Why Private Companies Shouldn't Overlook the Benefits of Directors and Officers Liability Insurance

Senior leaders at private companies often underestimate the need for directors and officers (D&O) liability insurance. Although they may not have the shareholder base that public companies do, private companies have owners, investors and other stakeholders — and their directors and officers could be targeted in a variety of lawsuits based on management actions. With private company D&O claims growing in frequency — occurring almost as often as claims against public companies — it is critical for privately held organizations to closely consider the purchase of D&O insurance to protect both individual directors and officers as well as the company itself.

UNDERSTANDING D&O COVERAGE

D&O insurance covers directors and officers of companies who are sued in their managerial capacity. It is typically thought of as essential for public companies, as suits against directors and officers of such companies often attract significant attention and create internal challenges for boards of directors. Due to the difference in their shareholder bases, private company directors and officers often perceive that they are not at risk. Similar lawsuits, however, can be and often are brought against privately held companies.

When purchasing a private company D&O policy, terms and conditions can vary by insurer and by risk. However, there are a number of considerations that generally apply to most private companies as they contemplate the purchase of D&O insurance.

D&O CLAIMS AND INSURANCE CONSIDERATIONS FOR PRIVATE COMPANIES

Directors and officers of privately held companies are vulnerable to legal actions in their managerial capacities, including employment suits, suits by creditors, suits by business competitors and customers, and actions brought by regulatory agencies. In each case, the suit may name the private company and its individual directors and officers as defendants.

D&O insurance also plays a key role in protecting private company directors and officers against litigation brought by investors. While other claims typically implicate the conduct of the company or specific employees, claims brought by investors often target the conduct of directors and officers themselves.

Common D&O claims can include:

- **Claims relating to negligent management:** This is a broad type of claim and includes negligent actions or inaction by the board in overseeing the company. These can either directly result in losses to the company or in misconduct by those supervised by the directors and/or officers.

Recent Cases Highlight the Need for Private Company D&O Insurance

Many notable private companies have been targeted in lawsuits that could be covered by D&O insurance. Often, these cases involve technology startup companies given the complicated nature of their underlying businesses, their reliance on major outside investors before going public, and the frequency with which these companies often do go public. However, the need for D&O insurance to protect against investor lawsuits is not limited to the tech industry. D&O coverage is equally important for private equity firms, investment funds, middle-market lenders, and other private companies. Consider the below recent cases:

EMPLOYMENT, ANTI-COMPETITIVE BEHAVIOR, AND ANTITRUST LITIGATION

A private car service company has been involved in a number of high-profile legal actions in the past few years related to its employment practices and alleged anti-competitive behavior. In one such action, the company's CEO was sued personally for alleged antitrust violations for purportedly engaging in an internal price fixing scheme among the company's drivers. The complaint focused on the CEO's conduct in his official capacity, and illustrates the litigation risks that face directors and officers of closely-held private companies.

SECURITIES FRAUD LITIGATION

A privately held health technology company was recently sued by one of its largest institutional investors for fraud under federal securities laws for purportedly fraudulently inducing it to invest and continue investing in the company. The suits named the company's CEO and president and COO as defendants, alleging that they had misrepresented that the company's proprietary technology was ready for commercial use.

- **Claims based on inadequate disclosures in financial reports or statements, or misleading statements to investors:** Such claims are often brought against private companies and their directors and officers relating to purported efforts to misrepresent the value of the company to potential investors. A private company can also be sued for violations of Section 10(b) of the Securities Exchange Act of 1934 — a regulation often believed to be reserved for public companies. Other claims include minority shareholder "oppression." These types of claims could involve efforts by majority shareholders to dilute the value of minority shareholders' interests, failures to provide adequate information about the company's business to minority shareholders, or other mistreatment or oppression of minority investors in the company.

  For private companies considering a public offering (whether debt or equity), D&O coverage should address pre-initial public offering (IPO) preparations exposures. While many companies will move to public company D&O policies once they become public, coverage for pre-IPO preparation can often bridge the gap between acts involved in looking to go public and actually going public. Coverage for pre-IPO preparations typically insures directors, officers, and the company in the event that an IPO fails and investors seek restitution of some kind.

- **Derivative actions brought against directors and officers by investors, claiming breaches of fiduciary duties or other claims:** These are actions brought by investors on behalf of the company. Typical derivative actions include claims of improper use or mismanagement of company funds or assets, or conduct otherwise detrimental to the company and its investors.

- **Breach of contract claims:** Such claims derive from the terms of an agreement between the company and its investors or other third parties, including explicit misrepresentations in the contract. These can include other violations of the contract such as the company improperly facilitating dilutive transactions or failing to provide adequate disclosures.

  It is important that private companies assess their risk profiles. If there is a risk of contractual liability exposure, then the company should seek a D&O policy with limited contractual liability exclusionary language. Some private company policies specifically exclude coverage for breach of contract claims brought solely against the company. At minimum, private companies should try to negotiate the language of the policy so that it provides coverage for directors and officers if directly faced with a claim for contractual liability. This can be done in a number of ways; for example, the policy can allow for an allocation of costs, judgments, and settlements as covered loss if claims are also brought against individuals.

- **Antitrust claims and regulatory actions:** Private companies often face allegations of anti-competitive behavior or violations of antitrust laws, which can lead to regulators bringing investigations and/or civil or criminal actions against the company and its directors and officers. These types of allegations can also lead to claims or lawsuits from consumers, sometimes in a class-action format. Claims for antitrust violations can often include accusations of price fixing and collusion. While US regulators have certainly been prominent leaders in this area, similar claims have been seen in other jurisdictions.

  If there is the potential for antitrust exposure, consideration should be given to whether, and to what extent, a company's D&O policy covers antitrust allegations. With the rise in anti-competitive allegations and investigations by regulators, many insurers have tried to exclude coverage for antitrust claims altogether or sublimit their exposure. Coverage should be expanded to the extent possible, and the policy's terms should be negotiated in order to provide coverage for non-indemnifiable antitrust claims where directors and officers are named.

Private companies should be aware of these litigation risks and should consider obtaining a D&O policy with language drafted in a way that is favorable and tailored to the specific needs of the company and its directors and officers. For example, exclusionary language should be limited to exclude coverage for a direct loss caused by a particular factor as opposed to excluding coverage for a broader claim, such as a resulting management claim.

MARSH

OTHER BENEFITS OF D&O COVERAGE FOR PRIVATE COMPANIES

There are a number of factors that can make privately held companies vulnerable to D&O claims. For example:

1. Directors and officers of privately held companies are more likely to be closely involved with all aspects of the business and thus named individually in any kind of litigation.
2. Private companies and smaller companies in general often do not have the same access to outside resources to prepare for or defend these types of actions. Therefore, lacking an insurance policy to protect directors and officers could be catastrophic.
3. Many private companies consider going public at some time. D&O insurance can help with an IPO and any related potential liability. In addition, establishing a relationship with insurers before going public helps present a more seamless transition to a public company D&O policy.

The need for D&O insurance is not limited to larger private companies and those potentially going public. Private companies should consult insurance advisors to help understand the potential risks they face and how a D&O insurance program can protect directors and officers in an increasingly evolving risk environment.

SARAH D. KATZ DOWNEY
Senior Vice President
US FINPRO D&O Product Leader
+1 212 345 3122
sarah.d.downey@marsh.com

NIRALI V. SHAH
Senior Vice President
Senior Advisory Specialist
US FINPRO
+1 212 345 1871
nirali.v.shah@marsh.com

DOUGLAS A. RAPPAPORT
Partner, Akin Gump Strauss Hauer & Feld
+1 212.872.7412
darappaport@akingump.com

JACQUELINE YECIES
Counsel, Akin Gump Strauss Hauer & Feld
+1 212.872.7479
jyecies@akingump.com

TIMOTHY SHEPHERD
Associate, Akin Gump Strauss Hauer & Feld
+1 212.872.8053
tshepherd@akingump.com

MARSH IS ONE OF THE MARSH & McLENNAN COMPANIES, TOGETHER WITH GUY CARPENTER, MERCER, AND OLIVER WYMAN.

This document and any recommendations, analysis, or advice provided by Marsh (collectively, the "Marsh Analysis") are not intended to be taken as advice regarding any individual situation and should not be relied upon as such. The information contained herein is based on sources we believe reliable, but we make no representation or warranty as to its accuracy. Marsh shall have no obligation to update the Marsh Analysis and shall have no liability to you or any other party arising out of this publication or any matter contained herein. Any statements concerning actuarial, tax, accounting, or legal matters are based solely on our experience as insurance brokers and risk consultants and are not to be relied upon as actuarial, tax, accounting, or legal advice, for which you should consult your own professional advisors. Any modeling, analytics, or projections are subject to inherent uncertainty, and the Marsh Analysis could be materially affected if any underlying assumptions, conditions, information, or factors are inaccurate or incomplete or should change. Marsh makes no representation or warranty concerning the application of policy wording or the financial condition or solvency of insurers or reinsurers. Marsh makes no assurances regarding the availability, cost, or terms of insurance coverage. Although Marsh may provide advice and recommendations, all decisions regarding the amount, type or terms of coverage are the ultimate responsibility of the insurance purchaser, who must decide on the specific coverage that is appropriate to its particular circumstances and financial position.

Copyright © 2017 Marsh LLC. All rights reserved. Compliance MA17-15265 21018