INSIGHTS | NOVEMBER 2018

Alternative Investment Management: A Changing Employment Liability Landscape

Alternative investment management companies, particularly private equity firms, have long faced potential employment practices liability (EPL) litigation as employers and putative employers of portfolio company employees. In recent years, courts have become increasingly friendly to such putative employer arguments, employment litigation has developed into a cottage industry for plaintiffs' attorneys, and the #MeToo movement has gained tremendous momentum. As a result, EPL litigation has increased significantly in both frequency and severity, and has also been fundamentally transformed such that it poses a threat to all alternative investment management firms, including venture capital and hedge fund managers.

It is important that alternative investment firms work to reduce their potential exposure to such litigation while also ensuring that their EPL and other insurance coverage is sufficiently broad and deep to appropriately respond when a claim does occur.

Traditional EPL Litigation

Traditional EPL litigation — claims by employees of a protected class alleging wrongful employment activity, including discrimination, harassment, wrongful termination, wrongful failure to hire, and wrongful failure to promote, based upon a protected status, like gender, race/ethnicity, religion, sexual orientation, or disability — has always been a threat for alternative investment management firms.

Indeed, alternative investment management has long carried a reputation, whether or not deserved, for being among the "old boys' network" industries characterized by a distinct and intentional lack of diversity or inclusion. A 2014 Babson College study found that only 6% of venture capital partners were women. And historically, allegations of wrongful employment behavior in the industry were typically resolved informally and confidentially behind closed doors, through severance agreements and the like.

But this is changing. One of the first high-profile exceptions to the historical rule was Ellen Pao's 2012 lawsuit against venture capital firm Kleiner Perkins Caufield & Byers. While a jury ultimately ruled against Ms. Pao's allegations of sexual discrimination and retaliation, the highly publicized trial exposed alleged behavior, practices, and compensation arrangements and levels that would become fodder for similar suits and threats by employees of other alternative investment firms.

Since Pao v. Kleiner Perkins, multiple alternative investment firms have faced allegations and been threatened with litigation concerning purported harassment and discrimination based upon employees' protected status. The information involved in such claims, including compensation levels and practices, hiring and HR policies and procedures, and proprietary investment strategies, is highly sensitive. Coupled with the potential reputational damage caused by public litigation, many firms — including private equity, hedge fund, and venture capital — have chosen to settle such matters prior to litigation, paying former employees millions and even tens of millions of dollars rather than face a potential media circus.

Putative Employer Litigation

Private equity firms have long faced allegations by portfolio company employees that private equity firms controlled, and were ultimately responsible for, portfolio companies' wrongful employment practices. Examples of such practices include:

- Post-purchase reductions in workforce that purportedly target older workers.
- Alleged liability for failure to comply with the Worker Adjustment and Retraining Notification Act requirements for employee notices prior to bankruptcy filing.
- Alleged participation, or complicity, in violations of state and/or federal wage and hour laws.
- Purported encouragement of, or complicity in, company-wide harassment and discrimination based upon race/ethnicity and gender.
- Alleged failure to properly respond to employee complaints about sexual assault, discrimination, and retaliation.

Courts have typically been skeptical of such putative employer theories, often dismissing sponsor firms early in litigation and thus with minimal defense costs. But that began to change in the last five to seven years and courts have become increasingly willing to permit plaintiffs to pursue putative employer theories against private equity and venture capital firms, activist hedge funds, franchisors, and large franchise operations, among others. Given the class action nature of much of this sort of litigation — and the ease of forum-shopping for plaintiffs' lawyers — the defense, settlement, and judgment costs of such claims can easily reach tens of millions of dollars.

Third-Party EPL Litigation and #MeToo

Retail and hospitality operations and other consumer-facing industries have always faced potential claims for discrimination and harassment against non-employees. Traditionally referred to in the insurance industry as third-party EPL litigation, such claims can come from customers and vendors, among others.

With high-profile allegations of harassment and sexual misconduct by venture capital and private equity employees against founders of potential portfolio companies — along with the rise of the #MeToo movement — potential third party EPL liability has also become an increasing concern in the alternative investment industry. The higher frequency and severity of EPL claims, increasing judicial willingness to permit novel liability theories, and potential reputational damage have quickly combined to exacerbate exposure. This, in turn, has made HR practices and procedures, as well as potential insurance coverage for such liability, a key focus for alternative investment firms.

Insurance

Insurance coverage for various types of harassment, discrimination, and misconduct essentially comes in five forms:

1. **Employment practices liability insurance (EPLI):** EPL policies cover claims by employees of a company against another employee or the company alleging an employment practices wrongful act based upon a protected status under state or federal law. In some instances, such coverage can also be negotiated to extend to similar claims by putative employees at portfolio companies, among others. EPL coverage is subject to certain limitations and exclusions, which can be materially different among insurers.

2. **Third-party EPL:** This covers a similar universe of claims and wrongful acts, but by non-employees, including clients, customers, vendors, and prospects. Such coverage is frequently not included within a standard EPL policy and must be added through a separate endorsement.

3. **Wage and hour liability insurance:** EPL policies — and many other types of policies, including directors and officers liability and casualty coverage — typically exclude what are known as wage and hour claims from coverage. These employment claims are related to a company's purported failure to properly follow state and federal laws regarding classification of employees as exempt or non-exempt, and payment of overtime, break time, and donning and doffing time, among others. While express coverage for such claims is typically more relevant to portfolio companies, attention should also be paid to how wage and hour exclusions in alternative investment firms' policies may also have unintended consequences.

4. **Professional liability:** When alternative investment firms are sought to be held liable for alleged wrongdoing at the portfolio company level, such exposure can be viewed as putative employer liability under EPL, third-party EPL, or wage and hour coverage. It can also be viewed as professional liability caused by alternative investment firms' investment activities related to the portfolio company. While alternative investment firms should consider to what extent they can obtain coverage for such exposures through the purchase of the above insurance policies, they should also consider to what extent primary or excess coverage can be obtained as part of their professional liability insurance coverage. This is typically referred to as general partnership liability (GPL) insurance

5. **Casualty insurance:** Physical injuries caused by sexual or other misconduct, along with medical bills and missed work time, among other costs, will often not fall within the coverages described above, absent manuscript policy language. It is therefore important that all businesses carry insurance to cover potential physical injuries to employees and third parties occurring on their business premises, caused by their employees in the course of their employment, and/or related to their operations. Alternative investment firms can also potentially integrate some level of excess coverage for such issues in the form of professional liability insurance coverage that extends to potential physical harm purportedly caused in the course of the firm's professional investment services — for example, in the course of providing advice to portfolio companies.

The purchase of the above policies should be considered at both the alternative investment firm and portfolio company level, with appropriate evaluation of the risk at each level, as well as potential interaction between any insurance policies purchased at either level.

Potential exposure for harassment, discrimination, and misconduct, along with associated insurance, has historically been an afterthought for many alternative investment firms. But shifting trends in the law and public opinion have significantly changed this landscape, likely permanently. It is incumbent upon every alternative investment firm to reevaluate its practices, policies, and procedures regarding such issues, and to evaluate potential insurance solutions to mitigate the costs of such issues when they do arise.

For more information on this topic, visit marsh.com, contact your Marsh representative, or contact:

MACHUA MILLETT
Chief Innovation Officer, FINPRO
+1 617 385 0308
machua.millett@marsh.com