS

Resist what may appear to be a “pump,” but do distribute news of a new customer, strategic partner, or potential up listing. A press release announcing a new hire can help dispel an underwriter’s notions of dormancy and drift. Have your broker arrange a call or meeting with your underwriter and compliantly share developments that may not as yet be reflected in your filings.



7. AVOID PROMISES

State formation documents contain your company’s required and permitted indemnifications, and these may be restated or enhanced in your governance policies. A casual suggestion that the company or another director intends to do more can be misinterpreted.

Many expect the ongoing crisis to change an ordinary cycle into a prolonged one, with factors specific to the D&O markets compounding pandemic related escalations. Anticipate the impact to be pervasive, spanning industry classes and all ranges of capitalizations. Look for underwriters to reassert their pricing leverage, narrow coverages and impose new exclusions.



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