

# Why Private Companies Need D&O



A white paper by:  
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It is a common misconception that because a privately held company is not publicly traded, it does not have D&O exposure. Nothing could be further from the truth. While publicly traded companies tend to have heightened exposure by comparison, privately held companies are also at risk for D&O claims. According to a recent Chubb study of private companies, more than 1 in 4 private companies experienced a D&O claim in the last three years, and the average loss was just under \$400,000.<sup>1</sup> This paper will briefly explain the basis for liability and the sources of claims against private companies. We will also discuss common types of private company D&O claims, as well as an overview of D&O insurance and the state of the marketplace.

### **The Basis of Private Company D&O Liability**

Directors and officers of any organization owe a duty of care and loyalty to that organization. This means that they act reasonably, informing themselves of material information necessary to make prudent decisions on behalf of the organization while avoiding conflicts of interest.

If a director or officer breaches their fiduciary duty and causes harm to the organization or stakeholders, those directors and officers can be held personally liable for the breach.

This does not mean that the directors and officers must make the “correct” decision in retrospect. The business judgment rule provides some level of protection for directors’ and officers’ decisions if they act in good faith and adequately inform themselves through the necessary due diligence in their decision-making. This doctrine does not provide a safe harbor for failing to make a decision or consider an issue; nor does it apply to a decision made without the requisite diligence and information.

### **The Sources of Private Company D&O Claims**

Private companies face claims from a myriad of sources, including shareholders, creditors, customers, vendors and regulators. Allegations are similarly wide-ranging, including but not limited to misrepresenting financial condition, deceptive or anti-competitive trade practices, and violation of federal, state or other law.

A look at actual claims is illustrative of these points:<sup>2</sup>

Many companies have a false sense of comfort that if they are closely held or family-held businesses, they don’t have an exposure. Unfortunately, some of the most contentious D&O claims have been from these types of businesses.

In a case that settled for \$129 million, a family owned a majority of the interest in a news organization and the board was composed mostly of family members. When the organization announced a \$13 million spend for naming rights on a new performing arts center, a minority shareholder sued, citing that they weren’t informed about the plans, the spend was more than the organization’s annual net income for the prior two years, and the theater recipient was tied to the chairman’s daughter. The settlement represented a buyout of the minority shareholder’s interest, a remedy available under state law.<sup>3</sup>

Another fallacy is that privately held organizations are not subject to regulatory scrutiny. SEC enforcement actions suggest otherwise. In a recent settlement with the SEC, the founder of an online payment company sought to sell some of his shares in private secondary transactions.

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<sup>1</sup>[https://www.chubb.com/us-en/\\_assets/doc/2018-04.20-14-01-1270-private-company-infobook.pdf](https://www.chubb.com/us-en/_assets/doc/2018-04.20-14-01-1270-private-company-infobook.pdf)

<sup>2</sup> These claims are used to illustrate the sources of claims. References to these matters do not imply that the claims were covered by D&O insurance.

<sup>3</sup> Cox Enters. v. News-Journal Corp., No. 6:04-cv-698-Orl-28KRS, 2008 U.S. Dist. LEXIS 129870 (M.D. Fla. Apr. 7, 2008).

Claims may occur at key life cycle events in a company's history; three notable examples are during merger/acquisition activity, bankruptcy and in the course of going public.

In the course of those transactions, he allegedly inflated earnings and made misleading statements. The SEC settled the matter for a \$640,000 penalty and disgorgement of his earnings plus interest.<sup>4</sup> The SEC has also made headlines by pursuing cases against Theranos, Zenefits and Credit Karma.<sup>5</sup>

Private companies can face antitrust or unlawful competition claims, which can be brought by competitors or regulators. In a recent Department of Justice press release, a privately held generic pharmaceutical company agreed to pay \$225,000 in criminal penalties and \$7 million in civil damages under the False Claims Act for conspiring with its competitors to fix drug prices.<sup>6</sup>

Competitors may allege anti-competitive or unfair business practices against an organization. For example, a medical testing company sued a competitor alleging unfair business practices. They alleged that the defendant had provided improper financial incentives to healthcare providers in violation of state and federal laws. The court agreed and awarded almost \$3 million in damages plus \$12 million in punitive damages.<sup>7</sup>

### **Events Contributing to Private Company D&O Claims**

Claims may occur at key life cycle events in a company's history; three notable examples are during merger/acquisition activity, bankruptcy and in the course of going public.

According to a recent Zurich white paper, merger activity invites claims brought by minority shareholders, but the source of potential plaintiffs can be broader than minority shareholders. "One scenario is a business partner who claims to have been damaged because of a merger, and sues for, perhaps, breach of contract or tortious interference," according to the report.<sup>8</sup>

Private companies face bankruptcy risk more often than publicly traded companies. First, the number of publicly traded companies is at an all-time low. In fact, the Wilshire 5000 index hasn't included 5,000 companies since 2005.<sup>9</sup> By comparison, there are millions of privately held companies in the U.S. Private companies might have limited financing options or be highly leveraged by private equity. Claims arise in the context of bankruptcy because shareholders are subordinated to creditors and might find themselves with limited recovery, if any, thereby encouraging claims against the individual directors and officers. In addition, the bankruptcy trustee will often seek recovery from individuals for the bankruptcy creditors.

When a private company files for an initial public offering (IPO), it's easy to imagine the risks of being a public company post-IPO, but it's important to remember that there's still risk to being a private company contemplating an IPO.<sup>10</sup> Specifically, there are claims that can arise for announcing, but failing to complete, an IPO (also known as "failure to launch" claims). In addition, claims can arise in the comments and disclosures made in the course of a road show.

### **How a D&O Policy Works to Protect Directors, Officers and the Entity**

Now that we've established the basis for directors' and officers' liability, it is important to understand how D&O insurance (D&O) plays a role in the protection against that liability. While an individual's first line of protection is indemnity from the corporation, D&O insurance also offers another important layer of protection.

<sup>4</sup> <https://www.sec.gov/news/press-release/2019-50>

<sup>5</sup> <https://www.cfo.com/fraud/2019/04/private-companies-beware-of-sec-scrutiny/>

<sup>6</sup> <https://www.justice.gov/opa/pr/pharmaceutical-company-admits-price-fixing-violation-antitrust-law-resolves-related-false>

<sup>7</sup> *Ameritox, Ltd. v. Millennium Health, LLC*, No. 13-cv-832-wmc, 2016 U.S. Dist. LEXIS 92846 (W.D. Wis. July 15, 2016).

<sup>8</sup> <http://hpd.zurichna.com/Whitepaper/Zurich-Liability-Exposures-PrivateD%26O.pdf>

<sup>9</sup> <https://www.wsj.com/articles/where-have-all-the-public-companies-gone-1510869125>

<sup>10</sup> For more information, please see: <https://www.ajg.com/us/news-and-insights/2019/11/going-public-a-do-discussion/>

As there is no standard language for any D&O policy, every word is important to read and evaluate.

D&O is often described as having three insuring agreements:

- Insuring Agreement A (sometimes referred to as “Side A”) pays on behalf of insured directors and officers for claims alleging a wrongful act for liability not indemnified by the organization and typically will do so with a \$0 retention.
- Insuring Agreement B pays the organization in excess of a retention for loss the organization has indemnified insured directors and officers.
- Insuring Agreement C (sometimes referred to as “entity coverage”) pays the organization in excess of a retention for claims alleging a wrongful act for liability of the organization.

| A  | B   | C  |
|--|---|--|
| <b>Non-indemnified Individuals</b>   | <b>Indemnified individuals</b>  | <b>Organization Entity</b>   |
| <b>Trigger</b><br>Actions of directors and officers that are not indemnified | <b>Trigger</b><br>Actions of directors and officers that are indemnified  | <b>Trigger</b><br>Actions of entity for claims   |
| <b>Pays</b><br>On behalf of directors and officers                           | <b>Pays</b><br>On behalf of entity to fund indemnification  | <b>Pays</b><br>On behalf of entity   |
| <b>Retention</b><br>None   | <b>Retention</b><br>Applies   | <b>Retention</b><br>Applies  |
| <b>Side A:</b><br>Personal asset protection of the directors and officers    | <b>Side B:</b><br>Corporate <b>balance sheet protection</b> for indemnification obligations to the directors and officers | <b>Side C:</b><br>Corporate <b>balance sheet protection</b> for the entity for covered alleged wrongful acts of the organization |

As there is no standard language for any D&O policy, every word is important to read and evaluate. Important definitions include the definition of “claim” and “wrongful act,” both of which are critical to trigger the insuring agreements.

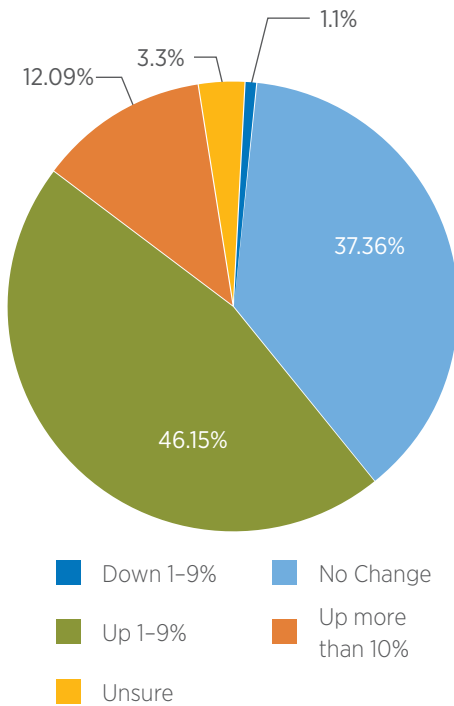
Exclusions are also far from standard. However, common exclusions tend to fall into certain categories:

1. Exclusions relating to exposure insured elsewhere, including exclusions for pollution, bodily injury, property damage, violation of ERISA, and in varying cases, claims arising from violation or labor and employment laws.
2. Exclusions relating to the nature of claims made and reported policies, including exclusions for claims previously noticed under prior policies, claims occurring prior to pending and prior litigation/proceeding dates, etc.
3. Exclusions relating to moral hazards, including exclusions for breaching contracts or committing fraud or gaining of illegal profit (the latter should contain a provision requiring a final adjudication as to the fraud and/or profit in order to delay triggering the exclusion based on allegation alone).
4. Exclusions relating to underwriting appetite, including any exclusions for antitrust or anti-competitive behavior, exclusions relating to specific operational or industry exposures, etc.

There are a few other policy terms that become important for private companies to evaluate and consider in their D&O policy, including whether they want a policy written on a duty-to-



## D&O Renewal Price Changes



Source: CIAB Market Survey

defend basis or reimbursement basis (non-duty to defend).<sup>11</sup> Other items to evaluate include the antitrust or anti-competition exclusions. These exclusions might be able to be amended or removed for additional premium. Professional services exclusions should be evaluated to be sure that D&O claims arising from the performance of professional services are still covered.

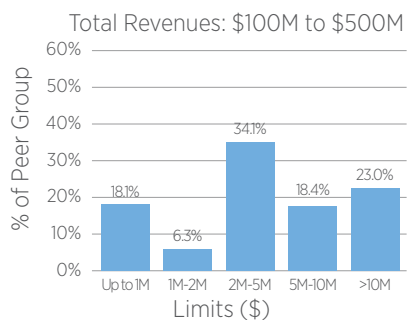
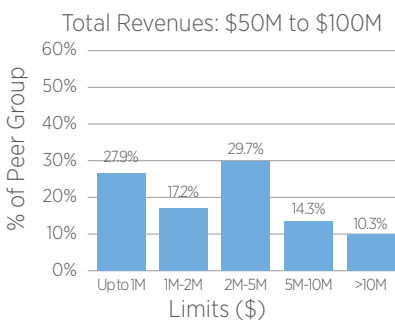
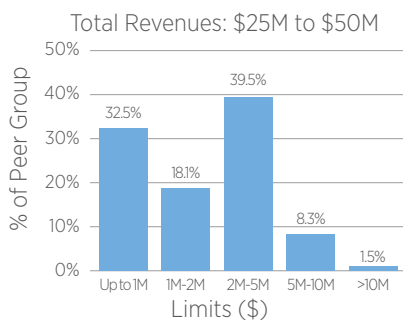
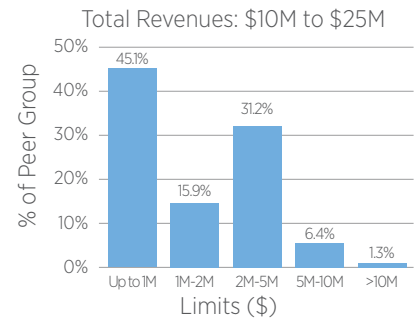
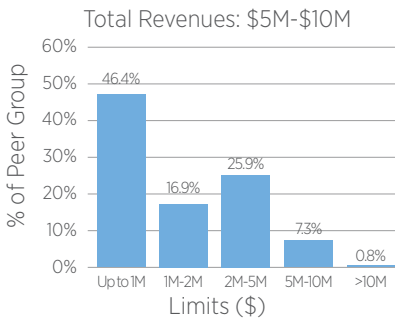
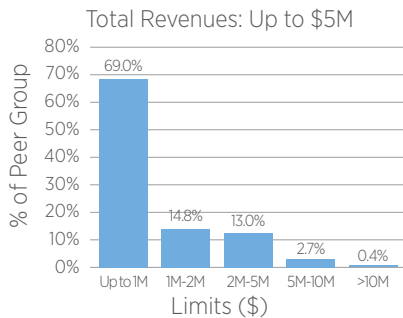
Over the last few years, the intersection between D&O and cyber claims has grown. More than ever, D&O claims are filed, arising from cyber-related events. At the same time, insurers are attempting to add exclusions for cyber claims on D&O policy forms to address what the market refers to as “silent cyber” and encourage the purchase of cyber liability for cyber claims. These exclusions should also be evaluated carefully to ensure that coverage is preserved for a D&O claim arising from a cyber event.

### The Private Company D&O Market

Currently, the marketplace for private company D&O remains more competitive than the public company D&O market. Overall, capacity is ample and renewal rates are flat to 10% increases on average. Given the breadth of entity coverage and the claims development in insurers’ books of business, it is possible that we will see this market shift and become firmer. We will continue to monitor these market developments.

### Benchmarking Private D&O Limits

We are frequently asked, “How much in D&O limit should we purchase?” Providing our clients with the necessary feedback requires an interactive process. That being said, the following charts, based on Advisen data, provide interesting feedback on how other companies in certain revenue bands are purchasing D&O insurance.



After understanding the basis for liability and the sources of claims, private company D&O becomes a prudent part of overall risk management and transfer. As always, Gallagher professionals are available to assist you in identifying your D&O exposures and tailoring products to address your needs.

<sup>11</sup> For more information, please see: <https://www.ajg.com/us/news-and-insights/2019/11/how-to-decide-between-duty-to-defend-and-reimbursement-policy-forms/>



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## About the Author

Natalie Douglass is responsible for the legal leadership of Gallagher's national Management Liability practice, including the development of intellectual capital, manuscripting policy language, negotiating enhanced coverage terms for Gallagher's book of business, and assisting in best practices for coverage and exposure analysis. Ms. Douglass also supports Gallagher's team of claim advocates in management liability claim disputes with carriers by navigating claim departments to escalate issues, articulating competing viewpoints on coverage positions, and facilitating negotiations between clients and their carriers.

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