

A man in a dark pinstriped suit, light blue shirt, and striped tie is sitting at a dark wooden table. He is smiling slightly and looking towards the camera. His hands are clasped on the table. The background is a plain, light-colored wall.

The Risk is Real

Chubb's Canadian Private Company Risk Survey reveals varied understanding of a quickly changing risk landscape.

Professional liability risks are typically associated with large public companies, but lately, private companies have found that they aren't immune. The shifting risk landscape is due, in part, to corporate governance regulations—like Sarbanes-Oxley and Canada's Bill 198—which created new standards to global expansion among small businesses. The result: a marked increase in lawsuits against private companies and their officers and directors, from investors, customers, employees, competitors and regulators.

In and of itself, this development is not news. Most insurers today know that their risks have changed.

What is new is how we refine our understanding of this quickly evolving, significant market. To this end, Chubb's latest Private Company Risk Survey—the third in a series that began in 2003 in the United States—offers a Canadian focus and provides a revealing lens into management liability and what it means for private companies on this side of the border.

Research firm Pollara conducted the survey through telephone interviews with specialty insurance decision-makers at 469 companies in the United States, and 300 across Canada. Participating companies comprised private, for-profit corporations or partnerships with at least 25 employees.

The survey examined company experiences with management liability, their concerns for the future and the measures in place to mitigate relevant risks. It also looked at management liability as a whole, and at the following individual lines of coverage:

Crime	Errors & Omissions (E&O)
Employment Practices Liability (EPL)	Cyber-theft
Directors & Officers (D&O)	Fiduciary
Workplace Violence	Kidnap & Ransom

Among the survey's most enlightening of findings, particularly given how much discussion has taken place on the topic, is an apparent gap between the risks that private companies face and the steps they take to protect against those risks. While more than 2/3 of firms had experienced some form of management liability event (typically a lawsuit), a full 1/3 had no policies in place to protect against them.

Why the gap? Respondents indicated that they perceived the risk as minimal, that they did not apply to small or private firms, and that they are sufficiently covered in another existing policy. As discussed below, the reality is that the risks are very real, they are

not typically covered in other policies and—particularly for smaller firms—the costs to deal with them can be crippling.

No one is immune

Many companies simply don't feel vulnerable to management liability risks because these risks are reserved for large public companies. As many as 31% of respondents (depending on line of coverage, in this case for D&O) without management liability insurance said the reason was that the risks were minimal.

The reality is that the risks are very real, and no company should consider themselves immune. In the last five years:

- 35% of respondents experienced a loss due to workplace crime, such as employee theft, vandalism or forgery.
- 34% faced an EPL event, often employee claims of harassment or discrimination.
- 25% had to deal with suits against company officers and directors for allegations such as inaccurate financial reporting.

Much of this reality stems from the fact that private companies today engage in many of the same "risky" activities as public firms. As a consequence, they face similar scrutiny from constituents over their decisions, execution of communicated strategies, and more.

A driving factor behind many of these activities is the economy. Private companies have to make some tough decisions to deal with the current economic downturn, some of which may negatively impact one or more constituents. Looking to the year ahead:

- 25% of respondents expect a reduction in workforce, which may precipitate legal action, theft and vandalism, or even violence from disgruntled employees.
- 24% plan on outsourcing some functions or operations, risky for the same reasons as reducing the workforce.
- 25% anticipate facing tighter access to capital, a "risky" proposition because of the decisions management may need to make as a result.

Positive economic conditions can also lead to

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“risky” behaviour:

- 61% of respondents expect to broaden their product line, possibly exposing the company to legal action for any flaws in the product design or manufacturing.
- 30% anticipate a major acquisition, which could lead to legal action from shareholders and other constituents who may disagree with the terms of the deal.
- 25% plan to open new domestic offices, each bringing with it new hires, new provincial or state regulations and other sources of risk for the company and its management.

Whether management’s actions are responsive to positive or negative conditions, company constituents—even competitors—are now acutely aware of their rights, and more willing to litigate for redress. Combined with the events they have already experienced, it follows that respondents expect to encounter further events over the next year:

- 34% expect to encounter a crime-related event.
- 31% anticipate having to defend against a D&O suit.
- 25% believe they will face EPL-related legal action or allegations.

It is worth highlighting that even the smallest companies surveyed—those with 25 to 49 employees—are vulnerable to management liability risks. Making up 34% of the firms surveyed, these companies took part in the same activities, experienced the same events, and were vulnerable to the same risks as larger firms; and as discussed next, it is these firms that ignore these risks at their peril, as the costs to deal with them can quickly escalate.

Similar risk, different consequences

While the management liability risks faced by public and private companies are similar, the consequences are not. Lawsuits and other events can be devastating to a private company, both financially and personally, not to mention the potential threat to the personal assets of its directors and officers.

Detrimental costs stem from the fact that companies must defend themselves against suits brought against them—whether the suit has merit or not.

As management liability suits are argued in civil court, it is instructive to review what happens when a civil suit is brought in Canada. Each province has unique procedural rules but all have similar elements. At the onset of a lawsuit, a company’s lawyer should provide a litigation budget addressing these procedural steps. Standard components of that budget include:

- **Pleadings:** Preparing the Statement of Defence
- **Factual Investigations:** Witness interviews and document review
- **Motions and Cross-Examinations on Affidavits:** As required by the Rules of Civil Procedure, both moving and responding
- **Discovery:** Review and preparation of documents, review of other parties’ documents, attending at examinations for discovery, and answering questions and documentary requests that flow from such examinations for discovery
- **Experts:** Retaining, instructing, being briefed by experts, reviewing experts’ reports
- **Legal Research and Analysis:** Case and precedent review
- **Mediation and/or Arbitration:** Selection and preparation as well as attendance
- **Pre trial conference(s):** Can be multiple events
- **Trial:** Preparation and attendance
- **Appeals:** Ordering and reviewing trial transcripts, preparation of factums, and attendance

Suffice it to say that the more complex the litigation, the more components and (billable) work is involved, and the higher the defence costs.

Findings from the survey paint a consistent picture. Including legal fees, penalties, settlements and other items, the average cost across all lines of coverage is almost \$100,000, with the breakdown by specific lines of coverage being as follows:

Crime	\$41,877
EPL	\$56,185
D&O	\$361,856
Workplace Violence	\$77,353
E&O	\$66,345
Cyber-theft	\$202,600
Fiduciary	\$26,500
K&R	\$34,000

With such costs, it could be argued that encountering even one \$100,000 event every five years would make most policies a prudent financial decision. The protection of cash flow becomes even more significant in prolonged cases, where defence budgets of \$1 to 3 million are the issue.

For some, the more costly expense is the personal damage to reputations and relationships. Plaintiffs sometimes

intentionally make the process as long and painful as possible, in the hopes that defendant fatigue will result in a more favourable settlement. Consider that some disputes last 5 to 10 years, and that most require heavy involvement on the part of defendants.

Costs can escalate even further when defendants start to focus more on winning the case than minimizing damages, an attitude bolstered by the common belief that winning parties in a civil suit can recover their legal costs. While true in principle, the successful party never recovers 100% of their costs. In the event that the unsuccessful party has become insolvent, the amount recovered is zero.

Is the policy enough?

Another prevalent reason cited for not taking out management liability insurance was the assumption that the risks were already covered by an existing policy. It's a common misconception that general liability (GL) insurance and umbrella insurance coverage will take care of every possible lawsuit. However, GL insurance does not typically cover the financial consequences of a private company's management liability risk exposure. By line of coverage, this reason was cited by companies in the following numbers:

Crime	26%
EPL	8%
D&O	18%
Workplace Violence	10%
E&O	15%
Cyber-theft	9%
Fiduciary	8%
K&R	3%

With management liability risks being very real and potentially overwhelming, it is dangerous to assume risks are covered under GL policies. The appearance of this misconception as a purchasing factor underscores the importance of companies working closely with brokers, legal counsel and other advisors to understand perfectly the risks they face, and the protection they need.

Don't Assume

While many of the survey findings may seem sobering, a positive side is that brokers and insurers are evolving to keep pace with the changing risk landscape. Moreover, solutions to protect against these risks exist not only in

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insurance, but also in internal controls and education.

While internal controls are already in place in a large number of private companies, these controls need to be maintained and updated as external risks evolve:

Written harassment and discrimination policies	75%
HR policies, procedures and training programs to help prevent losses	67%
Routine use of contracts when engaging with third parties, clients and customers	64%
Employee background checks	68%
Retain legal, HR and other consultants to address exposures	66%
Employment discrimination and/or sexual harassment training	54%

Companies can learn more about governance practices, for example, through courses offered at the Institute of Cor-

porate Directors. They should definitely look to brokers and legal counsel to understand fully the risks they face and the protection needed to mitigate them.

Many small companies actually look first to their lawyers for guidance on management liability risks. This is of course a prudent practice, but it is also wise to seek counsel from a skilled insurance broker who can review a company's full insurance portfolio and provide multiple competitively priced products to consider.

As it happens, it is currently a buyer's market for management liability insurance in Canada: companies can purchase \$1,000,000 in coverage for between \$2,000 to \$5,000, depending on a company's risk profile. What's more, most businesses have experienced cost savings in insurance in recent years, giving them extra funds to invest in strengthening their insurance coverage—particularly if risks have been underestimated or assumed covered elsewhere. ☑

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