

The long arm of the credit crisis

This is no time to be scrimping on insurance protection.

BY LISA M. JONES

WHAT IS THE IMPACT of tightening credit on private companies and smaller (micro-cap) public companies? And what risks does this create for their directors?

By now it isn't exactly front-page news that the subprime mortgage meltdown, which began during the third quarter of 2007, has deteriorated into a full-blown business credit crisis:

- The World Economic Forum's *Global Risks 2008* report cited "systemic financial risk or a system-wide financial crisis as the most immediate and severe risk" facing businesses worldwide.

- The U.S. Federal Reserve reported in April that 52% of banks had tightened lending standards for companies with sales under \$50 million, up from 30% in January.

- According to the *Chubb 2007 Private Company Risk Survey*, 33% of private company executives were concerned about tighter access to capital — and that was in late 2007, before the economy had deteriorated.

It has been said that the credit crisis affects only those companies with debt. But capitalism thrives on debt, so in reality most companies are affected, and smaller companies, in particular, are more likely to need access to credit simply to continue operations.

Some experts note that with banks operating under closer regulatory scrutiny the credit pendulum has simply swung back to more prudent loan risk assessment after a prolonged period of

reckless loan practices. But others note the pendulum may have swung too far, too fast — that even healthy companies are being deprived of needed funds for expansion and hiring.

Regardless, for companies that are unable to gain access to precious capital, the pain is real and is taking many forms:

- Many businesses are unable to get loans approved at all.

- Companies are having difficulty renewing and extending lines of credit.

- The waiting period for loans has dramatically increased, forcing companies to delay plans.

- Even growing companies that have good credit or that need capital in order to expand so they can meet orders are being hit with tighter credit terms and higher interest rates.

The restricted access to capital, combined with rising energy and commodities prices, has given many companies little choice but to implement cost-cutting programs, shelve

expansion and other investment plans or even close locations, trim employee benefits programs, and delay hiring and/or lay off employees.

So, what's the risk for directors?

Shrinking company profits, stock price volatility, and a rising threat of insolvency all pose serious D&O liability risks to directors. For public companies, investors increasingly are responding with lawsuits alleging inadequate disclosure and inaccurate financial reporting. D&O liability lawsuits are also on



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the rise against private companies. The *Chubb 2007 Private Company Risk Survey* shows that the costs associated with D&O liability lawsuits have increased by nearly 22% since 2005.

Unfortunately, the risks facing companies and their boards in this business environment don't end with D&O liability but also include:

- *Employment practices liability (EPL)*: Terminations and reductions in force tend to lead to both single-plaintiff and class action EPL lawsuits alleging discrimination or wrongful termination, the two most common EPL charges.

- *Fiduciary liability*: When investment returns are down, employees are more likely to call into question the options offered to them under their 401(k) plans. Also, when employees bring EPL suits over the loss of their jobs, they often include a breach of ERISA complaint alleging benefits owed to them.

- *Workplace fraud*: Employees in financially distressed companies are more inclined to steal company assets in order to protect themselves against the possible loss of their jobs — a problem that is exacerbated by a tight job market.

In today's uncertain economy, boards undoubtedly are under added pressure to address critical financial issues and to reduce "unnecessary" spending, especially in small to midsized companies. It is important to remember at times like this that scrimping on insurance protection may be unwise since companies are more vulnerable to unexpected loss.

In addition, it's critical that boards ensure the company adheres to loss control best practices across all business areas, despite their desire to look for ways to reduce spending.

And, of course, boards should consider consulting with general counsel to help minimize risk as well.

These steps are a wise approach and can offer a solid preventive investment against financial calamity that could push a company over the edge into insolvency. ■

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