

Private Company Directors and Officers Coverage

Should It Be First on Your List Rather Than Last?

By David J. Kummer

“But we are a private company,” is a typical response when trying to open a conversation about directors and officers (D&O) liability coverage with a prospect or client. It is interesting just how pervasive the opinion is that D&O is a “public company” coverage. Nothing could be further from the truth.

This perception is perhaps driven by the strong association between public companies and the coverage, rather than a true analysis of exposure difference between the two.

If you consider the broker’s role as the “push” and the buyer’s role the “pull,” there hasn’t been much of either. With regard to D&O, it has resulted in a hugely disproportionate number of uninsured private companies. Meanwhile, D&O related claims and lawsuits have continued to rise dramatically in the past decade for both private and publicly held companies. Directors and officers of private companies can and increasingly do face lawsuits from employees, vendors, customers, shareholders, investors and regu-

The company disengages and closes the process in a very professional manner. Six months later, company officers are served a lawsuit that proves very difficult to defend. The total defense and settlement costs ultimately exceed \$900,000. The theory of liability, the due diligence process was only a ruse to gain competitive advantage.

As another example, consider a new employee, a recent successful hire from the competition. Seven months after the hire, the company receives a lawsuit alleging the unauthorized use of confidential and proprietary information, along with other unfair acts of competition. The plaintiff alleges it has suffered irreparable and immediate injury, and includes actions for misappropriation of trade secrets, violation of the computer fraud and abuse act, unlawful access to stored information and unfair competition. The total defense and settlement costs ultimately exceed \$500,000.

These are two examples of many with private company D&O exposures. These types of exposures are very different than those addressed by traditional liability insurance, which requires either bodily injury or property damage to trigger coverage. D&O coverage is triggered by claims of financial damage. These are typically claims that, while acting in the capacity of and performing duties as a director or officer, actions (or lack of) cause another person or entity financial damage. As you can imagine, this creates a vast gray area and a virtually unlimited number of claims scenarios that can and likely have been pursued.

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D&O has also been treated as an ancillary coverage, an afterthought, by many retail brokers who have not devoted the time necessary to become familiar with the product and the exposures it addresses to adequately convey the need to the buyer. D&O policy contracts have also evolved dramatically in the past decade, making policy form comparisons a daunting task for those who do not devote full attention to the coverage. These factors have combined to create quite a dilemma.

Exposure to claims will rise if the company is involved in mergers and acquisitions, financial difficulty or bankruptcy, or disputes between stakeholders and/or family members.

Consider this real-life example. A client is considering the purchase of a company about a 10th of its size (i.e., competitor, distributor or supplier). Company officers engage in months of due diligence, only to discover (for any number of reasons) that the opportunity simply does not make sense.



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Liability can be based on the failure to fulfill one of the three duties a person has as a director or officer of a company. These duties are:

1) The Duty of Care — performing duties in good faith and a level of professionalism reasonably believed to be in the interests of the corporation with the care that a reasonably prudent person in a similar situation would use under similar circumstance,

2) The Duty of Loyalty — prohibits directors and officers from using their position to further or enhance their

personal or private interests. It requires the active elimination of any conflict of interest between oneself and the company.

3) The Duty of Obedience — requires that duties be performed in accordance and corporate charter directors and officers are not excused from compliance due to unfamiliarity with any laws governing their conduct.

Both the volume and value of D&O litigation is on the rise. Towers Perrin's "2007 Directors & Officers Survey of Insurance Purchasing and Claim Trends" reported payments to claimants increased from a median of \$54,000 in 2006 to \$234,000 in 2007, while the median figure for defense costs increased from \$44,409 to \$334,126 over the same period (Towers Perrin's most recent Annual Directors & Officers survey of 2008 did not include similar claim cost metrics). This trend is likely to sharpen considerably in the coming years in the midst of the current global economic downturn while companies continually push to do more with less.

While D&O is considered "mandatory" for public companies, the unique circumstances

that exist in private companies may actually make their exposure greater than that of a public company. First, simply due to size, the uninsured costs of defense and indemnity

can be crippling to a smaller company. In addition, corporate indemnification to individuals is typically not offered. Bad business decisions also can be much more visible in a small business environment. Finally, directors and officers of private companies are particularly vulnerable because often much of their personal wealth is tied to the corpo-



rate balance sheet and assets.

This final point is an important one. Liability for failure to perform one of the duties as a director or officer can and often does put the officer's personal assets at risk. Even if the company provides indemnity agreements to its directors and officers,

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many circumstances can prevent this indemnification from taking place. Despite the obvious one of insolvency or cash flow impairment, some circumstances are prevented by law. Properly endorsed with "Side A" coverage, D&O liability insurance is unique in that it is the only insurance coverage available to provide protection for personal assets.

Now, with a better understanding of the exposures directors and offices face, and the protection D&O coverage provides, ask the question again: Private company directors and officers coverage — should it be first on your list rather than last? ■

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