Directors & Officers Liability Insurance for Private Companies: Issues and Analysis
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“Directors and officers must act with the level of care that a reasonable person in similar circumstances would use. If the directors or officers violate this duty of care, and, as a result, the corporation loses money, the directors and officers can be held personally liable and ordered to pay damages to the corporation. The primary requirement of the duty of care is that directors and officers act on an informed basis. The common law standard of reasonable inquiry has evolved such that directors and officers ‘have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with the requisite care in the discharge of their duties.’”


A frequent (and serious) misconception is that companies without publicly traded stock do not require Directors & Officers Liability insurance (D&O). In reality, much of the case law governing the duties of directors and officers arises in the context of private held companies. This paper is intended to identify the exposures faced by private company directors and officers, and how D&O insurance can mitigate their financial risks.

Where Does Liability Arise?

Directors and officers of private companies face the same liability as those on public boards—and usually with fewer corporate resources to protect them. While federal securities laws are usually aimed at protecting the shareholders of companies engaged in interstate commerce, many of the duties imposed on directors and officers by the federal laws are grounded in common law and state statutes. Every state has both its own securities laws and case law providing a code of conduct for directors and officers. Such duties are not delegable.

In protecting their decision makers, publicly traded companies have access to resources beyond the means of many privately held companies. Investment bankers, attorneys, accountants and many other professionals will be called upon to assist in any major (and even not-so-major) transaction. The board may very well be larger than that of a private company, with more and varied expertise. Yet the law that governs directors’ actions imposes the same standards for both public and private companies.

Directors and Officers’ Fiduciary Duties

All directors and officers (public and private) owe the corporation the duty of care and the duty of loyalty. These are fiduciary duties, meaning that the individual must consider the corporation’s well being above their own. As one commentator put it:

• Directors and officers must act with the level of care that a reasonable person in similar circumstances would use. If the directors or officers violate this duty of care, and, as a result, the corporation loses money, the directors and officers can be held personally liable and ordered to pay damages to the corporation. The primary requirement of the duty of care is that directors and officers act on an informed basis. The common law standard of reasonable inquiry has evolved such that directors and officers “have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with the requisite care in the discharge of their duties.”

Such duties are not delegable. Breach of fiduciary duty is a common allegation in corporate litigation against directors and officers.

Directors and officers are protected by the “business judgment rule.” This rule protects directors and officers from liability for mistakes that they have made in the good faith management of the company. Based on the belief that courts should not impose their judgment to second-guess business, the rule does offer some protection from common law liability. There are significant limitations, however.

2 A third duty, that of obedience, is sometimes cited, although, for purposes of this paper, that is subsumed in the duty of loyalty.
4 Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). While Smith v. Van Gorkom has been criticized and pecked at, its core holding—that the business judgment rule only protects directors who actually exercise judgment—remains intact.
Directors and officers can rely on the business judgment rule by demonstrating they acted in good faith and not in their own self-interest. It offers no protection, however, for failure to make a decision or consider an issue. This is of immense importance and is often overlooked.

- It is important to keep in mind that the scope of the duty of care is far broader than that of the business judgment rule. It encompasses not only the board's action but also its inaction—that is, cases in which the directors are charged with negligence in failing to detect or respond to a problem, often referred to as the directors' “oversight function.” The business judgment rule, in contrast, is confined to cases where the board did in fact make a decision.5

A decision which turns out to be a bad one may be defended as a matter of business judgment, if management has been reasonably prudent and careful in coming to that decision. A careless decision—or a failure to make any decision—is not similarly protected. For example, if a finance officer simply neglects to inquire about network security (preferring to leave it to the technicians), that neglect is not protected by the business judgment rule.

Corporate Indemnification

To attract and retain directors and officers, companies generally promise through bylaws or separate agreements to provide indemnification of liability incurred in their executive position. While corporate law generally allows for broad indemnification, it is not adequate to mitigate personal risk. While no ongoing business likes to consider insolvency, it is a fact that many companies fail. Even a company with every intention of protecting its executives may be unable to continue to indemnify in this situation.6

Even for solvent companies, total indemnification is not a foregone conclusion. In most states, the company may not indemnify a director or officer for acts undertaken in bad faith or for personal gain.

Similarly, corporate indemnification for claims brought derivatively will be limited. A derivative action is one brought on behalf of the corporation, most often against corporate directors or officers. Usually, such an action is brought by a shareholder, although creditors or other parties may as well. The derivative plaintiff must first either demand that the corporation bring the action itself or demonstrate the futility of such a demand. Whatever funds are recovered go to the corporation.

In a derivative case, the corporation is permitted, in most cases, to indemnify a defendant director or officer, even if liability is established, except in cases of bad faith or personal gain. Even in those cases, indemnification may be permissible with a court’s permission, although the law varies by state. An analysis can be difficult.7

Under some circumstances, a company may simply refuse to indemnify. This is most common among former directors and officers. While the duty to indemnify may survive the termination of a board relationship, the director or officer may be unable to convince current management to provide defense and indemnification.

Basics of D&O Insurance

The coverage grants in D&O policies are not delineated by claimant or industry. Rather they are broad grants of protection for loss attributable to claims alleging wrongful acts of many stripes. D&O policies, true to their original purpose, protect individual directors and officers when the company is unable or unwilling to indemnify them. Such protection is crucial, as claimants can attack the personal assets of such individuals under state law. Separate policies, called “Side A Only,” are available to provide coverage for the benefit of the individuals alone, should that be deemed necessary. Current D&O policies, however, offer coverage for both the individuals and the corporate entity.

6 It is a common misconception that bankruptcy rules forbid indemnification of corporate management. While this is not true, it is likely that a trustee for a debtor facing liquidation can find better uses for dwindling resources than paying defense expenses for the individuals who brought about its demise.
7 For further analysis, see Ferrara, Misconceptions of Non-Indemnifiable Loss, FDCC Quarterly; Summer 2004, Vol. 54 Issue 4, p359, http://www.thefederation.org/documents/Vol54No4.pdf.
Assuming that coverage has been triggered, D&O policies will respond to claims in one or more ways. For claims against individuals for which corporate indemnification has been provided, the policy will reimburse the corporation for reasonable and necessary expenses incurred. If indemnification is appropriate, the policy may pay on behalf of the corporation. These two methods are known as “Side B” coverage grants.

For claims in which corporate indemnification has not been provided, the policies will respond directly on behalf of the individuals. This is known as “Side A” coverage. In such instances, there is usually no deductible or self-insured retention. Some policies, however, include “presumptive indemnification” provisions, which, as the name implies, treat every loss as if indemnification has been provided to the fullest extent of the law. In such policies, the same deductible or retention as would apply to Side B coverage would be imposed. These retentions can be substantial.

In addition, private company D&O insurance offers broad coverage for the corporation itself. This is known as “Side C.” This contrasts with coverage for public companies, for which coverage is limited to claims related to the purchase or sale of the company’s own securities, and, sometimes, for employment claims against individual insureds.

Private companies can purchase protection for a wide variety of claims. Employment practices liability coverage is a major component of a private company management liability policy, but the policy can also provide D&O coverage for claims by customers, creditors, competitors and regulators.

In addition to coverage for the payment of claims, a crucial element of D&O coverage is defense costs. As every litigant knows, even if ultimately successful, litigation costs money. Private company D&O policies address the cost of litigation in a variety of ways. Many policies provide the insureds with what is known as “duty to defend” coverage, in which the carrier assumes the obligation to defend the entire case, hiring counsel and controlling the strategy. In the event of uncovered matters, the insurer must defend the matter in its entirety until the case resolves, at which point, the insurer may allocate expenses. That said, some “duty to defend” policies provide a “100% Defense Allocation” under which a carrier agrees to pay for the defense of uncovered claims made in conjunction with covered claims.

“Non duty to defend” or “reimbursement” policies place control of the defense in the insured’s hands, with the reimbursed defense and indemnity expense allocated among covered and uncovered items. There are benefits and shortcomings to each method that insurance buyers must consider.

Sources of Private Company D&O Claims

Directors and officers of private companies are susceptible to the same types of claims as their public company counterparts, although the coverage provided by private D&O forms is markedly different. As noted above, private form D&O policies offer considerably broader entity coverage than public company policies, including employment practices liability insurance, for example. This is particularly valuable; these claims are among the most common types of D&O claims among private companies. Such claims include a variety of allegations, such as wrongful termination, discrimination and harassment.

Yet, employment claims are not the only ones faced by private companies. An Advisen report, created by Gallagher for this newsletter, showed almost one hundred claims (excluding employment actions) against private companies settled in 2014 for over ten million dollars. The report included over nine hundred claims in total.

Private companies also face securities claims. The term “securities” encompasses stocks, bonds, debt, investment contracts and many other instruments issued by privately held companies. In addition, mergers, acquisitions and other transactions can involve securities claims as

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*The data is drawn from Advisen’s Master Significant Case and Actions Database, using search terms including Director & Officer Liability Insurance, private companies and dispositions in 2014. Advisen’s data is compiled from public sources, and should be considered under-inclusive.*
well as general corporate duty claims. According to the Towers Watson survey, shareholders represent over one-third of all claimants against private companies.9

Another common misconception is that companies not publicly traded or family owned automatically face lower risk of litigation. Some of the most acrimonious litigation has been among relatives or brought by a single shareholder. Shareholder allegations brought against private company directors and officers include self-dealing and management entrenchment, improper or inadequate valuation of stock or other assets, misrepresentation of important corporate information affecting the value of shares or debt, management misconduct or negligence.

Beyond employees and shareholders, other sources of D&O claims include customers, competitors, governmental agencies and other third parties.

D&O Claim Examples

• A $1.47 billion jury verdict against six current or former directors of Amerco Inc., parent of U-Haul International, Inc. The lawsuit was brought by members of the Shoen family who own just under one-half of Amerco’s common stock and who alleged the defendants (other Shoen family members), wrongfully prevented the plaintiffs from gaining control of the company and caused the value of plaintiffs’ stock to sharply drop. In addition, one of the defendant directors was ordered to pay $70 million in punitive damages. The court later reduced the judgment to $461 million, and reduced the punitive damage award to $7 million. 1999

• Five independent truck stop owners, filed a class action suit against Comdata Network, Inc. (Comdata), Ceridian Corporation, Pilot Travel Centers LLC and Love’s Travel Stops & Country Stores, Inc. Comdata markets fuel cards that are used for payments by trucking companies at truck stops. The complaint alleged antitrust violations arising out of Comdata’s contractual relationships with truck stops in connection with its fuel cards. After five years of litigation, the parties settled for $130 million. 2014

• A $125 million derivative shareholder complaint was filed by John M. Ferolito et al., on behalf of Beverage Marketing USA, Inc. (BMU) against Domenick J. Vultaggio. The complaint alleged breach of contract pertaining to the Owner’s Agreement, and other related allegations. Prior to litigation, Ferolito and Vultaggio formed the AriZona Iced Tea business, consisting of 21 entities known as the AriZona Entities. All of the Arizona Entities are owned equally by Ferolito and Vultaggio, along with members of their respective families (Owners Groups). Due to strained relations between Ferolito and Vultaggio, the parties agreed that Vultaggio would assume primary responsibility for the day-to-day management over the AriZona Entities. In August 2008, Ferolito attempted to transfer a block of its shares without Vultaggio’s consent. Both sides litigated. In 2014, after six years of litigation, the court ordered the beginning of a court-supervised buyout for more than what Vultaggio offered, and less than what Ferolito wanted. 2014

• A class action lawsuit was filed against Cobb Electric Membership Corporation (Cobb EMC) on behalf of all former and current members of Cobb EMC from its organization in 1938 up through December 31, 2012. The Former Member Plaintiffs contended that Cobb EMC should retire all Capital Credits of former members and adopt a Revolving Plan with a Rotation Cycle of 10 to 20 years. The Current Member

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9 “2012 Directors and Officers Liability Survey” (the most recent available Towers Watson survey available).
• Plaintiffs intervened, contending that Cobb EMC should be required to adopt a Revolving Plan with a reasonable Rotation Cycle for the benefit of former and current members, but are opposed to an increase in their electric rates for the purpose of funding such a plan on the ground that the long-standing failure of Cobb EMC to retire Capital Credits was the fault of, among others, Cobb EMC’s former board of directors and former chief executive officer, for those acts they should not be penalized and which issues have already cost current members significant sums. The parties settled, establishing a cash fund of up to $98 million for the benefit of Settlement Class Members, in various combinations of cash and/or discounted service. 2014

• A jury in Virginia found that directors and officers of Tutorna.Net Inc. had misrepresented the value and transferability of investors’ stock and awarded $177 million. This case is unusual for several reasons: first, the case went to verdict in federal court. Second, Tutorna.Net Inc. is a private company and there was no public offering of its stock (which was, in fact, one of the complaints of the plaintiffs) and the verdict was awarded to a group of 13 plaintiffs. 2002

• The Federal Deposit Insurance Corporation as Receiver for TierOne Bank (FDIC) sued Gilbert G. Lundstrom, David L. Hartman, James A. Laphen, Randall B. Kidd, Delmar E. Williams, Charles W. Hoskins, Campbell R. McConnel and Ann L. Spence (Defendants), alleging defendants breached their fiduciary duty and committed acts of gross negligence. The Defendants approved a plan to generate so-called “Turbo Assets,” high-risk loans bearing interest rates greater than traditional mortgage loans, like CRE and ADC loans. The same Defendants recommended and approved numerous large high-risk ADC loans in the vicinity of Las Vegas, Nevada, an unfamiliar and volatile market. In addition, Laphen and Lundstrom created a bonus system for Kidd that incentivized the start of large fee producing loans in Las Vegas, without accountability for loan performance. The Las Vegas business quickly generated more than $200 million in ADC loans, over 75% of which became adversely classified by the end of 2008. Defendants continued to advance additional credit to Defendant Kidd’s stable of bad borrowers and continued to violate the bank’s Loan Policy, prudent lending practices, and federal regulations. In March 2014, the Federal Deposit Insurance Corp. settled its lawsuit against Defendants for $6.5 million, to be paid by two insurance companies. 2014

• Regal Cinemas sued W&M Properties over a real estate transaction under which W&M was to build a theater at a shopping center developed and owned by W&M. Regal alleged that W&M failed to apply for necessary approvals and delayed necessary remedial actions. At the conclusion of the trial, the jury found for Regal on Regal’s fraud claim, awarding actual damages in the amount of $5 million and punitive damages in the amount of $1 million against each defendant. 2004

• Shareholders of PMHI Holdings Corp. sued the majority (90%) shareholder/chairman and directors for self dealing, corporate waste and negligence. A Delaware court found the chairman liable for his deeds and the directors liable for failing to monitor and control the chairman. “Under Delaware law, it is fundamental that a director cannot act loyally towards the corporation unless she tries—i.e., makes a genuine, good faith effort—to do her job as a director. One cannot accept the important role of director in a Delaware corporation and thereafter consciously avoid any attempt to carry out one’s duties.”10 Despite the fact that the directors took no part and gained no benefit from the chairman’s self-dealing, they breached the duty of loyalty by failing to assure corporate information and reporting systems. This failure demonstrated a lack of good faith: the corporation could not indemnify the directors. The plaintiffs were awarded $3.9 million, plus interest of 25%. 2006

• Directors and officers of Trace International were found personally liable to the insolvent private company for $44 million. The court held the directors breached their duty of loyalty to the company by allowing the founder and largest shareholder to use corporate assets for his personal benefit, despite the fact that none of the directors benefited financially. Although the verdict against two of the directors was remanded in 2005, litigation lasted almost ten years. 2005

• APA Transport Corporation closed its facilities and terminated all of its employees in 2002, with only a week’s notice. A number of non-union and union employees, along with certain ERISA funds, filed suit against APA Transport and its management claiming that they had violated the notice provisions of the
• Worker Adjustment and Retraining Notification Act, which requires that 60 days’ notice be given before a plant shutdown unless the employer qualifies for certain exceptions. An appeals court refused to dismiss the action against corporate and individual defendants. 2008

While these cases do not often capture headlines, they nevertheless represent significant exposure to private companies. Even if directors and officers are ultimately exonerated, they can face years of litigation and substantial defense costs. Without adequate risk management measures, many companies and their executives will be unable to withstand the financial strain.

**Appropriate Limits of Liability**

One of the most challenging issues facing private and public companies alike is determining appropriate limits of liability. Unlike property insurance where you can rely on statements of values to make an informed decision, D&O and other executive liability lines of coverage with low claim frequency but high loss severity, do not allow for an exact formulaic approach to arrive at the appropriate decision. For our private company clients we rely on peer group benchmarking analyses combined with individual risk tolerance. The following are distributions of D&O limits carried by private companies according to revenue size.

**Distributions of D&O Limits**

Limits carried by private companies according to revenue size—Data Source: Advisen, Ltd.

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**Revenues Under $25M**

- ≤ $1M: 3%
- $1 - $2M: 18%
- $2 - $5M: 60%
- $5 - $10M: 18%
- > $10M: 1%

n = 10,268

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**Revenues $25M - $50M**

- ≤ $1M: 4%
- $1 - $2M: 11%
- $2 - $5M: 34%
- $5 - $10M: 35%
- > $10M: 16%

n = 952

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**Revenues $50M - $100M**

- ≤ $1M: 11%
- $1 - $2M: 24%
- $2 - $5M: 18%
- $5 - $10M: 14%
- > $10M: 24%

n = 475

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**Revenues $100M - $250M**

- ≤ $1M: 20%
- $1 - $2M: 14%
- ≤ $5M: 40%
- $5 - $10M: 14%
- > $10M: 10%

n = 318

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**Revenues $250M - $500M**

- ≤ $1M: 15%
- $1 - $2M: 9%
- ≤ $5M: 40%
- $5 - $10M: 10%
- $10 - $20M: 18%
- > $20M: 25%

n = 475

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**Revenues $500M - $1B**

- ≤ $1M: 1%
- $1 - $2M: 3%
- ≤ $5M: 13%
- $5 - $10M: 25%
- $10 - $20M: 29%
- > $20M: 29%

n = 72

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Conclusions
Directors and officers of private companies are exposed to similar risks as their public company counterparts. Although ultimate payouts of private company D&O claims typically fail to grab the headlines, the exposure remains significant. Settlements, verdicts or even defense costs alone may exhaust resources. Our clients realize that the cost for insurance relative to their exposures makes directors and officers liability insurance a prudent component of an overall risk management program.

About Gallagher’s Management Liability Practice
Gallagher’s Management Liability Practice (MLP) is a national practice dedicated to the development and implementation of risk management and risk transfer programs.

MLP specializes in protecting individuals and their companies against an array of executive and professional liabilities. Our specialized coverage expertise includes:

- Directors and Officers Liability
  - Public
  - Private
  - Not-for Profit
- Employment Practices Liability
- Fiduciary Liability
- Employee Dishonesty (Fidelity/Crime)
- Professional Liability
- Special Crime (including Kidnap & Ransome)
- Network Security/Privacy Liability
- Tax Liability
- Transactional Products

Due to the complexity of these risks and scope of coverage which can vary drastically among carriers and policy forms, dedicated expertise is essential to ensure your exposures are being adequately addressed. Our experts are prepared to analyze your management liability risk and design an appropriate risk transfer program.
About the Author

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