Directors & Officers Liability Insurance for Private Companies: Issues and Analysis

"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.'”¹

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 privately 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. In addition, these duties fall equally upon officers—even the most junior officers—as well as members of the board of directors of private as well as public companies.

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.² 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.”³

Such duties are not delegable.⁴ 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.

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

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.
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 state 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.

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.

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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 will believe there are 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.
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.

As is evident, unlike other commercial insurance policies, such as Comprehensive General Liability or Property insurance, Directors and Officers Liability policies vary widely. In addition to broad coverage, there are conditions and exclusions which can seriously affect coverage. As such, it is important to carefully review the provisions of D&O policies to determine whether the terms, conditions and costs meet the needs of all the insureds.

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 2016 for over five 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 well as general corporate duty claims. According to the Towers Watson survey, shareholders represent over one-third of all claimants against private companies.

Respondents to a more recent survey, conducted by Chubb Insurance, reported that 26% of private companies had experienced a “D&O loss” between 2013 and 2016.

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.

**Private companies experienced losses due to suits or fines.**

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<tr>
<th>Category</th>
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<tr>
<td>Customer</td>
<td>54%</td>
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<tr>
<td>Vendor or Supplier</td>
<td>37%</td>
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<td>Government or Regulator</td>
<td>27%</td>
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<tr>
<td>Competitor</td>
<td>27%</td>
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<tr>
<td>Partner or Other Shareholder</td>
<td>23%</td>
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A new area of potential liability arises from network, database, internet and other “cyber” activities. Both public and private companies see cyber liability as presenting a new threat.

Nor is concern limited to U.S. companies. A survey conducted by the U.K. law firm Allen & Overy and Towers Perrin noted that private companies management believe they may be liable to claims arising from shareholders, vendors and regulators.

**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.

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

- Plaintiff Caribevison, a Spanish television network entered into a joint venture agreement with America CV Entities, to be led by America CV CEO Omar Romay. Shortly after the venture commenced, the CEO began a series of actions, which he alleged diluted the percentage interests of Caribevison to approximately 20% and took control of the Board of Directors. Caribevison sued. On November 2, 2015.

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11 2016 Chubb Private Company Risk Survey
a jury returned a verdict for Caribevision in the amount of $58,431,074.00. The court also granted plaintiff’s request to dissolve the joint venture. 2015

• 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

• On March 25, 2011, Brigade Leveraged Capital Structures Fund Ltd. (Brigade Leveraged) and other investors (Collectively the Plaintiffs) filed a complaint in the Eighth Judicial District Court of Clark County Nevada against Fontainebleau Las Vegas Holdings LLC (Fontainebleau) and other several defendants including Miami developer Jeff Soffer; Las Vegas gaming executive Glenn Schaeffer, and investors Australian gaming titan James Packer and Packer’s company Crown Ltd.

Plaintiffs alleged that the Defendants fraudulently induced the Plaintiffs, as lenders, to extend financing to the Borrowers. Further, the Plaintiffs claim that certain Defendants breached fiduciary duties by failing to provide the Plaintiffs with accurate information concerning the status and progress of the project. The defendants are also accused of negligent misrepresentation and conspiracy to commit fraud/abetting fraud.

The lawsuit claims Packer personally conspired with Soffer to conceal cost overruns as Packer “recognized that if the lenders learned the truth about the project, the lenders would cease funding and the value of Crown’s investment in Fontainebleau would plummet. During a meeting in late 2007 or early 2008 in Las Vegas, “the Packer defendants agreed and conspired with the Fontainebleau defendants to continue to misrepresent the financial status of the project to the lenders,” the lawsuit alleges. On February 24, 2015, Fontainebleau Resorts Llc has reached a $115 million settlement with the plaintiff. The settlement was approved by the court. Under the terms of that deal, the insurers of the directors and officers would pay the estate $25 million, while Jeffrey Soffer, a principal in the project, would pay $2.5 million into the estate. Soffer and other parties related to him also agreed to waive $675 million in claims they had asserted against the estate, according to the settlement. In a separate deal, Soffer and the directors and officers of the company agreed to pay the term lenders $98 million, of which $93 million will come from D&O insurance and $5 million will be paid by Soffer. 2015

• 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.” 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

• A shareholder derivative complaint was filed on behalf of the nominal defendant Culligan Ltd. (Culligan or the Company), seeking to remedy defendants’ breaches of fiduciary duties and other wrongdoing which arose from a $610 million leveraged buyout of Culligan, and the buyer’s subsequent actions in stripping Culligan of its assets and burdening Culligan with debt, to the benefit of the buyer. After it acquired Culligan, the buyer fraudulently conveyed the cash assets of the business to its private equity partners by issuing a repayment of capital and a stock dividend and paying itself exorbitant consulting fees, thereby leaving Culligan heavily in debt, insolvent and unable to pay its debts as they came due. On May 19, 2015, a New York judge signed off on a $4 million settlement that narrows a shareholder derivative suit. 2015

• 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.

**Revenues Under $25M**

- ≤ $1M: 3%
- $1 - $2M: 18%
- $2 - $5M: 16%
- $5 - $10M: 62%
- > $10M: 1%

n = 8,275

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

- ≤ $1M: 4%
- $1 - $2M: 7%
- $2 - $5M: 32%
- $5 - $10M: 37%
- > $10M: 20%

n = 1,050

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

- ≤ $1M: 9%
- $1 - $2M: 5%
- $2 - $5M: 33%
- $5 - $10M: 20%
- > $10M: 33%

n = 811

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

- ≤ $1M: 18%
- $1 - $2M: 19%
- $2 - $5M: 14%
- $5 - $10M: 36%
- > $10M: 13%

n = 605

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

- ≤ $1M: 11%
- $1 - $2M: 12%
- $2 - $5M: 17%
- $5 - $10M: 33%
- $10 - $20M: 19%
- > $20M: 8%

n = 210

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

- ≤ $1M: 7%
- $1 - $2M: 27%
- $2 - $5M: 23%
- $5 - $10M: 22%
- $10 - $20M: 11%
- > $20M: 5%

n = 121
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 & Ransom)
- Network Security/Privacy Liability/Cyber 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

Donna Ferrara, Esq. is a Senior Vice President in Arthur J. Gallagher & Co.’s Management Liability Practice. This division focuses on risk management services, including insurance placement related to executive and management liability issues. During Ms. Ferrara’s three decades in the industry, her experience includes litigating and analyzing insurance issues, drafting policies, and aiding the settlement process. Ms. Ferrara is a frequent participant in industry forums as well as a respected contributor of articles on insurance, law, and technology, having been published in both legal and trade press. She has also been recognized as a “Power Thought Leader” by Risk & Insurance magazine.

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