MARSH

Marsh Risk Management Research **Briefing**

US GOVERNMENT SHUTDOWN SPARKS RISK AND INSURANCE CONSIDERATIONS

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The partial shutdown of the US government — stemming from an impasse over the federal budget — evokes a number of questions for risk and finance professionals: Could the shutdown give rise to events that affect companies' operations? If it lasts for an extended period, could the shutdown lead to a material loss of revenue? Does the potential exist for lawsuits stemming from actions a company may take in reaction to the shutdown? How might insurance policies come into play?

In the short term, the shutdown is unlikely to trigger a large number of insurance policies. However, the longer it lasts, the higher is the potential for the filing of lawsuits and insurance claims. Organisations that suffer losses or anticipate claims they believe are shutdown related should work with their insurance brokers, internal risk management resources, and legal counsel to review the details of any policies that may come into play and have a clear plan for handling claims.

As serious as the current situation is, an even more severe deadline looms later in October when Congress faces decisions regarding the country's debt ceiling. There is wide opinion that failing to raise the debt ceiling would risk far greater economic damage than the current government shutdown.

Following is Marsh's perspective on key concerns regarding the US government shutdown that began on 1 October 2013.

INSURANCE CONSIDERATIONS

PROPERTY

Much like the issues surrounding sequestration earlier this year, traditional property insurance policies are unlikely to respond in cases involving losses in business income that potentially could be attributed to the shutdown. The primary reasons why coverage might be excluded are:

- There is no physical loss to trigger coverage.
- Government action on budget issues is not covered.
- The proposed action — a shutdown — is a known potential loss.

Security and emergency response: There is the potential for security issues at some government properties — for example, federal agency office buildings and national parks — that may be left vacant or less secure as a result of the shutdown. Property insurance policies may respond in the event of any resulting physical damage.

HIGHLIGHTS

- Filings of insurance claims and lawsuits are likely to increase the longer the federal government shutdown lasts.
- Some entities that depend on the government for a large portion of their revenue or funding could face lawsuits from shareholders or other constituents should their financials be significantly affected by the shutdown.
- Businesses that lay off or furlough workers could face employment practices liability lawsuits.
- Cyber risks could increase if the shutdown is prolonged and key information and analysis by governmental agencies regarding cyber risks are not disseminated.
- Companies undertaking layoffs and furloughs could see a rise in workers' compensation claims due to an increase in "moral hazard" as employees face the prospect of job losses.
- Business interruption losses are unlikely to be covered by property insurance policies.

MARSH & McLENNAN COMPANIES

The Federal Emergency Management Agency's (FEMA) response to natural disasters that occur during the shutdown could be slowed (although when Tropical Storm Karen approached the US coastline in early October, FEMA recalled previously furloughed employees). The shutdown could also affect businesses' speed of recovery following a catastrophe, but likely will not have any impact on the underlying property insurance coverage. No matter how long the shutdown lasts, we are optimistic that FEMA and other agencies of the US government will be responsive to regional and national disasters. That said, it is possible that FEMA could be caught off guard by a rapidly developing catastrophe in which it could not recall furloughed employees quickly enough.

CASUALTY

Workers' compensation: If the government shutdown continues for a protracted period, some federal contractors may lay off or furlough staff, measures that generally increase the chance of a rise in workers' compensation claims. Such a scenario is not unique to a government shutdown; the increased "moral hazard" occurs when companies lay off employees under almost any circumstance. In other words, for some employees faced with the possibility of being laid off, a greater willingness may arise to submit workers' compensation claims that are based on unverifiable facts or that are not the result of workplace injuries.

As with other aspects related to the shutdown, the workers' compensation impacts could reasonably be expected to worsen the longer it persists.

Employers can take steps to reduce the potential increased frequency of questionable claims by instituting claims-handling controls that focus on thorough investigation. For example, when verifying the legitimacy of a workers' compensation claim, investigators could obtain formal statements from the employee, employer, and possibly others to verify the accident's occurrence.

As with other aspects related to the shutdown, the workers' compensation impacts could reasonably be expected to worsen the longer it persists. From the workers' compensation insurer perspective, for example, an extended shutdown would negatively affect payrolls and thus premiums. Combined with a potential spike in frequency of claims, this could create a potential for expected loss ratios to increase as a result of a prolonged shutdown. Were this to occur, insurers would likely attempt to push workers' compensation rates higher.

Liability considerations: The potential exists for some liability-related issues from the shutdown. For example, there could be a change in risk profiles for companies that actively alter their operations as a result of the shutdown. Changes in what a company does, how it does it, or who it engages with can all affect the risk profile, perhaps severely. It is therefore critical to understand how existing insurance will respond to such changes and to consult with brokers, your risk management resources, and legal counsel.

FINANCIAL AND PROFESSIONAL

Directors and officers (D&O) liability: Some entities that depend on the government for a large portion of their revenue or funding could face lawsuits from shareholders or other constituents should their financials be significantly affected by the shutdown. Typically, D&O insurance policies serve to protect organisations and their management from liability arising from potential drops in stock prices or from lawsuits alleging breach of fiduciary duty brought by customers, bond holders, or others. The current shutdown — and the possible fallout from a government default, should that happen — are very real reminders that all businesses should ensure that current D&O limits are appropriate to respond to potential securities or third-party risks.

Employment practices liability insurance (EPLI): Federal government contractors and other businesses that furlough or fire employees as a result of the shutdown could face claims under the Worker Adjustment and Retraining Notification (WARN) Act. The law requires most employers with 100 or more employees to provide notification 60 calendar days in advance of plant closings and mass layoffs. However, federal, state, and local government entities generally are not subject to the WARN Act.

Other potential employment-related issues include:

- Wage and hour claims from employees — including some at federal agencies — who have completed work or provided services, but have not been paid due to the shutdown.
- Retaliation claims if a business was to take adverse employment action against employees who participated in social media conversations about the shutdown.
- Employment practices liability insurance typically would respond to wage and hour and retaliation claims, but most EPLI policies exclude coverage for claims under the WARN Act, other than potential defense costs under some policies.

Cyber insurance: A prolonged government shutdown could increase the cyber risks facing US businesses. For example, information sharing regarding cyber threats could be hurt if operations at Department of Homeland Security (DHS) "fusion centres" are suspended or reduced. These centres serve as a conduit for dissemination of information about cyber attacks and related threats throughout the federal government and to state and local governments. A prolonged shutdown could also affect the DHS Industrial Control Systems Cyber Emergency Response Team (ICS CERT), which provides proactive risk assessments and reviews for critical infrastructure facilities and forensic reviews to facilities that have been victims of cyber attacks.

As always, organisations — including critical infrastructure — should remain vigilant in managing cyber threats. They should actively monitor potential threats and ensure that their cyber response plans have been properly tested and communicated to all employees. If it has been purchased, cyber insurance can respond in the event of a cyber attack, subject to policy terms and conditions.

ENVIRONMENTAL

The US Environmental Protection Agency (EPA) began operating with reduced staff following the shutdown. The impacts are most significant in areas where EPA has regulatory jurisdiction for enforcement, management, and environmental oversight. Remediation or redevelopment projects managed by EPA or other regulatory agencies, such as the Department of Energy and Department of Defense, may experience delays, which could result in increased costs or a change in the scope of work.

A critical component of all environmental insurance policies is that most remediation expenses must be pre-approved by the insurer, which means that any changes should be reported as soon as possible. Additionally, pollution legal liability policies often maintain a government-mandated trigger that stipulates that cleanup must be required by the governing regulatory body. If a federal agency maintains jurisdiction over the site, then approval of cleanup may be deferred during the shutdown, potentially causing a delay of claims adjustment by the carrier.

Mergers, acquisitions, and property transactions also may be delayed due to the inability of environmental consultants to obtain necessary technical information from federal government databases to support ASTM due diligence requirements. Environmental insurance policies supporting such transactions are underwritten in part by using these environmental due diligence assessments, so coverage caveats on certain conditions may apply until such time as the appropriate data can be secured and evaluated.

TRADE CREDIT

The shutdown is unlikely to cause events that trigger trade credit policies or to affect the overall trade credit insurance market. Organisations that are suppliers to the government or are otherwise dependent on it for revenue may be financially affected if the shutdown extends beyond a few days — for example, tourism companies or hotel operators linked to national parks or other attractions closed by the shutdown. However, trade credit policies often have claim waiting periods of 60 to 90 days before coverage is triggered.

Export-Import Bank: Because of the shutdown, the Export-Import Bank of the United States is no longer processing applications for political risk and trade credit insurance. Existing and current policies obtained through the bank will be honoured during the shutdown, but businesses that had been in the process of obtaining or renewing policies will not be able to proceed through the bank until the shutdown ends. The shutdown will be especially challenging for smaller businesses and their lenders, although some larger organisations also will be negatively affected.

SHUTDOWN IMPACT VARIES AMONG INDUSTRIES

Many industries will experience negative consequences from the shutdown, ranging from missed government inspections to delayed payments to lost business opportunities.

Many industries will experience negative consequences from the shutdown, ranging from missed government inspections to delayed payments to lost business opportunities. The repercussions will spiral the longer the shutdown lasts; companies in affected industries should be engaged in contingency planning, if they are not already. Organisations should also use the current shutdown as a wakeup call to review — or develop — plans for potential fallout should Congress not solve the looming debt ceiling issue. Following are considerations in some industry sectors.

COMMUNICATIONS, MEDIA, AND TECHNOLOGY (CMT)

Government contractors for information technology (IT) are feeling a great impact within the CMT sector. As the shutdown continues, there could be broad-based furloughs for such contractors and continued downward pressure on financials, which can materialise as a reduction in stock price. For the majority of government IT contractors, there will be measurable, uninsurable revenue losses. Larger organisations in this space will be able to withstand the downturn, but an extended shutdown could pose a significant threat to many smaller ones. An extended shutdown will force many companies in this sector to reevaluate their capacity to retain risk, and potentially to rethink their insurance programme structures and budgets if it leads to a sustained shift in operations.

EDUCATION

Higher education: The shutdown has interrupted federal funding to higher education institutions. The effect on cash flow at affected colleges and universities means that many research programmes and construction programmes have been or will be suspended. In addition, some security functions have been interrupted; however, programmes funded by institutions themselves or by corporate sponsors should continue apace. Schools and universities remain obligated to protect students, faculty, and the general public from any risks related to the work sites of construction programmes that are suspended as a result of the shutdown. Institutions will need to allocate resources to understand their potential safety hazards, including dangerous equipment (for example, cranes and vehicles).

As with other sectors, the length of the shutdown will determine the severity of the overall impact. For example, a number of issues will arise if students and faculty members are unable to obtain or renew their student visas and work visas. Foreign students can represent as much as 10% to 30% of a US college or university's tuition base, revenue that could be put at risk if an extended shutdown were to adversely affect students' ability to receive visas. Institutions should make sure to track their reliance on foreign tuition and the timelines — when students are scheduled to arrive and depart — for foreign students already on campus or waiting to enter the country.

If a federally funded clinical research programme is interrupted as a result of the shutdown, patients who can no longer receive treatment may attempt to hold the colleges and universities responsible, creating reputational and/or litigation risks. These colleges and universities may have contractual obligations to such patients that remain in effect even in the event of a suspension of federal funding; whether or not insurance will respond to litigation in this circumstance is largely untested. Institutions should carefully review their contractual obligations with patients and corporate partners and understand the effect of the shutdown on their cash flows. Organisations should also keep detailed records in the event they face litigation and/or need to file an insurance claim. Also at risk are specific biomedical science research, including tissue/cell samples, which may be vulnerable if a laboratory is shut down. Compromise of this work could adversely impact the outcome of findings and the integrity of samples.

K-12 schools: Some of the initial impacts to K-12 schools include a lack of direct federal funding for the Head Start preschool programme and school lunch programmes. Certain federal grants from the Department of Education and Department of Homeland Security (for school safety programmes) have also been interrupted. Some funding that schools receive indirectly from the federal government — through the states — also may be affected. Unfortunately, there is unlikely to be recourse for schools if Head Start or other federal programmes are suspended because of the shutdown. A suspension of Head Start could have a knock-on effect on US businesses' workforces if parents of enrollees are forced to stay home from work.

FOOD AND BEVERAGE

The partial government shutdown will affect parts of the food processing industry as there are several federal agencies and programmes that regularly interact with most food processors by providing services and regulatory oversight. As the shutdown continues, food and beverage companies need to stay aware of how it is affecting any government agencies with which they routinely engage. As far as reporting requirements, companies should make sure they continue to follow protocols as inspectors will, at some point, return to work and check on records.

US Department of Agriculture (USDA): Under the government shutdown, USDA will continue inspection of meat, poultry, and egg products, but will furlough more than 1,200 employees in other parts of the Food Safety and Inspection Service. Additionally, the USDA has stated that during the shutdown it will cease operations in the National Organic Program, the Pesticide Data Program, and any pesticide recordkeeping activities.

Food and Drug Administration (FDA): Under the government shutdown, the FDA will cease safety activities, including routine establishment inspections; some compliance and enforcement efforts; monitoring of imports; notification programmes, such as food contact substances and infant formula; and the majority of laboratory research. The FDA's contingency plans say the agency will continue limited activities, including "maintaining critical consumer protection to handle emergencies, high-risk recalls, civil and criminal investigations, import entry reviews, and other critical public health issues." As of this writing, the FDA's Reportable Food Registry portal is operational; ingredient and food companies that must comply with this regulation should assume that reporting requirements are unchanged during the shutdown.

Food and beverage companies should continue to follow good manufacturing practices (GMP) in the production of food products, and continue to follow all applicable regulatory requirements, including recordkeeping and internal testing. They should also closely monitor the USDA and FDA websites for additional information on the shutdown status for individual programmes. State and local food processing regulatory agencies also should be monitored as these agencies may have more current information.

HEALTH CARE

We are unaware of any hospitals that are expected to close their doors because of the government shutdown. Instead, we believe that the more immediate impact could be a delay in payments to hospitals and other providers from the Centers for Medicare & Medicaid Services. As this would amount simply to a lengthening of providers' accounts receivables, it is likely not covered by existing policies. Some clinical research, treatment, and disease prevention programmes run by the National Institutes of Health and the Centers for Disease Control have been suspended or otherwise affected by the shutdown. This could result in more traffic to private hospitals and other providers.

LIFE SCIENCES

The FDA is one of the main government agencies involved with life sciences companies. Roughly half of the employees of the Department of Health and Human Services (HHS) — which oversees the FDA — were furloughed at the start of the shutdown. Potential effects on life sciences companies include delayed drug approvals and delayed reviews of ongoing site inspection warnings. Meanwhile, the National Institutes of Health — also an HHS agency — has stopped reviewing grant applications. The overall impact of such delays will depend in large part on how long they last. Drug manufacturers could experience revenue losses as a result of delays in the Health Resources and Services Administration's management of the federal drug discount programme.

MANUFACTURING

The shutdown may significantly affect manufacturers that rely heavily on government contracts. The slowing of payments to military suppliers, defense contractors, and other companies could raise risk issues, including delayed payments, production disruptions, and layoffs.

The shutdown is a frustration for an industry that is already nervous due to uncertainties about the economy and the new health care law. Some companies estimate the shutdown could affect 10% to 15% of their US-based workforces, with at least one manufacturer publicly announcing plans to furlough thousands of workers. Other manufacturers are experiencing or could experience delays in shipments or production due to suspended federal inspections. Companies also worry that such delays due to suspended inspections may send customers elsewhere.

For manufacturers experiencing a disruption and loss in business income, business interruption (BI) and contingent business interruption (CBI) coverage is unlikely to be triggered because the loss is not tied to property damage or physical damage to a third-party, respectively. The shutdown could heighten the potential for uninsured BI losses such as reduced orders from the government. Other insurance coverage implications include some of those noted previously: D&O claims, EPLI claims due to furloughs, and workers' compensation claims.

Manufacturers should review all government contracts for payment language to determine if there are any options for the manufacturer to be paid regardless of the shutdown, or for partial payments or expedited payments after the shutdown ends.

PUBLIC ENTITY

Funding for road construction or other maintenance performed by state and local governments has been interrupted as a result of the shutdown. If planned work can no longer be performed and roads and bridges become unsafe, these governments could find themselves at risk for litigation and other claims related to road accidents.

REAL ESTATE

A prolonged shutdown could mean an extended period without federal oversight and processing of key real estate functions. Along with the broader economic effects of a lengthy shutdown, this could have a significant negative impact on the housing market and real estate industry. The US Department of Housing and Urban Development (HUD), which runs the Federal Housing Administration (FHA), furloughed most employees as a result of the shutdown. Although the agency was providing some services to the public, FHA loan approvals are likely to be slowed during the shutdown. Meanwhile, with many Internal Revenue Service employees furloughed, mortgage firms largely will be unable to verify borrowers' income via tax returns in the near term. By law, any mortgage loan approval is subject to the review by the mortgage lender of at least one year's worth of federal tax returns, which must be verified in writing by the IRS.

LESSONS FROM THE SHUTDOWN

Although it is difficult to take steps now regarding the current government shutdown, it highlights the need for organisations to plan for a variety of risks, including the ripples from events that do not directly affect them. Although the shutdown on its own may not cause difficulty for a particular company, organisations need to plan for a cascade of risk events.

As is the case with natural catastrophe risks, most companies cannot entirely avoid the impacts of a government shutdown. Effective preparation, however, can help mitigate the damage to an organisation and help protect its bottom line. Risk mitigation steps to take include:

- Establish thorough business resiliency plans as part of an enterprise/strategic risk management programme that addresses government shutdowns. Such a plan should also consider issues related to employee benefits and layoffs arising from work shortages.
- Insulate the business from sole reliance on US government contracts.
- Perform supply chain management and vendor assessments on the impact to US and international vendors and suppliers.
- Review insurance policies for coverage and/or coverage gaps related to BI and other coverage. Also, carefully examine insurance policies to see if any form of remuneration exists. Discuss with your broker at the next renewal if it is possible to mitigate this risk.
- Review human resource policies on furloughs and layoffs. Be prepared to have these discussions with workers about the company's plans and how it can help them during the period. Being proactive can help avoid the potential for fraudulent claims such as workers' compensation claims that typically arise out of mass layoffs as seen during recession periods.
- Consider the impact of political risks overseas.

Damage from the government shutdown should be limited so long as it does not stretch out for long. But with a potential debt ceiling crisis on the horizon, the outlook is by no means clear; companies should be checking their preparedness and contingency plans.

Although the shutdown on its own may not cause difficulty for a particular company, organisations need to plan for a cascade of risk events.

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