EXECUTIVE PROTECTION

D&O INSURANCE

Private Management Liability

This article examines D&O insurance issues of particular concern to private companies. It should be noted that the potential liability exposures and the available insurance solutions for private companies and their directors and officers are quite different than for public companies.

WHY SHOULD PRIVATE COMPANIES BUY D&O INSURANCE?

Most public companies don't need to be persuaded that their company needs D&O insurance. Public company executives generally understand that D&O insurance is an indispensable prerequisite for a company whose securities are publicly traded.

However, the view among at least some private company managers is different. These officials, particularly those at very closely held companies, feel they are unlikely to need the insurance because, they believe, they are unlikely to ever have a D&O lawsuit. In our experience, just about every company that has ever had a claim was quite sure, before the claim arrived, that they would never have a claim. Executives who have survived a claim know better; too many company officials find out the hard way that when they recognize they need the insurance after all, it is too late. The fact is, the right time to buy the insurance is when you think you don't need it.

Many of those who resist the need for D&O insurance are affiliated with companies that have only a very small number of shareholders. These company executives look at the ownership structure and conclude their company could never have a D&O claim. This perspective overlooks the fact that plaintiffs in a D&O claim include a much broader array of claimants than just shareholders. D&O claims plaintiffs also include customers, vendors, competitors, suppliers, regulators, creditors and a host of others. In our litigious age, just about anybody is a prospective claimant.

And when a company has a claim, expenses mount quickly. Even frivolous suits can be expensive to defend and resolve. At the same time, the cost of insurance to protect private companies against D&O claims is relatively low. Indeed, the incremental costs of private company D&O insurance, on top of the company's employment practices liability (EPL) insurance (and no entity should do business in this country without EPL insurance) is relatively slight.

For the low cost, private company D&O insurance buyers obtain coverage that is quite broad. Private company D&O insurance policies are materially broader than D&O insurance for public companies. In particular, the entity coverage under a private company D&O policy is significantly broader than the entity coverage under a public company D&O insurance policy. The entity coverage in public company D&O insurance policies is generally limited just to securities claims. However, private company D&O policies contain no such limitation, so the private company D&O insurance policy provides significant balance sheet protection for the insured entities.

Because the private company D&O insurance policies provide broad coverage at a relatively low cost it should be a part of every private company's risk management portfolio– not just private companies with a broad ownership base.

COMBINED OR SEPARATE LIMITS?

A recent D&O insurance innovation is the development of modular management liability policies. These permit various management liability coverages to be combined in a single policy. The typical modular policy consists of a declarations page (identifying the limits of liability and the policy period, and so on), a general terms and conditions section applicable to all of the separate coverage parts, and then separate coverage parts for each of the various management liability coverages (such as D&O, EPL, Fiduciary, Crime, etc).

These modular policies have become quite popular and do have certain advantages. The first is that the policies simplify the management liability insurance acquisition process by reducing what would otherwise be a series of discrete transactions into a single insurance transaction. The modular structure also ensures that the various coverages are coordinated, which could be important in the event of a claim that straddles several coverages.

The modular structure does present questions with respect to the limits of liability. Many buyers, attracted by the convenience of multiple coverages combined in a single policy are also attracted by the possibility of combining the limits of liability for the various coverages into a single, combined aggregate limit, under which a claim payment under any of the various coverages would reduce the amount of insurance remaining for a separate claim under any of the coverages.

There is no doubt that combining the limits of liability into a single aggregate limit affords cost savings for the buyer. For some insurance buyers, particularly very small enterprises, the cost saving consideration justifies the decision to structure the insurance into a single aggregate limit.

For most other enterprises, however, the combination of all the coverages into a single limit may be a poor choice. A combined limit presents the possibility that a prior claim might reduce the amount of insurance available for a later, more serious claim. The fact is that when things go wrong, multiple problems can arise at once.

Our greatest concern is that a prior, unrelated claim against the company might leave company executives with insufficient remaining insurance to protect them if a separate claim later arises against them as individuals. This concern is particularly applicable in the bankruptcy context, in which company indemnification is unavailable. The executives could be left without insurance or with insufficient insurance at the time when they need it most.

We have a bias in favor of separate limits for the separate coverages, because we believe that there should be a fund of insurance available to protect the individual executives, without a concern that entity claims might exhaust the insurance. Of course, as noted above, cost considerations may nevertheless dictate that some small enterprises will purchase combined limits. But most insurance buyers should not allow relatively small premium differences to drive important insurance decisions, potentially leaving the company with insurance that might not afford sufficient protection when the hour of need arises.

DUTY TO DEFEND OR DUTY TO INDEMNIFY?

Public company D&O insurance is written on a reimbursement basis, based on the insurer's duty to indemnify the insured company for its defense expenses and claim resolution costs. Under this duty to indemnify type of coverage, the insureds select their defense counsel, subject to the insurer's consent, and the insureds control the claim. The insurer reimburses the insureds for these costs.

Private Company D&O insurance may also be written on a duty-to-indemnify basis. In addition, however, private company D&O insurance is often written on a duty-to-defend basis, under which the insurer selects the defense counsel and controls the defense. Many private company D&O insurance carriers offer their prospective insureds the choice of whether or not the coverage will be written on a duty-to-indemnify or a duty to defend basis.

There are certain advantages to the duty-to-defend structure. The first is ease of administration. Under the duty-to-defend coverage, the carrier appoints defense counsel and takes care of managing the claim. The policyholder doesn't have to deal with legal bills and so on. This can be particularly helpful for smaller and more routine claims. In addition, the counsel the carrier selects is often experienced with these kinds of claims, which can also contribute to a smoother claims resolution.

Another advantage of a duty-to-defend coverage is that, in general, if any part of the claim is covered, the insurer must defend the entire claim, even those parts of the claim that are not covered. This unified defense avoids what can be a recurring problem under a duty-to-indemnify policy when a claim encompasses both covered and uncovered matters; in that circumstance under a duty-to-indemnify policy, the defense costs must be allocated between the covered and uncovered matters and the insurer reimburses only the defense expenses associated with the covered matters (often only a percentage of total defense expenses). The process of determining the allocation can be contentious and disruptive at a time when the insured and the insurer ought to be trying to work together to resolve the claim.

But despite these advantages of the duty-to-defend coverage, there may be times when duty-to-defend coverage is not the best choice. In particular, many policyholders are not comfortable having the insurer's counsel defending a claim. This may be particularly true with more serious and more sophisticated litigation, which some insureds feel are outside the capabilities of some insurer-selected defense counsel. Also, although the topic involves issues far beyond the scope of this article, a host of issues arise when the insurer is defending a claim subject to a reservation of rights to deny coverage for any settlements or judgments.

There are no absolute answers to the question whether the D&O coverage should be written on a duty-to-defend or a duty-to-indemnify basis. It is a question each insurance buyer must decide in consultation with their insurance adviser.

One innovation the D&O insurance industry has introduced in recent years is an optional duty-to-defend policy, which gives the policyholder the option of tendering the claim defense to the carrier at the outset of the claim. The advantage of this arrangement is that it allows the policyholder to let the carrier handle the smaller or more routine matters, while allowing the company to select its own counsel and manage its defense on more significant matters or matters of greater concern to the company.

PUBLIC OFFERING EXCLUSION

The critical distinction between private and public companies is that public companies have publicly-traded securities and private companies do not. Private company D&O insurers do not intend to cover exposures arising from the issuance or subsequent trading of publicly-traded securities, and so private company policies typically have a public offering exclusion.

One particular concern with this exclusion is that it should not be written so broadly that it would preclude coverage for claims arising from pre-IPO activities. If a company is preparing to go public, the company and its senior executives undertake a variety of activities that may create potential liability exposures. If the company ultimately goes public, the public company D&O insurance policy, put in place on the offering date, should pick up coverage for all claims arising from the offering-related activities. However, if the company does not complete the offering and claims result, or if offering activity claims arise prior to the offering date, then the private company D&O insurance policy is the one that would respond to the claims.

Because of the heightened claims exposure associated with pre-offering activities, it is critically important that the public offering exclusion is worded in a way to afford coverage for these kinds of claims. Unfortunately, this is an area where there is a significant and serious lack of uniformity in available wordings, and many of the wordings available are not well-designed to provide the full extent of coverage needed. For example, many carriers, in an attempt to address this concern, will include a so-called "roadshow carve back" from the securities offering exclusion. These wordings, while helpful, are not sufficient to address all of the potential pre-IPO exposures, because pre-offering problems might arise that have nothing to do with the roadshow.

The concerns arising in connection with coverage for pre-IPO activities is a good illustration of the unavoidable fact that even with respect just to private company D&O, there is no standard D&O insurance policy. Each D&O insurance carrier has forms that differ from their competitors' and most policies are generally the subject of extensive negotiations. In order for D&O insurance buyers to be assured that they have the broadest available terms and conditions and appropriate insurance structure, it is critically important that they select a knowledgeable and experienced broker to assist in their acquisition of the insurance. The best brokers also have skilled and experienced claims advocates available to protect their clients' interests in the event of a claim.

PROGRAM STRUCTURE

In light of the escalating average claims severity and of the catastrophic potential for defense expense to deplete policy limits, it may be necessary to reconsider commonplace concepts of limits adequacy. Increased limits alone, however, may not solve all of the problems.

Part of the solution has to be program structure. Clearly, one of the factors that can contribute to limits depletion or exhaustion is that so many different people are accessing the insurance, particularly when there are multiple simultaneous claims. One way that well-advised corporate officials can ensure they are not left without insurance to protect them as individuals is through supplemental D&O insurance structures dedicated solely to their own protection.

These supplemental structures might take any one of a number of different forms, including for example, excess Side A coverage for a specified group of individuals, or even through an individual D&O insurance policy (so-called IDL coverage). While there are a variety of ways this supplemental insurance might be structured, the possibility of catastrophic claims underscores the importance of addressing these issues as part of the insurance acquisition process.

The point of these supplemental insurance structures is to ensure that no matter what happens, the individuals (or some subset of them, for example, the non-officer directors) will have insurance devoted to protect them.

Moreover these alternative structures often have broader coverage than the "traditional" D&O insurance; for example, they often contain fewer exclusions. They also provide so-called "drop down" protection when they provide first dollar coverage, in the event, for example, that the underlying traditional D&O insurers have become insolvent or seek to rescind coverage. In addition, because these alternative insurance structures protect only specified individuals, the insurance cannot be siphoned off for the payment of entity claims or the claims of other individuals who are not insured under the structure.

The complexity of these limits selection and program structure issues underscore how indispensable it is that insurance buyers enlist knowledgeable and experienced advisors in their D&O insurance acquisition process. In particular, it is important that buyers ensure not only that their advisors have access to the data described above as it is relevant to the limits selection process, but also have the ability to explain the limitations of the data as well as the additional considerations that should be taken into account. In addition, the insurance advisor should be able to guide the company through the process of selecting the right insurance structure to ensure that the company and its directors and officers are adequately protected even in the event of a catastrophic claim.

CONTACT US

Conner Strong & Buckelew
connerstrong.com | 1-877-861-3220

NEW JERSEY PENNSYLVANIA DELAWARE FLORIDA