

## No Small Potatoes

### Small And Medium-Sized, Privately Owned Companies In Canada Face Several Of The Same Management Exposures As Larger Corporations, And Yet Many Don't Purchase Directors And Officers (D&O) Liability Insurance. Why Not?

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The corporate landscape in Canada has often been characterized as one dominated by small and medium enterprises (SME). In fact, there are about 2.3 million SMEs in the country and they employ approximately two out of every three Canadians in the private sector, according to Statistics Canada. SMEs are defined as enterprises with fewer than 500 employees. Small enterprises have less than 99 employees; medium enterprises have between 100 and 499 employees, while micro enterprises are those with fewer than five employees. In Canada, SMEs account for about 60% of all new jobs created in the private sector.

It's clear that SMEs are an important engine of Canada's economy. Less clear is why so few of them buy management protection in the form of Directors and Officers (D&O) or Employment Practices (EPL) liability insurance. Several studies show the take-up rate of management liability protection amongst SMEs has been slow.

Canadian data is scarce, but a recent survey by Chubb Insurance found 37% of U.S. companies do not purchase any type of management liability insurance. In a survey of private companies, the majority of survey participants (63%) did not buy directors and officers liability or employment practices liability insurance. Based on our experience, the similar trends seem likely to apply in Canada.

Smaller privately owned companies may think their exposure to management liability risk is low or negligible, but that is not necessarily the case. In fact, another study by Chubb Insurance Company of Canada showed private firms both here and south of the border face similar rates of:

- lawsuits against their directors and officers;
- legal action involving general management liability; and
- lawsuits from their customers.

In a survey released in September 2008, Chubb discovered private companies in Canada and the United States faced similar lawsuits from customers (16%), competitors (5%), vendors (6%) and partners or shareholders (3%) in the last five years. The average cost to the affected Canadian companies was \$338,699. One-third of Canadian companies and almost a quarter of U.S. firms experienced an employment-practices related incident in the last five years. Judgments, settlements, fines and legal fees for such incidents cost affected companies an average of \$63,724.

So you have a slow uptake of liability protection and management exposures for SMEs in Canada. The result: an insurance coverage gap for an alarming number of privately held companies.

## WHY SMALL COMPANIES DECLINE PROTECTION

There are many reasons why SMEs tend to decline management liability protection. The first is that most D&O policies are written with the larger corporation in mind. As the old adage says: if you're a hammer, then everything looks like a nail. Many privately held companies say the application process is too cumbersome and the information requirements too broad. The second is that SMEs tend to perceive the price as too high. Again, this "one-size-fits-all" approach has been a problem with some traditional D&O and management liability policies.

Underwriters design products, applications and business processes around larger risks, with publicly traded companies, shareholder lawsuits and audit controls in mind. But many privately held corporations don't have the same risk profile.

Some SMEs may feel they are not exposed to management liability, but in reality the exposure is simply different for a privately held company. For example, instead of public shareholders, the issue of lawsuits is far more likely to involve partners or private shareholders.

SMEs also tend to have fewer internal control mechanisms -- such as human resources or compliance officers and company protocols -- than larger corporations. In addition, they are more vulnerable when negotiating with vendors or large suppliers, since the SME is typically the smaller of the two parties. Moreover, privately held companies are likely to face short-term cash flow issues, which is reflected in relatively higher bankruptcy rates for small businesses.

## SME EXPOSURES

The bottom line is that SMEs can, and do, face a number of liability issues related to directors and officers and employment practices. Executive and non-executive business owners are increasingly being held accountable for their actions. Business owners are faced with greater corporate governance issues and are exposed to the increased vigilance of other partners, shareholders, employees and the public. Also, the number of claims aimed at establishing the personal liability of business owners or partners of a privately held company has increased.

Several distinct examples exist of privately held companies facing litigation related to bankruptcy, misrepresentation, wrongful dismissal and dissolution of a partnership. In one case, a retail company expanded too much during a time of economic difficulty.

Its revenues shrank, but inventory and supplies continued to grow. The result was bankruptcy. The company faced statutory liabilities and the directors were left exposed to pay for amounts owing (including unpaid wages). The settlement amount came to \$765,000 (including \$165,000 for defence costs).

In Ontario, *Bill 198* has made it easier for shareholders to sue companies along with their directors and officers. In the last 18 months, the number of lawsuits has increased significantly as a result of this legislation.

## A FRESH APPROACH

The unique risk profile of SMEs means management liability insurance solutions need to be tailored to fit the needs of these corporations. Creative, targeted products are required that simplify the process and yet still address the risk exposures of privately held companies in Canada. Underwriters and brokers have taken note.

Given the corporate D&O market has gradually been reaching a saturation point in Canada, some insurers are now targeting the SME market. One packaged policy offers a low minimum premium, a streamlined application process, no requirement for audited financials and coverage for a wide range of industries. The policy automatically includes D&O, EPL and Entity coverage, but it can also be extended to cover Errors & Omissions and Fiduciary Liability.

For SMEs, the benefit is a simplified application that can be filled out in less than an hour, not days. Protection is available at realistic premiums. Coverage is offered on a claims-made basis.

Brokers in Canada should be interested in the SME market because of the importance of small commercial clients to their practices. Although many of these clients likely have a CGL policy in place, a significant proportion do not have management liability protection.

This is a great way for brokers of all levels to extend the product suite and fill any insurance gaps in a client's portfolio. It also gives brokers an excellent opportunity to build closer relationships with business owners, CEOs and CFOs.

When it comes to management liability, it's clear a potentially significant coverage gap exists for many privately held companies in Canada. Equally clear is that many of the management liability products are not well suited to the SME market. The main purpose of any new D&O or EPL insurance solution should be to help protect these organizations. It's time for a fresh perspective on small and medium enterprises.

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