Taking Risks with Risk

Highlights from the Chubb 2010 Private Company Risk Survey

Are companies cutting back on insurance protection in order to reduce costs during a difficult economic climate? Even when it means assuming more risk?

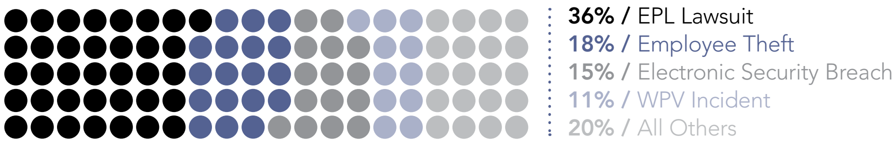
For many privately owned companies, the answer appears to be yes.

According to the *Chubb 2010 Private Company Risk Survey:*

- Overall, the percentage of private companies purchasing various types of professional and management liability insurance policies fell in 2010 from 2007, the last time Chubb conducted its survey—a span of time that roughly encompasses the recent global financial crisis.
- Insurance purchase rates are fairly low—only about **1 in 4** private companies buy management liability, professional liability, or crime insurance policies.
- A gap apparently exists between executives' understanding of risk and their companies' willingness to attempt to transfer their risk through insurance.

What's disturbing about the findings is that **when companies self-insure or ignore risk, they actually assume *more* risk.**

Chubb's survey shows that many private company executives seem to understand the gravity of certain exposures—in particular, employment practices liability and workplace fraud and, to a somewhat lesser extent, electronic security breaches and workplace violence. The following chart illustrates how executives responded to the survey question, **"Which *one* loss event covered by the survey would cause the *most financial damage* to your company?"**



As you can see, the executives seem to recognize certain risks as being potentially damaging to their company financials. Yet the survey also shows that many executives don't make the relatively small investment in risk transfer—*i.e.*, purchasing insurance—as protection against those risks.

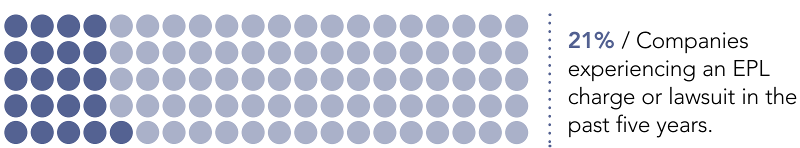
For a deeper look at how private companies are managing their professional and management liability risks, we present the following survey findings.

Key findings tell risky story

Employment Practices Liability (EPL)

*36% of the executives responded that an **EPL lawsuit** would cause the **most financial damage** to their company.*

- EPL lawsuits are among the largest and most common risks faced by private companies. In fact, more than **1 in 5** companies surveyed **(21%)** experienced an EPL charge or lawsuit in the past five years.

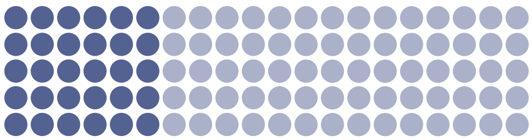


- In *Employment Practices Liability: Jury Award Trends and Statistics* (2009 edition), Jury Verdict Research reported a median compensatory award for EPL lawsuits in 2008 of **$326,640**—an all-time high. But it's important to remember that even a mere charge of employment practices misconduct must be defended and can damage the bottom line. Among the companies in the Chubb survey that experienced an EPL charge or lawsuit in the past five years, the average cost was:

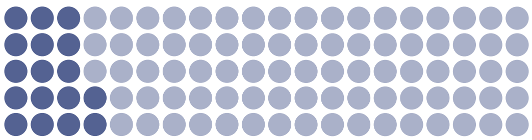
$51,975

*Of these companies, **46%** reported costs to the company ranging between **$20,000** and **$750,000**.*

- **Many companies are planning reductions in workforce (RIFs) or ways to outsource jobs.** Because both of these activities can have a negative impact on employees, they can result in EPL lawsuits alleging wrongful termination, discrimination, and/or retaliation.

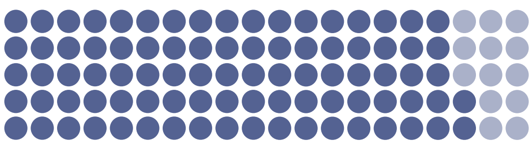


30% / Executives saying it's likely they will reduce work force in year ahead.

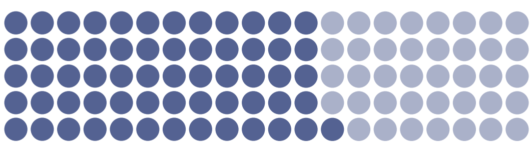


17% / Executives saying it's likely they will outsource functions/ operations in year ahead.

- **Are companies taking care to reduce their chances of suffering an EPL loss?** Most companies participating in the Chubb survey employ good EPL risk mitigation practices, such as having written policies banning discrimination and harassment and having HR policies, procedures, and training programs designed to help prevent losses.



87% / Companies that have policies banning discrimination and harassment.



61% / Companies that have policies, procedures and training programs to help prevent EPL losses.

- **It's important to remember that the mere existence of such policies and procedures does not guarantee an ironclad defense against an EPL charge.** EPL insurance is a critical component of any EPL loss prevention program. However, only **27%** of companies surveyed purchase this coverage:

Size of company:	Purchases EPL insurance:
25-49 employees	**20%**
50-99 employees	**33%**
100-249 employees	**38%**
250 or more employees	**50%**

Small companies, which are less likely to buy EPL insurance and possess fewer resources than larger companies, are especially vulnerable to the potentially significant financial hit of an EPL suit.

Retaliation: The Forgotten Risk

A commonly overlooked area of EPL risk is retaliation. According to the Equal Employment Opportunity Commission (EEOC), retaliation charges have been steadily rising and now represent the second most common type of EPL charge. Yet few initial EPL claims are made for retaliation. Typically, a charge of retaliation is brought as a secondary charge in response to how the company treats the employee who brought the original complaint for discrimination or sexual harassment. Retaliation is certainly a risk that every company faces, regardless of its stellar employment policies.

A Light at the End of the Tunnel?

Some findings from the *Chubb 2010 Private Company Risk Survey* suggest that executives are optimistic about an improving economic climate. When we asked the executives about their companies' plans during the next 12 months:

- Close to half (44%) said it's likely they will add to their work force.
- More than half (54%) indicated they planned to broaden their product or service offerings.
- 12% said it's likely their company will make a major acquisition or purchase.

Of course, a stronger economy should bolster business activity and, in turn, the need for insurance protection.

- **Are companies protected from EPL losses under some other policy?** Asked why they don't purchase EPL insurance, more than **1 in 4** executives surveyed **(27%)** said the company already had EPL coverage under another policy.

  In Chubb's experience, this is likely a mistaken belief. A general liability policy typically does not cover EPL, and some D&O liability policies may provide a measure of EPL coverage for the directors and officers, but not for the company. In other words, companies that don't purchase EPL insurance probably do not have any EPL coverage at all, or at least not the same broad insurance offered by an EPL policy.

Workplace Crime

*18% of the executives surveyed said that **employee theft** would cause the **most financial damage** to their company.*

- **Workplace fraud losses can be high-frequency/high-severity events.** Consider recent data from two respected sources:
  - **Fraud is common:** 30% of companies worldwide experienced at least one incident of financial fraud in the past 12 months. (*Global Economic Crime Survey*, PricewaterhouseCoopers, November 2009)
  - **Fraud is costly**: U.S. organizations lose approximately 5% of their annual revenue to fraud. Smaller companies (fewer than 100 employees) were the hardest hit with a median loss of $155,000. [*2010Report to the Nations on Occupational Fraud & Abuse*, Association of Certified Fraud Examiners (ACFE)].
  - **Fraud is increasing**: U.S. workplace fraud schemes increased during the global financial crisis from 2008 to 2009 in terms of number of incidents (+55.4%) and dollar losses (+48.9%). (*Occupational Fraud: A Study of the Impact of an Economic Recession*, ACFE, 2009).

- **Do private companies respond by buying fidelity/crime insurance?** Most do not, despite the widespread nature and rising tide of employee theft.

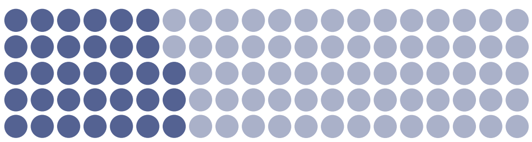
Size of company:	Purchases fidelity/crime insurance:
25-49 employees	16%
50-99 employees	22%
100-249 employees	23%
250 or more employees	43%

It would appear that most companies participating in the Chubb survey are uninsured against potential workplace fraud losses—especially smaller companies, which can least afford to incur fraud losses.

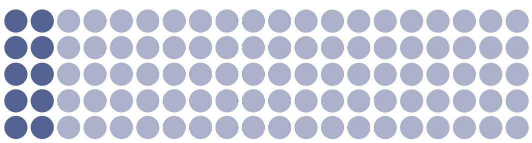
Cyber Liability

*15% of the executives surveyed said that an **electronic security breach** would cause the **most financial damage** to their company.*

- **Cyber attacks on businesses are extremely common.** In a May 2010 survey of more than 2,100 companies worldwide, Symantec Corporation found that 73% of small and midsized companies experienced a cyber attack in the past year, and that 30% of the attacks were "somewhat/extremely effective." (2010 Global SMB Information Protection Survey)
- **How are companies responding to the threat of cyber attacks?** Only **one-third** of private companies surveyed by Chubb have response plans in place for responding to electronic security breaches, while a relatively small number are developing such a plan.

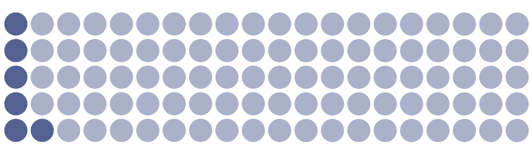


33% / Companies with incident response plans for an electronic security breach.



10% / Companies planning to create incident response plans for an electronic security breach.

Furthermore, very few companies purchase cyber liability insurance—possibly a reflection of the fact that cyber insurance has only been available to commercial buyers for a few years.

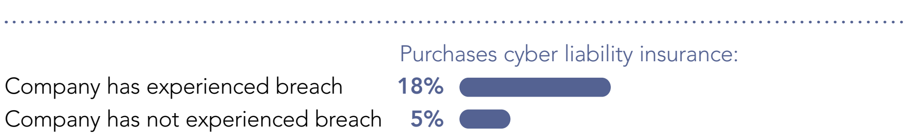


6% / Companies purchasing cyber liability insurance.

In a word, the overall response by companies to manage their expanding cyber exposures is troubling.

- **So, do companies really understand their cyber risk?** Maybe not. In the Chubb survey, the most-cited reason for not purchasing cyber coverage was "low risk/no exposure" **(47%)**, suggesting that many executives may not understand their exposure—or they may not understand how to quantify the potential loss associated with a cyber threat.

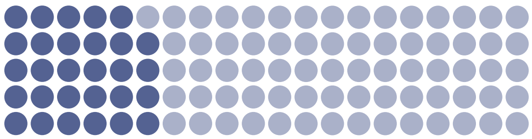
  It's worth noting, however, that companies that reported having experienced an electronic security breach are **more than three times as likely** to buy cyber insurance than are companies that have not experienced a breach:



Workplace Violence

11% of the executives surveyed said that a ***workplace violence incident*** *would cause the* ***most financial damage*** *to their company.*

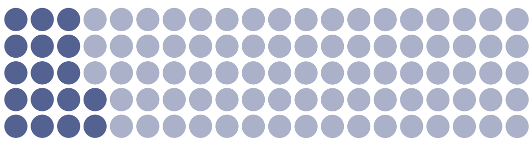
- **About 3 in 10 companies (29%) plan to reduce their work forces.**



29% / Executives saying it's likely they will reduce work force in year ahead.

Workplace reductions can trigger violence by employees who either 1) hold a grudge as a result of being laid off or 2) are fearful of being laid off and, under stress, take drastic action.

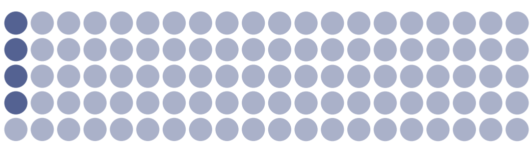
- **Approximately 1 in 6 companies (17%) also plan to outsource functions or operations.**



17% / Executives saying it's likely they will outsource functions/ operations in year ahead.

The practice of outsourcing job functions can cause employees to feel threatened and, like work force reductions, may trigger violence by outsourced employees or those who fear their jobs will be outsourced.

- Although **1 in 9** executives **(11%)** clearly acknowledge the potential financial impact of a workplace violence event by responding that it would cause the most financial damage to their company, **only 1 in 25 companies actually purchase workplace violence expense insurance:**



4% / Companies that purchase workplace violence expense insurance.

- **The Chubb survey found that executives in larger companies were more likely to express concern about the potential financial damage of a workplace violence event than those in smaller companies:**

Size of company:	Executives concerned about the potential impact of a workplace violence event:
250 or more employees	19%
Fewer than 250 employees	8%

- **Why don't more companies buy workplace violence expense insurance?** The most common reasons given by the executives surveyed for not purchasing this coverage are:

"Low risk/no exposure"	43%
"Have not needed it in the past"	19%
"Already covered under another policy"	18%

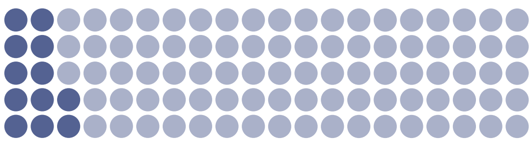
Workplace violence might be one of those risks executives don't want to think about, but should. Consider:

- A 2005 Bureau of Labor Statistics survey of 7.1 million U.S. private industry business establishments found that 4.8%—more than 340,000—experienced an incident of workplace violence in the previous 12 months. (*Survey of Workplace Violence Prevention*)
- From 2003 to 2008, an average of 498 homicides occurred annually in the workplace, according to the Bureau of Labor Statistics. (*Census of Fatal Occupational Injuries*)
- Perpetrators of workplace violence include coworkers, customers/clients, and criminals.

Directors and Officers (D&O) Liability

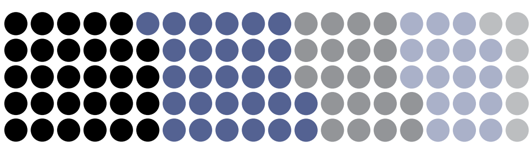
*About **1 in 6** company executives participating in the Chubb survey believe it is likely their company will experience some type of D&O liability-related loss event in the coming year.*

- **Like public companies, private companies and their directors and officers are vulnerable to lawsuits.** In fact, nearly **1 in 8** of the companies Chubb surveyed experienced a D&O liability lawsuit in the past five years:



12% / Companies experiencing a D&O lawsuit in the past five years.

- **Who is suing?** D&O liability lawsuits against private company boards can have many sources. Although private company executives may believe that a lack of shareholders helps protect them against the risk of a D&O lawsuit, most such suits come from other sources:



29% / Customer
28% / Government/regulatory agency
20% / Vendor
17% / Competitor
6% / Partner/Shareholder

- **A D&O lawsuit can be costly.** Among the companies participating in the Chubb survey that experienced a D&O liability lawsuit in the past five years, the average loss (settlement, judgment, and legal costs) was:

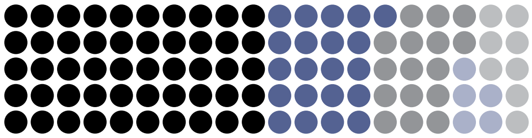
$225,682

D&O liability is a low-frequency/high-severity risk, so it isn't surprising that, although only **12%** of the companies reported being sued in the past five years, losses of **$5 million** and **$1 million** were cited.

- **Few private companies purchase coverage.** Despite the potential severity of D&O lawsuits, only **1 in 4** private companies participating in the Chubb survey—and fewer than half of larger companies participating in the Chubb survey—purchase D&O liability insurance:

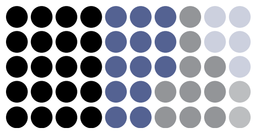
Size of company:	Purchases D&O liability insurance:
25-49 employees	20%
50-99 employees	26%
100-249 employees	44%
250 or more employees	48%

- **Yet when companies *do* purchase D&O liability insurance, it is often because someone recommended it:**



50% / Recommended by someone*
21% / Concerned about financial failure or business performance
16% / Prevention/protection/minimize risk
5% / Sued or experienced related loss in the past
8% / Other reasons

***Breakdown of the 50% – Recommended by:**

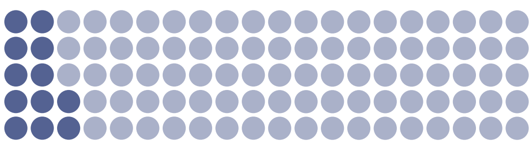


20% / Company executive
13% / Risk manager
10% / Agent or broker
5% / Attorney
2% / Business associate/Friend

Errors and Omissions (E&O) Liability

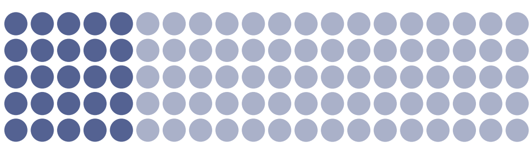
A company doesn't have to do anything wrong in order to be sued.

- **E&O lawsuits can be damaging.** Looking at just the **55%** of private companies in the Chubb survey that perform services for a fee, **12%** of those companies' executives said that an E&O lawsuit would cause the most financial damage to their company.



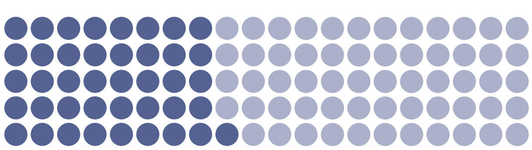
12% / Executives saying an E&O lawsuit "would cause the most financial damage" to the company. (Of companies that perform services for a fee.)

- **Most companies that perform services for a fee go without E&O liability insurance.** Of the **55%** of private companies surveyed by Chubb that perform services for a fee, only **1 in 4** purchase E&O liability insurance.



25% / Companies that purchase E&O liability insurance. (Of companies that perform services for a fee.)

Even many companies that have a *contractual requirement* to carry E&O liability insurance don't purchase this coverage:



41% / Companies that perform services for a fee and have contractual requirements to carry E&O liability insurance but do not purchase this coverage.

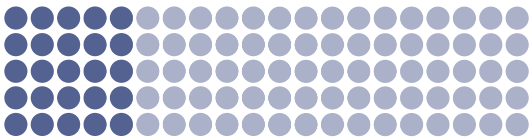
- However, looking at *all companies* in the survey, those that have experienced an E&O lawsuit are somewhat more likely to purchase E&O liability insurance **(25%)** than are those that have not experienced such a lawsuit **(20%)**.

In Chubb's experience with insuring miscellaneous service providers (such as credit reporting services, employment agencies, security systems services, and other business services), *even when a company believes it has rendered its services properly, an unhappy client can bring a claim.* Not only that, but groundless E&O allegations must still be defended—and those defense costs, normally insured by an E&O policy, can be significant.

Fiduciary Liability

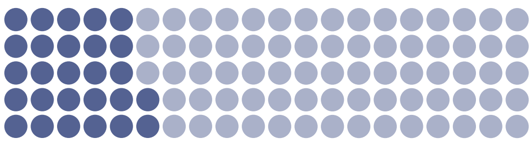
Do companies fully understand their fiduciary risk?

- **About 1 in 4 executives surveyed by Chubb say it's likely their companies will reduce or eliminate some employee benefits during the year ahead**—a potential source of fiduciary liability lawsuits by disenchanted employees and/or retirees:



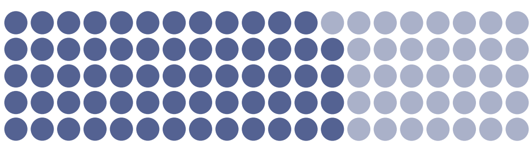
25% / Executives saying their companies likely will reduce or eliminate some employee benefits in the year ahead.

- **Only about 1 in 4 companies surveyed by Chubb purchase fiduciary liability insurance:**



27% / Companies that purchase fiduciary liability insurance.

- **Nearly 2 in 3 private companies surveyed by Chubb engage an outside service provider to help manage their employee benefits:**



64% / Companies that engage outside service providers to manage their benefits.

When you compare the **64%** of companies that use an outside service provider for their benefits to the relatively low purchase rate for fiduciary liability insurance, it seems possible that most companies may not fully recognize the potential exposure faced by their fiduciaries—and even their board members—to allegations of breach of fiduciary duty, especially when you consider:

- The Department of Labor requires a fiduciary to monitor those they appoint to perform fiduciary duties. Failure to do so could lead to an ERISA claim.
- As a result of the U.S. Supreme Court's *LaRue v. DeWolf* ruling in 2008, it is now easier for an individual plan participant to bring an action for losses to his/her individual account.
- Changes in the laws governing employee benefit plans—including ERISA, the Pension Protection Act of 2006, COBRA, and HIPAA—make it more challenging than ever for fiduciaries to navigate.

About the survey

Between January 20, 2010 and February 16, 2010, Chubb interviewed 451 decision-makers in the United States and 296 in Canada by telephone in order to gain a better understanding of their needs. The purpose of the study was to learn:

- The level of concern about and perceived impact of management liability and professional liability exposures.
- Measures the companies have taken to mitigate potential risks.
- The incidence of events that could trigger litigation.
- The financial impact of litigation and other risk events.

Chubb Group of Insurance Companies

www.chubb.com

Chubb, Box 1615, Warren, NJ 07061-1615.

Form 14-01-1020 (Ed. 7/10)