



Private Company D&O Exposures

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Owners, board members and executives of private companies often question whether their exposures warrant purchasing D&O insurance. Many believe that D&O principally provides protection against shareholder lawsuits, which they largely envision as a public company problem. Private companies, however, are exposed to a large number of risks for which D&O may represent the best protection. These include lawsuits by regulators, customers, vendors, competitors and partners or shareholders. Additionally, recent developments, including heightened regulatory enforcement activities, the growth of social media, and the passage of the federal Jumpstart Our Business Startups (JOBS) Act, are creating additional exposures for private company directors and officers.

Private company D&O policies are often packaged with coverage for employment-related risks such as harassment, discrimination and wrongful termination. These are among the most common types of claims against private companies and their directors and officers, and insurance protection is increasingly viewed as essential. Policies also can frequently be customized to provide fiduciary (ERISA) liability and fidelity coverage, thereby providing broad protection for many of the types of adverse events that threaten private enterprises and their decision-makers.

Liability landmines for private company directors and officers

Board members and senior managers of even very small companies, who never imagined that they would be sued, increasingly find themselves embroiled in litigation or battling regulatory enforcement actions. In some cases, the exposures are well-established, but the frequency of claims has increased in recent years. The number of employment-related actions, for example, has grown as a result of the recession and continued sluggish economy. Other exposures are comparatively new to private companies. Foreign Corrupt Practices Act enforcement, for example, was not even on the radar of most private companies a few years ago. Now it represents an exposure many cannot afford to ignore as companies expand beyond their home countries, and as enforcement actions increase sharply across the board.

Exposures that have long faced private company directors and officers include employment-related claims, shareholder lawsuits, creditor actions, competitor lawsuits, and lawsuits brought by customers. But while these exposures are not new, both the likelihood of experiencing a claim and the potential consequences of an event are often underestimated by owners, directors and senior executives of these companies.

Employment-related claims.

Employment-related suits are by far the most common type of lawsuit faced by private company directors and officers. In recent years, the number of employment practices claims filed against directors and officers has doubled.¹ Within that category, claims of wrongful termination are the most common.² For fiscal year 2012, the Equal Employment Opportunity Commission (EEOC) reported nearly 100,000 individual charge filings.³



Shareholders of private companies also may sue for inadequate or inaccurate disclosure in private placement materials.

Shareholder lawsuits.

While they may not be subject to the same sorts of federal class action suits that plague public companies, private company directors and officers are by no means insulated from suits by shareholders. In fact, shareholder suits comprise the second largest category of lawsuit brought against private company directors and officers.⁴ A common allegation is that majority shareholders took an action that benefitted them, but at the expense of minority shareholders. Shareholders of private companies also may sue for inadequate or inaccurate disclosure in private placement materials.

Shareholders now almost routinely challenge announced mergers and acquisitions. One study found that, as concerns mergers involving companies sold for \$100 million or more, better than 90 percent resulted in lawsuits in 2010 and 2011.⁵ While public companies and their directors and officers are commonly targeted, private companies are not immune.⁶

Creditor and bankruptcy trustee actions.

For private companies facing financial difficulty, creditors may call into question the accuracy of financial information they relied upon when they extended credit. Creditors also have successfully sued directors of failed companies for breach of fiduciary duty, alleging, for example, that directors allowed a company's assets to be squandered.⁷ Bankruptcy trustees also may sue to recoup losses from directors.

Competitors.

Suits by competitors often include allegations of anti-trust or unfair competition. Other allegations found in lawsuits by competitors include misrepresentation of a competitor's products, infringement of a competitor's trade dress, inducing customers to breach contracts with a competitor, and enticing employees to leave a competitor. These suits sometimes involve complex areas of the law, and can be expensive to defend.

Customers.

Disputes with customers can lead to lawsuits against an organization, as well as its directors and officers. The types of lawsuits brought by customers include those stemming from contractual disputes, debt collection, the costs or quality of products or services, refusal to extend credit, and discrimination.

The shifting liability landscape of private company directors and officers

Companies of all types and sizes function within a rapidly changing, increasingly complex world where technology, shifting demographics, regulation, economic factors, and changing social and cultural norms can result in often unanticipated changes in risk profiles. In addition to the exposures noted above, which have long confronted private company officers and directors, new exposures are becoming more significant, and potentially serious emerging exposures are lurking on the horizon. Many of these newer and emerging exposures are an outcome of heightened enforcement actions by regulators and law enforcement agencies. Additionally, the recently signed JOBS Act may result in increased exposure to litigation for some private companies and their directors and officers.



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Regulatory enforcement

Private companies fall under the regulatory oversight of a variety of federal and state agencies, some of which have become increasingly aggressive in pursuing enforcement actions against private company directors and officers. Some regulations are specific to certain industries such as healthcare and financial services, but others, such as those dealing with competition, cut across all industries. Even the SEC, which typically is viewed as strictly a public company regulatory agency, can have jurisdiction over private companies under certain circumstances.

A 2011 Accenture survey of executives from 397 companies found that 89 percent expected regulatory risk to increase in the next two years.⁸ Among the regulatory agencies that are increasing their scrutiny of private companies are the Department of Labor, the National Labor Relations Board and the Federal Trade Commission. Additionally, the Department of Justice has significantly stepped up enforcement of the Foreign Corrupt Practices Act and the Fair Claims Act, both of which have significant implications for private company directors and officers.

Wage & hour claims. Actions alleging violation of the Fair Labor Standards Act (FLSA) are sharply higher – growing 33 percent between FY 2008 and FY 2012, in which a record 7,064 lawsuits were brought by the U.S. Department of Labor. These cases typically involve allegations of failure to pay appropriate overtime wages or improperly classifying workers as independent contractors.⁹

National Labor Relations Act. The National Labor Relations Board (NLRB), whose powers extend to both unionized and non-unionized employees, has become more active in recent years. One area where the NLRB has turned its focus is employee communications through social media such as Facebook and Twitter. The bureau is concerned that the social media policies of many companies interfere with employee's ability to engage in "protected concerted activity," as defined under the National Labor Relations Act.

Bribery. As more private companies conduct business in foreign countries, they increasingly are targeted for violations of the Foreign Corrupt Practices Act (FCPA), which prohibits payments to foreign officials to obtain or retain business. Prosecutions have skyrocketed since 2008, including prosecutions of private company representatives. In a PwC survey of private company executives, 76 percent said that corruption is a key risk of venturing into emerging and fast-growing markets.¹⁰

False Claims Act. Healthcare companies in particular need to be aware of their exposures under the False Claims Act, which was amended in 2009 and 2010 to give it more teeth in pursuing healthcare-related claims. Speaking before the American Bar Association in June, Acting Assistant Attorney General Stuart F. Delery noted that he has been "struck by the sheer volume of the cases that are brought -- and the recoveries that are obtained -- under this statute. Since January 2009, the Civil Division, working with our partners in the U.S. Attorney offices, has recovered over \$11.1 billion under the False Claims Act."¹¹

Consumer protection and competition laws. The FTC has stepped up enforcement activities concerning both consumer protection and competition. Three of the FTC's top six Significant Civil Penalty Cases for March 2011 through February 2012 involved private companies.¹² Recently, the Commission has become an Internet watchdog, focusing on how products and services are represented online and who recommends or endorses them.



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The JOBS Act

Signed into law by President Obama in April, the JOB Act is intended to stimulate growth by making it easier for companies to raise money, and to reduce onerous disclosure requirements for smaller businesses. In doing so, the distinctions between public and private companies are blurred, potentially resulting in heightened exposure to lawsuits for company officers and board members.

Emerging risks

Whether a massive multinational company or a midsize manufacturer or retailer, the risk landscape is likely to be regularly reshaped by powerful social, political and economic forces. Some current developments bode well for corporate directors and officers. The number of business bankruptcies, for example, fell in 2012, due significantly to an improving economy. As previously noted, bankruptcy can trigger lawsuits against directors by creditors or bankruptcy trustees. But while the economic recovery is welcome, economic growth also can produce perils for directors and officers. Especially as the pace of the recovery picks up, some companies may be tempted to act hastily or to overreach as they act to seize perceived new opportunities. Missteps can lead to lawsuits or regulatory enforcement actions. Companies that increase the use of temporary staff or independent contractors to bridge manpower shortfalls as business grows also may unwittingly increase their exposure to enforcement actions under the Fair Labor Standards Act.

While many economists are forecasting growth for the foreseeable future, the recovery remains fragile. Continued economic recovery is not inevitable. In fact, the economy contracted at an annual rate of 0.1 percent in the last quarter of 2012.¹³ Federal spending cuts are scheduled to take effect March 1 and, with the expiration of a temporary cut in early January, most Americans are now paying higher payroll taxes. These and other factors could cause a drag on the economy, with potentially adverse consequences for companies and their directors and officers.

Although the credit crisis has passed, regulations passed in response to it and the ensuing recession may increase the exposure of private company directors and officers to regulatory actions and private litigation. The Dodd Frank Act, for example, while principally focused on Wall Street firms and public companies, may ultimately increase expectations by investors and business partners, and lead to heightened exposures for a wider array of companies and their directors and officers. A similar effect was seen after the passage of the Sarbanes Oxley Act in 2002, when lenders, investors and potential business partners began to consider SOX corporate governance requirements as “best practices” for both public and private companies.

Companies in the healthcare sector also should be aware of potential D&O exposures resulting from implementation of the Patient Protection and Affordable Care Act, also known as Obamacare. The Act itself does not create any new causes of action that would result in a D&O claim, but it does encourage fundamental changes in healthcare delivery and compensation models that could leave hospitals and other healthcare organizations, as well as their directors and offers, vulnerable to allegations of mismanagement or breach of fiduciary duties.



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Insurance coverage

Directors & Officers Liability (D&O) insurance provides protection to companies, their executive officers, and their board members for many of the types of events described above. D&O insurance generally covers insureds for claims made by third parties alleging acts, errors, omissions, misstatements and misleading statements by board members and corporate officers. Subject to the specific terms and conditions of a policy, D&O not only will indemnify insureds for settlements with third parties, but also for defense costs, which often can exceed the cost of settlements.

Some of the exposures discussed above may be excluded under some standard D&O policies, though coverage may be available for additional premium. In other cases, especially those involving regulatory violations, insurance indemnification may be prohibited as a matter of public policy. Coverage nonetheless may be available for certain costs associated with investigations as well as for defense costs. Since D&O policies can vary materially among insurers, it is important that agents and brokers carefully evaluate policy forms to assure that coverage is appropriate to each client's exposures

Employment practices liability coverage is routinely bundled with D&O for private companies and, in fact, is often a key selling point of private company D&O policies. Other coverages, such as fiduciary liability, also may be packaged with D&O. Agents and brokers, however, should carefully assess their clients' coverage needs and determine whether a packaged approach is most appropriate. If, for example, D&O and EPL share the same policy limit, an EPL settlement will decrease the available recovery for another type of claim. Another alternative for assuring adequate protection is to purchase Side-A only D&O coverage, which provides an additional layer of protection to directors and officers.

Side A policies typically do not share limits with other coverages such as EPL and Fiduciary, meaning that an EPL claim will not reduce the amount of coverage available under the Side A policy. Moreover, conventional D&O insurance – so-called A-B-C coverage – provides protection for the company's directors and officers, and also, under some situations, for the company itself. Directors and officers therefore share the policy limit with the company. Settlement of a claim against the company can leave the directors and officers without coverage. Side A coverage applies only to the directors and officers, and assures that they will be indemnified under a broad set of circumstances.

Conclusion

Never before have private company directors and officers been so exposed to lawsuits and regulatory investigations and enforcement actions. While many may think of D&O insurance as protection typically purchased by public companies to protect against lawsuits by shareholders, D&O coverage, often packaged with EPL coverage, is often the best choice for a wide array of exposures faced by private companies and their officers and directors.



NOTES:

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- ² Serge J. Adam and Dirk E. Ehlers, "Prevailing Sources of Liability for Private Companies and Their Directors and Officers" <http://www.higginbotham.net/docs2/Private%20Company%20D&O%20Liability.pdf>; "Private Company D&O: Why Going Without Will Hurt," http://www.thehortongroup.com/Insurance_Library/307200913872456/
- ³ "Charge Statistics: FY 1997 Through FY 2011," EEOC <http://www.eeoc.gov/eeoc/statistics/enforcement/charges.cfm>
- ⁴ Serge J. Adam and Dirk E. Ehlers, "Prevailing Sources of Liability for Private Companies and Their Directors and Officers" <http://www.higginbotham.net/docs2/Private%20Company%20D&O%20Liability.pdf>; "Private Company D&O: Why Going Without Will Hurt," http://www.thehortongroup.com/Insurance_Library/307200913872456/
- ⁵ Cornerstone Research and Robert M. Daines, cited in "Merger Lawsuits Yield High Costs and Questionable Benefit," DealBook <http://dealbook.nytimes.com/2012/06/08/merger-lawsuits-yield-high-costs-and-questionable-benefits/>
- ⁶ "M&A Is Claims Magnet For Private Companies, Experts Say," Advisen <http://mlfn.advisen.com/articles/article178110787590437364.html>
- ⁷ Why Private Company Management Liability is Critical, Willis http://www.willis.com/documents/publications/Services/Mergers_and_Acquisitions/Private_company_white_paper.doc?zK-FUNjAO5C30QHvUYDIBg&usg=AFQjCNE8QTKi3Z-A91UNZryEv-3Y-LcQ8Q
- ⁸ Report on the Accenture 2011 Global Risk Management Study http://www.accenture.com/SiteCollectionDocuments/Microsites/risk-research-report/Accenture_Global_Report.pdf
- ⁹ Seyfarth Shaw, cited in "Record number of federal wage-and-hour lawsuits filed in FY12," Business Management Daily <http://www.businessmanagementdaily.com/32579/record-number-of-federal-wage-and-hour-lawsuits-filed-in-fy12>
- ¹⁰ Cited in Foreign Corrupt Practices Act: What you don't know could cost you, PwC <http://www.pwc.com/us/en/private-company-services/publications/assets/gyb-63-foreign-corrupt-practices-act.pdf>
- ¹¹ "U.S. Dep't of Justice, Acting Assistant Attorney General Stuart F. Delery Speaks at the American Bar Association's Ninth National Institute on the Civil False Claims Act and Qui Tam Enforcement," Press Release, Office of Pub. Affairs <http://www.justice.gov/iso/opa/civil/speeches/2012/civ-speech-1206071.html>
- ¹² "States & Data," FTC <http://www.ftc.gov/os/highlights/2012/stats.shtm>
- ¹³ "Recovery Shows a Soft Spot," The Wall Street Journal <http://online.wsj.com/article/SB10001424127887324156204578273611039517142.html>

