

Underwriting Considerations for D&O Insurance

Directors and officers (D&O) liability insurance is an insurance coverage sought by public, private and non-profit organizations to help protect their executives from costly legal actions. Over the years, insurance companies have refined their underwriting practices for D&O insurance to reward organizations that implement proactive risk management measures.

While organizations across the United States have developed a greater appreciation for the importance of D&O insurance, many misconceptions about the underwriting process for D&O insurance persist. This article examines some of the information that underwriters generally review when they receive an application for D&O liability insurance.

THE BASICS

Applications for D&O insurance generally start by asking applicants for a basic profile of their organization. In particular, underwriters want to establish the organization's size, location and industry. While this information may seem basic, it impacts an underwriter's willingness to accept an application for coverage, and sets the price, terms and conditions of the policy.

It should be noted that an organization's industry may contribute to an insurance company's perception of the D&O risk posed by an applicant. When forming an opinion of a potential new client, underwriters will often take into consideration any recent litigation trends, along with their own underwriting experience with organizations in that sector.

THE ORGANIZATION'S FINANCIAL CONDITION

Typically, underwriters will require organizations to submit a copy of their audited financial statements along with their application for D&O coverage. Underwriters require this information in order to develop an understanding of an organization's financial circumstances, particularly its key income statement components and balance sheet components. This information is used to create a range

of financial ratios and can be used by an insurance company to benchmark an applicant to other similar organizations within its industry.

One of the main questions the underwriters will be trying to answer is whether an organization has sufficient cash or credit available to fund its operations and service its debt obligations for the proposed policy period.

Organizations with a strong financial standing operating in an industry with positive economic outlook are generally looked upon favorably by underwriters.

CLAIMS HISTORY

Insurance companies, by their nature, want to extend coverage to organizations that will allow them to remain profitable. Insurance companies generally view an organization with a history of frequent claims or pending litigation as undesirable, and may decline to offer coverage or charge more for coverage based on the likelihood of a future loss.

While each insurance company has its own internal D&O underwriting practices, underwriters typically look at the following:

- Recent civil or criminal action, or administrative proceedings alleging violation of a federal, state or foreign securities law
- Involvement in insolvency or bankruptcy proceedings
- Instances of employment or labor-related litigation or proceedings
- Disputes over employee benefit or pension plan

MERGERS AND ACQUISITIONS

If an organization has been involved in merger or acquisition (M&A) activity, underwriters will typically investigate the reasons for these transactions to gain an understanding of its associated risk. Insurance companies are interested in this information because financing activities and M&A activity are events that often lead to D&O claims.

Depending on the nature of an organization's M&A activity, an underwriter may recommend certain conditions or restrictions in the D&O coverage provided to the organization or choose to decline coverage altogether.

EMPLOYMENT PRACTICES

Current and former employees are a common source of D&O insurance claims, especially for private and non-profit organizations. In order to get a better sense of how likely an organization's directors and officers are to be pulled into a dispute with employees, insurance companies will typically ask a series of questions related to employment practices. Common questions include, but are not limited to, the following:

- Does your organization have a formal human resources department?
- Does your organization have an employee handbook?
- Has your organization recently completed any layoffs, facility closures or early retirement programs?
- What is your organization's annual turnover rate?
- Does your organization have policies forbidding discriminatory conduct in the workplace?
- Does your organization have formal hiring and interviewing guidelines?

INTERNATIONAL EXPOSURES

Organizations that have operations in foreign countries tend to face a higher degree of D&O risk due to the complex compliance requirements that exist in each jurisdiction. Accordingly, underwriters will typically ask an organization applying for D&O coverage what percentage of its business is done in the United States and other countries.

DIVERSITY OF BUSINESS ACTIVITIES

Generally, D&O risk is lower for organizations that concentrate their efforts in one core business activity. For this reason, underwriters may look more critically at organizations that are involved in too many unrelated areas where the directors don't have expertise in that type of operation. As a rule of thumb, the longer an organization has been involved in a business activity, the D&O risk associated with performing that activity decreases.

ADDITIONAL CONSIDERATIONS FOR PUBLIC COMPANIES

For publicly traded companies, insurance companies often require additional analysis from their underwriters during the application process. In addition to the areas previously mentioned, D&O underwriters may examine a publicly traded company's accounting practices, corporate structure, stock price volatility, executive compensation, disclosure practices and corporate governance.

MORE INFORMATION

Whether your organization is a non-profit, privately held or public company, it is likely that it can benefit from a D&O policy. While the application and underwriting process for D&O insurance may seem daunting, LaPorte's knowledgeable insurance professionals are here to ensure your organization finds the insurance coverage it needs.

Contact us today to learn more about the appropriate protection for your company against potential D&O liability.