

CORPORATE INSURANCE LAW

Expert Analysis

Are Private Companies' Liability Risks Adequately Insured?

We live in a litigious society and, as a result, many publicly owned companies may view litigation costs and insurance premiums as simply costs of doing business. Accordingly, public companies generally employ executives who are well versed in risk management, insurance and the use of insurance to address exposure to anticipated risks.

In many respects, private companies face risks similar to those faced by public companies. Yet private companies may not take the same approach as public companies with regard to insurance. A recent survey commissioned by the Chubb Group of Insurance Companies suggests that many private companies are not adequately insured, in part because their executives may not understand which risks are covered and which are not covered by their existing insurance policies as well as which risks would be covered by other available insurance products.¹

Pollara Strategic Insights administered the survey for Chubb and the revealing results are based on a telephone survey of 450 decision-makers associated with private companies in the United States.

Purchasing Insurance

According to the Chubb survey results, in 2013, only 28 percent of the surveyed private companies purchased directors' and officers' (D&O) liability insurance. Likewise, less than 31 percent of the surveyed companies purchased any of the related liability insurance products that are often purchased along with D&O insurance, including employment practices liability



By
**Howard B.
Epstein**



And
**Theodore A.
Keyes**

insurance (EPL), fiduciary liability coverage, errors and omissions insurance (E&O), crime insurance or cyber risk coverage. Only EPL insurance was purchased by more than 30 percent of the companies, and just barely more than 30 percent. In fact, far less than half of the surveyed companies purchased even one of these types of liability insurance.

These percentages seem strikingly low, particularly considering the survey finding that 44 percent of the surveyed companies experienced at least one loss related to D&O liability or one of the related types of liability in the three years prior to the survey. In addition, the survey revealed that private company executives are significantly more concerned with these liability risks than they were in 2010, when the survey was last administered. In fact, the number of executives concerned with the risks associated with EPL, E&O, employee theft, cyber breach or benefits-related claims more than doubled in that three-year period. For some reason, however, the increased concern has not translated to an increase in the purchasing of insurance to address these risks.

Misconceptions About Scope

According to the Chubb survey, one reason that private companies may not purchase D&O and related liability insurance products is that private company executives mistak-

only believe their general liability (GL) policies cover these risks.

To the contrary, the scope of GL policies is generally limited to risks associated with claims by third parties for bodily injury, personal injury, advertising injury and property damage and defense expenses associated with such third-party claims. Nevertheless, the survey results revealed that an astonishing 65 percent of the executives polled mistakenly believed that their GL policy provided coverage for D&O related risks. Further, more than half of the executives also mistakenly believed that their GL policy covered EPL, E&O and fiduciary liability risks. While less than half believed that their GL policy covered cyber risks, the vast majority (more than 90 percent) did not purchase coverage for such risks anyway.²

D&O and Other Products

Based on the survey results, it appears that a brief primer may be in order regarding the more common liability insurance products that are available for private companies.

D&O—directors' and officers' liability insurance covers risks associated with loss from actual or alleged wrongdoings of a company's directors and officers. For example, D&O insurance is implicated when a director breaches a duty to the shareholders through ordinary negligence, or perhaps by pursuing personal profit at the expense of the corporation. These policies typically provide coverage to the individual directors and officers as well as to the company to the extent that the company has indemnified the directors and officers (pursuant to company bylaws or indemnity agreements). Many D&O policies also provide direct coverage for claims against the company, particularly for securities claims.

HOWARD B. EPSTEIN is a partner at *Schulte Roth & Zabel*, and THEODORE A. KEYES is special counsel at the firm.

E&O—errors and omissions insurance covers claims for loss arising out of professional services performed for a third party. For example, E&O insurance may be implicated by claims that an investment adviser negligently advised a client investor or by claims arising from alleged misrepresentations in marketing materials.

Fiduciary Liability—fiduciary liability insurance provides coverage for loss arising out of the breach of a duty associated with benefit plans. For example, fiduciary liability coverage may be implicated where company executives are accused of negligently selecting outside service providers to manage benefit plans for the company. This coverage can protect company executives from personal liability associated with such claims.

EPL—employment liability coverage covers risks associated with employment practices. For example, EPL coverage is typically implicated by claims for workplace harassment, discrimination and retaliatory practices.

Crime—crime policies typically cover loss associated with theft, fraud and forgery by employees.

Cyber risk—cyber risk insurance typically covers loss associated with data leaks through theft or other unauthorized disclosures. These policies may cover first-party damages and expenses incurred by the insured as a result of a data breach and third-party claims for damages.

None of the risks described above are typically covered by GL policies.

Frequency of D&O Claims

D&O insurance is routinely purchased by public companies, yet the Chubb survey results indicated that only 28 percent of the surveyed private companies purchased D&O insurance in 2013. This is surprising because, according to a 2012 Towers Watson survey, D&O claims are nearly as likely to be filed against private companies as public companies. According to that survey, over the past 10 years, D&O claims have affected 33 percent of public companies and 27 percent of private companies.³ Despite the similar percentages, there appears to be a disconnect causing substantially less private company executives to purchase D&O insurance.

In addition to misconceptions about the scope of GL policies discussed above, one other possible explanation for the modest level of interest in D&O insurance is that private companies often have a small number of shareholders and, as a result,

executives may not anticipate a D&O claim. However, “[t]his perspective overlooks the fact that the plaintiffs in D&O claims include a much broader array of claimants than just shareholders. D&O claims plaintiffs also include customers, vendors, competitors, suppliers, regulators, creditors and a host of others.”⁴

A recent survey commissioned by the Chubb Group of Insurance Companies suggests that many private companies are not adequately insured.

Remarkably, the Chubb survey results also indicate that private companies remain likely to overlook D&O insurance and related insurance products even where they are simultaneously undertaking activities that might increase their exposure to liability risks, including increasing or reducing the work force, reducing or eliminating employee benefits or engaging in negotiations for a merger, acquisition or sale of a portion of the business. In fact, in the current climate, nothing increases the likelihood of a D&O claim like a merger, which is often followed closely by shareholder suits alleging a breach of duty by management and seeking an increase in the price paid for their shares.

The Expense of D&O Claims

D&O claims can be expensive to resolve for both public and private companies. The Chubb survey reported that the average costs incurred by surveyed companies as a result of a D&O claim, including judgments, settlements, fines and legal fees, approached \$700,000 in 2013.

In fact, as we have discussed in previous columns, the potential for a regulatory investigation may alone provide company executives with sufficient incentive to purchase D&O insurance. The Towers Watson survey confirms that surveyed directors and officers have expressed increased concern over regulatory claims, with 83 percent of respondents ranking regulatory claims as a top three risk of concern.⁵

In the case of a regulatory investigation, the cost figures reported by the Chubb survey may understate the likely costs. At the outset, the company will likely be faced with substantial legal fees to defend against the investigation, including complying with sub-

poenas for documents and electronic data, as well as potentially for interviews of present and former employees. In addition, regulatory investigations often spur the filing of lawsuits by shareholders or investors, resulting in, at minimum, additional legal fees. Without a D&O policy, companies are unlikely to be insured for the legal fees incurred due to the investigation or the related lawsuits.

Looking Forward

It is important not to overstate the value of the Chubb survey, as it is based on the responses of a limited number of private company executives. Nevertheless, even assuming that the percentages reflected by the Chubb survey understate the number of private companies that purchase D&O and the related insurance policies discussed above, and that the survey exaggerates the number of executives that are confused about which types of policies cover which risks, the survey still appears to point to a significant disconnect between the risks faced by private companies and the insurance purchased.

Certainly, insurance is not the only way to address risk and is sometimes an imperfect solution. However, insurance is a tool that should be in the private company toolbox for minimizing exposure to risk. If these survey results paint the correct picture, then many private companies need to learn more about their risks and the available insurance products, so that they can make appropriate and educated decisions regarding risk management.



1. Worth the Risk?: Highlights from the Chubb 2013 Private Company Risk Survey (Chubb) <http://www.chubb.com/businesses/csi/chubb12192.pdf>

2. We covered cyber risk liability insurance in some detail in a column in May 2013. “Insuring Against Cyber Risks: Coverage, Exclusions, Considerations, New York Law Journal, Vol. 249, No. 98 (May 22, 2013).

3. 2012 Directors and Officers Liability Survey, Towers Watson. <http://www.towerswatson.com/en-US/Insights/IC-Types/Survey-Research-Results/2013/03/Directors-and-Officers-Liability-2012-Survey-of-Insurance-Purchasing-Trends>

4. Kevin M. LaCroix, Private Companies: Risks, Exposures and Insurance, *The D&O Diary* (Jan. 27, 2014) <http://www.dandodiary.com/2014/01/articles/d-o-insurance/private-companies-risks-exposures-and-insurance/>

5. The Tower Watson survey was conducted via online questioning of 325 organizations that purchased D&O insurance.

Reprinted with permission from the March 4, 2014 edition of the NEW YORK LAW JOURNAL © 2014 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # 070-03-14-06

Schulte Roth & Zabel

Schulte Roth & Zabel LLP
919 Third Avenue, New York, NY 10022
212.756.2000 tel | 212.593.5955 fax | www.srz.com
New York | Washington DC | London