Executive Liability Insurance for ESOP Companies and Their Executives

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Introduction

The ESOP Association's endorsed Executive Liability Insurance Program allows its members to purchase insurance protection in the areas of (i) Directors and Officers Liability, (ii) Fiduciary Liability, (iii) Employment Practices Liability and (iv) Crime. Additional coverages are now available such as Cyber Liability Insurance.

These coverages can be offered in one single policy making coverage both comprehensive and cost effective. For more information, you may contact Jeff Gelburd, Vice President of Murray Risk Management and Insurance at (717) 735-7176, or (800) 533-5271, extension 381 or by email to jgelburd@murrayins.com. Or alternatively, Patrick Dixon, Account Executive Murray Risk Management and Insurance at (717) 205-0268 or by email pdixon@murrayins.com.

A description of the exposures and insurance protection is explained below:

Directors & Officers Liability

The Exposures to Directors and Officers

While Sarbanes-Oxley does not directly apply to privately held companies, the values set forth by this Act are not unique to just public companies. It is fair to assume privately held companies will be held to similar standards of corporate governance.

Directors and Officers of companies, whether privately or publicly held, are required to perform the following three basic duties: (1) Duties of diligence or acting with care that a reasonably prudent person in a similar position would use, (2) Duty of loyalty, and (3) Duty of obedience.

Director and Officer lawsuits involving privately held ESOP companies can evolve from several sources including.

- Claims by customers, suppliers, manufacturing representatives and distributors for breach of contract, false advertising, refusal to extend credit, debt collection, misrepresentation, deceptive trade practices and dishonesty or fraud;
- Legal actions by competitors for violations of federal antitrust statutes, interference with business opportunities, unfair competition, trademark/copyright/patent infringement, product or company defamation, and unlawful disclosure or use of trade secrets;

- A variety of different types of shareholder claims are possible. Claims can allege there were breaches of the duty of candor with respect to misrepresentations in and/or omissions from private placement materials or of loyalty with respect to agreements the corporation had entered into. Claims by shareholders who are also employees owning stock in their company ESOP may not be covered by the D&O policy if breach of fiduciary duty under ERISA is alleged. However, coverage may be found in the Fiduciary Liability policy explained later.

- Employment-related lawsuits for discrimination, harassment, wrongful termination or breach of contract. Such claims may also be covered under Employment Practices Liability insurance if provided.

- Claims brought by regulatory agencies or the government. Such claims may involve environmental or employee safety matters or for privately held businesses in certain industries such as financial institutions, can face investigations and claims by certain regulatory agencies with respect to suspected or actual wrongdoing.

In response to Board pressure, a greater percentage of corporations are purchasing D&O Liability Insurance on behalf of their Directors and Officers. According to a recent survey conducted by Towers Perrin, more than 66% of public and private companies surveyed have received a record number of inquiries from potential board members concerned about their D&O insurance, an increase of 16% from a similar survey conducted previously. The survey also showed that companies are responding to these inquiries by providing broader personal liability protection.

Directors and Officers Liability Insurance:

Directors and Officers Liability Insurance covers past, present and future Directors and Officers appointed or elected to the Board. Coverage is usually written in a three-part form. The first part covers payments made directly by the Director and Officer for losses arising from claims made against them which are not indemnifiable by the corporation they serve. The second part is a corporation reimbursement contract to repay the corporation any amount it is obligated to indemnify their Directors and Officers for claims made against them. A third part covers the company itself for loss which it is legally obligated to pay. This third part responds to suits naming the company by itself.

Coverage provided directly to Directors and Officers is typically referred to as "Side A" coverage. Side A coverage applies in situations when a corporation may not be able to indemnify its directors and/or officers such as in situations as a result of insolvency or when indemnification is not be permitted by law. New issues have begun to drive the purchase of Side A coverage and more insurance policies are providing separate Side A coverage with a specific sub-limit.

The policy will usually cover past, present and future Directors, Officers and employees of the corporation and its subsidiaries. Policy limits purchased are generally between $1,000,000 and $5,000,000 with additional limits being purchased by larger corporations. It should be kept in mind that defense costs are included in the policy limit, and these costs could assume a good portion of the policy limit. Deductibles or retentions can range from $5,000 to $100,000.

Because the policy uses a "claims made" form, it is vital that the corporation notify the carrier in writing of any potential or actual claim as soon as possible as coverage will only apply to those claims (or circumstances which could lead to a claim) which the carrier is notified of during the policy period. It is also important to remember that if coverage is moved to another insurer, full continuity is provided by the new policy to avoid coverage disputes. This can usually be achieved by completing a "renewal" application for the new insurer or not answering the warranty questions in the insurer application.

The policy allows the corporation to purchase "Discovery" or an extension of time, usually twelve (12) months or longer terms beyond the policy's expiration or cancellation date if the policy is canceled or non-renewed. The extension will cover claims reported during the extended time only if the "Wrongful Act" occurred during the previous policy term. Because of the complex nature of the D&O Policy, it is best to get professional advice when questions about the policy arise. Failure to have complete information can possibly lead to claims (or circumstances leading to a claim) not being covered by the policy.

When purchasing coverage, note that there will be an ERISA exclusion in the policy and Fiduciary Liability Insurance (described below) should be purchased. Be careful of the D&O policy containing a major shareholder exclusion which could exclude coverage from the ESOP or other major shareholder. Always purchase this coverage from the same insurer providing the Fiduciary Liability Insurance.

Fiduciary Liability

Exposures to Plan Fiduciaries

ERISA (the "Employment Retirement Income Security Act of 1974") governs all aspects of pensions including ESOPs. ERISA greatly expanded trustee and fiduciary responsibility for management of plan assets to include any individual or organization that exercises any control or authority over the operation of the plan. ERISA makes plan trustees and fiduciaries personally responsible for any damages incurred by a plan participant as a result of a breach of fiduciary duty.

ERISA defines a fiduciary as any person who (i) exercises any discretionary authority or control in the management or disposition of its assets; (ii) renders investment advice for a fee or other compensation; or (iii) exercises any discretionary authority or responsibility for plan administrators.

Due to their unique nature, allegations of breach of fiduciary duty involving ESOPs can be somewhat distinct compared to other benefit plans. This is because ESOPs are designed to invest primarily in employer securities. All assets of an ESOP must be held in a trust. The assets must be held and managed by a trustee or fiduciary. The trustees have a fiduciary responsibility to act exclusively for the purpose of providing benefits to plan participants and beneficiaries. The trustee must act prudently and according to the plan documents.

There has been more focus lately on Fiduciary Liability Insurance as a result of the Department of Labor (DOL) audits of ESOPs and the erosion of Plan Sponsor ability to indemnify plan fiduciaries. In most cases, Fiduciary Liability Insurance will cover DOL audits and penalties. Insurance is still the best way to protect plan fiduciaries.

One of the most common violations involving ESOPs is the incorrect valuation of employer securities. This can occur when purchasing, selling, distributing, or otherwise valuing stock. Other violations include the failure to provide participants with the specific benefits required or allowed under ESOPs such as voting rights, ability to diversify their account balances at certain times, failure to disclose required information or making misleading representations to participants or beneficiaries, conflict of interest and the right to sell their shares of stock when received.

The purchase and sale decisions raise the possibility of significant financial liability for a trustee or fiduciary. The trustee or fiduciary may be required to use personal resources to make plan participants whole for financial losses in connection with an excessive purchase price for company stock or failure to sell company stock to a willing buyer at a good price.

There are several appropriate ways for a trustee or fiduciary to limit exposure to fiduciary liability claims. Careful plan design may limit fiduciary discretion and therefore potential liability. The company (plan sponsor) may also engage an independent trustee. This may help reduce, but not totally eliminate fiduciary risk to management or other insiders.

As in any ERISA Plan, plan sponsors may not, by law, indemnify the trustees or fiduciaries for losses caused by fiduciary negligence. The trustees or fiduciaries may, however, purchase Fiduciary Liability Insurance. This may be the most cost effective way to shift fiduciary liability risk away from the plan sponsor, management and other insiders.

To help mitigate risk and potential liability, it is suggested that plan sponsors consider the following:

- Seek professional help in designing the ESOP documents including the Plan Document.
- Strictly adhere to fiduciary structure and document all governance steps and decisions.
- Continually review the investment of employer stock and develop a list of factors to be reviewed. Follow and update that list as appropriate.
- Communicate accurately when discussing employer stock with employees and make sure they are clearly advised of the risks inherent with an employer stock investment.
- Consider engaging in an independent trustee to serve participant interests, or a qualified outside firm for plan administration and recordkeeping. Request indemnification from outsiders for any errors they may make and obtain evidence of their errors and omissions insurance policy.
- Purchase adequate Fiduciary Liability Insurance.

Fiduciary Liability Insurance:

Fiduciary Liability Insurance provides coverage to past, present and future fiduciaries of the plan sponsor.

The policy also covers the plan itself (ESOP) and the plan sponsor. For there to be coverage, the claim must allege breach of fiduciary duty.

Like Directors and Officers Liability Insurance, coverage is written on a "claims made" form. As a result, the plan sponsor must notify the insurer in writing of any potential or actual claim as soon as possible as coverage will only apply to those claims (or circumstances which could lead to a claim) provided to the insurer during the policy term. When moving coverage to another insurer, it is important that the new insurer provide full continuity of coverage.

In most cases, the plan sponsor will be able to purchase "Discovery" or an extension of time, twelve (12) months or sometimes longer terms beyond the policy's expiration or cancellation date if the policy is canceled or non-renewed.

Coverage includes claims arising out of an error or omission in the administration of the plan. Coverage can also be extended to cover health/welfare or other retirement plans.

Minimum limits of liability usually purchased for the policy are $1,000,000, and the deductibles range anywhere from $0 to $10,000. Policy limits can be shared with the Directors and Officers Liability or provided separately.

Always consider purchasing this coverage from the same insurer providing the Directors and Officers Liability Insurance.

This coverage is not to be confused with ERISA Bond coverage which the Department of Labor states all plan sponsors are required to purchase covering the assets of the plan.

Employment Practices Liability Insurance

Exposures to Companies and their Executives

Expanded employer liability poses both a challenge and a risk to businesses of all sizes around the country. Employment law has changed significantly in recent years. Large settlements and the increase in frequency have increased awareness and the need for this insurance.

The Age Discrimination and Employment Act, the Equal Pay Act and the Family Medical Leave Act pose new exposures for claims against employers if policies and procedures are not properly followed or implemented.

It's not surprising to see that with the increased awareness comes the increase in frequency and severity of employment related claims. Costs associated with defending these claims can be extremely high and well into the six figures.

Insurance Coverage

Coverage can be purchased separately or combined with the Directors and Officers Liability (and Fiduciary Liability). Third Party Liability coverage is also available.

Employment Practices Liability coverage applies to claims brought as a result of the following:

- Wrongful dismissal, discharge or termination, actual or constructive, of employment;
- Employment related misrepresentation;
- Violation of employment laws;
- Sexual or workplace harassment;
- Discrimination;
- Wrongful failure to employ or promote;
- Wrongful deprivation of career opportunity including a wrongful failure to hire or promote;
- Failure to grant tenure, negligent evaluation; and/or;
- Failure to provide adequate workplace or employment policies and procedures.

Employment Practices Liability Insurance will also cover the company. This policy may be the only source of insurance protection for these types of claims. Usually, General Liability and Workers' Compensation policies do not cover employment related practices. Most, if not all General Liability policies have excluded coverage for employment related claims.

Policy limits start at $1,000,000 but can be as high as $5,000,000 or $10,000,000. Limits can be purchased separately or combined with the D&O and/or Fiduciary Liability. Deductibles for Employment Practices Liability can be as low as $15,000 and as high as $100,000. Deductible size depends on the insurance underwriter's analysis of company size (number of employees) and past loss experience.

Commercial Crime

The Exposure

ESOP companies are no different than other companies in having exposures to loss of money, securities and other property resulting from dishonest acts committed by an employee or other persons. Few companies recognize the deep bite that employee theft – big or small – can take out of a company's profit margin. Fraud can happen at any level of a company. Loss can be more substantial when high level executives are involved. Small businesses are often the hardest hit by employee fraud. Almost half of the fraud cases studied in a recent report involve small companies with the median loss at almost $100,000.

Any company can be a victim of employee dishonesty claims. However, companies that experience fast growth and mergers, use outside vendors, have a significant number of employees with expense accounts, or have high value inventory seem to be more vulnerable to employee dishonesty.

Limiting Your Exposure

A company having strong internal controls is perhaps the best form of loss prevention. Internal controls should address payroll, collection of funds from outside employees, fraudulent refunds, kickbacks, cash register theft, bank account reconciliation, and fictitious vendors. One of the best internal controls is to have separation of duties among those employees who handle money or company funds. Careful hiring practices are another form of effective control.

Insurance Coverage

Provided below is a brief summary of the types of crime coverage available.

- **Employee Dishonesty** – Insures against loss caused by the dishonest or fraudulent acts of employees involving a corporation's money, securities, or other property.
- **Forgery or Alteration** – Insures against loss due to forgery or alteration of checks and other instruments (drafts, promissory notes or similar written promises or orders).
- **Loss Inside Premises** – Insures against loss of money and securities inside the premises or banking premises resulting directly from theft, disappearance or destruction. Includes loss (i) due to actual or attempted robbery of a custodian, or (ii) in a safe or vault resulting from an actual or attempted safe burglary. Coverage includes loss from damage to the premises or loss of or loss from damage to a locked safe, vault, cash register, cash box or cash drawer on premises.
- **Loss Outside Premises** – Insures against the destruction, disappearance of wrongful abstraction of money, securities and other property outside the premises while in the care and custody of a messenger or armored motor vehicle company.
- **Computer Fraud** – Insures against loss sustained as a result of or damage to money, securities and other property resulting from the use of any computer to fraudulently cause a transfer of such property from inside the premises or banking premises to a person or place outside the premises.

Insurance limits typically purchased for each of these coverages are $100,000 with deductible of $5,000.

Additional limits and smaller or larger deductibles are available. Insurance underwriters will base deductible size on level of internal controls, employee count and company revenues.

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If you have questions about how to best protect your ESOP company and its executives, please contact Jeff Gelburd at jgelburd@murrayins.com or by calling 717-620-2476

Note: The above commentaries are to provide an overview concerning these insurance coverages. It is recommended that the proposed policy and its endorsements be reviewed prior to purchasing this coverage.