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Financial Services and Management Liability

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Financial Institutions

Federal Court Vacates SEC Rules That Would Have Imposed Significant New Regulatory Obligations on Hedge Funds and Private Equity Funds

The Fifth Circuit Court of Appeals recently struck down the US Securities and Exchange Commission's (SEC) requirements that hedge funds and private equity firms must detail quarterly fees and expenses to investors.

Last year, the SEC issued rules under the Investment Advisers Act of 1940 requiring new disclosures by certain private investment funds. Private funds were first required to register with the SEC starting in 2010 under The Dodd-Frank Wall Street Reform and Consumer Protection Act, and the number of private funds and their assets under management have dramatically increased since then, from roughly 30,000 funds managing $10T in 2012 to 100,000 managing more than $25T in 2022.

The SEC argued that while such funds are only directly available to sophisticated large investors, many small investors are indirectly exposed through vehicles like public and private pension plans and endowments that invest in private funds, and those small investors require additional protections.

A group of trade associations challenged the rules in federal court, arguing, among other things, that they exceeded the SEC's statutory authority from Congress. Industry groups had argued to the Fifth Circuit that the agency overstepped its authority and that rules were not necessary for the "highly sophisticated" investors that pour money into private funds.

The Fifth Circuit Court of Appeals vacated the rules, concluding that:

> The Dodd-Frank Act expanded the SEC's authority to require disclosures only with respect to retail investors, not the sophisticated market participants in private funds and (b) the proposed rules were not sufficiently connected to preventing fraud to justify relying on the SEC's general authority under the Investment Advisers Act.

The court also stated in its opinion that the SEC's claims of fraud prevention were too vague to justify the ruling explaining that *"the Commission largely fails to define the fraudulent acts or practices that the final rule purportedly is designed to prevent."* The court further stated, *"and while some conduct could involve fraud, the Commission has only observed misconduct by about 0.05% of advisers."* The appeals court rejected an argument from the SEC that the rule was necessary because it would weed out fraud, ruling that the SEC is conflating a lack of disclosure with deception.

> This ruling **creates uncertainty** around the SEC's regulatory scheme, **especially with private funds**.

Hedge fund and private equity managers in the Fifth Circuit are obviously the most immediately impacted, with their new compliance obligations deferred for now and potentially indefinitely.

However, SEC information requests and enforcement action are likely to remain focused on the issues such as fee allocation and conflicts of interest addressed by the rule.

The SEC has relied on the same statutory authority for a host of other rules directed at fund advisors that may now also be vulnerable to challenge, including those addressing cybersecurity and predictive data analytics.

SEC Cracks Down on Recordkeeping Provisions

> In recent years, the SEC has made **major changes** to **broker-dealer recordkeeping rules.**

Historically, the SEC's broker-dealer recordkeeping rule was that firms were required to preserve electronic records exclusively in a non-rewriteable, non-erasable format, known as the "write once, read many" format. Amendments to the electronic recordkeeping, prompt production of records, and third-party recordkeeping service requirements applicable to broker-dealers, security-based swap dealers (SBSDs), and major security-based swap participants (MSBSPs) were proposed.

In 2022, the SEC adopted rule amendments designed to:

- Modernize recordkeeping requirements given technological changes.
- Make the rule adaptable to new technologies in electronic recordkeeping.
- Facilitate examinations of broker-dealers, SBSDs and MSBSPs.

The amendments added an audit-trail alternative under which electronic records can be preserved in a manner that permits the recreation of an original record if it is altered, over-written or erased. The audit-trail alternative is designed to provide broker-dealers with greater flexibility in configuring their electronic recordkeeping systems so they more closely align with current electronic recordkeeping practices while also protecting the authenticity and reliability of original records. The amendments apply the same requirements to nonbank SBSDs and MSBSPs.

Fast forward to 2024, and 16 firms, including five broker-dealers, seven dually registered broker-dealers and investment advisers, and four affiliated investment advisors will combine to pay more than $81M in civil penalties to settle charges for widespread recordkeeping failures of the federal securities laws. Eight firms were charged with violating recordkeeping provisions of the Securities Exchange Act of 1934 and with failing to reasonably supervise to prevent and detect these violations. The remaining firms were charged with violating provisions of the Investment Advisers Act of 1940.

For example, in addition to the significant financial penalties, each of the firms was ordered to cease and desist from future violations of the relevant recordkeeping provisions and was censured. The firms are also required to:

- Retain independent compliance consultants.
- Conduct comprehensive review of their policies and procedures relating to the retention of electronic communications found on personal devices.
- Review their frameworks for addressing noncompliance by their employees with those policies and procedures.

The Commission believes that the amendments and continued investigations into firms' recordkeeping will ensure the Commission's goal to preserve market integrity and protect investors.

Environmental, Social and Governance Outlook

The SEC has released its finalized climate change disclosure guidelines, which the agency first proposed in October 2022. In March, the SEC adopted rules to enhance and standardize climate-related disclosures by public companies and in public offerings. This decision comes after an ongoing demand by investors for more consistent and reliable information about the financial implications of climate-related risks on their operations.

Aside from these guidelines providing investors with decision-useful information, they will also require that climate risk disclosures be included in a company's SEC filings, such as annual reports rather than on company portals, which will help create more transparency.

Specifically, the final rules will require a registrant to disclose:

- Climate-related risks that have had a material impact on the registrant's business strategy, results of operations or financial condition.
- The actual and potential effects of any identified climate-related risks on the registrant's strategy, business model and outlook.
- Any transition plans, scenario analysis or internal carbon prices.

- Any oversight by the board of directors of climate-related risks and any role by management in assessing and managing the registrant's material climate-related risks.
- Information about a registrant's climate-related targets or goals and if any have been materially affected or likely to be affected.
- The capitalized costs, expenditures expensed, charges and losses incurred due to severe weather events and carbon offsets/renewable energy credits.

In a statement on the rules, SEC Chairman Gary Gensler stated, *"By requiring large broker-dealers . . . to disclose execution quality . . . investors will be better able to factor execution quality into their decisions, and you will be able to compare the brokers when you select them."*

The requirement of more types of data go into these execution quality reports is also being proposed. Institutional investors often use a percentage-based metric system to compare risks and evaluate execution quality, and Chairman Gensler believes that by giving regular investors the advantage of using these metric systems it will be easier for them to compare broker-dealers.

The amendments will require broker-dealers and market centers to present summary reports on execution quality that everyday investors can understand.

Fannie Mae and Freddie Mac Mortgage Lending Adjustments Causing Concern

Fannie Mae and Freddie Mac's recent adjustments to their mortgage lending guidelines, particularly shifting from actual value to replacement cost basis for property insurance, have sparked significant concern. The National Association of Mutual Insurance Companies and the Independent Insurance Agents and Brokers of America expressed strong opposition to these changes in an April 17 letter to the Federal Housing Finance Agency, urging an immediate suspension.

In addition, the American Bankers Association has voiced its opposition, stating that:

- The new product does not meet a need that is not already being met by the private market.
- Freddie has not demonstrated that the program will bring cost savings to borrowers that is not already being provided by the private market.
- It will not benefit low to moderate income borrowers consistent with the broader mission of the enterprises.
- It is not likely to bring greater stability to the primary mortgage market – and indeed may threaten stability.

Lawmakers expressed that *"It is crucial to understand that second mortgages, such as home equity loans, are consumer loans that finance spending and consumption."* They further added that *"According to preliminary estimates, this proposal could lead Freddie Mac – and likely Fannie Mae – to finance hundreds of billions in additional equity extraction, which will only counteract the effects of tighter monetary policy and worsen inflation for Americans."*

These modifications could have profound real-world consequences, potentially creating problems for many homeowners who are unable to meet new coverage requirements or the purchasing adjustments of higher-cost insurance policies. The switch threatens to disrupt an already uneasy property market, especially impacting insurers in states prone to catastrophic risks who rely on actual cash value for roof claims following numerous catastrophic events.

$350M Payout in Baltimore Bridge Collapse

A $350M insurance payout is expected in the collision of a Singapore-flagged container ship with the Francis Scott Key Bridge in Baltimore on March 26, 2024. This marks the beginning of what is expected to be a lengthy process to determine responsibility for the estimated $1+ billion cost of the bridge's collapse.

Most of the financial burden will likely be carried out by reinsurers, who may attempt to spread coverage to mitigate the impact. However, the marine insurance sector has already been facing challenges in recent years, including losses from events like the Houthi rebel attacks in the Red Sea. The fallout from this bridge collapse further exhausts global marine insurance pricing.

The check will hit the upper limit of Maryland's coverage for the bridge. The payment will provide business-interruption coverage for the Port of Baltimore, which is already dealing with losses of $88M per year in tolls. The insurer is also expected to support Maryland in suing the owner and operator of the Dali cargo ship to recover some losses.

While this specific incident affects the insurance industry's current operations, there are broader implications on how financial institutions approach the underwriting of risk management projects. Investors may monitor how insurers manage these substantial claims and assess their financial stability for future problems. Insurers need to manage their risks and establish a stable internal financial setting for when large-scale projects are presented.

Catastrophic Risks Driving Property and Casualty Insurance Prices Up

Catastrophic risks are pushing up property and casualty insurance prices as we enter H2 2024. The rising occurrence of severe weather events such as tornadoes, hurricanes and other perils has led property insurers to experience record-high payouts.

This trend is particularly pronounced in states prone to catastrophes like Florida and Louisiana, where escalating premiums over the past five years have contributed to the closure of many businesses. In Florida alone, average property premiums have surged 27% in the past year. Businesses should carefully assess their exposure in these high-risk states as the frequency and severity of billion-dollar disasters continue to escalate.

Financial institutions may need to assess or update their own risk exposure requirements due to the increasing insurance costs. Institutions could possibly allocate even more capital to cover those catastrophic losses and adjust their risk outlooks. The lending decision-making of banks, particularly businesses that have a higher exposure to catastrophic risks, could also be affected due to higher insurance costs.

Directors & Officers

Deciphering Cooperation in SEC Investigations

Recently, the SEC has emphasized that timely cooperation not only enhances credibility but also improves the chances of securing favorable outcomes for investigation targets.

The SEC outlined specific behaviors that qualify as cooperation, such as providing documents that are not compelled, conducting internal investigations and waiving privileges to facilitate the development of a comprehensive record.

However, not all actions are considered cooperative. Merely complying with subpoenas and document requests is expected and does not necessarily qualify as cooperation. Moreover, there are behaviors, according to the SEC, that can hinder cooperation efforts and negatively impact credibility. The SEC warned against unreasonable delays in document production, spurious privilege claims, witness coaching, conflicts of interest and attacks on SEC staff, labeling such conduct as "*lawyers behaving badly.*"

The SEC has provided a framework that outlines the range of tools available to facilitate and reward cooperation, emphasizing its importance in fulfilling the agency's mission of protecting investors and maintaining fair and efficient markets.

They established guidelines for evaluating cooperation by individuals and entities involved in its investigations. These guidelines consider factors such as:

- The value and nature of the cooperation.
- The importance of the underlying matter.
- The accountability of the individual or entity.
- The acceptance of responsibility for misconduct.

Similarly, the SEC has articulated measures for evaluating cooperation by companies, including self-policing, self-reporting of misconduct, remediation efforts and cooperation with law enforcement authorities.

Cooperation in SEC investigations and enforcement actions can take various forms, ranging from providing valuable information to actively assisting in the investigation process. The benefits of cooperation can be substantial, including reduced charges and sanctions, or even the possibility of no enforcement action being taken at all. This incentivizes individuals and entities to proactively engage with the SEC and contribute to the resolution of matters under investigation.

Cooperation with the SEC is not only a regulatory requirement but also a strategic approach for mitigating potential enforcement actions. By actively engaging with the SEC, individuals and entities can contribute to the detection of violations, enhance the effectiveness of investigations and potentially avoid or minimize sanctions. Understanding what constitutes cooperation and adhering to ethical conduct can significantly influence the outcome of SEC inquiries, underscoring the importance of transparency and accountability in the regulatory process.

Robotic Automation Company Hit with AI-Related Securities Suit

As artificial intelligence (AI) becomes a larger component in the operations and decision-making of many companies, concerns about how this technology is employed could affect companies' litigation risk exposures. Companies that publicly promote using AI strategies in their business may be susceptible to allegations of overstating their AI capabilities.

For example, a robotic process automation (RPA) company that uses AI tools to conduct repetitive humanlike tasks has been struck with a lawsuit by one of its shareholders. In September 2022, during a time when the demand for the company's RPA tools was declining, the company announced a turnaround strategy. Along with their rebranding strategy to attract more demand, the company overhauled its sales strategy, too, focusing on selling a plethora of products to larger customers rather than selling single-product offerings.

The company claimed at the time that its turnaround strategy allowed them to seek larger clients and that their AI-powered products set them apart from the competition.

Initially, the company stated that the turnaround strategy increased sales, and its share price went up. However, in May 2024, the company announced the departure of their CEO, while at the same time stating their disappointing 1Q 25 sales report. They explained that the company's poor results were due to execution challenges on large-deal contracts and that the potential of their AI-powered platform was not being realize. Following some disconcerting statements from the company's CEO, its share price fell 34%.

On June 20, 2024, a plaintiff shareholder filed a securities class lawsuit against the company and some of its officers. The complaint was made on behalf of investors that purchased the company's securities between December 1, 2023, and May 29, 2024. The complaint alleges that, contrary to the company's statements about their turnaround strategy's exceptional performance, it had failed instead. The plaintiff claimed that the company's AI-powered platform was confusing to customers and could not be scaled adequately. These issues caused the company to struggle to close or expand large multiyear deals, according to the plaintiff. This was a direct violation of Section 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder regarding misstatements and omissions.

SEC Chair Gary Gensler has frequently expressed the possibility of investors being misled by statements about specific company's AI capabilities. These companies overstate their AI potential to capitalize on the enthusiastic AI market, a perception called "AI washing" that Gensler has made notorious in the past few years.

This is the third AI-related securities action lawsuit to be filed this year, along with previous lawsuits against two other technology companies. From the perspective of a securities litigation risk allegation, the concerns involve allegations that the defendant company insufficiently disclosed risks associated with its AI-based strategy to its shareholders. Many companies continue to face the pressure from their investors and marketplace to implement AI strategies at a time when the technology is rapidly changing.

In the ever-evolving technology push-pull with regulators, companies must weigh overall risk and reward when determining the best possible AI strategies. Companies will need to define their services completely so investors can finance confidently and understand their specific risks in the AI market.

What a Recent Pay Decision Means for Executive Compensation

The Delaware Court of Chancery in January voided a CEO's compensation package. By its own words, the court had gone where no Delaware court dared go before, overriding a favorable shareholder vote to find that an executive compensation package was fundamentally unfair. The company may appeal, and the broader implications, if any, will take some time to reveal themselves. However, here are three general themes of note from the decision.

The Moving Goalposts of Executive Compensation

What constitutes an enlightened executive compensation program has long been something of a moving target, informed by governance lessons of the past. First, we understood that it was better to pay senior executives largely in stock, more closely binding their personal outcomes with those of the company. Then we learned that those stock grants should be heavily contingent on long-term performance targets, to avoid perverse incentives for financial manipulation. Finally, we came to appreciate that those performance targets need to be sufficiently difficult, to require a true value add to the company commensurate with the proposed compensation.

This company's compensation package appeared to pass these tests, at least on its face. It bound the CEO's personal fortune to the fate of the company for a long period against what seemed at the time remarkably ambitious performance targets. As the Delaware court noted, the market capitalization targets required that the company grow essentially by the size of a Ford or GM for each tranche of the CEO's stock to vest and for the company to maintain that market cap over time.

However, even discounting for the improbability of reaching the performance targets, the compensation package was independently valued at more than $2B at the time of the grant. Institutional Shareholder Services called the amount "staggering" and recommended that shareholders vote against it, despite the challenging performance goals. Shareholders ultimately did approve the plan, but the Delaware court found the package was simply unfair and that even a favorable shareholder vote could not save it against the backdrop of a fatally flawed governance process.

The Substance of the Process Matters

The process for arriving at the compensation plan seemingly adhered to governance norms. The board had a compensation committee composed of nominally independent directors that retained an outside compensation consultant and a

valuation expert. There were extensive deliberations about performance targets and testing of those targets against long-term expectations. Many meetings were held over several months before the board ultimately approved the package and put it to a shareholder vote.

However, when the Delaware court looked closely at the governance process, they found what they considered to be significant deficiencies. The court concluded that the directors were not actually independent of the CEO, the compensation consultant did not provide any meaningful benchmarking, and some of the performance targets were not as difficult as they may have seemed based on the company's own projections. Among other issues, the court found that several of the "independent" directors owed their personal wealth to the CEO, among other close ties. These and other important details were not disclosed in the proxy, and thus the shareholder vote was not adequately informed. It then became the company's obligation to prove that the compensation package was fair. The company was not able to do so, as it was unable to provide evidence that the unprecedented compensation package was necessary to retain the CEO.

What we do not know from this case is whether the package would have survived judicial review with the benefit of a more rigorous process and more clearly independent directors. The court might never have reached the fundamental fairness of the compensation if it had found the proxy disclosures accurately described the governance process to shareholders.

Fairness and the Minority Shareholder

Despite the Delaware Chancery Court's voiding of the compensation package, shareholders voted to reaffirm the compensation package, which was originally approved in 2018. Another vote on the package was held in hopes of showing that if the package was approved again, the court could be persuaded to reinstate it. It should be noted that more than 70% of voting share voted in favor of the package, which was almost identical to the 2018 vote. The company will next ask the judge to revisit the decision due to the vote. If the judge refuses, the company is likely to appeal.

What Comes Next

The implications for directors on other boards are less clear. While this compensation package may be considered to have been such an outlier to not serve as an effective example, insureds should expect additional scrutiny on the independence of compensation committee members, reaching beyond the mere fact that they do not work for the company to encompass personal, social and outside business relationships with officers. This attention will be especially acute where a CEO holds considerable ownership, even if less than a majority.

Applied to more pedestrian circumstances, this decision, if anything, only further emphasizes the well-understood importance of a truly independent governance process relying on external expert advice to craft carefully benchmarked and reasonable executive compensation programs with transparent shareholder disclosures.

It appears that over the last five years, there has been a notable uptick in the frequency of lawsuits initiated by stockholders against directors and executives concerning compensation-related issues. Plaintiffs are introducing innovative claims against boards in these instances. Moreover, courts are shifting towards employing the entire fairness standard of review instead of the traditionally more lenient business judgment standard, thereby enabling these compensation-related lawsuits to progress beyond the initial motion to dismiss phase. When claims withstand a motion to dismiss, the likelihood of reaching a settlement increases. This can potentially lead to substantial attorney fees and unfavorable publicity for the companies involved.

Such litigation brought by shareholders in their own interest or in the name of the company are typically covered under insurance. For a discussion on your specific business needs and comprehensive insurance solutions for directors and officers as well as those of the company, NFP's professionals are available to assist and navigate the diverse exposures your business may encounter.

Cyber

Company Loses Millions on Deepfake Scam

Recently, cyber criminals utilized an AI deepfake to induce a finance department employee at a Hong Kong company to transmit wire transfers valued at HK$ 200M ($25.6M USD). As this incident occurred very recently and is still under investigation, the Hong Kong police have redacted a number of details regarding the event, such as the names of the victim company and employee. However, based upon news reports, here is what we know so far.

The company involved had a multinational presence. The finance employee, located in Hong Kong, was initially contacted by the CFO based in the UK. We now know that the contact was made illicitly by fraudulent actors. The worker was apparently suspicious of the tenor of the CFO's email requesting "secret transfers" of funds. However, the fraudulent actors subsequently set up a video call not only with the CFO but also with other known colleagues. Yet the only real person on that video call was the victim. The call was in fact comprised of computer-generated images using the likeness/images of the CFO and several work colleagues known to the victim.

Based upon his interaction on the video call, the finance employee proceeded to initiate 15 separate wire transfers to five different bank accounts. It was not until a week later when he followed up to check on the transfers that he discovered the awful reality — the money was gone.

So how were the thieves able to pull off a seemingly elaborate and well-choreographed scheme such as this? Unfortunately, it's not as elaborate as you may think.

A deepfake involves an algorithm fed into a computer that allows the machine to "learn." The algorithm can recreate not only a person's voice but also inflection and intonation. It can duplicate a person's mannerisms, making it difficult to discern real from deepfake in a video or phone conversation. It does require a source, however. Unfortunately, there is plenty for cyber criminals to harvest from on the internet. Unlike decades ago, where only celebrities or political figures would have videos, movies, news clips and more posted online, there is a multitude of social media platforms now that contain our images, videos and voice imprints which thieves can potentially cull from. In the subject case, it is believed the scammers may have pulled a publicly available video from a local online newspaper to ultimately duplicate the video call.

> It is important that **any** company, large or small have a well-developed protocol regarding the **review and authorization for financial transactions.**

While it may seem antiquated or low tech, a preset internal series of security questions or passcodes is an excellent way to ensure that information is being provided to the genuine individual. Remember that no matter how sophisticated the deepfakes are, the scammers should only be able to duplicate and produce publicly available information. Presumably they would have no way of providing a confidential set of predetermined security responses or passwords.

Additionally, a callback to a trusted phone number is a good practice to implement. Email correspondence can be spoofed or hijacked, and calling a number on a potentially hijacked email thread can also be unsecure.

Finally, ensure that employees receive consistent cyber training not only on how to spot scams but also on how important it is to follow internal security protocols.

Healthcare Cyber Attacks Shows Vulnerability

In February 2024, a healthcare services group suffered a major distributed denial-of-service cyberattack on their systems, forcing the company to disconnect more than 100 systems. The hacking groups BlackCat and RansomHub have claimed responsibility for the attacks thus far, claiming to have taken over 10 terabytes of the company's data. The attack capitalized on the cyber vulnerabilities across the company's systems, with a state senator highlighting that if the company had multifactor authentication in place, that the attack might have gone differently.

The attack is expected to cost the group around $1.6B throughout 2024, excluding further potential litigation costs or regulatory fines. It is essential for insureds to make sure all systems are up to date with proper cyber safeguards and that their third-party vendors are establishing their own protections with sensitive data.

Employment Practices Liability

US Supreme Court Rules on Case Involving Dismissed Pro-Union Employees

The US Supreme Court heard a case brought by the National Labor Relations Board (NLRB) against a food and beverage retailer involving the termination of pro-union employees. The controversy emerged when several employees, advocating for the formation of a union, were allegedly retaliated against and fired by the retailer. The workers argued that their termination was a direct response to their pro-union activities, a claim the retailer denied. The case had garnered attention for its potential implications on workers' rights to organize and the broader landscape of labor relations.

The Supreme Court ruled in favor of the retailer, setting a new standard for preliminary injunctions under §10(j). District courts must now apply the traditional four-part test for all NLRB requests for such injunctions, which is a win for employers.

This decision reduces the risk for employers of having to immediately reinstate an employee challenging their termination. The NLRB now faces a higher burden to demonstrate the necessity of injunctive relief, allowing employers to make employment decisions without immediate legal consequences. However, employers should be aware that if the NLRB later wins an unfair labor practice case, the make-whole remedy requires compensating employees for all costs incurred due to their termination.

The above is yet another example of the importance of understanding and having in place employment practices liability insurance (EPLI) policies. EPLI policies serve as a safeguard for employers, offering protection against the potential financial burdens associated with claims arising from the employment relationship. While EPLI addresses issues such as discrimination, harassment and wrongful discharge, among others, it's important to note that certain claims, such as violations of the National Labor Relations Act, may not fall under its purview; however, retaliation and retaliatory discharge claims may be covered. Regardless, businesses should explore options for coverage to mitigate defense costs and employment-related exposures.

DOJ Targets Citizenship Status Discrimination and Unfair Documentary Practices

Since the start of 2024, the US Department of Justice (DOJ) Civil Rights Division has pursued and settled several cases related to citizenship status violations and unfair documentary practices.

The Immigrant and Employee Rights Section (IER) of the Civil Rights Division enforces the antidiscrimination provision of the Immigration and Nationality Act. This federal law prohibits:

- Citizenship status discrimination in hiring, firing, and recruitment or referral for a fee.
- National origin discrimination in hiring, firing, and recruitment or referral for a fee.
- Unfair documentary practices during the employment eligibility verification process (generally, Form I-9 and E-Verify).
- Retaliation or intimidation.

The IER has targeted companies ranging from higher education institutions to nursing homes. The civil penalties have ranged from a few thousand dollars to over six figures paid to the United States and, in some cases, back pay to the affected workers. In addition to the monetary portion of the settlement, other settlement provisions include retraining employees, revising eligibility verification policies and instituting multiyear monitoring periods.

Federal law requires employers to follow Form I-9 and E-Verify rules consistently, regardless of an employee's citizenship or immigration status. When completing the Form I-9, the employee should complete Section 1 and the employer should complete Section 2. The employer must allow the employee to show their choice of acceptable documentation. In addition, employers should not ask employees to prove their citizenship or immigration status when they complete the Form I-9. This could be deemed unlawful. If you use E-Verify, do not create an E-Verify case for someone before hiring them. The case creation should only come after completing a Form I-9. We recommend that employers check the Employer Fact Sheet located on the DOJ website.

Employers at risk for violating federal, state or local immigration laws will find these violations are typically not covered by the basic EPLI coverage form. However, immigration violation coverage can be added to EPLI policies via endorsement.

The immigration violation coverage endorsement typically addresses three types of costs that are normally excluded by standard EPLI provisions:

- Defending managers/supervisors charged with criminal violations of federal, state and local immigration laws.
- Criminal fines & penalties related to immigration violations.
- Civil fines and penalties associated with immigration law violations.

In addition to allegations of immigration law violations, claims alleging discrimination may be made against an entity, particularly those based on national origin of the claimant. Such claims would typically trigger coverage under an employment practices liability policy.

DOL Issues a Final Rule on Employee or Independent Contractor Classification Under the Fair Labor Standards Act

On January 10, 2024, the US Department of Labor (DOL) announced its new final rule on classifying workers as employees or independent contractors under the Fair Labor Standards Act (FLSA). The 2024 IC Rule rescinds the 2021 IC Rule, which applied a variation of the traditional multifactor test but emphasized two core factors that were largely determinative of whether a worker is an employee or independent contractor. This emphasis on two core factors was a stark deviation from the traditional economic reality test adopted by the courts going back to the 1940s.

The 2024 IC Rule, effective March 11, 2024, *"retain[s] its longstanding interpretation, as it did in the 2021 IC Rule, that economic dependence is the ultimate inquiry, and that an employee is someone who, as a matter of economic reality, is economically dependent on an employer for work — not for income."* The rule disposes of the emphasis on two core factors and returns to a *"totality-of-the-circumstances analysis in which the economic reality factors are not assigned a predetermined weight [but instead] each factor is given full consideration."*

The DOL acknowledged that *"the 2021 IC Rule did not fully comport with the FLSA's text and purpose as interpreted by the courts and departed from decades of case law applying the economic reality test."* The DOL further recognized that *"[the 2021 IC Rule] provisions narrowed the economic reality test by limiting the facts that may be considered as part of the test, facts which the Department believes are relevant in determining whether a worker is economically dependent on the employer for work or in business for themselves."*

Therefore, in an effort to align the analysis with historical interpretations, the 2024 IC Rule rescinds and replaces the 2021 IC Rule with a new Part to 795 to Title 29 of the Code of Federal Regulations. The DOL believed that *"leaving the 2021 IC Rule in place would have a confusing and disruptive effect on workers and businesses alike due to its departure from decades of case law describing and applying the multifactor economic reality test as a totality-of-the-circumstances test."*

The 2024 IC Rule:

- No longer uses core factors but instead *"returns to the totality-of-the-circumstances analysis of the economic reality test in which the factors do not have a predetermined weight and are considered in view of the economic reality of the whole activity."*
- Adopts a six-prong totality-of-the-circumstances analysis to ultimately determine economic dependence, including opportunity for profit or loss depending on managerial skill, investments by the worker and the employee, degree of permanence of the work relationship, nature and degree of control, extent to which the work performed is an integral part of the employer's business, and skill and initiative.

EEOC Settles AI Employment Discrimination Suit

The Equal Employment Opportunity Commission (EEOC) recently added another agency victory in procuring a six-figure settlement in its merit lawsuit against an online teaching service. The defendant hired tutors based in the United States to provide online tutoring services from their homes and other remote locations to students in China. The EEOC alleged that the company programmed their application software to automatically reject female applicants over the age of 55 and male applicants over the age of 60. As a result of the programming, the company excluded over 200 otherwise qualified applicants in violation of the Age Discrimination in Employment Act. The parties settled the suit for $365,000.

This lawsuit and settlement are indicative of the agency's targeted initiative to address the use of AI and the potential for discrimination in violation of the various federal laws under its purview. In 2021, the EEOC launched its Artificial Intelligence and Algorithmic Fairness Initiative aimed at insuring that the use of software, including AI, machine learning and other novel technologies used in the recruitment and hiring process, comply with federal civil rights law. In furtherance of its goal, the EEOC aggressively targeted the issue by releasing a number of technical assistance documents. On May 12, 2022, the EEOC issued *"The Americans with Disabilities Act and the Use of Software, Algorithms, and Artificial Intelligence to Assess Job Applicants and Employees."* The guidance *"explain[s] how employers' use of software that relies on algorithmic decision-making may violate existing requirements of Title I of the [ADA] . . . and provides practical tips . . . on how to comply with the ADA…"*

Most recently, in May 2023, the EEOC issued a technical assistance document titled *"Select Issues: Assessing Adverse Impact in Software, Algorithms, and Artificial Intelligence Used in Employment Selection Procedures Under Title VII of the Civil Rights Act of 1964."* This guidance discusses how existing Title VII requirements may apply in assessing adverse impact by employment selection tools that use AI.

As companies look toward streamlining and optimizing human resources functions, we can expect an increased utilization of AI technology. Currently, nearly one in four organizations use automation and/or AI to support HR-related activities, and one in four organizations plan to start using or to increase their use of automation or AI in recruitment and hiring over the next five years.

When it comes to assessing employment litigation exposure and AI implications in the workplace, there are several important considerations:

- AI systems used in hiring and human resources can sometimes introduce bias into decision-making inadvertently.
- If your company already uses or is planning to use AI technology in recruiting, consider conducting audits to ensure there is no unintended disparate discriminatory impact against a particular demographic, which may lead to legal exposures.
- Discrimination and disparate impact claims such as the ones at the center of this matter constitute employment practices wrongful acts under standard EPLI policies.
- Claims brought by the EEOC alleging wrongful employment practices acts would likewise constitute claims as defined by an EPLI policy. These types of claims should be reported to your EPLI policy, and NFP will assist its clients in doing so.
- As the use of AI becomes more prevalent, along with its concurrent risks as illustrated above, it is likely to become a component in the insurance underwriting process.
- Using an outside vendor for recruiting or HR services may lead to claims against a company as the actual employer. Inquire as to the vendor's use of AI, their third-party discrimination liability insurance and their professional liability insurance. Additionally, when selecting an AI vendor, ensure that the vendor has also conducted bias audits.

The legal and regulatory landscape for AI in the workplace is continually evolving. EPLI policies may need to adapt to changes in laws and regulations related to AI and employment practices.

> You will need an insurance broker that is **well-versed in EPLI and the evolving AI exposure**.

Meet the Experts

Contacts

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