PRIVATE?…YES, BUT BULLETPROOF?…THINK AGAIN

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Directors' & Officers' Liability for Private Companies

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Litigation against the directors and officers of publicly held companies is well documented and highly visible. On virtually a daily basis, The Wall Street Journal and New York Times chronicle a myriad of class action lawsuits brought by angry shareholders who allege that they have suffered significant financial loss due to the decisions, actions, or lack thereof, of board members and other corporate officers.

What is not nearly as well documented, or visible, is the litigation brought against the directors and officers of privately held companies. While approximately 250 publicly traded companies are the targets of securities class action litigation annually, it is estimated that over 2500 private company boards are sued each year. As one example, there are very few VC/PEG partners (who sit on the boards of portfolio companies) that have NOT been named in such litigation. While class actions against the board members of privately held companies are rare, lawsuits brought by individuals alleging that they have suffered financial loss due to the following are commonplace:

- corporate mismanagement
- refinancing/dilution
- termination/demotion
- fraud/misrepresentation
- breach of fiduciary duty/duty of loyalty
- IP disputes
- bankruptcy

In addition, board members and their companies must also defend themselves against litigation/investigation brought by regulatory bodies (e.g. Department Of Justice, State Attorney Generals, Federal Drug Administration) as well as other interests including competitors and customers.

Most companies which are aware of the growing number of actions against the board members of privately held firms now include Directors' & Officers' Liability (*"D&O"*) policies as a foremost priority within their overall insurance portfolios. While not a panacea, D&O insurance does allow executives and their companies to transfer a significant portion of their financial risk to insurers. Increasingly, directors and officers are cognizant that without D&O insurance in place, their personal assets are at risk. Unfortunately, too many individuals gained their awareness after having fallen prey to one of the three great myths still circulating at the board level.

MYTH #1 – *"I'm indemnified by the Company for my role as a board member"*. You are, provided that the company can legally and financially provide you with indemnification. As examples, it cannot legally do so if you are named in a derivative action; it cannot financially do so if it's insolvent.

MYTH #2 – *"I'm covered by my Personal Umbrella insurance."* You **may** have some coverage for sitting on non-profit boards, but you have **no coverage** on a "for profit" board.

MYTH #3 – "*My Company buys liability insurance."* If it's not specifically Directors' & Officers' Liability insurance, you are not covered.

D&O insurance is designed to serve two main functions: 1. Direct insurance recovery for individual directors/officers when they cannot be indemnified by the Company, and; 2. The protection for the Company and its balance sheet since D&O fulfills the Company's financial obligation to indemnify its directors/officers.

There are many factors to consider when evaluating D&O insurance to protect your company and board. The three areas listed below are always critically important and represent the key issues typically raised by CFOs and other directors/officers:

I. **Insurers – How do you choose the *"right"* one?** While capacity, coverage and cost are a significant part of the buying decision, a bigger picture must first be considered…the security and experience of potential insurers.

   a. An insurer's financial ability (typically measured by A. M Best, S&P, et al) and willingness (actual practices and precedent known by your broker, attorneys, and peers) to pay claims.

   b. An insurer's experience in and commitment to underwriting both D&O overall and D&O specifically for your *"space"*.

II. **Limits – How much is enough?** A few items to consider as you make this determination:

   a. Unlike most other types of insurance, your D&O limit is eroded by the cost to defend the litigation, in addition to the settlement itself.

   b. Defense costs routinely run well into six figures and often into seven.

   c. Additional $1,000,000 increments of D&O limits are relatively inexpensive.

These considerations make the point that D&O limits are often underestimated. Brokers that specialize in D&O can help you avoid this pitfall by providing benchmarking for peer companies in terms of size and industry.

III. **Scope of Coverage – an insurance policy is a contract.** Unfortunately, polices provided by D&O insurers are also like snowflakes – no two are alike. The good news is that the scope of coverage can be negotiated by a knowledgeable broker with specific D&O expertise. Standard, off-the-shelf policies offered by insurers are usually unacceptable because their terms are too restrictive. While every provision of a D&O policy is important and merits attention in the placement process, the following are among the most important:

a. **Severability** – as an individual director/officer, make sure the policy will provide coverage for you in the event that other executives fail to disclose material information or commit fraud (or other unsavory actions). Additionally, ensure that you have non-rescindable coverage for non-indemnifiable claims.

b. **Choice of Counsel** – if sued, whom do you want to defend you? An attorney appointed by the insurer or an attorney of your choice? This issue needs to be negotiated before the D&O policy is put into place and should address allowable rates as well. As part of this process, you should gain an understanding of the overall pros and cons of electing to defend yourself vs. putting the duty to defend on the insurer.

c. **Fraud** – while no policy will cover someone who actually commits fraud, your policy should provide coverage for individuals who have been accused of fraud, up until that accusation has been *"finally adjudicated"*.

d. **Financings** – for many privately held companies, raising money on an ongoing basis is a critical component of their operations. Accordingly, it is imperative that your D&O insurer provide full and unrestricted coverage, at no additional premium, for any and all financings. Unfortunately, many insurers either restrict/exclude coverage or require each financing to be underwritten on an individual basis.

e. **Bankruptcy** – while no one wants to talk about it until forced to, bankruptcy happens – frequently. The time to negotiate coverage that ensures individual directors/officers maximize their benefits under the policy is when the policy is first placed. D&O underwriters are unlikely to broaden coverage when they discover the company is headed toward either a Chapter 7 or 11 filing.

In conclusion, directors and officers of privately held companies must be aware that they can be sued in their roles as such, and consequently need to ensure that appropriate D&O insurance is in place to protect both their personal assets and the balance sheet of the company on whose board they serve. D&O is a unique, complex, and ever changing form of insurance for which you need a broker with demonstrated expertise to ensure that you, your fellow board members, and your company are as well protected as possible.