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Directors and officers (D&O) insurance insights 2024

The top risk trends boards of management need to guard against

> “Diversity in the boardroom continues to allow companies to have varied approaches when presented with problems

Key risk trends for 2024

Ongoing inflation, refinancing and insolvency pressures, geopolitical issues, and electoral uncertainty are just some of the headwinds D&Os need to be prepared for.

Since the world eased out of lockdown a new normal has not made daily challenges for companies any easier. Inflationary pressures remain across the globe. In the UK, for example, while inflation rates have slowed, they remain considerably higher than Bank of England targets.

Refinancing of existing debt is proving a shock to the system for some firms. After years of low interest rates, firms refinancing debt are feeling the effects on their profit and loss statements (P&L). While the ability to provide a positive earnings before interest, taxes, depreciation, and amortization (EBITDA) message remains, the impact is clearly being felt for many firms within their cash flow. Directors and Officers are seeing fresh pressure on cash generation. Decisions around how the company finances capital expenditure (Capex) and manages its debt profiles are under more scrutiny from stakeholders. Directors and Officers must choose between new debt at higher rates, discussions with shareholders on equity raisings and, in some cases, easing of Capex in the business.

Economic growth across the globe remains disappointing. Across Europe, the UK and US the most optimistic suggestions are for modest growth in Europe, although sluggish is a more common theme. The likelihood of a recession in the US and UK in 2024 continues to rise.

Considering current interest rate challenges and a bleak outlook on UK and US recessions in 2024, it is unsurprising to learn that insolvencies in the UK are above pandemic levels. However, we are also seeing higher than pre-pandemic insolvencies. A report by the Centre of Economics and Business Research notes that in the UK there were over 6,700 business insolvencies in Q2 2023[1]. To put this into perspective, the average in the quarters leading up to the pandemic was around 4,100. We are now seeing insolvency activity in line with peaks after the global financial crisis in 2009. It is worthwhile noting that insolvency is not only an SME concern. We have seen high profile insolvency in the UK, most notably in the retail sector.

Meanwhile, globally, business insolvencies are expected to rise by +10% in 2024, according to Allianz Trade[2], a third consecutive annual rise.

Geopolitical risks and other uncertainties

There remain considerable geopolitical issues across the world. At the time of writing, it is approaching two years since the start of the Ukraine war. Heavy sanctions against Russia and Belarus remain. While a significant number of businesses have exited trading in these territories, Directors and Officers should be prepared for the aftermath of the conflict if or when it ends. Is there a strategy in place to return to these territories and with the increasing focus on environmental, social, and governance issues how will stakeholders respond to the 'social' decisions taken by the board? The Israel-Hamas war brings further uncertainty across the region and the globe. From a board of directors' perspective, this is a further reminder following the Ukraine war of the responsibility to ensure the safety of employees. Are suitable kidnap and ransom (K&R) processes in place and have the directors prepared the company to withstand business interruption in higher risk territories?

Finally, to add to the challenges of rising costs and insolvency, 2024 will bring uncertainty with key elections in the UK and the US. With polling possibly taking place against a negative economic backdrop, Directors and Officers must be prepared for how any new government will impact their business. As previously noted, higher interest rates will have an impact on Capex, which typically eases in the build-up to elections due to uncertainty.

The challenge for Directors and Officers for 2024 is to be prepared for the headwinds. To be nimble is not only to cut headcount, but to have a strategy that can adapt when presented with a block to the business. Diversity in the boardroom continues to allow companies to have varied approaches when presented with problems. To assist with the challenges ahead, the C-Suite should push beyond the norm in their industry and allow themselves a better chance to be on the front foot for the future.

The fallout from the US banking crisis

In March 2023, a number of US banks experienced a rapid withdrawal of deposits, leading to them being either dissolved or taken over. What led to this issue, is the crisis over, and what does the future hold?

Part of what led to these failures was simply poor banking practices. For example, the Federal Deposit Insurance Corporation (FDIC), the independent agency created by the Congress to maintain stability and public confidence in the nation's financial system, was warned in January 2023 that Signature Bank was in trouble, as it had allegedly facilitated countless illegal crypto transactions[3]. It had continued to loan monies tied to taxi medallions, the transferable permits in the US that allow taxi drivers to operate, years after it was clear they were no longer valuable, and had to write off US$129mn of these loans[4]. Then, the February class action arising out of the failed cryptocurrency exchange FTX led to a significant drop in deposits.

Rising interest rates, a global effect of the Covid pandemic, have also had an impact on US banks. Silicon Valley Bank (SVB)[5], as an example, invested most of its capital in long term, low interest rate treasury bonds and mortgage-backed securities. As interest rates rose, depositors started withdrawing money to get higher rates of return, which eventually led to a run on the bank.

This was also the situation with First Republic[6]; its business model provided cheap mortgages to wealthy customers. Although very profitable while interest rates were low, this left it exposed as interest rates rose and it was locked into long-term mortgages.

Social media impact and factors to watch

Social media also had an impact on the banking crisis. SVB's depositors were largely tech and healthcare startups, who were invested in by venture capitalists. When depositors started to withdraw funds, some of these venture capitalists advised their clients to start spreading their assets to other banks. This advice hit Twitter (now known as X) leading to a run on the bank in which it lost a significant amount of its deposits. The bank closed on March 10, 2023.

Each of the banks that failed, or came close to failing, resulted in a securities fraud claim. The first suit for Signature Bank was filed on March 14, 2023, just a few days after the bank failure. There is no data for the final disclosure loss, but there was a US$2.5bn market cap loss.

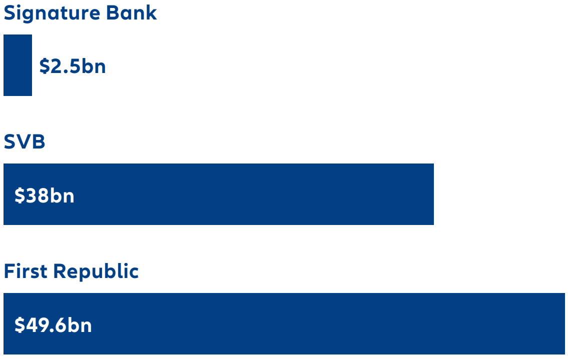
Similarly, two suits have been filed against SVB, both showing a $9.5bn final disclosure loss and a $38bn market cap loss[7]. First Republic was sued just a month later, showing a $49.6bn market cap loss. Each of these claims has, assuming they survive the Motion To Dismiss, the ability to exhaust entire insurance towers.

While we are still watching some banks closely, it appears the banking crisis is over. However, there are two factors to keep an eye on.

First, we are watching banks with large commercial property portfolios. Some banks are selling property loans at a discount, even when borrowers are current with repayments, a sign of their intent to reduce exposure to the commercial real estate market[8].

Second, the Treasury has its lowest cash balance since 2017. There will be a strain on the banking system as the treasury rebuilds this cash balance. The government plans to issue 1.1 trillion in short-dated Treasury bills before the end of the year[9], which will push up yields on government debt and suck cash out of the banking system. If large depositors pull out funds to invest in Treasury Bills, this may put increased pressure on banks.

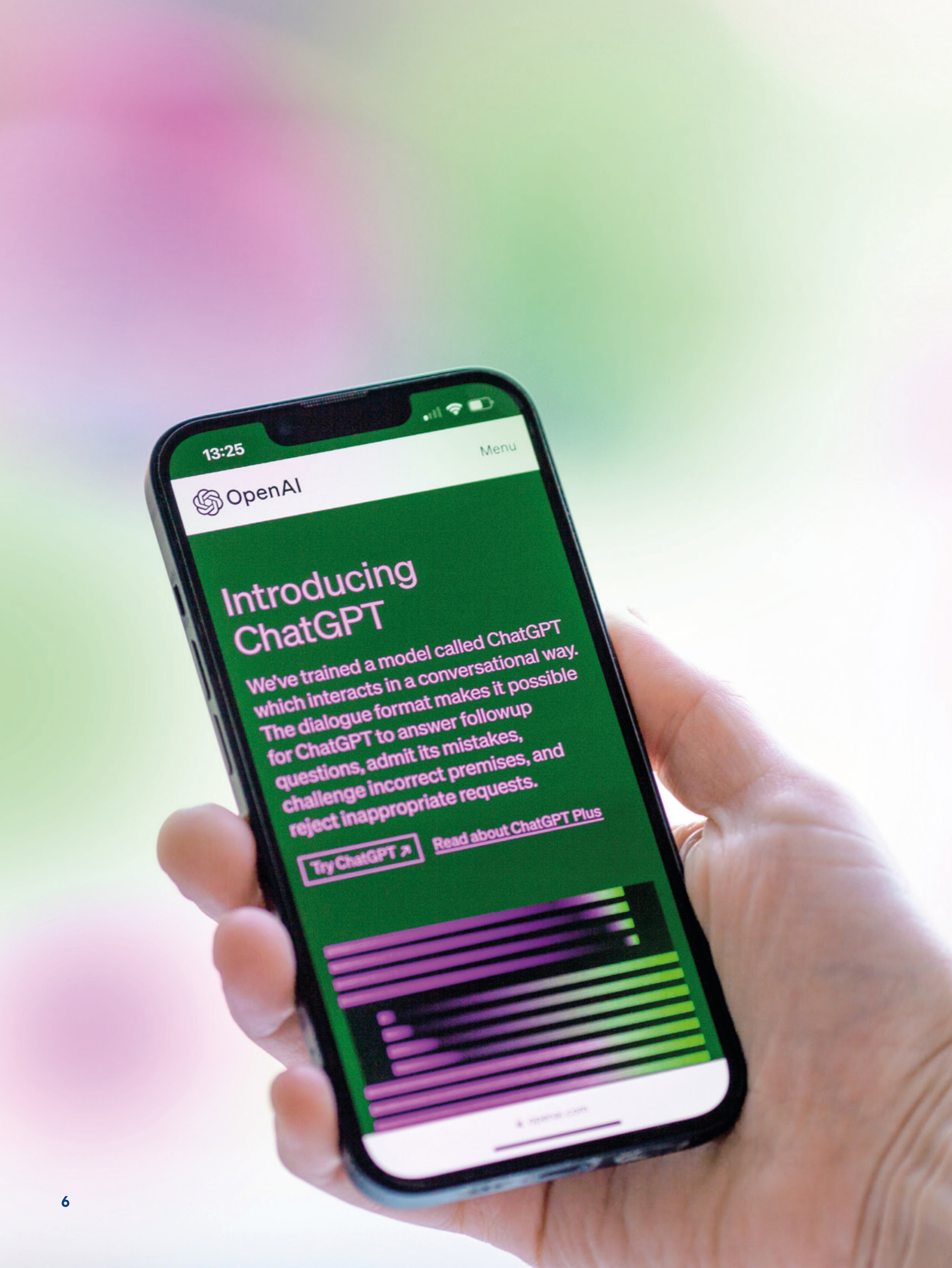
Cited market cap losses



US$1trn

US Treasury borrowing drive may put pressure on banks

> It appears the banking crisis is over. However, there are two factors to keep an eye on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Everyone's talking about GenAI

The technology has hit the headlines, but what risks does it pose for D&Os, and how can organizations ensure they adhere to legal and ethical protocols surrounding its use?

Generative AI (GenAI) is a term used to describe algorithms that can be utilized to create content such as text, audio, images, video, and code. It does this by learning patterns from existing data then using the knowledge to generate outputs. The content it generates can be highly complex and can mimic human creativity.

The discussion around the utilization of GenAI has been building throughout 2023 as the expanse in its capabilities is now impacting how corporations think about their business models and processes. According to the latest annual McKinsey global survey[10] there has been a rapid take-up in GenAI tools, with one-third of the survey respondents saying their organizations are using GenAI regularly in at least one business function.

While the potential for AI to create competitive advantages seems limitless, there will also be challenges associated with the adoption of the technology that organizations should consider. These include:

1. **Cybersecurity threats –** which are already front of mind for directors, according to the annual **Allianz Risk Barometer** survey – might be heightened by the implementation of GenAI tools.
2. **Increased regulatory risk** as governing bodies globally look to create regulatory frameworks.
3. **Demand for more corporate transparency** and adequate disclosures with the credible quantification relating to the risks and rewards of GenAI.
4. **Unrealistic investor expectations** about the technology's capabilities.
5. **Threats over the responsible use of GenAI technology,** managing bias and misinformation.

Litigation recently filed against AI companies, OpenAI, Microsoft and Google, has already highlighted some risks related to privacy and/or copyright law violations[11]. These cases, along with the items noted above, have the potential to bring securities claims, intellectual property claims, breach of fiduciary duty claims, misrepresentation claims, and shareholder and derivative lawsuits.

As investors increasingly demand transparency and data about how companies are utilizing and investing in GenAI, the onus will be on the leaders of organizations to thoroughly understand the technology and its appropriate use case for their businesses.

Involving the appropriate experts in creating a structured approach to effectively communicate to stakeholders is one part of the process. Taking the initiative in establishing guardrails on utilization and clearly outlined parameters on the usage prior to adoption is another.

Organizations can mitigate the risks associated with GenAI technologies by setting up best practices and deploying agile methods to keep governance, compliance protocols, and legal frameworks current and able to adapt to the technology as it evolves.

While developments in GenAI are exciting, they also carry potential risks, so close monitoring of their evolution will no doubt remain a high-priority topic on the boardroom agenda.

ESG claims are here to stay

D&Os face risks relating to their decision-making on a growing list of emerging issues.

Deliberation of current issues in corporate management often conflates discussion of ESG principles with corporate sustainability practices. Conceptually, ESG is a framework to assist investors in measuring a corporation's handling of a broad range of environmental, social, and governance issues. The practice of corporate sustainability attempts to promote environmentally conscientious, societally responsive, and ethical governance practices, balancing the interests of investors with the interests of other stakeholders, including employees, customers, suppliers, counterparties, governments, communities, and public advocates.

Corporate sustainability offers a counterpoint to economist Milton Friedman's theory of "shareholder primacy", which has dominated commonly held definitions of corporate purpose in a capitalist economy for more than 50 years.[12] Rather than accept that the sole responsibility of a corporation is to maximize [short-term] profits for its shareholders, advocates of corporate sustainability stress the importance of creating long-term corporate value, serving not solely the interests of their shareholders, but also the interests of their customers, employees, suppliers, and the communities in which they operate. In principle, sustainable governance practices can elevate a corporation's ESG profile, enhancing perceived value to investors focused on promoting ESG-related causes.

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In an increasingly polarized world, claims can be made on either or both sides of any given issue

Some commentators have expressed frustration about the persistent and elevated attention given to ESG in discussion of corporate management. Much of this seems due to the lack of clarity around what constitutes an environmental, social, or governance issue (for example, is privacy a 'social' issue; how are we to understand 'governance' in the context of ESG versus everyday corporate management?). Other concerns include the lack of consistent and objective guidelines to measure a corporation's attentiveness to ESG factors, and disagreements about the correlation of ESG scores, however derived, with corporate performance.

At the same time, some have argued that the conduct of evaluating and acting upon the impact of various ESG issues on corporate performance and valuation (including, for example, climate change, diversity and inclusion in the workforce and the boardroom, or human rights issues within supply chains) does not involve an alternative governance model but rather the ordinary and necessary exercise of a director's traditional duties.

Disclosures and exposures

And yet, scepticism about the definitional contours of ESG, or about whether sustainable governance constitutes a fundamentally new management approach, will not lessen the very real risk that corporate directors and officers face claims relating to their decision-making over deepening challenges facing companies on a growing list of emerging issues.

The number of countries introducing ESG-reporting mandates has grown considerably in recent years, exposing companies and their directors to costs of responding to investigations, enforcement actions, and potential fines and penalties for suspected non-disclosure or misrepresentation. Such requirements also expose directors to claims by private litigants, not only for alleged misrepresentation but also due to dissatisfaction with what required disclosures reveal about a company's commitment to various ESG issues.

Of course, not every constituency among a broad group of stakeholders, indeed not every shareholder, holds the same view on any issue or the same view as to whether or what actions directors should take. In a world that is becoming increasingly polarized politically and socially, the very need for directors to evaluate and address the impact of various ESG factors on corporate value creates risk that claims will be made, by activist shareholders or by other motivated stakeholders, on either or both sides of any given issue.

ESG issues

Below are just a few recent examples of claims against corporate directors:

- **ClientEarth vs Shell Plc & Ors** [2023] EWHC 1137 (Ch) (shareholder derivative litigation under the UK Companies Act of 2006 alleging, inter alia, failure by the board to properly manage climate risk).
- **City of St. Clair Shores Police and Fire Retirement System vs Unilever Plc et al**, U.S. District Court, Southern District of New York, Case No. 22-05011 (shareholder class action for alleged failure to disclose a decision by Unilever's subsidiary Ben & Jerry's to stop selling its products in the Israeli Occupied Territories).
- **Spence, et al. vs American Airlines, Inc, et al.**, U.S. District Court, Northern District of California, Case No. 4:23-CV-00552-O (derivative suit against company benefits plan fiduciaries for alleged breach of duties by investing with funds that pursue ESG strategies and other activities which purportedly fail to maximize financial benefits in the sole interest of the plan participants).
- **Simeone vs The Walt Disney Company**, State of Delaware Chancery Court, Civil Action No. 2022-1120-LWW (shareholder suit seeking disclosure of company books and records over decision of board to oppose the Florida "Don't Say Gay" legislation, contending that the directors put their own beliefs ahead of the interests of shareholders or flouted the risk of Disney losing valuable rights granted by the State of Florida by their actions).

Market dynamics the state of the D&O insurance sector

Companies have benefited from competitive market pricing and broader coverage terms for D&O insurance during 2023. What is the outlook for 2024?

Public and private companies throughout 2023 have continued to benefit from competitive market pricing and broader coverage terms. New entrants coming into the insurance market contributed to there being an environment of ample capacity, further leading to a more competitive market overall.

That, coupled with the reduced number of Initial Public Offerings (IPOs), provided companies with a more favorable D&O market versus the shift in the market due to profitability challenges seen in 2020/2021, which led to higher premiums, stricter terms, and reduced capacity in both primary and excess insurance. Third-party data showed a notable trend in 2021, with double-digit increases in D&O insurance prices across major markets worldwide. Conversely, there has been double-digit decreases across major markets worldwide in 2023[13].

This does not come without some concerns, however, as noted by rating agency, Fitch Ratings. According to Fitch: "The US D&O liability insurance segment continued to generate favorable loss ratios through the first half of 2023 despite heightened pricing pressure and material declines in premium volumes tied in part to increased competition." But it also warned: "The likelihood of sustainable segment profitability at current levels has been greatly reduced by weaker pricing and the potential for claims volatility from a myriad of sources. However, recognition of reserve redundancies from the most recent accident years may support near-term underwriting results."[14]

Class action activity

Looking at the end of 2023, federal securities class actions sat at 201 (as of December 11) versus 197 in 2022 and 212 in 2021[15]. However, the total settlement dollars are up significantly versus historical levels *(see chart)*. According to insurance brokerage, Woodruff Sawyer[16], total settlement dollars paid out in all of 2022 were US$2.4bn, and in the first half of 2023, that total is already at $3.1bn. Even with a $1bn settlement excluded from the data set, the settlement figure for the first half of 2023 is the highest it has been in the last 10 years.

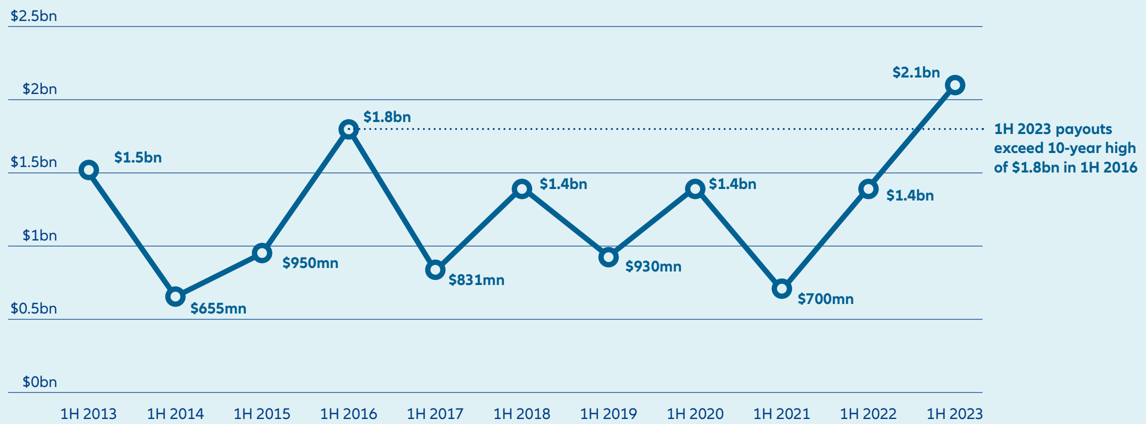
These settlement figures, along with the sharp increase in defense cost across all claims, may impact the market in the nearer term, especially for newer entrants that don't have the portfolio size to withstand these issues.

When looking ahead to 2024, the market looks like it will remain competitive. However, there are signs of underwriting discipline returning as the market continues to assess the impacts of security class actions filings and increased defense costs, along with the realization of inflationary impacts, increasing regulatory scrutiny, bankruptcy rates and an active plaintiff's bar, along with the backing of litigation funders.

"The market continues to assess the impacts of security class actions filings and increased defense costs

Total settlement dollars

US$ paid out in first six months of each settlement year (1H 2013 to 1H 2023). Excluding $1bn+ settlements



Source: Woodruff Sawyer, D&O Looking Ahead, D&O Considerations for 2024

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Contacts

For more information contact your local Allianz Commercial Communications team.

Asia Pacific
Shakun Raj
shakun.raj@allianz.com
+65 6395 3817

Ibero/LatAm
Laura Llauradó
laura.llaurado@allianz.com
+34 660 999 650

North America
Jo-Anne Chasen
jo-anne.chasen@agcs.allianz.com
+1 917 826 2183

UK and Nordics
Ailsa Sayers
ailsa.sayers@allianz.com
+44 20 3451 3391

Central and Eastern Europe
Andrej Kornienko
andrej.kornienko@allianz.com
+49 171 4787 382

Mediterranean/Africa
Florence Claret
florence.claret@allianz.com
+33 158 858863

Lesiba Sethoga
lesiba.sethoga@allianz.com
+27 11 214 7948

Olivia Smith
olivia.smith@allianz.com
+27 11 214 7928

Global
Hugo Kidston
hugo.kidston@allianz.com
+44 203 451 3891

For more information contact az.commercial.communications@allianz.com

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Allianz Global Corporate & Specialty SE

Dieselstr. 8, 85774 Unterfoehring, Munich, Germany

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