MARSH

ARE YOU CONFIDENT?

D&O COVERAGE CONSIDERATIONS WHEN YOUR COMPANY IS PRIVATE OR NON-PROFIT

Many private companies and non-profit organizations believe that there is no need to purchase directors' and officers' (D&O) liability insurance, due in part to the belief that the only significant source of liability to a director or officer is from a disgruntled shareholder of a company. However, lawsuits filed by shareholders represent only a portion of all reported lawsuits brought against directors and officers. Many other types of D&O lawsuits are brought by other parties, including employees, customers, creditors, vendors, competitors, and regulators — exposures that exist regardless of the number of shareholders or whether the company is private, non-profit, or public.

There are many exposures that present potential liabilities to the personal assets of directors and officers of privately-held and non-profit companies, and this extends to the personal assets of their spouses and estates.

LEGAL STANDARDS OF CONDUCT FOR DIRECTORS AND OFFICERS OF PRIVATELY HELD COMPANIES AND NON-PROFIT ORGANIZATIONS

The applicable legal standards of conduct for directors and officers of privately held and non-profit companies are identical to those of publicly held corporations. All directors and officers are subject to three basic duties in performing their responsibilities:

- Obedience.
- Loyalty.
- Diligence.

Purported breaches of these duties can lead to claims against directors or officers of privately held companies and non-profit organizations.

INDEMNIFICATION:

Though a company's by-laws usually provide some type of indemnification to its directors and officers, there are many situations where corporations are unable (or unwilling) to provide such indemnification. Examples include:

- Inability to Indemnify: financial insolvency or insufficient cash flow.
- Unwillingness to indemnify: new management team/ corporate takeover.
- Derivative claim: Claim is brought on behalf of the corporation and, in certain jurisdictions, indemnification is not permitted.
- Interpretation of "good faith:" In many jurisdictions a corporation is not obligated to indemnify its directors and officers if the director or officer did not act in "good faith."
- Agreed not to indemnify: Bylaws of some organizations preclude indemnification for certain acts. Commonly, alleged fraud or intentional misconduct may not be acts for which a director or officer is indemnified.

In the above scenarios, the only buffer between a claim and an individual's personal assets is D&O insurance.

PRIVATE COMPANY EXPOSURES:

Claims by employees: Claims alleging harassment, discrimination, and wrongful termination against the company itself and the directors and officers. A properly designed private or non-profit D&O insurance program can respond to these claims (commonly known as employment practices liability – EPL) against the entity and individual insureds.

Claims by customers, clients, and consumer groups: Common allegations include harassment, discrimination, violation of civil rights, contract disputes, misleading statements and false advertising. In addition, clients can also become claimants in the event of financial impairment of the company.

Claims by competitors, suppliers, and other contractors: Common allegations include anti-trust violations, unfair competition resulting in lost business by the competitor, and infringement of patent, trademarks, and trade secrets.

Claims by other third parties: Claims vary from those relating to environmental contamination to employee health and safety. Additionally, privately held and non-profit corporations can face investigations and claims by certain regulatory agencies, including the SEC and DOJ, with respect to suspected or actual wrongdoing.

Claims by shareholders/lenders: Suits brought by private shareholders, bondholders, or other investors or lenders. Claims can include alleged misrepresentation and inadequate or inaccurate disclosure in financial reporting of private placement materials. Due to lack of availability of a private company's financial data, these stakeholders rely heavily on the materials and statements made by private companies. Other examples of shareholder claims affecting private companies include:

- Breaches of the duty of care with respect to how the directors and officers handle the sale of a corporation or how they missed a great business opportunity for the corporation.
- Breaches of the duty of loyalty with respect to deals the corporation enters into with companies owned in whole or in part by one or more of the directors and/or officers.

Mergers and acquisitions (M&As): A private or non-profit company can enter into an M&A as the buyer or seller. D&O insurance can help protect against potential claims, including:

- Disgruntled shareholder suits.
- Alleged financial misstatements or misleading statements about the company's revenue sources/market share.
- Failure to perform appropriate due diligence when making an acquisition.
- Bankruptcy resulting from a failed transaction.
- Claims from past creditors and/or vendors of the acquired company.

Succession planning and corporate governance: Many private companies are run by, or have founding members (and sometimes their families) closely involved, in the day-to-day operations through their ownership stakes in the company which results in:

- Proxy disputes when founders are pushed out of their leadership roles.
- Legal disputes amongst family members when they are a part of an ownership trust relative to the operation of a company or potential transactions.
- Poor succession planning can lead to leadership vacuums and/or disputes in the event of a sudden change in leadership due to illness or death.

WHY DO PRIVATE AND NON-PROFIT COMPANIES NEED D&O INSURANCE?

- To protect the personal assets of directors and officers and those of their spouses and estates.
- To protect the income statement and balance sheet of the company.
- To attract and retain qualified outside directors.
- To establish a relationship with an insurer before a potential initial public offering (IPO).

- To avoid diverting management attention to protracted and costly litigation.

WHAT DO PRIVATE AND NON-PROFIT COMPANY D&O POLICIES COVER?

Private company D&O policies afford coverage to the board of directors, executive officers and employees of a corporation for claims made against them in their capacities as such. These policies further afford coverage to the corporate entity for purported breach of duty, negligence, error, misstatement, misleading statement, act or omission in the performance of their duties to manage the company. Often, private and non-profit company D&O policies include broad coverage for claims involving violations of employment practices laws, thus sometimes minimizing the need for a separate stand-alone employment practices liability policy. Program limits and coverage provisions should be assessed on an annual basis.

RISKS TO SPECIFIC TYPES OF ENTITIES:

- ***Healthcare/managed care:***
  - Employment practices liability claims. Specifically a spike in "doctors' claims" if a doctor has lost his or her privileges at a hospital, which can occur after a consolidation of healthcare organizations or an acquisition of a multi-physician practice by a healthcare organization. These claims typically come in as a hybrid D&O and EPL claim.
  - Anti-trust claims against healthcare companies that have gone through a merger or acquisition continue to be an area of focus. Joint ventures and purchasing cooperatives created in this space have also raised the concern of increased anti-trust activity surrounding these entities.
  - Impact of health exchanges on managed care companies and the Affordable Care Act's future. Public health exchanges or public marketplaces designed to administer the government regulated and standardized health care plans by managed care companies have sustained significant losses related to the high exposure population that has signed up for these plans. This in turn has resulted in a financial drain on many (but not all) managed care companies. Though the change in administration and the likely repeal of the ACA (in whole or in part) is expected to change the landscape of healthcare, it is too early as of this writing to tell how; any significant changes will likely be a multi-year process.
- ***Foundations:*** Corporate governance for foundations is a frequent area of criticism especially if there is the perception of poor succession planning and excessive executive pay. There have also been claims regarding perceived inefficiencies in the use of funds raised that are actually used towards the stated mission.
- ***Higher Education***: Higher education institutions face a number challenges including distressed not-for-profit higher education. Moody's reported in 2015 that 1 in 10 colleges suffer from acute financial distress due to falling revenues and weak operating performance, which is magnified in graduate programs where law schools are seeing historic declines in enrollment. There are also a number of higher education institutions with hospitals that carry the same exposures as a stand-alone health system, such as anti-trust, D&O and EPL claims brought by doctors, to name a few.
- ***Private Companies in Financial Distress:*** Private companies in financial distress can have negative repercussions just as it would in the public company space, such as claims of misrepresentation or breach of fiduciary duty brought by secured creditors (lenders, banks, financers, board represented equity holders) and unsecured creditors (vendors, equity holders with no board representation) against the company, its board and officers.

For more information on this topic and others, visit marsh.com, contact your Marsh representative, or contact:

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