A New Decade for Management Liability Insurance:

Private Company Risk Trends and What Lies Ahead
For most large public companies, management liability insurance is an expected expense. Private companies, however, generally feel they have less exposure to management liabilities and, therefore, are more reluctant to purchase coverage. As a result, private companies often go without coverage or adequate limits. Today, as the range of risk exposures facing private company executives and directors has significantly increased in a post COVID economy, it is time to reexamine the exposures private companies face.

In this white paper, we have highlighted key trends that have substantial risk implications for private company senior management as well as factors that are driving changes in the directors & officers and employment practices liability insurance marketplace.

MANAGEMENT LIABILITY INSURANCE IS OFTEN OVERLOOKED BY PRIVATE COMPANIES

Alleged management wrongdoings that often make the headlines typically involve large, publicly traded corporations. Knowing their exposure, most public companies transfer their risks with insurance to protect against costly management liability claims. But the fact is, private companies share many of the same management liability exposures as large corporations and are held to the same fiduciary duties, and the Private Company D&O product addresses more perils than the Public Company D&O contract.

Private companies may also be under the assumption that their general liability or commercial business owners’ insurance policies will protect them against management liability risks. However, these policies are woefully inadequate in responding to economic damages claims without underlying bodily injury or property damage.

MANAGEMENT LIABILITY RISK TRENDS AND EXPOSURES FACED BY PRIVATE COMPANIES

COVID-19 versus the Great Recession

Federal Reserve Chairman Jerome Powell recently suggested that the economy could contract by up to 30% during the second quarter of 2020 - what’s expected to be the biggest drop in quarterly GDP in U.S. history - due to community lockdowns across the country and voluntary business closures in an effort to combat the spread of COVID-19. By way of comparison, the sharpest quarterly drop in economic activity during the 2008 financial crisis was an 8.4% decline in the fourth quarter of 2008, with roughly 170,000 small businesses closing between 2008 and 2010. In a matter of months, the COVID-19 pandemic resulted in over 630,000 retailers either permanently or temporarily closing their doors, with one in four small businesses saying they are less than eight weeks away from closing permanently, according to polling by the U.S. Chamber of Commerce.
In October of the Great Recession, the unemployment rate hit 10%. In the wake of COVID-19, the most recent rate by the Labor Department showed an unemployment rate of 14.7%, while acknowledging that this number is likely closer to the 20% mark due to information gathering issues.

According to the CNBC Small Business Survey, small-business financial confidence has crashed from 64% in the first quarter of 2020 to 48% in the second quarter. Unfortunately, the COVID-19 pandemic may result in an uptick in private businesses filing bankruptcy, as proprietors feel the impact of state-mandated lockdowns and worry that reopening too soon may create even more financial setbacks that will be difficult to recover from.

The impact of COVID-19 will vary greatly by class of business and jurisdiction. However, spikes in the management liability claims environment have already triggered potential coverage and rate changes.

With the management liability marketplace firming prior to COVID-19 and its enormous stresses on management, we will continue to see an upward trend in premiums and a tighter market, with renewals expected to take much longer to underwrite. Currently, private company renewals in all states and especially in California are already experiencing challenges regarding rates and retention, and are likely to see more exclusions, higher retentions, and lower limit offerings.

**The COVID-19 Pandemic and the Current Risk Management Environment**

Given the above, liquidity concerns and insolvencies will be on the rise. As a result, management personnel will begin to develop proactive strategies to prepare for and cope with this short-term liquidity-constrained environment. While expense-cutting strategies, such as debt restructuring, reduction in CAPEX, and personnel decreases can help solve short-term liquidity issues, these cash-flow improvement options put them at greater risk of potential liabilities. In addition, any capital infusions, government backed lifelines, or outright sale of the entity pose additional exposures.

**Payment Protection Program**

Because of the volume of the Payment Protection Program (PPP), and the speed with which applications are submitted and funds are disbursed, the government will employ what is known as a "pay then chase" method of fraud enforcement. Most commonly seen in federal healthcare programs, especially Medicaid, the "pay then chase" idea accepts on the front end that some improper funds will be paid out, and that fraud will only be identified and punished retroactively. Under a pay then chase model, the penalties are harsh, in theory deterring wrongdoing from the outset.

A key weapon in the government’s arsenal for punishing waste and abuse under TARP was the False Claims Act (FCA). The FCA, which dates to the Civil War era, imposes liability on companies and individuals for submitting false claims for funds to the federal government. Its breadth and scope are far-reaching, especially in the healthcare and government contracting sectors where it is ordinarily employed. The FCA is incredibly punitive, even in its civil iteration, allowing for fines of $10,781.40 to $21,562.80 per false claim, plus treble damages. TARP participants faced FCA claims for actions like misrepresentation of financial need or use and non-compliance with program terms. Even second-order participants, like those who billed vendors who received TARP funds or made misrepresentations affecting TARP funds disbursed to others, found themselves in the enforcement crosshairs.

After the passage of TARP, the federal government recovered billions of dollars from entities and people that it accused of fraud and abuse.

While we do not have any specific investigation examples from PPP, the following example shows the potential issues in taking funds from the federal government where defense costs exceeded $500K.

**Example:**

Federal agencies conducted a formal investigation into the activities of a defense contractor for the armed services. They investigated the company and its owner / president for alleged overbilling of the government for labor, improperly charging their lobbying costs into the contracts, and also for allowing foreign nationals to work on certain government contracts in violation of The International Traffic in Arms Regulations.
**Mergers and Acquisitions**

The number of private companies entering into merger and acquisition agreements continues to grow; 54% of private companies surveyed said they expect to increase their average number of M&As over the next 12 months. While a pandemic constrained economy may slow some deal making, it will hasten others. The speed and lopsided bargaining power found when the selling entity is selling out of financial distress can lead to complex claims by all stakeholders (on either side of the transaction) when any surprises happen post transaction. Other M&A-related lawsuits filed against private companies can involve bad faith negotiation, breach of contract or tortuous interference, claiming to have been damaged as a direct result of the new company agreement.

Example of buyer suit after purchase where settlement and defense exceeded $4M:

Three years after purchasing a company, the buyer alleges it was induced into purchasing the company based on misrepresentations, in that certain material information was concealed which masked its true financial condition. The buyer specifically alleges that a substantial amount of the company's inventory was defective which led to unanticipated litigation.

**Bankruptcies**

Lawsuits occur when creditors, shareholders or other stakeholders sue, claiming that directors and officers were negligent in their actions and communications, or acted in their own interests and not in the interest they owed to other stakeholders. These cases often involve bankruptcy trustees suing in an attempt to recover losses, and can even include the bankrupt company electing to sue its own directors and officers, claiming a breach of fiduciary duties. In many instances, directors and officers may find their personal assets are at risk if the bankrupt company is unable to indemnify them for their legal fees. Even if the defendants prevail, lawsuits can result in hundreds of thousands of dollars in defense costs.

Claims example where settlement and defense exceeded $2M:

A bankruptcy trustee filed a lawsuit against a company’s managing members alleging breach of duty of loyalty, breach of duty of care, fraudulent transfers, unlawful distributions and unjust enrichment in a scheme to loot the remaining assets of a failing company. The members allege that they were always acting on behalf of the company’s best interests and that its failing was outside of their control. They blame the bankruptcy on a change in certain laws that adversely impacted its business.

**EPL Overview**

Only 3% of companies with fewer than 50 employees have EPL insurance coverage, and 33% of companies with 50 or more workers have no EPL coverage at all.

EPL insurance provides protection for companies against a number of employment-related lawsuits such as harassment, retaliation, wrongful termination and defense costs for breach of employment contract, as well as discrimination on the basis of race, national origin, religion, sex, pregnancy, age or disability. And while larger corporations typically carry considerable coverage for these types of risks, private companies can be extremely vulnerable to employment practice risks.

The following are EPL trends that employers are likely to encounter and should be discussed with your private company clients.
**Increasing Employment Practices Liability Due to COVID–19**

COVID-19 is adding to the increased number of race, disability and discrimination charges, including incidents involving prejudice against certain ethnic groups relating to how the pandemic originated and spread. Anticipating that this might become an even bigger issue over the next several months and beyond, the Employers Council has investigators on staff who are working specifically with employers and managers to assist with the anticipated growth in alleged discrimination and prejudice issues related to the pandemic.

COVID-19 is also impacting broader discrimination issues regarding the Americans with Disabilities Act. Just because more employees are working remotely during the pandemic, doesn’t mean a company’s management protections for workers should be eased. For example, if an employee becomes ill with COVID-19, or is unable to return to the workplace because an underlying health condition increases the employee’s risk should he or she contract the virus, that person’s personal information – including name – cannot be released and must be protected. There also may be situations where an employer must accommodate an employee regarding compliance issues. For example, an employer may insist that all employees wear protective face masks; however, some employees might not be able to comply with the wearing of certain types of masks due to a physical or mental health condition. Employers who aren’t flexible in the management of their accommodation processes may increase their exposure to a discrimination claim or lawsuit.

When it comes to an immediate reduction in capital and operating costs, most employers have cut expenses by laying off and furloughing some or all of their workforce, as well as imposing salary and benefit reductions or freezes. As a result of these actions, labor and employment lawsuits have already begun to increase, with more to come as employees return to work. Employment-related liability risks can include discrimination and wrongful termination claims, as well as class action lawsuits brought against employers who conducted layoffs allegedly without complying with the federal Worker Adjustment and Retraining Notification Act. The WARN Act is a federal law that requires most employers with 100 or more employees to give a 60-day notice in advance of mass layoffs or plant closings. The law can be strengthened by individual state law, and has personal liability implications for management personnel.

In addition to the WARN Act, COVID is creating issues for employers in navigating the Fair Labor Standards Act. The Fair Labor Standards Act (FLSA) is the primary federal law governing wage and hour laws. The FLSA outlines employer requirements regarding overtime pay, minimum wage, and exempt vs. non-exempt employee classification and 29 U.S.C. §§206(a) and 207(a); 29 CFR §516.2(a) and (c); 29 CFR §516.3. With salary reductions the norm, employers may inadvertently fall below the FLSA salary test guideline. Further, when extra equipment such as masks, PPE and thermometers are required to work, payment and time allocation for “donning and doffing” could be a class action FLSA concern.

Workplace safety standards are governed by the Occupational Safety and Health Administration (OSHA), which contains directives on offering a workplace “free from recognized hazards that are likely to cause death or serious physical harm” (Occupational Safety and Health (OSH) Act of 1970, 29 USC 654(a)(1). The Department of Labor and Health and Human Services released a 35-page guidance on preparing workplaces for COVID-19, which has good advice that comes with a great deal of discretionary judgement. While this guidance has the best of intentions, the plaintiffs’ bar is watching and it is reasonably certain that guidance will be used to create new standards for a majority of employers.
The #MeToo Movement

Sexual harassment claims have been a basis for many employment practices’ liability claims. However, since the start of the #MeToo movement in 2017, EPL claims have increased in frequency and severity. At the end of 2019, employees filed 7,514 sexual harassment charges with the Equal Employment Opportunity Commission. Today, #MeToo continues to have a lasting effect on employers. Not only have state and local governments enforced stricter legislation and protections against workplace harassment, but also plaintiffs’ attorneys are seeking larger compensation for damages.

EPL claims have increased in frequency and severity since 2017

Biometrics and Privacy

Current concerns exist involving the litigation arising from biometric data, with Illinois being the first state to pass legislation concerning the collection of this type of information. Biometric data can include everything from retina scans to fingerprints to voice recognition, as well as DNA, scent, and gait recognition. Companies continue to use this type of information for things such as clocking in and out, restricting access to sensitive areas of a workplace, or even to monitor productivity.

Current legislation requires employers to have a written policy, schedule, and guidelines revolving around data collection, as well as in the retention and destruction of any biometric data collected. It also limits the company’s right to disseminate this information and more importantly, allows for a private right of action should the employer not comply. Other states are following suit, with Texas, Washington, California, New York and Arkansas all having passed legislation or currently in the process. Other states are likely to follow suit.

Lawsuits from the plaintiff bar are also on the rise. Between 2008 and 2019 over 200 BIPA suits have been filed. These are generally in the form of a class action which can be vastly more expensive to defend than a traditional EPL claim. Most recently, the American Civil Liberties Union filed suit against Clearview AI, a leading facial recognition software company, claiming they violated the Biometric Information Privacy Act in the state of Illinois. The insurance market has responded by either adding specific exclusions for claims arising from the collection of biometric data, or by asking additional questions at the underwriting stage. It’s also not uncommon to see increased EPL retentions for these types of class actions.

EEOC Claims

With the rise of the #MeToo movement, the EEOC has seen a drastic increase in complaints filed with the agency. The EEOC noted there was a 12% jump in sexual harassment complaints in 2018 compared to the prior year. This represents the first increase in the past decade of sexual harassment complaints. However, sexual harassment complaints aren’t the only issues the EEOC sees. In 2019, 53.8% of all charges filed were for retaliation and 33% were for race. Given the current social climate, these numbers are likely to increase. And while EEOC complaints tend to be more of a nuisance type claim than a severity type claim, it is worth noting the EEOC recovered a total of $92.7M in fines and penalties between 2018 and 2019 alone.

Wage and Hour in California

COVID-19 has had a profound impact on the hospitality and retail industry. Most of these employees are paid hourly, and with most restaurants and retail stores being closed, many have been furloughed or laid off. The plaintiff bar has historically been active in bringing class action claims against employers that incorrectly classify employees, fail to pay them minimum wage, or fail to pay them for overtime. But COVID-19 has created new problems. For example, in California, there are various legal challenges employers
must now navigate. Employers will most likely need to allow employees to use paid sick leave during a self-quarantine as that may qualify as “preventative care” if the employee has been exposed to COVID-19. And under California Labor Code section 230.8, employees may use up to 40 hours a year for “child related activities” including “child care provider or school emergency” which is defined to include the unexpected closure of a school.¹³

The nuances to the wage and hour laws (particularly in California) are vast. Carriers have traditionally provided a small sublimit ($100k-$250k) for defense only for these claims. As the litigation continues to increase, and the D&O / EPL market continues to harden, these sub-limits are becoming harder to find. Some carriers have provided products to respond specifically to wage and hour suits. These policies tend to be expensive with large retentions, but they respond to defense and damages, which is unique. Beazley has historically been the leader on this product, but they have recently exited the marketplace due to adverse claims activity. Bermuda markets can still entertain the coverage, but premiums are high, retentions are higher, and underwriters are extremely selective in offering terms.

SELLING CLIENTS ON THE IMPORTANCE OF MANAGEMENT LIABILITY INSURANCE

84% of underwriters believe that companies aren’t as aware as they should be regarding the risks and costs of D&O litigation.¹⁴

The following can help you determine the best coverage for your clients to mitigate risks when faced with selling challenges in this market.

» **Maintain an open dialogue with carriers and underwriters.** To properly assess and place a risk, underwriters and carriers need to understand the details about the business’s risk culture and governance. Narratives on employee safety, disaster preparedness, and financial contingency plans, etc. are critical. Telling a story behind the application and financials is a bigger differentiator than ever before.

» **Engage in robust underwriting at renewal.** This includes spending more time consulting with clients to develop any alternative and / or more competitive options to secure the coverage they need while controlling costs. This is especially important for companies that are facing financial challenges to ensure the best financial representation in the management liability market. Businesses under stress will not prioritize insurance information requests, but a timely and open dialogue around the importance of such information is critical.

» **Consider carriers that offer EPL loss control services.** Many private company carriers offer loss control tools and guidance to help clients better mitigate EPL claims at no additional cost. This can be used as a selling point to encourage clients to utilize these valuable services. Companies are, unfortunately, having to lay off employees due to the current pandemic. Consulting with employment attorneys provided by the carrier helps cut costs and prevent claims.

» **Consider rebalancing existing policies.** It may be necessary to help clients identify and then reevaluate how much risk transfer they need to protect board members and management. For example, Side A DIC insurance with its broader coverage and separate limits for directors and officers may be needed to fill critical coverage gaps. As the company and market environment change, it may be necessary for you to rebalance or even introduce new concepts to clients in an effort to best mitigate risks. Of course, the Side A DIC product is predicated on insolvency, so that market is increasing premiums, tightening capacity, and ramping up underwriting questions.
Consider the alternatives to a traditional D&O policy. There are certain scenarios where a private company can’t indemnify its directors or officers, such as when the company is in bankruptcy, is settling a derivative lawsuit or when insurance limits have been exhausted. Side A of a D&O insurance policy responds when a company cannot indemnify its directors and officers. Coverage can often be purchased as a stand-alone policy and can be an alternative to a traditional policy for specific clients.

Take a holistic approach to risk management transfer. When reviewing a client’s risk exposure, consider a well-rounded management risk program. Be prepared to discuss all insurance options that may be available to clients, including D&O, EPL, fiduciary, crime and cyber insurance.

CONCLUSION

Never before have boards and executive management of private companies had more responsibility when it comes to liability risk management. Moving forward, companies must be proactive in the identification of potential liability exposures and risk transfer solutions, including a holistic management liability insurance program.

For more information on how Worldwide Facilities can help you determine the best risk mitigation insurance program for your private company clients, please contact an expert today.

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6. Ibid.
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