

Why Every Privately Held Firm Should Have D&O

Risk of D&O Liability May Be Greater Than at Public Company

Editor's note: This column first appeared in the March 23, 1998, issue of InsuranceWeek (now, of course, Insurance West). Because we have gotten so many requests -- about 75 -- for permission to reprint this column, we are publishing it again. The author, Los Angeles attorney Michael Rossi, informs us that his beliefs and his view of the directors-&-officers insurance marketplace have not changed since his column was first published more than a year ago.

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"The corporation is privately held, so D&O insurance is not necessary:'

How many times have you heard one of your clients say that? Even worse, how many times have you said that to one of your clients?

I am not overstating my reaction to that statement when I say I "bristle" every time I hear someone say it. Why? Read on and find out.

This article is intended to serve two purposes. First, it seeks to educate all agents and brokers who believe that a privately held corporation does not need directors-&-officers insurance. An agent or broker who advises a client in that regard is buying a ticket to E&O land. Second, this article is intended to help agents and brokers who are trying to persuade their privately held corporate clients to buy D&O insurance.

I can unequivocally state that any director or officer of a privately held corporation who does not insist that

the corporation carry some form of D&O insurance is playing a dangerous game with high stakes for him or her, his or her spouse, and his or her estate.

It just doesn't make any sense to expose the personal assets of one's self, one's spouse and one's estate to risk of uninsured loss when there are affordable insurance products available that can minimize the risk of having to pay for such a loss. There especially is no reason for an outside director not to insist on D&O insurance being carried.

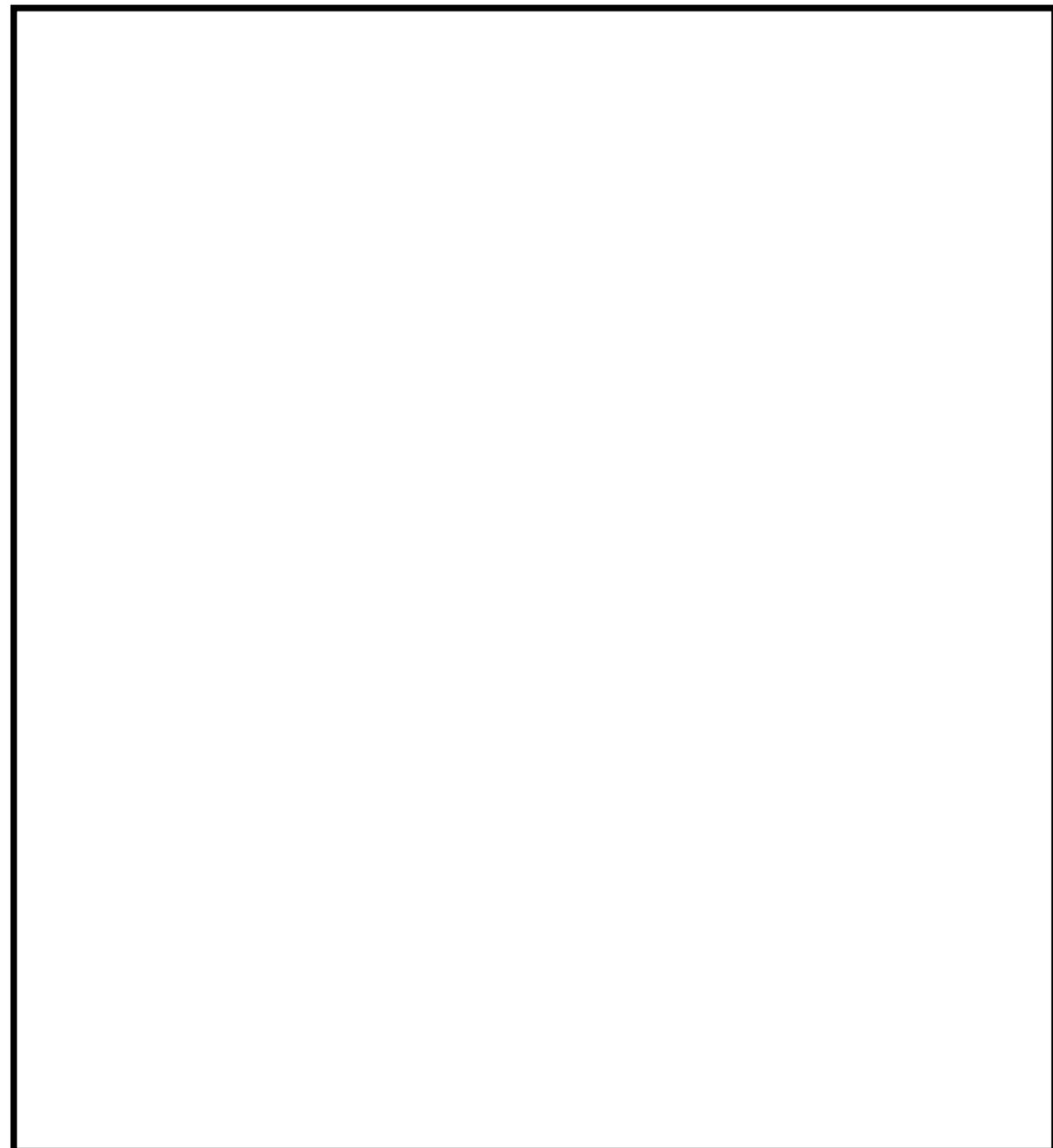
The only conclusion I can draw from such behavior is that the director simply does not know or appreciate the risks he/she faces.

D&O insurance premiums have fallen to incredibly low levels for all buyers, including privately held corporations. Several insurers are vigorously trying to tap into this market. The prices I've seen these companies quote for meaningful limits are very affordable. I am sure there are other carriers that are going after what appears to be an untapped, but lucrative, market.

So there does not appear to have been a better time for privately held corporations to buy D&O insurance, and there really is no longer the excuse that D&O insurance is too expensive for privately held corporations.

No D&O, No Help

In order to "bring home" this issue, I will discuss several real-life experiences I have had with privately held corporate clients. Some clients came to me with a claim and had D&O insurance -- so I was able to help. Some clients came to me with a claim but had no D&O insurance -- so I could do nothing but say, "You should have had D&O insurance" and watch as the



corporation and its two shareholder owners/operators struggled with litigation and settlement costs they could not afford.

In one case, a client and two of its officers were being sued by one of the company's competitors after an attempted purchase of the competitor fell through. The competitor alleged that my client never had any intention of buying it, and that the two officers of my client who held discussions with the competitor relating to the purchase feigned interest in the purchase so as to gain access to sensitive trade secrets of the competitor, which my client allegedly used to its advantage after the attempted purchase fell through.

The complaint alleged fraud, unfair competition, interference with prospective economic advantage, infringement of trade secrets and several other alleged wrongful acts. The client luckily had D&O insurance. Because the trade-secrets claims involved manufacturing processes rather than marketing information, the "advertising-injury" coverage provided by the client's comprehensive-general-liability policy could not respond. However, the client's D&O carrier responded to the claim and covered defense costs and a large portion of the settlement.

Obviously, if no D&O coverage had been purchased, the client would have been forced to pay all the defense costs and the full amount of the settlement.

Company Sues Ex-Employee

In another case, my client hired a seasoned employee from one of its competitors, bringing the person in as an officer. About a year later, that new officer's ex-employer sued my client and the officer, alleging that the officer had misappropriated trade secrets and violated certain provisions of his termination agreement.

As with the claim discussed previously, because the trade-secrets claims involved manufacturing processes rather than marketing information, my client's CGL policy did not respond to the claim. However, the client had D&O insurance.

The D&O insurer initially balked at providing coverage, arguing that the person's wrongful acts took place not in his capacity as an officer of my

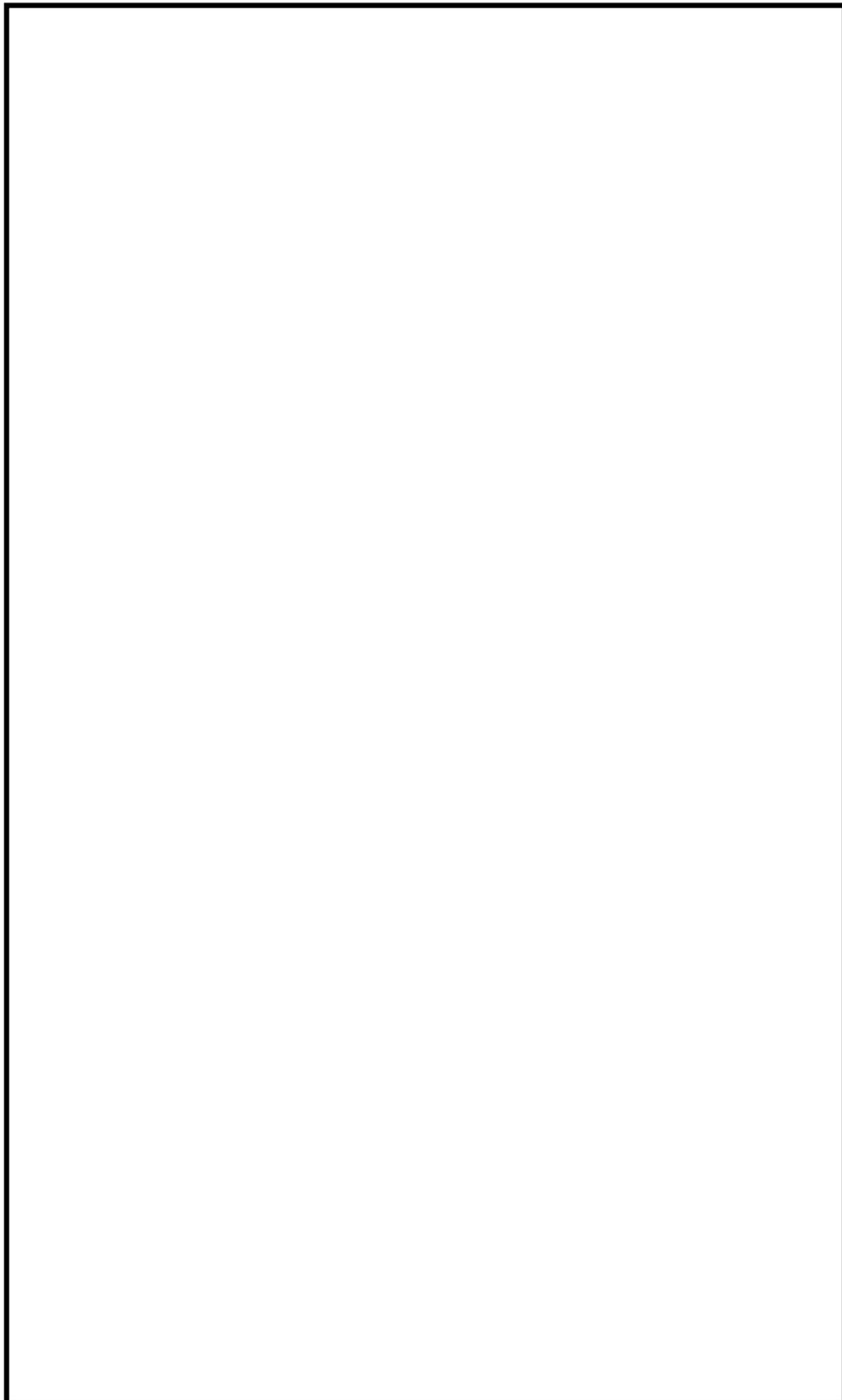
client but rather as an employee and/or ex-employee of the claimant. However, the D&O carrier provided coverage after I recited case law that found in favor of coverage for the very type of claim that was at issue.

Again, D&O insurance was essential for saving a privately held corporation from having to pay substantial defense and settlement costs.

In another case, my client entered into an agreement with another company in which my client agreed to act as wholesaler of certain goods to the

company. The company thereafter did not like the deal that was struck and sued my client and its two officers (who also were co-owners, because they were the only shareholders), alleging that what my client did was enter into a franchise agreement without following the necessary procedures and making the necessary representations relating to franchising.

Because there was no "property damage," "bodily injury," "personal injury" or "advertising injury," my **D&O** *continued on next page*



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client's CGL policy did not respond. Unfortunately, my client did not have D&O insurance.

Falling Through CGL Cracks

Nobody had ever advised the client of the need for D&O insurance, that several types of claims could "fall through the cracks" of coverage afforded by CGL policies. There was nothing I could do but sit and watch these two nice, honest people struggle with their ordeal.

This client has had to incur defense

costs that it can ill afford and does not have enough money to pay for what the claimant would take in a settlement, let alone what the claimant is asking for in damages. Unless something changes, this one claim could well bankrupt the client.

It would have been easy to add D&O insurance to the company's portfolio when it purchased insurance at the outset of its operations, but nobody knew of its importance. This one mistake will eviscerate much of the company's profits earned over the past two years, and if it drives the company into

bankruptcy, just think of all the hard work gone to waste.

In addition to my own experience as a coverage lawyer, there are also certain "facts" about the risks faced by directors and officers of privately held corporations that prove D&O insurance is essential. I'm not the only one to have made this observation. In preparation for this article, I reviewed articles by several commentators, some who spoke on their own behalf and others who prepared reports for certain D&O insurers. I agree with much of what I read and therefore I have summarized it as follows.

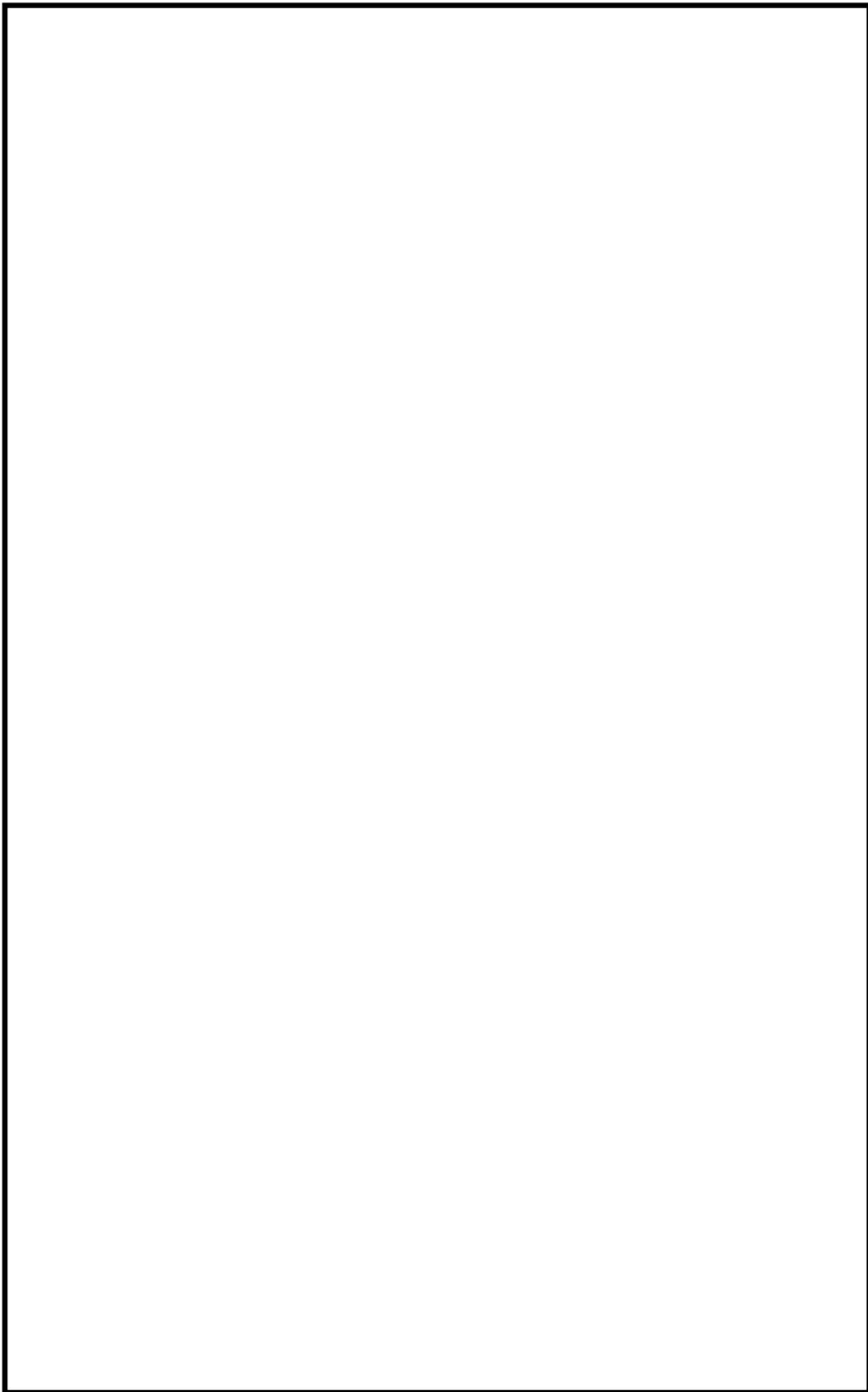
Private/Public: Little Difference

One of the misconceptions under which many people labor is that directors and officers of privately held corporations do not face the same risks as do directors and officers of publicly held corporations. That simply is not true. Directors and officers of privately held corporations face virtually all of the same risks as their publicly held counterparts, even risks associated with the securities laws of the United States.

Just because the corporation is not publicly traded does not mean it has not issued a "security" that is subject to U.S. securities laws. Many forms of instruments can be classified as a security for scrutiny by the Securities and Exchange Commission.

In addition, directors and officers of privately held corporations owe the same duties to shareholders as do their counterparts at publicly held corporations. And it is no safe harbor that, for example, all of the shareholders of a privately held corporation are relatives or friends. Friends one day can be bitter enemies the next, even when they are relatives. If you think differently, follow the saga of divorce law in the United States.

And it also is no safe harbor that a director or officer merely is acting on behalf of the corporation. The individual still can be personally liable for his or her acts on behalf of the corporation. Indeed, it has been argued by some experts that directors and officers of privately held corporations are at more risk of claims because most privately held corporations simply do not have the same resources as large publicly held companies, so that many



decisions by directors and officers of privately held corporations are made without full or accurate information.

What types of claims have been made against directors and officers of privately held corporations? Here are descriptions of several claims I have gathered from different articles on this subject. In most instances, the claims described would not be covered under CGL insurance or any other insurance that companies typically purchase, but could be covered and typically are covered under D&O insurance.

Claims by Shareholders

A variety of different types of shareholder claims have been made in the past, and continue to be made. Some claims allege there were breaches of the duty of candor with respect to misrepresentations in and/or omissions from private-placement materials.

Some claims allege there were breaches of the duty of care with respect to how the directors and officers handled the sale of the corporation, or how they missed a great opportunity for the corporation.

Some claims allege there were breaches of the duty of loyalty with respect to deals the corporation had entered into with companies owned in whole or in part by one or more of the directors and/or officers.

Claims by Employees

Several types of claims have been made by employees, with alarming frequency, in the last several years, especially in the area of employment-practices liability (i.e., claims for wrongful termination, discrimination and harassment). Such claims have been in the form of both allegations of actual wrongful termination, discrimination or harassment, as well as of negligent supervision and/or failure to follow up with respect to complaints of wrongful termination, discrimination or harassment.

Claims by Competitors, Customers

As noted previously, directors and officers of privately held corporations face claims by any party with which the corporation contracts or even discusses a contractual relationship (whether competitor, customer or other contracting party). Because
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many contracts and other negotiations for privately held corporations are handled by an officer of the company (especially for smaller privately held corporations), officers are at risk for claims arising out of their contracting and negotiating activities.

The personal experiences related at the beginning of this article bear out this risk in spades.

Claims by Government Agencies

A variety of claims can be made by government agencies against the directors and officers of privately held corporations. Such claims vary from those relating to environmental contamination to employee health and safety. In addition, privately held corporations in certain industries, such as financial institutions, can face *investigations* and claims by certain regulatory agencies with respect to suspected or actual wrongdoing.

Non-Indemnifiable Claims

OK, so after reading all of what is discussed previously, the directors and officers of a privately held corporation still are not convinced that D&O insurance should be purchased. What I often hear is, "The corporation will reimburse us for any claims. Therefore, we don't need to buy any D&O insurance."

Is that a sound position? Not in my

book. A fact commonly overlooked by many directors and officers is that certain D&O claims are not indemnifiable by the corporation. Certain shareholder derivative actions are perfect examples. Some are intended to force directors and officers to put money back into the corporation's coffers, after the directors and officers commit wrongful acts that cause the corporation to lose money or other assets with value.

If the corporation were to reimburse the directors and officers for such claims, the whole purpose for such a derivative action would be defeated. Thus, many of such claims cannot be indemnified by the corporation.

The only thing standing between the claim and the personal assets of the directors and officers, therefore, is D&O insurance. If no D&O insurance is available, the money will come from the personal assets of the directors and officers.

There is another type of non-indemnifiable claim. This one is well-known but never appreciated. It's the claim that can be indemnified by the corporation but because the corporation is insolvent, it has no money to indemnify the directors and officers. The corporation's insolvency is not a defense to a D&O claim.

Thus, as with claims that are simply non-indemnifiable (such as certain types of shareholder derivative claims as noted previously), directors and officers

facing claims when their corporation is insolvent likely will have to pay defense and indemnity costs out of their personal assets, unless D&O insurance is in place to provide coverage.

Spouses, Estates Exposed Too

Another little known fact is that the spouses and estates of directors and officers also are exposed to the liabilities faced by directors and officers. It is often, therefore, very simple to extend coverage under a D&O policy to the spouses and estates of directors and officers, with respect to claims against such directors and officers. (The policy will not respond to claims against a spouse for conduct of the spouse.)

Even if a director or officer is willing to take the risk of uninsured loss for himself or herself, it seems very, very wrong to me that the director or officer also is willing to expose his or her spouse to such uninsured liability, knowing of the risk of such liability.

I hope this column can be used for its two intended purposes. If you are an agent or broker who wants to know more about the risks faced by directors and officers of privately held corporations, this article should provide you with information that can serve as the beginning, or continuation, of your knowledge on the subject. If you are an agent or broker who wants to advise a client on the need for D&O insurance for privately held corporations, this column help you as well.

I am sure that some readers will decry this column as "fear-mongering" for some clandestine purpose (to generate money for me or my firm, perhaps?) The fact of the matter is, I have thought about writing this article for nearly a year now, and I wrote it for just one, simple reason: I don't ever want to see another director or officer face the ordeal of defending against a D&O claim without having D&O insurance.

Michael A. Rossi is an attorney in the Los Angeles law firm of Troop Steuber Pasich Reddick & Tobey LLP. He works with agents and brokers to provide legal advice to policyholders from all over the world with respect to insurance-program reviews and audits, initial placements and renewals, and coverage disputes. He can be reached at (310) 728-3311 or by e-mail at mrossi@inslawgroup.com.