

Private Company Directors & Officers Liability Insurance

Directors and Officers Liability (“D&O”) Insurance coverage is an essential part of managing a privately held company in today’s litigious environment. Lawsuits naming directors and officers alleging mismanagement affect companies of all sizes. However, the directors and officers of private companies are the ones who are often most vulnerable to personal liability if they haven’t undertaken a thorough risk assessment. In many instances, executives of privately held businesses are involved in all aspects of the day-to-day operations and decision-making of the company. As such, those individual directors and officers are more likely to be named in lawsuits initiated by any number of sources, including employees, customers, creditors, and government regulatory agencies. Moreover, in closely held companies the owners’ personal net worth may be tied to the financial health of the firm making costly management liability claims all the more devastating. All of these factors create the need to transfer managerial and fiduciary risks to a third party. A comprehensive D&O insurance policy from a qualified insurer can absorb many of the risks to which managers and fiduciaries of private companies are exposed.

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It could be argued that the directors and officers of some private companies are more exposed than those at many publicly held companies due to the fact that they usually have fewer resources available to them (from a financial and personnel perspective). Directors and officers of privately held companies possess the same duties and fiduciary obligations to investors and limited partners as do their counterparts at publicly held companies. Given the level of risk assumed it is increasingly important that D&O insurance is procured to protect the interests of the individual directors and officers, as well as the company’s balance sheet.

Unfortunately, not all entities share this belief and may learn a costly lesson when directors and officers are forced to use corporate assets to pay defense costs, settlement amounts and/or judgments associated with litigation; or, in a worst case scenario, directors and officers may be forced to use their own personal assets to defend themselves. Even if the company indemnifies the directors and officers, the individuals may still be exposed in the event the company becomes insolvent and there is no insurance in place.

For more information, please contact your Frank Crystal representative.

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There are a number of key reasons that D&O liability insurance is purchased by privately held companies:

1. To protect the personal assets of the individual directors and/or officers;
2. Reimbursement for defending corporate lawsuits, especially since those costs can exceed the net worth of small privately held companies;
3. To insure against investor/partnership lawsuits against private companies for inadequate or inaccurate disclosure in financial reports and statements made in private placement materials;
4. To protect against lawsuits alleging bad business decisions which are likely to be more visible in a small business environment thus attracting the attention of investors, regulators, and others;
5. Protection from lawsuits alleging bad business decisions or a breach of fiduciary duty made by directors and officers which negatively impact the finances and operations of the company;
6. Many companies use a D&O insurance program as a recruitment tool to attract qualified individuals to their Boards. Absent of a comprehensive D&O insurance program, desirable executives are hesitant to hold a Board seat without adequate indemnity in place.

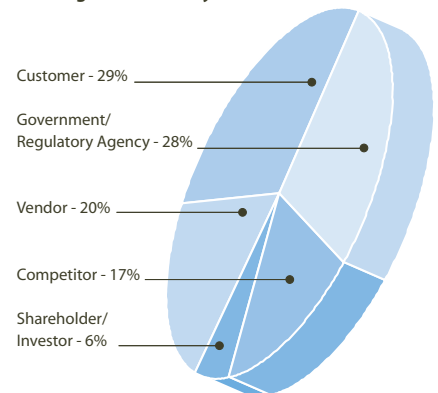
Private companies are also exposed to allegations of misrepresentation by creditors or customers, conflicts of interest and other breaches of fiduciary duty, regardless of shareholder ownership structure. The most recent Towers Watson D&O Liability Survey reported that 26% of private companies had a D&O claim of some kind in the last ten years. This number has doubled since the 2008 survey. Unlike public companies where the most common source of lawsuits are shareholder/investor related, D&O liability claims made against private company boards have a wide variety of sources. The following outlines the most common sources of claims filed against privately held entities.

A private company D&O lawsuit is expensive regardless of who brings the litigation. In addition to settlements, legal costs accrue quickly during the full lifetime of a claim. Among the companies participating in a 2010 Chubb survey of private organizations, one in eight experienced claims against its D&O insurance policy in the last ten years. Of those companies that experienced a D&O liability lawsuit in the past five years, the average loss including settlement, judgment, and legal costs was approximately \$225,000.

The Towers Watson survey findings suggest that asset size has a direct correlation to the likelihood of a D&O claim. Forty-two percent (42%) of companies with more than \$10 billion in assets reported a claim, compared to twenty-two percent (22%) of companies with less than \$250 million in assets that reported a claim. In addition to asset size, there are many factors to consider when determining the appropriate total Limit of Liability for your D&O insurance program. Other variables to consider and analyze include company ownership structure, Board of Directors composition, industry sector, risk appetite, peer group data, and business model. However, smaller private companies should not use these statistics as a reason to dismiss the need for a D&O policy. On the contrary, it is the smaller company that truly needs this insurance because they lack the corporate assets to defend claims and, if necessary, pay settlements.

Based on the above information, the risks inherent to positions on a Board of Directors of a privately held entity present a material financial exposure to the individuals. The recommended risk management approach to protecting the interests of the individual directors and officers is a D&O insurance program.

Most Common Sources of Claims Filed Against Privately Held Entities



A traditional D&O insurance policy includes three insuring clauses. Coverage under the Side-A Insuring Agreement provides coverage for the individual directors and officers where the company is legally or financially unable to indemnify them. Coverage under Side-B provides corporate reimbursement coverage to the extent that the company indemnifies the individual directors and officers, usually in excess of a self-insured retention or deductible. Finally, coverage under the Side-C Insuring Agreement provides coverage for the liabilities of the entity itself.

One of the more significant features of a private company D&O policy is the inclusion of a “duty-to-defend” obligation from the insurer. This provision provides two key benefits to the policyholders. First, the handling of the claim is transferred from the insured’s obligation to the obligation of the more experienced insurance carrier. Second, defense costs are substantially lower as a result of pre-negotiated law firm rates, which are often one-third of what an uninsured company and/or its directors and officers would spend. This feature of the policy alone is a tangible benefit for private companies in the event of a management liability claim and will prove to outweigh the cost of the insurance policy itself.

In addition to D&O liability exposure, privately held companies are vulnerable to Employment Practices claims. Within the United States, employment law is a rapidly evolving and ever-changing area of litigation. This has resulted in an increasing level of former, current and prospective employees becoming more cognizant of their rights in today’s workplace. Even companies with robust employment policies, guidelines, and procedures are susceptible to lawsuits alleging employment practices violations such as harassment, discrimination, wrongful termination, failure to hire/promote, retaliation, and other employment-related allegations. In 2009 alone, the Equal Employment Opportunity Commission (EEOC) received over 93,000 charges, the second highest number on record. In order to respond to such violations - even absent of a material settlement amount - the process can be time-consuming and costly. As such, many privately held companies elect to transfer this risk through a carefully crafted Employment Practices Liability (“EPL”) insurance policy. Many insurers offer EPL insurance within their suite of products designed for private companies.

Depending on the desired scope of coverage of the policyholder, brokers can utilize different EPL insurance structures to meet the goals of any insured. The most common structure utilizes one single shared aggregate Limit of Liability for both D&O and EPL perils. The alternative design employs separate, stand-alone Limits of Liability for each coverage section (D&O or EPL). Under this structure, claims filed under one coverage section will not be able to erode the Limits of Liability designed for the other risk exposure. Based on a company’s specific risk profile, the self-insured retention level may differ for D&O and EPL claims under either insurance program structure. While a properly negotiated EPL insurance policy will mitigate the company’s exposure to financial loss, today’s most comprehensive EPL products also provide loss control services to mitigate the likelihood of future EPL losses and afford policyholders with access to some of the top employment related law firms in the country, at discounted rates.

During the last several years, many of the most highly respected and financially sound insurers have placed an added focus and dedicated significant resources towards underwriting D&O insurance for privately held companies. This landscape has created additional competition within the insurance marketplace and generated very favorable results for policyholders with respect to all aspects of the placement including cost, self-insured retention levels and policy wording. Today’s D&O arena for private companies includes more than 25 capable insurers with experience in the underwriting and claims handling for this line of insurance. This has generated an unparalleled amount of capacity available in the insurance marketplace for clients of all risk profiles.

In the end, privately held companies are susceptible to a range of different allegations brought by a variety of sources, making the risk of a lawsuit that could be covered by a D&O and EPL policy greater than ever for private companies. As the legislative landscape continues to evolve and legal costs continue to explode, we recommend transferring your management liability risk to a qualified insurer to best protect the interests of the company and its directors and officers. The policy premiums have never been more competitive and policy language continues to expand allowing these policies to respond to an increasing number of perils.

In order to evaluate your company's risk profile in connection with management liability exposures and discuss comprehensive insurance solutions, please contact Frank Crystal's Management & Professional Risk Group.

About Frank Crystal & Company

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