

**Why Should Private Companies Purchase
Directors and Officers Liability Coverage?**

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Introduction

It's a common question that never seems to get answered. Why purchase private company directors and officers liability coverage? Insurers spend a great deal of time and effort educating producers about the need for Private D&O, but the typical perception of private company owners is that they do not need to purchase D&O coverage. This is due in large part to the fact that most private company D&O lawsuits are quietly settled and are not splashed across the front page of the Wall Street Journal like many of the claims brought against public companies. However, private companies are sued every day - often for events that are not covered by General Liability, Employment Practices or Fiduciary Liability policies. Because private company D&O coverage can be a very important risk management tool, insurance company representatives and producers need to be able to explain to owners of private companies why they should purchase the coverage. References to "Private D&O coverage" in this article includes similar coverage available in many specialty insurance company "package policies" where the coverage of a stand-alone Private D&O policy is approximated with separate D&O and EPL coverage parts (often combined with Fiduciary Liability, Crime and other coverages).

Once an insured has made the decision to purchase stand-alone employment practices liability coverage, as many companies have over the past five years, can they afford not to purchase Private D&O as well? Private D&O coverage almost always encompasses EPL coverage. If you obtained side-by-side quotes from most companies for EPL and Private D&O on the same account, the premium difference would likely be relatively negligible. Therefore, although there is relatively little extra cost associated with the

coverage, the potential litigation savings is greater than most insureds realize (as will be seen below).

The Private D&O market is not nearly as hard as it is for other management liability products. Unlike Public D&O, coverage enhancements remain widely available and pricing is quite competitive. Insureds have the ability to either tailor stand-alone coverage to their individual needs, or purchase package policies that offer the additional benefits of common terms and conditions and additional savings if the insured purchases multiple coverages under one aggregate limit.

These specialty package policies have become extremely popular as small to mid-size companies, with arguably less overall exposure, purchase a single policy covering multiple lines from EPL to crime to fiduciary liability coverage. Some policies even offer Errors & Omissions and Kidnap & Ransom coverage. Although these package policies offer a number of different coverage options, many private company owners still decline to purchase Private D&O coverage even though the incremental cost makes it fairly inexpensive.

Private D&O coverage will likely never enjoy the status that Public D&O, Employment Practices or Fiduciary liability policies due in some part to the relative lack of media attention to the types of issues and claims it covers. One of the only types of private company claims that receive any publicity are family-related issues, such as those currently reported involving the Pritzker Family. It has been reported that Liesel Pritzker has alleged that the family has improperly taken money from her trust fund and is suing for roughly \$1 billion (USA Today, December 12, 2002). In the past these types of family issues would have been specifically excluded by exclusions under almost all D&O policies. Many insurers are no longer specifically excluding coverage for family-related claims unless the account has already experienced a claim. Some of these claims are excluded by the insured vs. insured exclusion; however, for multi-generation families and trust-related ownership this exclusion may not bar coverage. While there are occasional family-related disputes involving a private company that make the newspapers such as

the Pritzker case, much like it was noted above for other types of private D&O claims, these disputes are typically not aired in public.

Typical Private Company Exposures – Why They Should Buy

So what kinds of claims are private company owners subject to that are only covered by a Private D&O policy? What do agents, brokers and their clients need to know about Private Company D&O?

Duty to Defend – Priceless for Small Private Companies

First, and most importantly, Private D&O is usually written on a duty to defend basis - this is particularly true for small to mid-sized insureds. It is well understood that that the duty to defend is broader than the duty to indemnify. See *Couch on Insurance*, 3rd ed. at sec. 200:3. Where at least one allegation of a lawsuit is potentially covered, many states require the insurance company to defend the entire lawsuit. See *Couch* at sec. 200:26. This is less significant in EPL where the allegations are often related and covered by the policy. However, for non-EPL claims a Private D&O policy can often be called upon to respond where, for example, fraud is alleged in conjunction with a breach of contract claim that would otherwise not be covered. Duty to Defend is a valuable coverage that can easily exceed the cost of the policy and significantly protect the financial position of a privately held company.

Private company owners should also consider that any lawsuit against a small or mid-sized company takes a tremendous amount of the owners' time and energy, taking away from their ability to manage the day-to-day operations of the company. This can cost them and their company substantially in terms of lost opportunities, dissatisfied customers and employees and a host of other potential problems. These costs can often be greater than purely monetary damages, which are often easier to see. Therefore, the primary benefit to the insured is having an experienced insurance company and outside counsel with expertise to handle these issues which should significantly reduce the impact of the lawsuit on the owner's time. Considering the cost of the coverage, having someone to handle the defense of a claim is invaluable.

Employment Practices Liability

The next important point is that Private D&O coverage almost always contains the same comprehensive Employment Practices Liability coverage as a stand-alone EPL policy. The EPL exposures to companies is well documented, and will not be further elaborated here other than to say that its relative importance as a risk management tool has grown to such an extent over the past ten years that for most companies it is a core insurance coverage purchase. It should be noted that some insurers have included limited Employment Practices coverage in their Private D&O policy, but in most cases it is the same Employment Practices enhancements that they provide in their standalone form. Producers should make sure that the coverage they offer to their private company client contains all of the coverages appropriate to the unique exposures faced by their client.

Fiduciary Duties

Third, it is important to impress upon private company owners that Private D&O protects the directors, officers and often employees of the insured for their acts in their capacities as such. Directors and officers of private companies have duties that they owe to the corporation – the same as those they would owe to a public company. If they breach those duties they can be held personally liable. This liability can be separate and distinct from the company, and vice versa. Many owners of private companies do not realize this fact, thinking that they are protected by the LLC or Inc. suffix to their company name. Many claims are brought against both the company and some or all of its directors and officers, but claims may be brought solely against the company and some claims may be brought solely against the directors and officers. In some cases, the company cannot indemnify the owner/officer/director for their actions. This is where the Private D&O policy may be the only coverage that will respond.

When making business decisions on behalf of the company, directors and officers must fulfill two basic fiduciary duties: 1) the duty of care, and 2) the duty of loyalty.

The Duty of Care: This duty requires that the directors and officers are diligent in managing the affairs of the corporation. Directors and officers must keep themselves reasonably informed of all matters necessary to a given business decision and must act with the care which a reasonably prudent person in a similar position would use under similar circumstances. For example, if the board of directors reviewed and approved a business deal for the corporation which ended up in a significant loss to the company and adversely impacted the company's net worth a shareholder might sue them alleging breach of fiduciary duty (of care).

The Duty of Loyalty: The duty of loyalty requires that there be no conflict between the corporation's interests and the director's or officer's interests. Directors and officers may not engage in personal activities that would injure or take advantage of the corporation. For example, a company officer might see an opportunity to expand the company's business, but instead of having the company capitalize on that opportunity, the officer starts his own company to do that business. The officer may be sued by the company, or by a shareholder, alleging that the officer usurped a corporate opportunity in violation of his fiduciary duty (of loyalty).

Who Sues & Who's Getting Sued?

The Tillinghast-Towers Perrin Directors and Officers liability survey for 2001 reported that private company D&O claims come from the following sources: Employees (51%), Customers and Clients (21%), Competitors (5%), shareholders (16%), Government (3%), and other parties (4%).

Employees: The coverage under Private D&O policies for employees must not be discounted. In a private company, important decisions will often be carried out within the job description of an employee. Rather than offering coverage to employees just for EPL, nowadays an insured can typically add their employees for *any* act, error or omission they commit in their capacity with the company. Depending on the type of

company being insured the underwriter might utilize an errors & omissions exclusion (explained below) restricting coverage for the employees' actions, but this could still be a valuable enhancement.

Government: Companies often conduct business that is, to some extent, regulated by one or more governmental authorities. Government agencies are usually vested with some enforcement rights and abilities that allow them to bring actions on the government's behalf for alleged violations of regulations. These claims are usually focused on the company itself, but may also implicate directors and officers. In some situations, the company is not permitted to indemnify the directors or officers of the company for these violations. Without Private D&O coverage the directors and officers may have to pay for and direct their own defense and satisfy any settlements or judgments out of their own pockets.

Competitors: Competitors can bring claims alleging any type of wrongdoing that has harmed them. Claims such as unfair competition and restraint of trade (i.e., antitrust), patent or trade secret violations, or interference with contractual relations are typical examples of competitor claims. These claims are also usually focused on the company itself, but may implicate directors or officers.

Entity Coverage: A very important point to impress upon owners of private companies is that Private D&O coverage includes coverage for the entity itself. According to the Tillinghast-Towers Perrin Directors and Officers liability survey for 2001 the corporate entity has historically been named in 80% to 90% of all suits brought against directors and officers. The entity coverage provided in Private D&O policies is the element that could save a company from financial ruin. The importance of this coverage is in how it is granted. Typically, like the coverage offered to the directors and officers, the company is covered for any act, error or omission ... period. Although subject to the policy exclusions, it is easy to imagine dozens of scenarios in which a company could spend hundreds of thousands of dollars in connection with a claim brought against it. Producers should ask their clients whether the corporation or the

directors and officers individually could afford to defend themselves in a suit that could have been covered by a very affordable insurance policy.

Suits against directors and officers can be significant enough to put a company out of business. The owner of a private company could, in effect, be betting the business if he or she decides not to purchase Private Company D&O. Most D&O underwriters can provide plenty of examples where D&O suits against private companies cost hundreds of thousands of dollars to defend, and in some cases settled for millions of dollars. Many of these insureds would never have envisioned being involved in these cases and their companies would not have survived without Private D&O Liability insurance.

Outside Directorship Liability (ODL): Many D&O policies also extend coverage for Insured Persons who serve as directors on boards of certain types of outside organizations, other than the Insured Organization. This is referred to as outside directorship liability coverage or “ODL” coverage. There are two important issues to address with ODL coverage.

First, most ODL coverage applies only if the outside organization is a charitable and/or non-profit organization. ODL coverage extending to outside for-profit organizations is usually provided by endorsement only if the organization(s) is specifically scheduled on the policy. Second, ODL non-profit coverage is provided on a “double excess” basis (2XS). This means that the ODL coverage is excess insurance above any 1) other insurance the outside entity may have; and 2) any indemnification to which the insured person is entitled, except from the Insured Organization. The presumptive indemnification rules also apply to the outside entity. Sometimes ODL coverage is also excess of indemnification by the Insured Organization, in which case the coverage is provided on a “triple excess” basis (3XS). This “triple excess” form is usually the type of coverage provided for for-profit entities.

ODL coverage is a double-edged sword. On the positive side, a private company can protect itself from potential claims against it that might arise out of one of its Directors or

Officers service on an outside entity. On the negative side, the private company's policy limits are being exposed to potential depletion for acts not directly related to itself, but rather the outside entity. Some companies have been left without coverage after an ODL claim has depleted their policy limits. This is an issue a purchaser should consider carefully when deciding whether and to what extent (particularly on for profit coverage) to include ODL coverage on their policy.

Exclusions

So what are some of the exclusions in the Private D&O policy? Because the definition of "Wrongful Act" in a D&O policy is so broad, as discussed above, the policy's exclusions are the primary vehicle through which the insurer determines the scope of coverage provided. Aside from the typical exclusions found in a D&O policy, a Private D&O Policy will typically contain the following additional exclusions, for the reasons discussed below.

Contractual liability: Whether assumed from another (indemnity) or the insured's own contract liability, this is considered to be a business risk and is typically not covered by D&O policies. Because the company is almost always the party to the contract, not the Director's & Officer's, contractual liability is generally regarded as an entity exposure. Therefore, a "contract" exclusion is usually found in those policies granting entity coverage, but is often limited so that it applies only to the entity.

Securities liability: Private D&O policies will typically contain some form of securities exclusion. A company can still probably negotiate coverage for transactions that are not required to be registered under securities laws. Colloquially this coverage is referred to as a "private placement carve-back" (to the securities exclusion). Technically, a private placement is but one type of securities offering not required to be registered under securities laws so the coverage is actually broader than solely for "private placements" as the name suggests. Furthermore, if a private company decides to become a public company, they should seriously consider purchasing a Public Company D&O Policy

prior to its Initial Public Offering. This will ensure the proper amount of protection for the company whose exposure will become very different as a result of going public. The private coverage can either be cancelled by the insured or some sort of extended reporting period could be purchased. Alternatively, the Public D&O carrier would likely provide full prior acts for very little additional premium in comparison to the premium for the Public D&O policy.

Errors & Omissions: As it was mentioned above, companies engaged in the performance of professional services for others can purchase specific errors and omissions coverage. Private D&O coverage is not structured or priced to cover this exposure and therefore it is typically excluded.

Intellectual Property: Intellectual property cases can be extremely costly (both defense costs and indemnity payments) and specific coverage can be obtained for companies with this exposure under dedicated intellectual property policies. Private D&O coverage is not priced for this exposure. However, coverage can sometimes be obtained for the insured persons.

Claims – Getting to the Meat of It

The final unanswered question remains, what kinds of claims have been made under Private D&O policies and how much have they cost? What follows are some general descriptions of actual claims brought against private companies and the impact they had on the insurance policy. On our book of business, about 60% of the claims that we have received on Private D&O have been employment related. This is similar to the results reported in the Tillinghast-Towers Perrin Directors and Officers liability survey for 2001, where historically 70% of the claims made against Private Company D&O have been employment-related. Many of the 30 to 40% that are non-EPL claims eventually get denied because the allegations are simply excluded by the policy, e.g. breach of contract. However, consider some the following private company claim examples:

Limited partners of a limited partnership sued the controlling interest in the partnership in 8 separate lawsuits alleging breach of fiduciary duty, fraud, misrepresentation and a host of other allegations. The partnerships had been established as investment vehicles and the risky investment targets were substantially devalued when the internet bubble burst. The investors allege that they were particularly disillusioned regarding how their money was ultimately used vs. what they were told it would be used for. Defense expenses total around \$3,000,000 and alleged damages, not all of which are necessarily covered, are estimated to be in excess of \$20,000,000.

A claim arose out of the merger of two entities where shareholders allege that they never received shares they were supposed to receive in the transaction. Specific causes of action include misrepresentation, breach of fiduciary duty, civil conspiracy, economic coercion, shareholder oppression and declaratory judgment. Despite numerous coverage issues impacting the availability of coverage for all defendants in the matter, defense expenses exceeded \$50,000.

An insured person was named in a lawsuit alleging breach of contract against the company. The insured person is alleged to have misrepresented the true nature of the contractual relationship and is also alleged to not be entitled to the protection of the corporate structure. Since the contract itself was with the entity and not the person, it was hoped that the individual would simply be dismissed from the lawsuit. Unfortunately the matter quickly shifted to bankruptcy court which has been slow to remove the person from the suit. Defense expenses exceed \$250,000.

An insured contracted to receive materials and services from another company on a “time and material” basis for a retooling project. Insured owed \$300,000 under the agreement. Upon hearing rumors of financial troubles of the other company, the insured made assurances that they would pull through its cash flow problems and payment would be forthcoming. The insured subsequently filed Chapter 11. Suit was brought alleging unjust enrichment, seeking an accounting, breach of contract, fraud and seeking to pierce the corporate veil of the insured, i.e. that insured is dominated by one or more

shareholders such that it is the alter ego of these shareholders and, therefore, has no separate mind, will or existence of its own. It is anticipated that \$50,000 will be spent to take the matter to trial.

The Bottom Line

In summary, owners of private companies that have not traditionally purchased Private Company D&O insurance need to be made aware of the affordably priced policies and packages available to them in today's market. They need to understand the value of the duty to defend contract, defense coverage provided by experienced insurance companies and outside legal counsel and that Private Company D&O can include the same comprehensive Employment Practices Liability coverage as a standalone policy. In addition, they need to understand their exposures, who can sue them and what types of claims can be covered. Finally and maybe most importantly, they need to understand both that they have personal liability in many cases that can only be covered by Private Company D&O and that coverage for the entity can save their company from financial ruin in the event of a catastrophic claim. The bottom line is that the more purchasers are educated, the greater the market need will be for the coverage.