

# THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

## Middle Market D&O Coverage



CHRISTOPHER DUCA is President of Navigators Pro, a division of Navigators Management Company, Inc., and a member of the board of directors of Navigators Insurance Company. Navigators Pro offers financial insurance products including directors and officers, fiduciary, employment practices liability and crime insurance for privately held and publicly traded corporations. Mr. Duca previously was Executive Vice President of Global Specialty Risk, Inc., where he headed the Middle Market Group of its wholly owned managing agency, Axcelera Specialty Risk, Inc. The underwriting team that he led at Axcelera Specialty Risk, Inc., has joined him at Navigators. Prior to joining Global Specialty Risk, Inc., he worked for Reliance National's Financial Products Division and AIG member company National Union Fire Insurance Company of Pittsburgh, PA's Management Liability Division. He is a graduate of Villanova University

where he earned a BS in Business Administration. He is also a graduate of FDU-Madison where he earned an MBA in finance. He conducted doctoral studies at Fordham University where he earned an MA in economics.

**(WAJ917) TWST: May we start with a quick overview of Navigators Pro?**

**Mr. Duca:** Navigators Pro was founded on September 1, 2001, in anticipation of the market need for a D&O facility primarily focused on middle market publicly traded and privately held firms. The world changed on September 11, 2001. We knew success would be achieved with focus. The market segment that we focus on is small cap companies that are traded on NASDAQ and AMEX, as well as privately held firms. The overall D&O market has not focused on this group and therefore it's been under served. Our approach as a niche player is to provide insurance solutions to meet the needs of Directors and officers.

**TWST: What's the company's background?**

**Mr. Duca:** Navigators Pro is an operating unit of The Navigators Group, Inc. (NAVG: NASDAQ). Navigators has been providing insurance solutions to policyholders for over 29 years. We are a niche specialty P&C company. We have consistently outperformed our industry peers. Navigators Insurance Company is rated "A" Excellent by the rating agency A.M. Best. We are a company that is very

focused on understanding the exposures facing our insureds. A number of our insureds have been with our company for years and Navigators has built an excellent reputation on claim service.

**TWST: Where does the expertise come from to go into this new niche?**

**Mr. Duca:** We have a team of underwriters that has focused on the middle market D&O for over a decade. We have worked together in this area and our core competency is underwriting specialization, particularly in emerging growth companies. Navigators takes a "bottom-up" approach to underwriting and risk selection. Some of our competitors take a "broad brush" or index approach. The lack of risk differentiation is highly inefficient, where good insureds are essentially subsidizing higher risk companies.

**TWST: Who are you competing with in this space?**

**Mr. Duca:** There are a number of competitors, but essentially our success has been to fill holes in D&O programs because of the compression of insurance limits that has occurred in the hardening D&O market. We also provide primary policies where incumbent insurers have either walked away from their clients or insureds that have expe-

rienced significant changes in policy coverage terms or pricing. We accurately price insurance programs to match the corresponding risk.

**TWST: What is going on in the marketplace today? What are the key issues?**

**Mr. Duca:** One of the key issues right now is the high level of uncertainty in exposure and unevenness in claims activity. The D&O industry is facing an avalanche of securities class action cases. These are “mega cases” that involve the corporate scandals over the last two years, which have primarily targeted the large Fortune 500 companies. Unfortunately, a number of small cap companies have been caught up in this wake as far as higher pricing and more restrictive coverage terms.

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What is happening in the marketplace is that there’s more stabilization in pricing, and terms and risk differentiation is improving. Navigators has been constructive in the D&O market inefficiency where demand has outpaced supply. We’ve been providing solutions to the smaller cap companies to close the gap on this asymmetrical market response. Our products are designed to meet the needs of small cap companies.

**TWST: What’s been the response as you’ve developed this product?**

**Mr. Duca:** We have robust demand. Most companies that compete against large competitors know that when you’re closer to the client and you tailor your products to meet the client’s needs, customers respond. The market rewards profit to companies that provide solutions to problems. Our policyholders have responded very favorably to Navigators’ product offering and we continue to grow profitably. The best indicator of our success is what our policyholders think, and they’re very positive about Navigators.

**TWST: When you look at your policies and compare them to what you’re offering versus your competition, what sets you apart?**

**Mr. Duca:** Navigators is unencumbered by past liabilities; therefore, we focus on coverage rather than price. I think that a business model that focuses solely on price is not a sustainable one. Most of the directors and officers that we insure are concerned about coverage. If a claim is filed against an insured, they want to feel confident that the policy will respond to covered losses as defined in the policy.

What we try to do is provide the broadest coverage possible because that is essentially the key driver in purchasing a D&O policy. Insurance buyers want the policy to respond in the unlikely event that they have a claim.

**TWST: Are there things that you’re providing that other people aren’t?**

**Mr. Duca:** One of the differentiators that we provide is our product called IDL InNAVation(sm). This is an endorsement that is part of our primary policy. There are a number of competitors that offer an IDL policy. An IDL policy is geared for the independent Director.

Our endorsement provides coverage for the independent Director as part of the primary policy. IDL InNAVation(sm) increases security and certainty to independent Directors including audit committee members under their D&O coverage by providing enhanced protection from a policy rescission.

The reason why this is a key issue for small cap companies is because of the importance of recruitment and retention of independent Board members. The idea of facing the potential of a D&O policy rescission is something that is a bit disconcerting to management — if they have to explain to their independent Directors that there may not be a D&O policy to respond to a securities class action lawsuit.

**TWST: As you go out and offer this policy, how are you determining who gets it and who doesn’t?**

**Mr. Duca:** It is available for a select number of companies. The criteria include a myriad of relevant risk characteristics. We use a “distributed optimization” algorithm as an underwriting tool to assess risk. One of the areas that we look at is quality management. We want to see an effective, experienced, high-caliber management team that’s accountable to shareholders. We look for an independent Board or one where the majority of the Directors are independent and are true stewards of corporate governance with an eye to constructive skepticism.

An ethical corporate culture is important. The corporate culture should be based on principles that foster an environment that’s open, transparent, honest, responsible and rewards integrity.

Corporations need to have consistent performance. Corporations that execute on business objectives typically have lower stock

volatility and provide higher long-term values to shareholders. The axiom is substance over hype.

A strong market position or category leader is an indicator of competitive advantage. We evaluate a corporation's product life cycle, their market position and strategy. These are critical predictors for continued success.

We also analyze financial flexibility. Lofty stock prices based on "capitalized reputation" could evaporate overnight. There are a number of small cap companies that have parabolic stock charts. Is the stock price sustainable? Will the company have access to the capital markets? Indicators of sustainability are the company's cash flow from operations and their debt capacity. Is the company "bullet proof" or is it Wall Street's "flavor of the month" that can get caught up in a capital market freeze?

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Sound disclosure, compliance with Sarbanes-Oxley, the securities laws, and adherence to the corporate governance standards of the NYSE and NASD SROs (self-regulatory organizations) are the baseline. A company's disclosure practices that are accurate, timely, comprehensive and clear provide insight to the culture at the top of the organization.

The internal controls of the financial reporting operations need to institutionalize performance and integrity. The controls drive enterprise resilience. Does the company have an effective risk management awareness structure to alert management, similar to the requirements of Section 404 from Sarbanes-Oxley where companies have to monitor, document and attest to their own internal controls?

These are the key components that we evaluate. Companies that score well are preferred.

**TWST: So they have to be up to snuff to get attention from you?**

**Mr. Duca:** Corporations with lower risk should be provided with more options, including enhanced coverage. The theme of a "flight to quality" applies here.

**TWST: Can companies change their culture to qualify for this, or is that really hard to do?**

**Mr. Duca:** Companies that consistently deliver tend to have ethical corporate cultures. Any company that is in a transformation mode would be eligible provided that they can demonstrate

that positive change is sustainable. We do write a number of companies that are turnaround scenarios. A company may have had a product disruption which requires a product relaunch or may be faced with an accounting scandal. The Board's mandate is to retool the company. A new management team is brought on to stabilize operations, restore credibility, and improve performance.

Special situation scenarios include coverage for the new management team, provided they have a sound business plan. Companies that are faced with serious structural problems that approach the situation with incrementalism are not viewed by us as fostering positive change or a fresh start.

**TWST: So a very careful review of the company is done before you step up to the plate.**

**Mr. Duca:** That's right.

**TWST: From your perspective as you look at the market, what's the big risk you're taking here?**

**Mr. Duca:** Our risk is that we have made an assessment and we rely on the financial statements that are filed with the SEC. Within the application process, there are certain representations that are made by the insured, and an unacceptable risk is the information provided to us is not true. For those scenarios, the insurance carrier should not be expected to respond.

The risk that is acceptable comes down to a company that's run ethically and is well managed but has some sort of "shock" or unexpected event. As Robert Shiller, author of *The New Financial Order*, writes, "The risk management infrastructure is the understanding of the frailties of human decision making." We accept that type of risk. Our products provide security and certainty to directors and officers so that they can make appropriate business decisions. If directors and officers are prudent in executing their fiduciary duties to shareholders, they shouldn't be risk averse. Sometimes these decisions do not work out as planned because there are a number of external factors.

The risk that we're willing to insure is for covered loss where the directors and officers appropriately execute their fiduciary duties to their shareholders.

My big concern is the climate that Sarbanes-Oxley compliance appears to be creating. Boards and managements appear to be more focused on checklists and are becoming more risk averse. Di-

rectors and officers need to be executing their duties and focus on strategic thinking and planning. Compliance is important and it's required, but it should not consume the board and management in terms of how they're operating their business. The fabric of the capitalist system is to reward entrepreneurship and responsible risk taking.

Executives should buy a directors and officers liability policy to reduce uncertainty. Navigators wants to be there as a partner to insure directors and officers.

Alan Greenspan, Federal Reserve Chairman, stated that "Insurance deals with the problem of spreading risk in converting potential large, unknown costs into a steady stream of known insurance premiums that facilitates the forward planning so essential to an effective business operation." That's what we think our role is.

**TWST: Thank you.**

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