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Risk Management in the Boardroom

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On March 18, 2009, Foley & Lardner LLP presented "Risk Management in the Boardroom" as part of its National Directors Institute — 2009 Web Conference Series. Foley Securities Enforcement & Litigation Partner John R. Landis moderated a series of panel discussions addressing incorporating risk management into corporate planning and decision-making.

"Risk" has become a buzzword as a result of the recent economic downturn. Was this company's investment too risky? Did that company fail to account for the full risk of its financial instruments? Are the collateral assets propping up this company too risky? But for business executives and boards of directors, assessing risk is nothing new. Good business leaders will spend a great deal of time preparing for and managing various risks. The latest economic downturn is only the most recent example of why risk management is so important.

Trends in Directors and Officers (D&O) Liability

The first panel discussed trends in D&O liability and insurance. Members of the panel were Gordon "Chip" Davenport III, Foley Insurance & Reinsurance Litigation Partner, and Steve Shappell, Aon Corporation's Managing Director of Financial Services Group Legal & Claims Practice.

The trend in D&O liability is a bit alarming. Both the frequency and severity of claims are on the rise. Insurers are generally able to predict "severity," or the size of settlements. However, they have little ability to predict for "frequency," or the number of claims brought. Since the economic downturn in the fourth quarter of 2008, the frequency of claims has skyrocketed as the stock market (measured by the S&P 500 and the Dow Jones) has declined. During the economic downturn of the first part of this decade — the last time the frequency of claims ballooned — insurers were slow to respond with corresponding rate increases; however, they did respond eventually. It already has been noted that the recent economic recession has resulted in a dramatic increase in the frequency of claims. The question is whether insurers will soon increase their rates to account for this rise in claims.

There are some differences between the current economic downturn and the downturn from the early 2000s. These differences might mitigate against insurers needing to increase their rates too dramatically. First, the dismissal rate of these claims is significantly higher now than it was earlier in the decade. Second, there are more insurers in the D&O liability market to spread the risk. Third, insurers began segregating premiums by sector. For example, the energy sector had a decrease in rates in the fourth quarter of 2008 (over the fourth quarter of 2007), while financial institutions experienced a large increase in rates during the same time period. For these reasons, the increase in frequency of claims may not result in the kinds of rate increases seen during the previous downturn.

D&O Coverage — Private Companies

There is a misconception that private companies do not need D&O liability coverage because private companies have no exposure to U.S. Securities and Exchange Commission (SEC) regulations. Yet the trends discussed above in regard to public companies are similar to the trends in coverage for private companies. Private companies often experience some type of potential D&O liability event. In fact, the latest Chubb Private Company Risk Survey, sponsored by Chubb Group of Insurance Companies, showed more than one in five private companies had a D&O liability suit within the past five years. Private companies rely on exemptions to SEC registration, so directors and officers of private companies do have exposure, albeit a different type than the directors and officers of public companies. For that reason, private companies are just as likely to notice the fluctuations in insurance rates.

D&O Policies — Important Considerations

Coverage for International Operations
Some foreign countries require insurers to be authorized and admitted to the foreign country for coverage of claims arising in that country. In other words, an American company that is insured by an American insurance company and that has operations in a foreign country may not be able to extend its American insurance policy to the foreign country operations — even if the American insurance policy, on its face, purports to do so.

Brokers and larger insurance companies can provide strategies for companies with foreign operations, and businesses are encouraged to ensure that their existing policies provide the proper coverage for operations in foreign countries.

Coverage in a Financial Downturn
In financially difficult times, it is appropriate to review and evaluate whether a business has the appropriate insurance coverage. Of course, if a company does not have appropriate coverage, it should address that concern immediately. To the extent that a company has appropriate coverage, its policies should maximize the proceeds that flow to the business in the event of a bankruptcy (instead of being considered part of the estate of the bankrupt company). For example, some policies will not insure for claims by a bankruptcy trustee (on behalf of the estate) against a director of the company (under the "insured v. insured" provision). The insured v. insured provision should carve out bankruptcy proceedings to avoid this situation. Another way to eliminate D&O liability coverage from being considered part of the bankrupt business's estate is to purchase A-side-only coverage, which protects directors and officers exclusively. Finally, both public and private companies have seen an increase in investigations by the SEC. Some companies have begun negotiating coverage to cover investigations by the SEC.

Enterprise Risk Management (ERM) in Today's Environment

The second panel focused on the benefits of ERM, particularly in light of the difficult economic times. Members of this panel were Laura Taylor, Aon Corporation's Managing Director of Strategic Account Management; Eric Blanchard, United Stationers Inc.'s General Counsel; Jeff Stolle, Career Education Corporation's Director of Risk Management; and Ann Gariti, Aon Risk Services' Illinois Division Managing Director.

ERM is the process by which a company manages its risks, typically using the same platform to manage risks across all aspects of the company. A successful ERM program must have the support of the company's board and its executives.

Effectively implementing an ERM program is a process that typically can last several years. It is important that the company views the ERM program as something that adds real value to the business by creating a system to plan for, identify, and respond to potential and realized risks. To that end, the ERM program should be incorporated into the business's strategic plan. In order to accomplish that goal, top executives should meet monthly to discuss the main risks facing the company. Monitoring and responding to each risk should be "assigned" to a specific executive. While some naysayers may dismiss these techniques as nothing new, that does not undercut the main point: These techniques, by any name, are important to the efficient functioning of a business.

Companies should note that the process of creating and continuing an ERM system is particularly vulnerable when new executives transition into the company. Because executive support is so essential to an effective ERM program, ERM must not be lost in the shuffle of the transition.

Assessing Insurance Company Credit

The third panel focused on the financial and credit strength of insurance companies. Kelly Superczynski, Aon Benfield's Head of Global Rating Agency Advisory Group, provided an overview of how to rate the strength of insurance companies.

Many people are left wondering about the strength of their own businesses as well as their insurance companies. When analyzing an insurance company, the most important factors to consider are profitability and impairment.

Profitability
The market currently is in a "soft" underwriting cycle, with price competition among insurers and relaxed underwriting terms, though some insurers believe a harder market is on the horizon. This soft cycle is unusual in that it is overlapping a downturn in the financial markets. During previous soft cycles, insurance companies were able to realize investment gains as a way to offset business losses; in this cycle, that is not a possibility.

Impairment
Although the press has paid a good deal of attention to the impact that Ponzi schemes and overstated assets have had on the books of many insurance companies, Ms. Superczynski noted that the impact of these impairments historically has been a minor portion of the overall impairment to insurance companies. A majority of the insurance impairment is caused by companies under-reserving and insurance companies trying to grow too quickly. For that reason, the best way to analyze how an insurer is handling its impairment is to analyze an insurer's underwriting methods.

Analytical Points and Analysis
When analyzing the strength of an insurance company, it is important to consider both quantitative and qualitative factors. Quantitative factors include looking to the company's balance sheet for its capital and reserves as well as the company's liquidity in the event of a need to make large payments. Qualitative factors include analyzing the company's underwriting procedures, the company's access to capital, the company's reinsurance, the company's ERM, the management of the company, and, to the extent the insurance company has exposure to property, its catastrophic coverage.

It also is important to consider the longer-term trends of particular companies by examining the past five years, rather than just the past year.

Conclusion

Due to the recent economic downturn, managing risk is very important to the survival of a business. But planning for risk is essential in any economy. For more information on this session or Foley's National Director's Institute — 2009 Web Conference Series, visit Foley.com/NDI or contact the following panelists:

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