Holland & Knight
Industry Focused. Relationship Driven.®

Private Companies Need D&O Insurance, Too

By Shannon A. Graving and Thomas H. Bentz Jr.

Directors' and officers' policies aren't just for public corporations. D&O protection can save owners of a closely held business from bankruptcy in the event of a lawsuit against the company.

Owners of many private companies, particularly those that are closely held by relatives, believe they have no need for directors' and officers' (D&O) insurance. Unfortunately, they may learn a costly lesson when they incur defense costs or, worse, pay settlement amounts or judgments. Private companies may be subject to claims from a number of plaintiffs for a variety of reasons.

When a family's assets are tied up in a single company, uninsured loss is a serious concern. Consider this: When directors and officers are sued, their first line of protection for their personal assets is indemnification from the company. When those same directors and officers own the company, indemnification essentially comes from their own pockets. Depending on the size of the claim and the depth of their pockets, a lack of insurance to reimburse the company could result in bankruptcy. Therefore, private companies must have broad D&O insurance protection. In fact, you should think of it as a part of your estate planning; otherwise, there may be little to pass on to the next generation.

Many plaintiffs, many causes of action

Most people think of shareholder suits when they think of D&O insurance claims. As discussed below, that is a risk, even for private companies, but it is not the only one. Lawsuits may be brought by employees, competitors, customers, creditors, investors, government agencies and vendors for such causes of action as fraud, unfair competition, interference with prospective economic advantage, wrongful interference with a contract, infringement of trade secrets, breach of contract and violations of various regulations.

The most common suits against private companies are employment practices liability claims. In its 2007 Directors and Officers Liability Survey, Towers Perrin reported that 43% of all claims against private companies in 2007 were made by employees. Many D&O insurance policies for private companies include employment practices liability insurance, which covers claims from employees (including potential and former employees) alleging a myriad of wrongful acts, such as discrimination, harassment and wrongful termination.

The next category of frequently filed claims consists of those by shareholders. Towers Perrin's 2007 Directors and Officers Liability Survey found that 32% of all claims against private companies in 2007 were made by shareholders. Directors and officers at private companies owe the same fiduciary duties to their shareholders as do those who serve public companies. Disputes may erupt even if shareholders are friends or relatives of the company's directors and officers. Since private companies may not follow the same rigorous procedures as their public counterparts and are more likely to contract with affiliated businesses, there may be more room for questioning whether management complied with its fiduciary duties and acted with due authority.

It is important to note that a company can be subject to securities laws on the federal and state level even if its shares are not traded on an exchange or over the counter. Private companies are at risk for a number of securities-related claims, such as for errors or omissions in private placement materials.

Transactional risks

Significant corporate transactions, such as a sale, acquisition, merger or initial public offering, increase the risk of a claim dramatically. Some family members may believe the company should be sold for top dollar, while others may feel that the value in keeping the family business exceeds the proposed purchase price. Whoever loses the argument may sue the company and its directors for breach of the duty of care or loyalty.

Another possibility is that employees and third parties may disapprove of the deal and bring suit. A transaction can even trigger the filing of latent claims. For instance, an employee who is the subject of harassment may take no action out of a sense of loyalty to the company. Once the owners decide to sell, the employee may feel the company is no longer loyal in return and decide to file suit.

In the case of an IPO, decisions and actions that may be the subject of claims are often made far in advance of the IPO effective date. If a company is considering going public in the foreseeable future, it is particularly important that it purchase D&O insurance immediately in order to provide coverage of all pre-IPO decisions and activities.

Obtaining broad coverage

Simply purchasing a D&O insurance policy is not enough. There are a number of steps you should take in order to obtain the best protection for your assets.

1. Arm yourself with information. Once you have engaged a broker, he or she will obtain a number of premium quotes for your company. Do not just compare premiums. Each D&O insurance policy is unique, with its own virtues and flaws. Be sure to ask for a comparison of key terms such as the insuring clauses, the definition of “claim” and the exclusions. Understand what is covered. It may be helpful to pose possible claim scenarios and ask whether you would be covered. For instance, what happens to your coverage if your company declares bankruptcy?

2. Request an independent expert review. Your broker will be able to provide invaluable information about limits, will work with potential underwriters to obtain quotes and can advise on terms and conditions. However, you should also request an independent review by an attorney who specializes in D&O insurance to ensure that the company’s program provides the best coverage available. Such an attorney should be highly experienced -- he or she should review dozens of policies each year and advise on claims, not simply answer a few questions as an adjunct to his or her main practice.

An independent expert review should be requested annually. Market conditions change from year to year. In addition, new policy forms may be available because of new insurers entering the market and existing insurers offering new policies and endorsements. As a result, if your company renews its policies without the benefit of a fresh review, you most certainly will not have the best protection or be able to obtain maximum value for your insurance dollars.

3. Be vigilant about coverage. Negotiating the best policy will not ensure payment of covered loss. Companies must also comply with the notice and cooperation provisions in their policies. Providing notice is often not the first concern when there is a lawsuit, but if your company does not provide prompt notice, you risk losing coverage. The same is true if your company does not comply with the cooperation requirements. Whenever a claim is made, it is in your interest to ask if your D&O insurance policies have been consulted, whether the applicable insurers have been notified and if someone is responsible for complying with policy conditions.

The bottom line

There are multiple potential plaintiffs who may file claims against private companies for a variety of reasons. In order to protect your assets, it is advisable to purchase D&O insurance. It is not enough to simply purchase any policy. You and your company should take the steps described above. Otherwise, your family’s assets may be unnecessarily at risk.

This article appeared in “Family Business” Magazine, Winter 2009. Shannon A. Graving and Thomas H. Bentz Jr. are attorneys at the law firm of Holland & Knight LLP. They specialize in D&O and management liability insurance, with a focus on D&O policy negotiation and coverage counseling (www.hklaw.com) Please e-mail the authors at shannon.graving@hklaw.com or thomas.bentz@hklaw.com with questions about this article.

Copyright © 2009 Holland & Knight LLP All Rights Reserved

8702408_v1